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Israel: Staff Report for the 1999 Article IV Consultation

This report was prepared by a staff team of the International Monetary Fund following discussions with the officials of Israel on economic developments and policies. The report was then considered by the IMF's Executive Board in the context of the IMF's periodic consultation with Israel, as required under Article IV of the IMF Articles of Agreement. The views expressed in the staff report itself are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF or of the authorities of Israel; a supplementary statement by IMF staff may also be included. The views of the Executive Board as expressed in the discussion of the Article IV consultation report and as summarized in a Public Information Notice (PIN) are also included. In addition, a statement by the member country authorities may be appended. Further background documentation prepared by IMF staff for the consultation may be published separately at a later date. The policy of publication of Article IV staff reports allows for the deletion of market sensitive information.

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INTERNATIONAL MONETARY FUND

ISRAEL

Staff Report for the 1999 Article IV Consultation

Prepared by the Staff Representatives for the 1999 Consultation with Israel

Approved by Michael Deppler and G. Russell Kincaid

February 29, 2000

- The 1999 Article IV consultation discussions were held in Jerusalem and Tel Aviv during December 1–12, 1999. For purposes of Fund relations, the West Bank and Gaza Strip continue to fall under Israeli jurisdiction in accordance with Article XXXI, Section 2(g) of the Articles of Agreement. However, the mission focused on the Israeli economy and did not meet with representatives of the Palestinian Authority, as the Middle Eastern Department is undertaking the Fund's work on the West Bank and Gaza Strip.

- The Israeli representatives included Minister of Finance Shochat, former-Governor Frenkel, other senior officials, representatives of the private sector, the Histadrut, and the Knesset.

- The staff team comprised Mr. Clark (RES-Head), Mr. Gerson, Ms. Kong, and Mr. Mesquita (all EU1). Mr. Wijnholds, Executive Director for Israel, attended the meeting at which the concluding statement was discussed.

- The concluding statement was released publicly. The authorities plan to participate in the pilot project for the release of Article IV consultation staff reports.

- Israel has accepted the obligations of Article VIII, Sections 2, 3, and 4 and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions (Appendix I). Israel has consented to the Eleventh Quota Increase and the Fourth Amendment.

- Israel has subscribed to the SDDS. Israeli data are generally adequate for effective surveillance, though data on quarterly GDP tend to be subject to large and frequent revisions.

- At the conclusion of the 1998 Article IV consultation, Directors commended the authorities for their firm policy stance in the wake of a sharp depreciation of the sheqel and urged them to adhere closely to their budget targets.

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I. Macroeconomic Background

A. Recent Developments

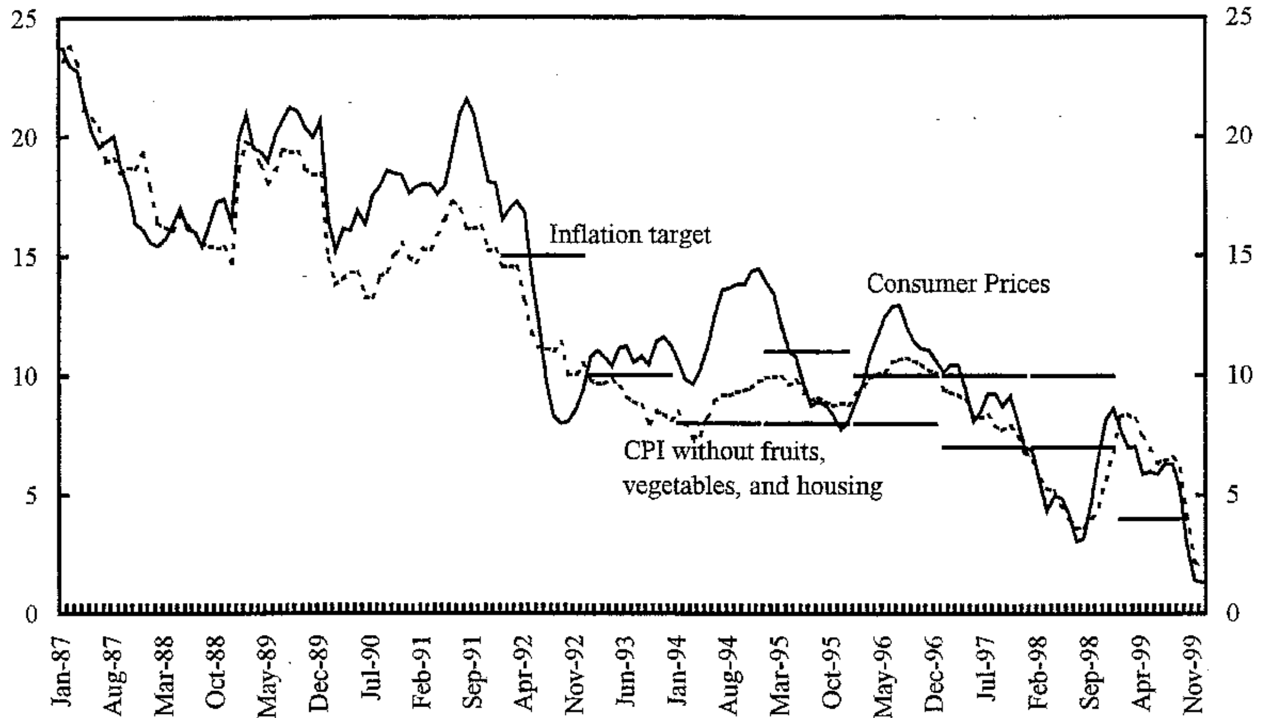
1. **Economic policies were tightened in 1997–98, in response to signs of an overheating economy after several years of very fast growth.** Real interest rates increased and the fiscal policy stance became significantly contractionary. As a consequence of the tight monetary policy, the domestic-foreign interest rate spread widened, bringing about a significant nominal and real appreciation of the sheqel. These factors, combined with the deceleration of the immigration wave, contributed to an economic slowdown and an increase in unemployment (Table 1). The slowdown created conditions for a further "step" decline in Israeli inflation, which fell to low single digits from double digits between mid-1996 and mid-1998 (Figure 1). Monetary policy—which has operated in an inflation targeting framework with crawling bands since 1992—was eased through mid-1998 in light of the weakness in the economy and the likelihood that the inflation target for that year would be undershot.

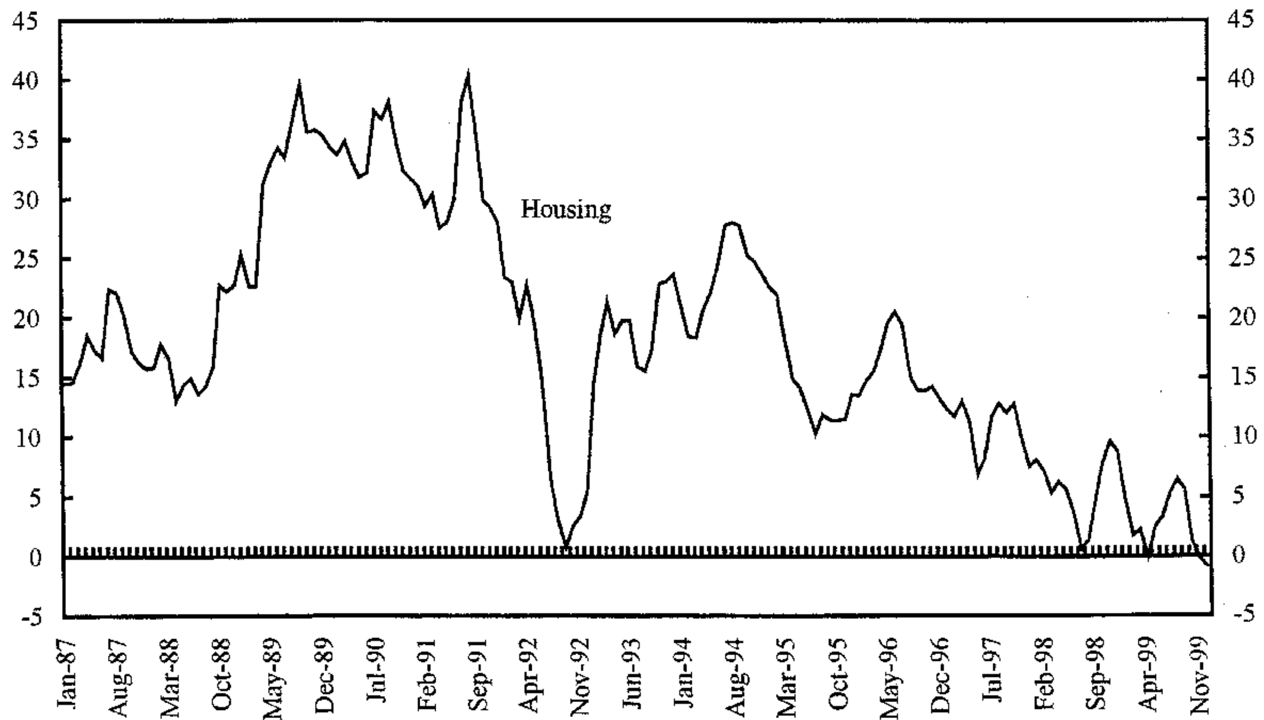
2. **This monetary easing was subsequently abruptly reversed to contain the inflationary impact of a large depreciation of the sheqel induced by the Russian/LTCM crisis.** The response to the crisis was successful in arresting and partly reversing the depreciation of the sheqel and managed to keep inflation on a declining trend. At the same time, in spite of the political weakening of the Netanyahu administration throughout the second half of 1998, the 1999 budget approved by the Knesset adhered to the path of fiscal consolidation adopted since 1996.

3. **Renewed optimism about the peace process appears to have had a positive impact on the economy.** After elections held in May 1999, Prime Minister Barak took office at the head of a broad coalition of center-left and religious parties. While the political shift implied some loss of momentum on the implementation of structural reforms, notably of privatization, the renewed emphasis on the peace process seems to have heightened business confidence, which has helped reactivate the economy. The recent retirement of Bank of Israel Governor Jacob Frenkel after eight years at the helm, and his replacement by former head of monetary operations David Klein, had few repercussions in financial markets.

4. **The Israeli economy appears to have turned the corner in 1999, with activity rebounding strongly beginning in the second quarter.** GDP contracted in the first quarter, recovered sharply in the second quarter, and grew on average by 4–5 percent in annual terms in the last six months of the year. The recovery has been led by domestic demand, in particular private and public consumption (induced by an improvement in confidence and

Figure 1. Israel: Inflation, 1987-99
(Percentage change from the corresponding period one year earlier)





Source: Central Bureau of Statistics; and Bank of Israel.

the electoral calendar, respectively), and nonresidential investment (Table 2, Figure 2).[1] Industrial production increased on average by 1 percent relative to 1998 (Figure 3). However, preliminary data suggest that the pace of activity may have weakened in the fourth quarter, when the "state-of-the-economy" index fell by about 1 percent and industrial production was stagnant (Table 2), highlighting the fragility of the recovery.[2] Improved output performance has not been accompanied by an increase in inflation. Exchange rate appreciation combined with the subdued pace of economic activity in the first quarter of 1999 led to a three-month period of price declines that set the tone for inflation trends during the rest of the year (Table 2, Figures 1 and 4). Monthly inflation thereafter averaged about 0.3 percent for the overall CPI index and 0.2 percent for the underlying index, which excludes fresh fruits and vegetables, and housing. On a 12-month basis, inflation ended 1999 at 1.3 percent, significantly below its 4 percent target for the year (Figures 1 and 4).[3] Inflation expectations, derived from the spread in yields of unindexed and indexed bonds traded in the Israeli capital market, declined to about 3 percent by end-1999 (Figure 4).

5. Unemployment has remained high, averaging about 9 percent of the labor force in 1998 and 1999 (Tables 1 and 2, Figure 5) compared to an average of 6–7 percent in recent decades, and is not projected to decline significantly until the second half of this year. Unemployment has increased because employment growth, although positive, has not kept up with the increase in the labor force. Real wages have risen moderately, with gains in the business sector outweighing declines in the public sector. Employment in the high-technology sector expanded by about 6 percent per year in 1996–98, and high-tech firms have reportedly been facing a shortage of domestic skilled labor in the last year or so, while employment in traditional low-skilled manufacturing and construction declined by about 6 percent and 2 percent per year, respectively, in the same period, partly reflecting downward inflexibility in wages.[4] (This structural unemployment among unskilled Israelis was exacerbated by the presence of a pool of low-skilled, relatively inexpensive foreign workers

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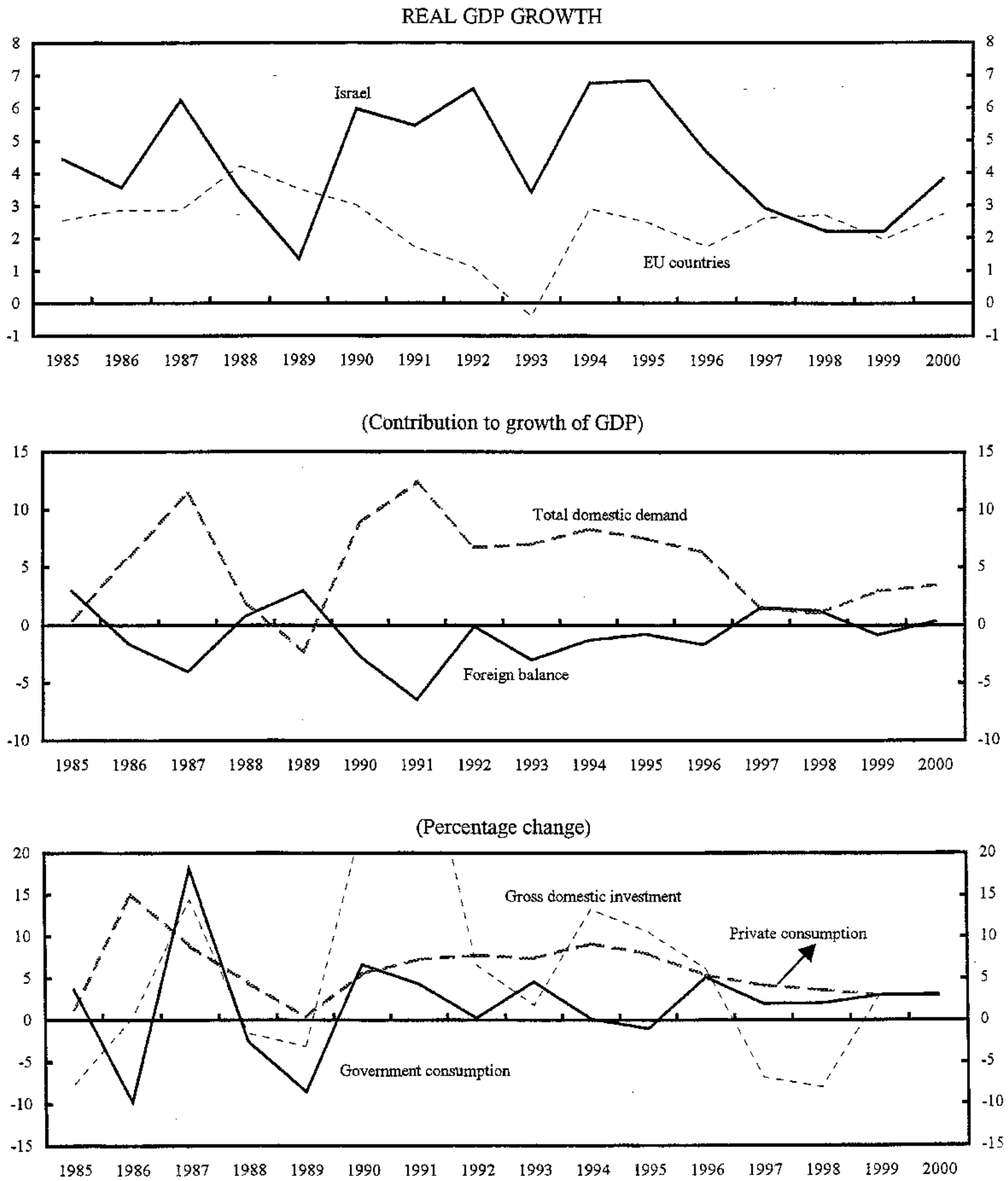
[1] It should be noted that to a significant degree the recovery in nonresidential investment was a result of three exceptional events: an expansion in El Al's fleet, investment in Intel's Qiryat Gat plant, and replenishment of stocks in the diamond polishing industry.

[2] The state-of-the-economy index is a key high frequency indicator of activity, and reflects changes in industrial production, retail sales, imports, and employment in the business sector.

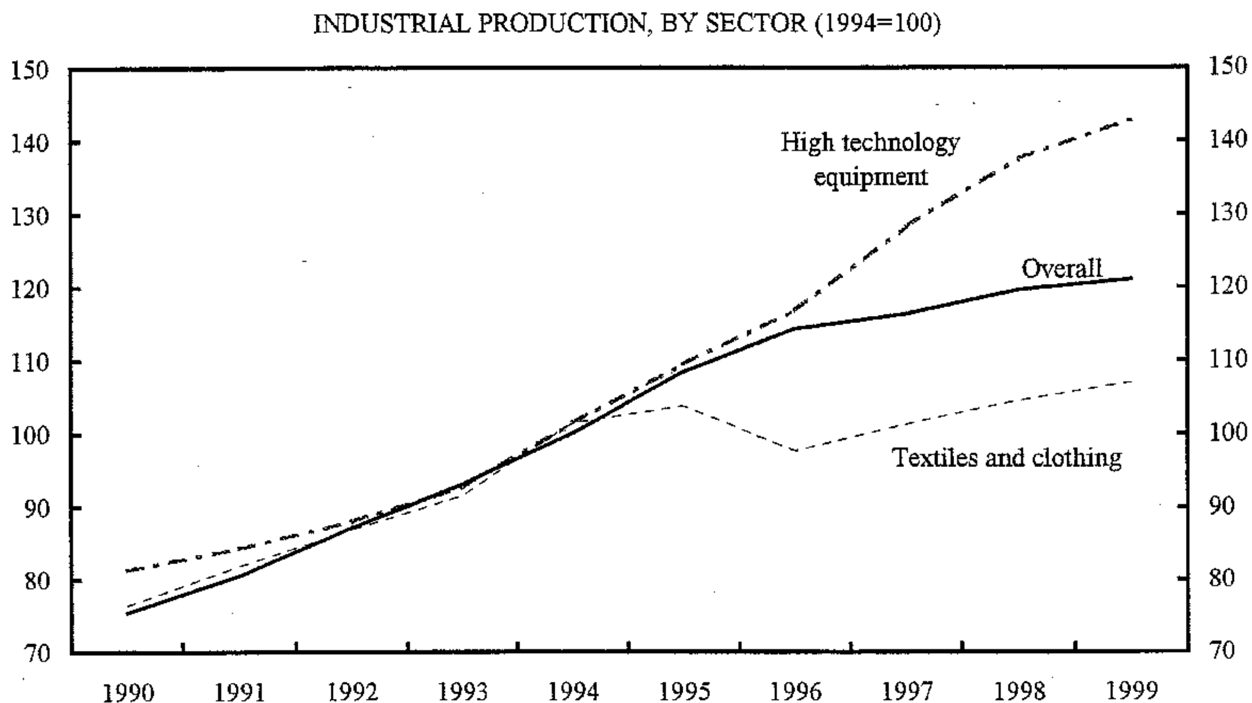
[3] Targets are set as the rate of growth of the overall CPI in the 12 months to December of each year.

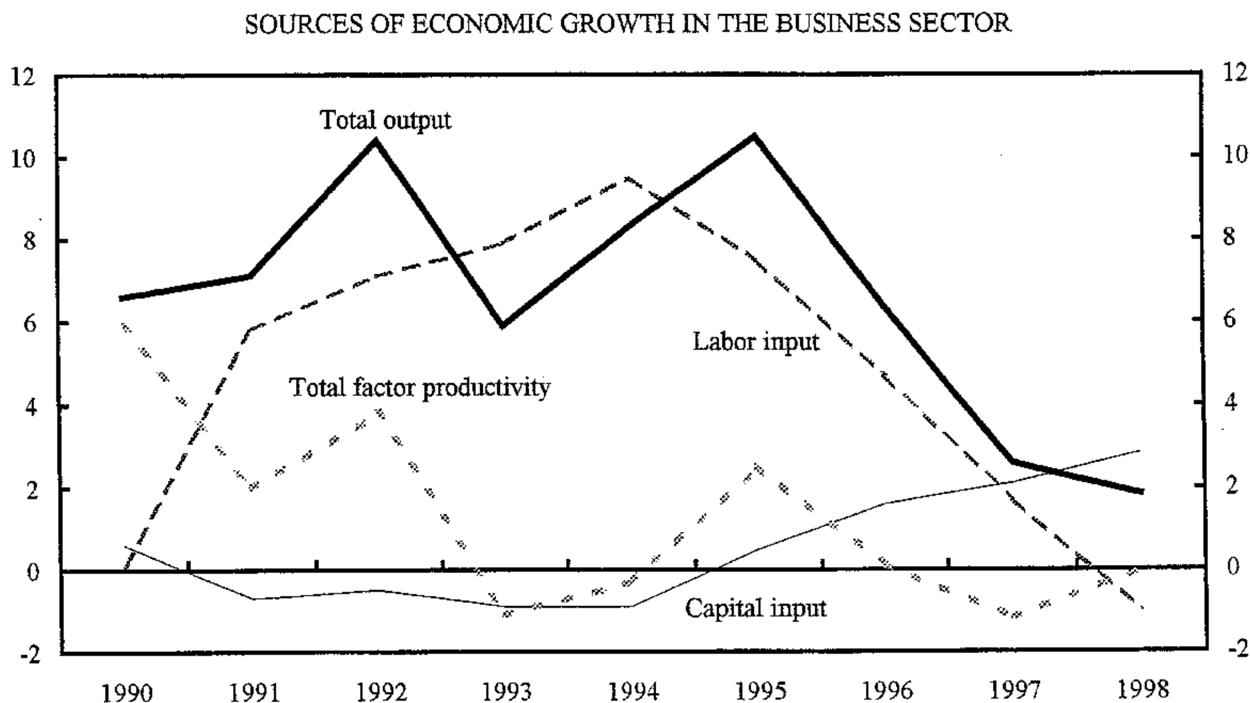
[4] Specifically, the high-technology/skill-intensive sector includes the machinery and equipment, electric devices, electronic components and communications equipment, scientific equipment, transport vehicles, and computer services industries, whereas the traditional low-skilled sectors include food, beverages, and tobacco, textiles and clothing, footwear and leather products, diamond processing, and construction.



Source: Central Bureau of Statistics; and staff estimates.

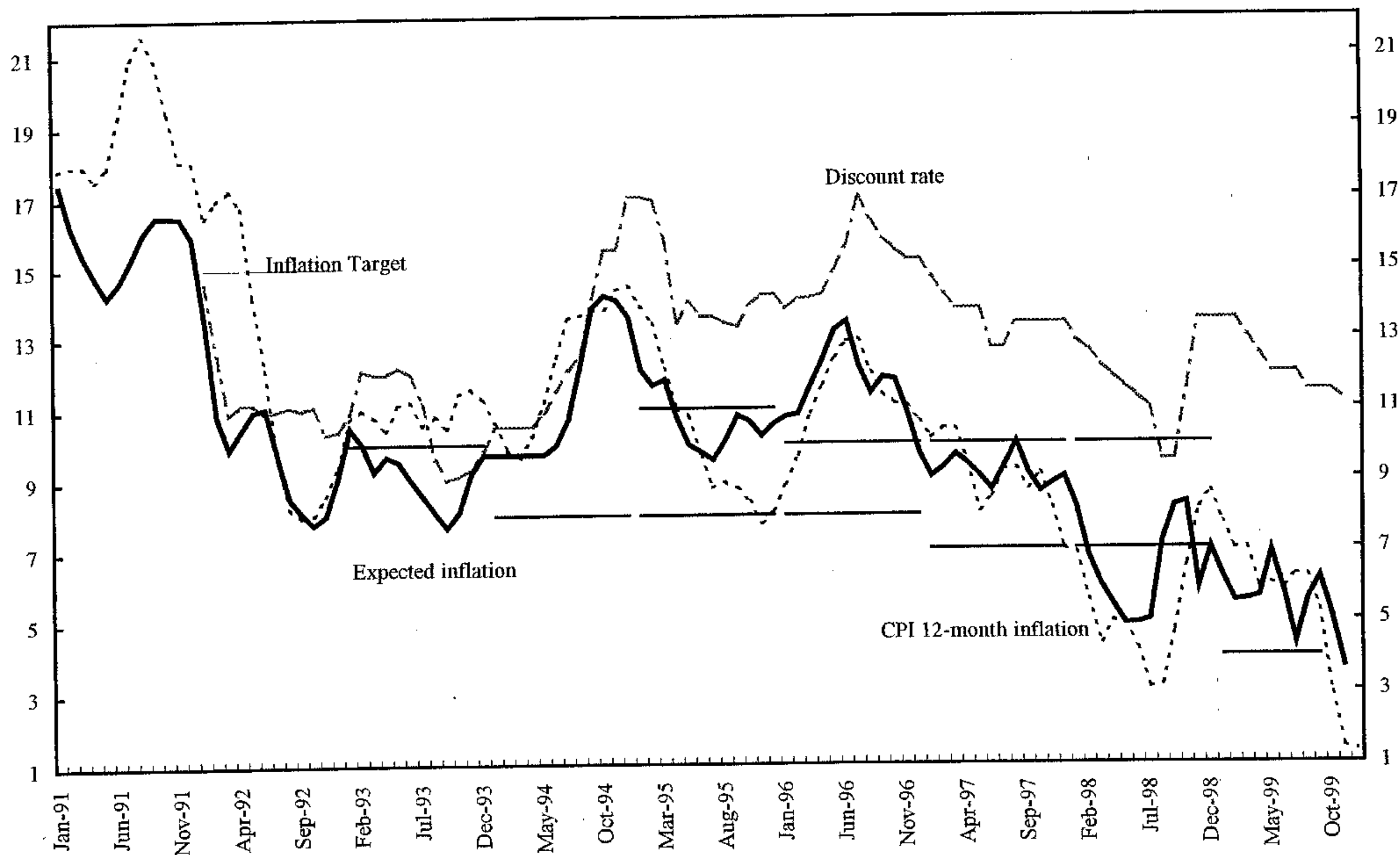
Figure 3. Israel: Sources of Economic Growth, 1990-99





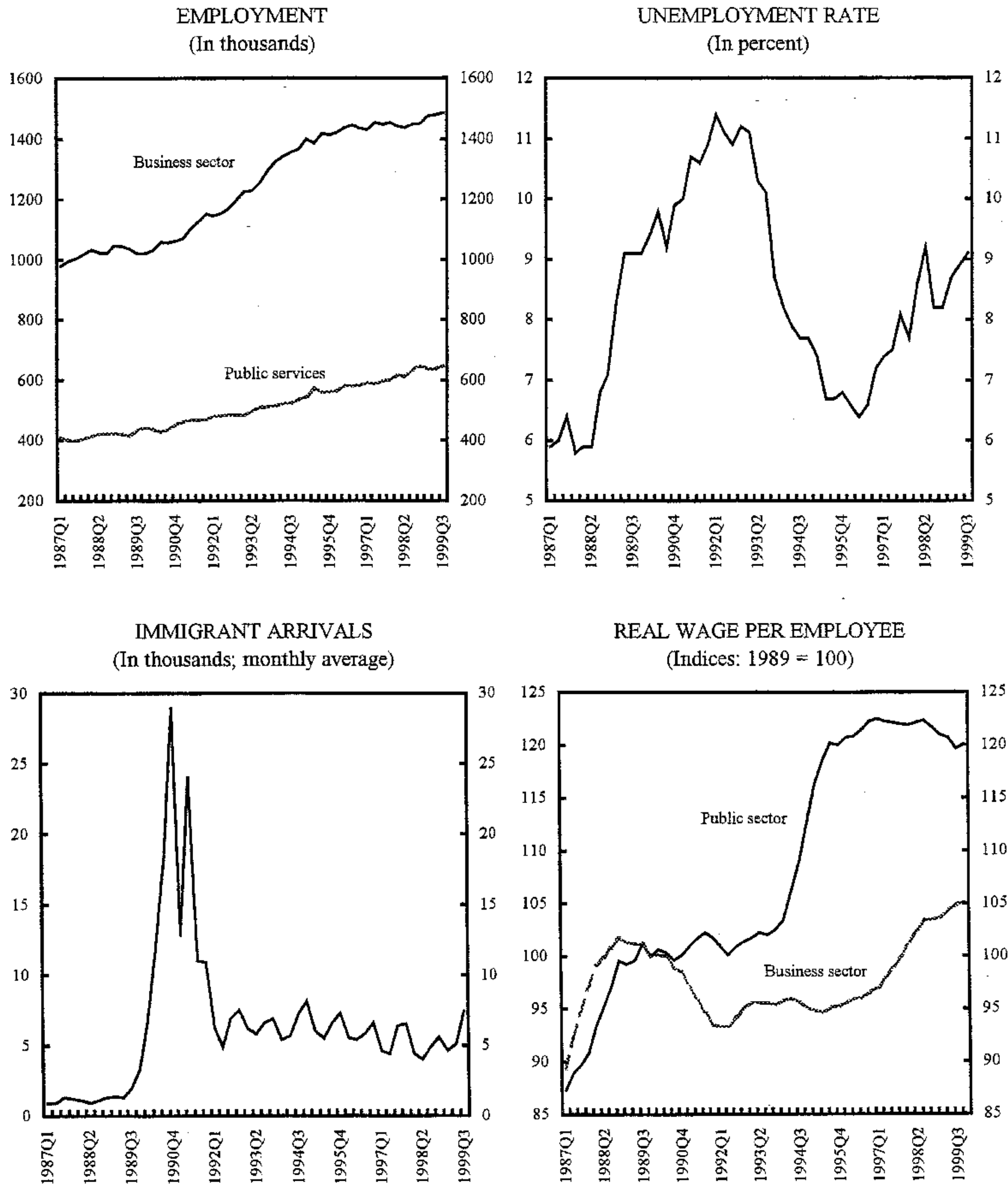
Source: Central Bureau of Statistics; and staff estimates.

Figure 4. Israel: Official Discount Rate and Inflation, 1991-99
(In percent)



Source: Bank of Israel.
1/ Calculated using the spread between interest rates on indexed and nonindexed government bonds of 12-month duration.

Figure 5. Israel: Labor Market Indicators, 1987-99



Source: Bank of Israel.

who arrived during the construction boom and have remained in Israel.)[5] Thus, a portion of the labor force is effectively trapped in unemployment because it lacks the skills to compete in the new economic structure.

6. **The trade balance deteriorated substantially in 1999, reflecting both domestic and international factors, but the overall balance of payments remains healthy**. The increase in domestic demand has boosted imports, while the lagged effect of the international trade slowdown and the previous appreciation of the sheqel limited Israeli exports in the first half of 1999. As a result, the current account deficit is expected to reach about 1.8 percent of GDP in 1999 compared with 0.7 percent in 1998 (Tables 1 and 3; Figure 6). The increase in the current account deficit has been comfortably financed by a surge in FDI inflows, especially into the high-technology sector. Direct investment into Israel increased from about US$1.1 billion in the first ten months of 1998 to US$2.4 billion in the corresponding period of 1999.

7. **On balance, the Israeli economy appears less vulnerable to a financial crisis than in the past, although some indicators suggest weaknesses remain**. On the one hand, public debt exceeds 100 percent of GDP (see Table 4), real interest rates are high, and the debt/GDP ratio has increased somewhat in the last few years. In addition, gross short-term external debt remains high, both as a percentage of reserves (90–100 percent) and of total debt (42 percent). While official foreign exchange reserves are relatively large (Tables 2 and 4), banks have a negative short-term net foreign asset position of about US$6 billion, equivalent to one-quarter of gross reserves. On the other hand, as declining inflation has created scope for a reduction of real interest rates, the risk of explosive debt dynamics appears to have been reduced somewhat. Israel has had no difficulty in accessing international capital markets and retains its investment grade status. At the third quarter of 1999, the average risk-weighted capital adequacy ratio of the five largest banks was 9.7 percent, not much above the 9 percent regulatory minimum introduced in March 1999.[6]

8. **Preliminary data indicate that the 1999 fiscal target was missed by a narrow margin**. The deficit is estimated to have been 2¼ percent of GDP (Table 5, Figure 7), above the budgetary target of 2 percent, but well below the official forecast of about 3 percent at the

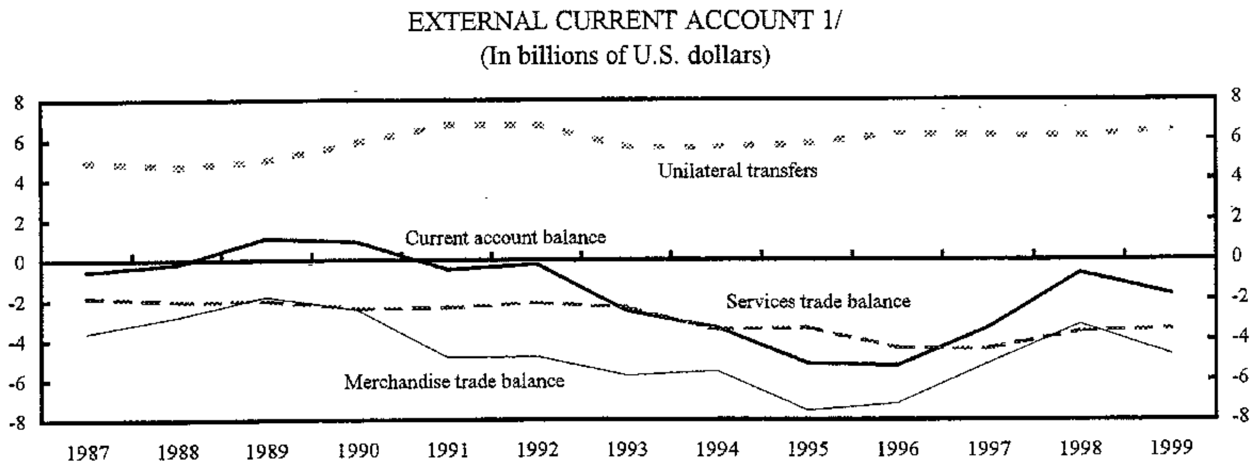
---

[5] The total number of non-Israeli workers has been stable at about 190,000 in the last three years, and their share of the total labor force declined from a peak of 8½ percent in 1997 to 8 percent in 1999.

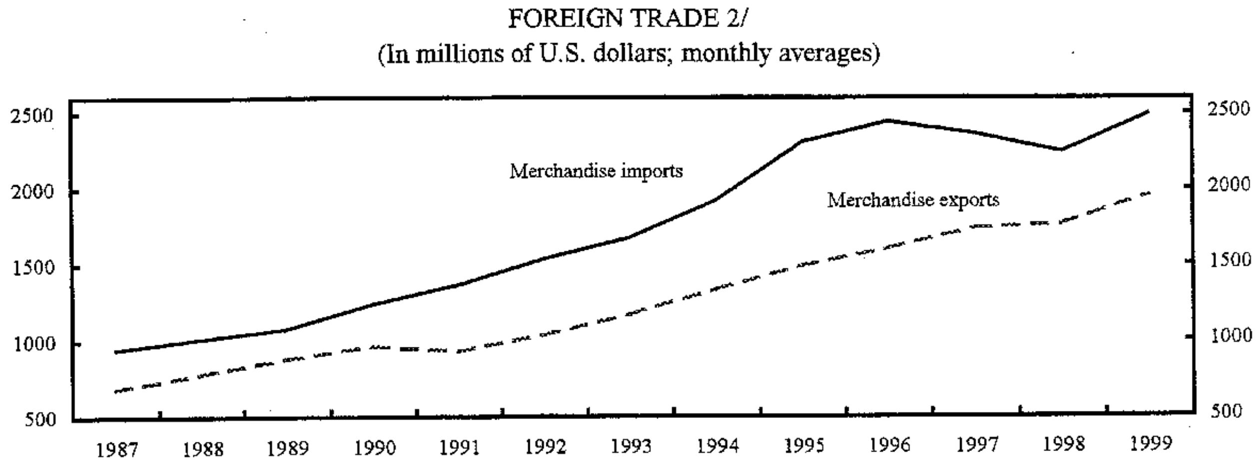
[6] An in-depth analysis of the financial system will be undertaken in the context of a Financial System Stability Assessment mission requested by the Israeli authorities.

Figure 6. Israel: Selected Balance of Payments Indicators, 1987-99

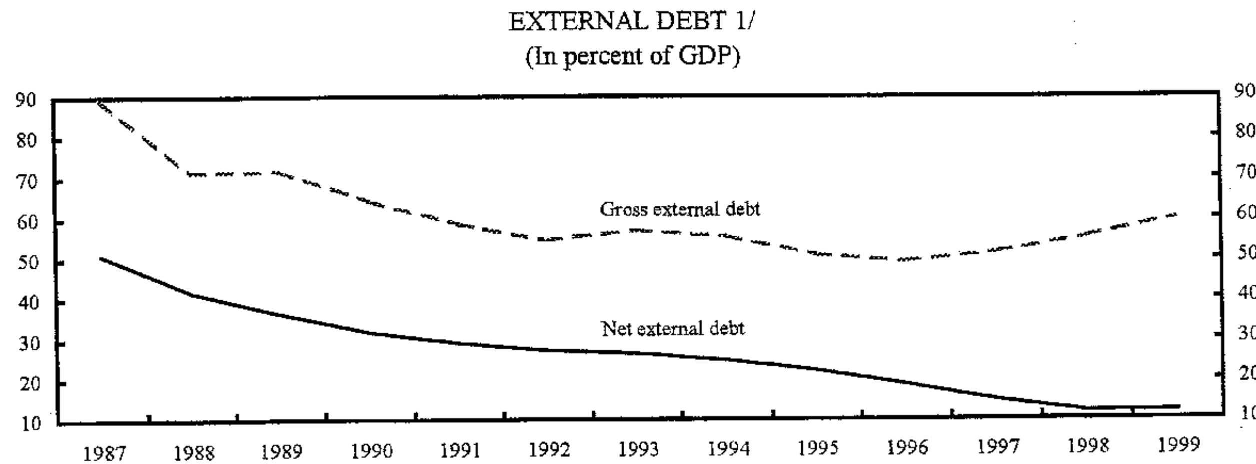
EXTERNAL CURRENT ACCOUNT 1/
(In billions of U.S. dollars)



FOREIGN TRADE 2/
(In millions of U.S. dollars; monthly averages)

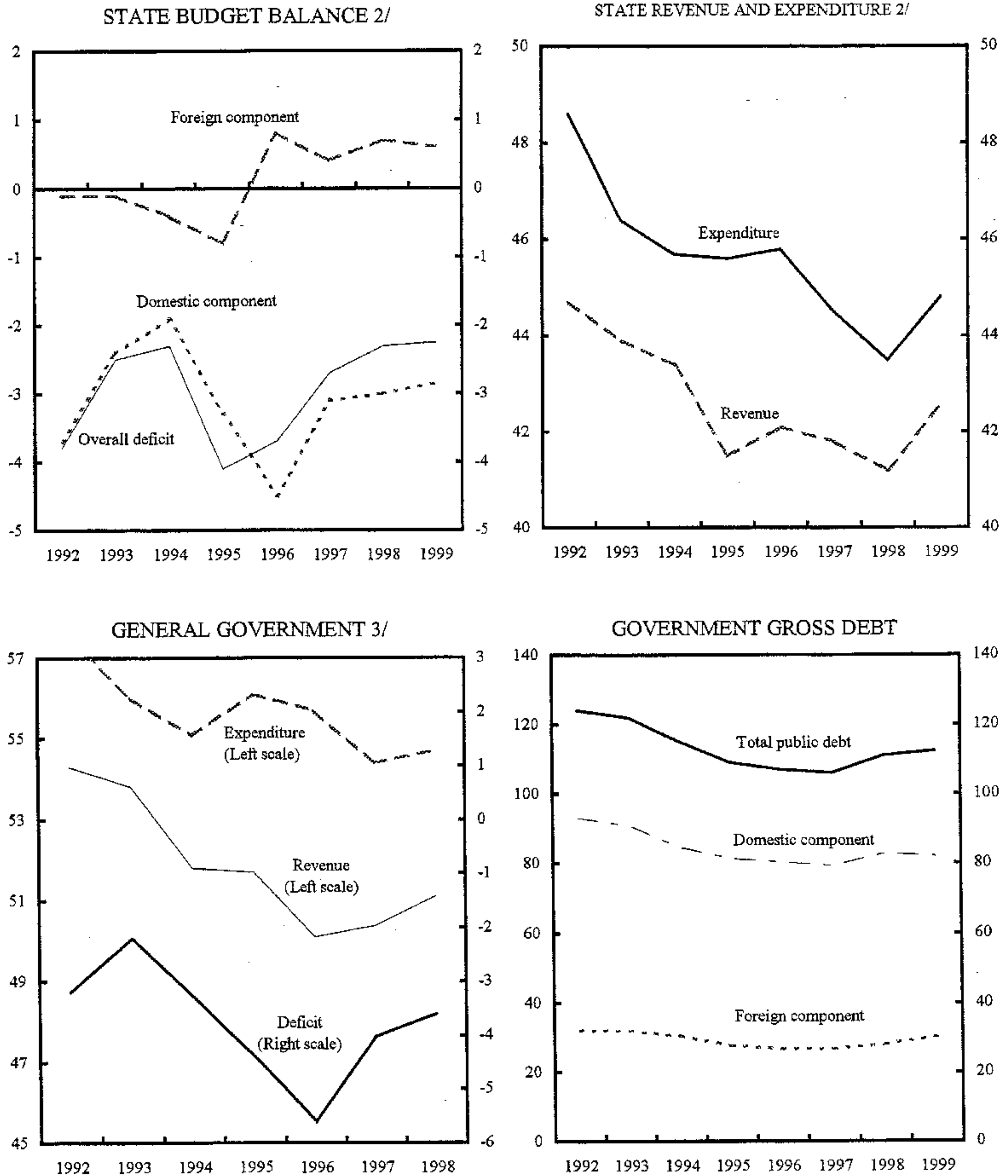


EXTERNAL DEBT 1/
(In percent of GDP)



Sources: Bank of Israel; IMF, International Financial Statistics.
1/ Data for 1999 are Fund staff projections.
2/ Excludes ships and aircraft.

Figure 7. Israel: Selected Fiscal Indicators, 1992-99 1/
(In percent of GDP)



Sources: Israeli authorities; and staff estimates.
1/ Includes only the "real" component of interest payments.
2/ 1999 data reflect staff estimates.
3/ Percent of GDP; national accounts classification basis.

time of the mission.[7] This underperformance relative to the original budget largely reflects the fact that economic growth was slightly slower than the 2½ percent rate assumed in the budget; on a cyclically-adjusted basis, the deficit was somewhat smaller than budgeted. The negative impact of the 1998 sheqel depreciation on corporate income taxes and unbudgeted civil service wage increases granted by the previous government also contributed to the deficit overrun, although these were more than offset by a sharp increase in relatively highly taxed consumer durables imports during the last four months of the year, by additional revenue from real estate transactions, and by delays in implementing some expenditure programs due to political squabbles within the governing coalition. Staff estimates suggest that the fiscal impulse was contractionary in 1999, continuing a trend established in 1997–98. The debt/GDP ratio is estimated to have risen to 111–112 percent of GDP in 1998–99, reflecting in part the impact of the sheqel depreciation on the value of foreign currency debt.

Table 5: Israel: Alternative Measures of the Fiscal Balance and Fiscal Impulse, 1996-2001 1/

(In percent of GDP)

	1996	1997	1998	1999	2000	2001
Conventional balance 2/	-14.1	-10.9	-7.6	-7.4	-5.8	-5.4
Operational balance 3/	-3.7	-2.7	-2.3	-2.3	-2.5	-2.3
Cyclically adjusted operational balance 4/	-3.7	-2.2	-1.5	-0.6	-0.8	-0.4
Fiscal impulse 5/	-0.5	-1.4	-0.8	-0.9	0.2	-0.4
Memorandum items:						
Output gap 6/	-0.1	-1.0	-1.8	-3.5	-3.6	-4.0
Debt/GDP	107	106	111	112	110	108
Real effective interest rate 7/	5.3	5.7	7.2	7.5	6.5	6.0

Sources: Israeli authorities; and Fund staff estimates.

1/ Baseline scenario.

2/ Includes all interest on government debt.

3/ Excludes the nominal component of interest on sheqel-denominated government debt.

4/ Adjusts revenue and expenditure to account for the impact of the cycle on the operational balance.

5/ Annual change in the cyclically adjusted operational balance.

6/ In percent of potential GDP. A positive (negative) figure indicates output above (below) potential.

7/ The discount rate plus 1 percent (effective borrowing rate) minus average CPI.

---

[7] The "operational deficit" presented by the authorities includes only real interest expenditure, and differs from a conventional deficit measure in that it excludes the monetary correction needed to compensate sheqel-denominated debt holders from any loss of principal value arising from inflation. On a conventional definition, the deficit in 1999 was about 7½ percent of GDP. *Unless otherwise noted, all references to "the deficit" in the text refer to the authorities' presentation.*

9. **With the exchange rate now effectively freely floating as a consequence of very wide trading bands, monetary policy has focused exclusively on the inflation target rather than responding to movements in the value of the sheqel.**[8] Despite a gradual series of cuts in the Bank of Israel's discount rate—which has declined from 13½ percent in late 1998 to 10¼ percent in February 2000—renewed confidence in the economy and the still large gap between Israeli and foreign interest rates has put upward pressure on the sheqel in recent months, resulting in a drift toward the more appreciated end of the band that has offset part of the depreciation that occurred between 1994 and the fall of 1999 (Figure 8). Staff calculations based on the macroeconomic balance approach and the latest available real effective exchange rate indices indicate that the exchange rate was not significantly out of line with fundamentals at the end of 1999, and other indicators, namely, trends in real unit labor costs and unit labor costs relative to partner countries, suggest that competitiveness improved significantly since 1996–97 (Figure 9). While the recent appreciation has led to some loss of competitiveness, on balance the staff does not view the current external value of the sheqel as placing Israeli exporters at a competitive disadvantage.

10. **Economic ties with the West Bank and Gaza Strip (WBGS) remain important; in the first three quarters of 1999 sales of goods to the WBGS were equivalent to about 6 percent of total Israeli exports, whereas purchases from the WBGS were equivalent to about 1 percent of total imports**. Moreover, the Israeli economy continues to rely on Palestinians and foreign workers as a source of unskilled labor, but there are calls for stricter enforcement of labor regulations, as well as harmonization of regulations for foreign workers. At present, a sizable number of Palestinian workers appear to be engaged in informal employment arrangements, and as such tend to be relatively less expensive to employ.[9] The Israeli authorities are engaged in discussions with the Palestinian Authority on a permanent economic settlement, and the Israeli position is to offer free trade in exchange

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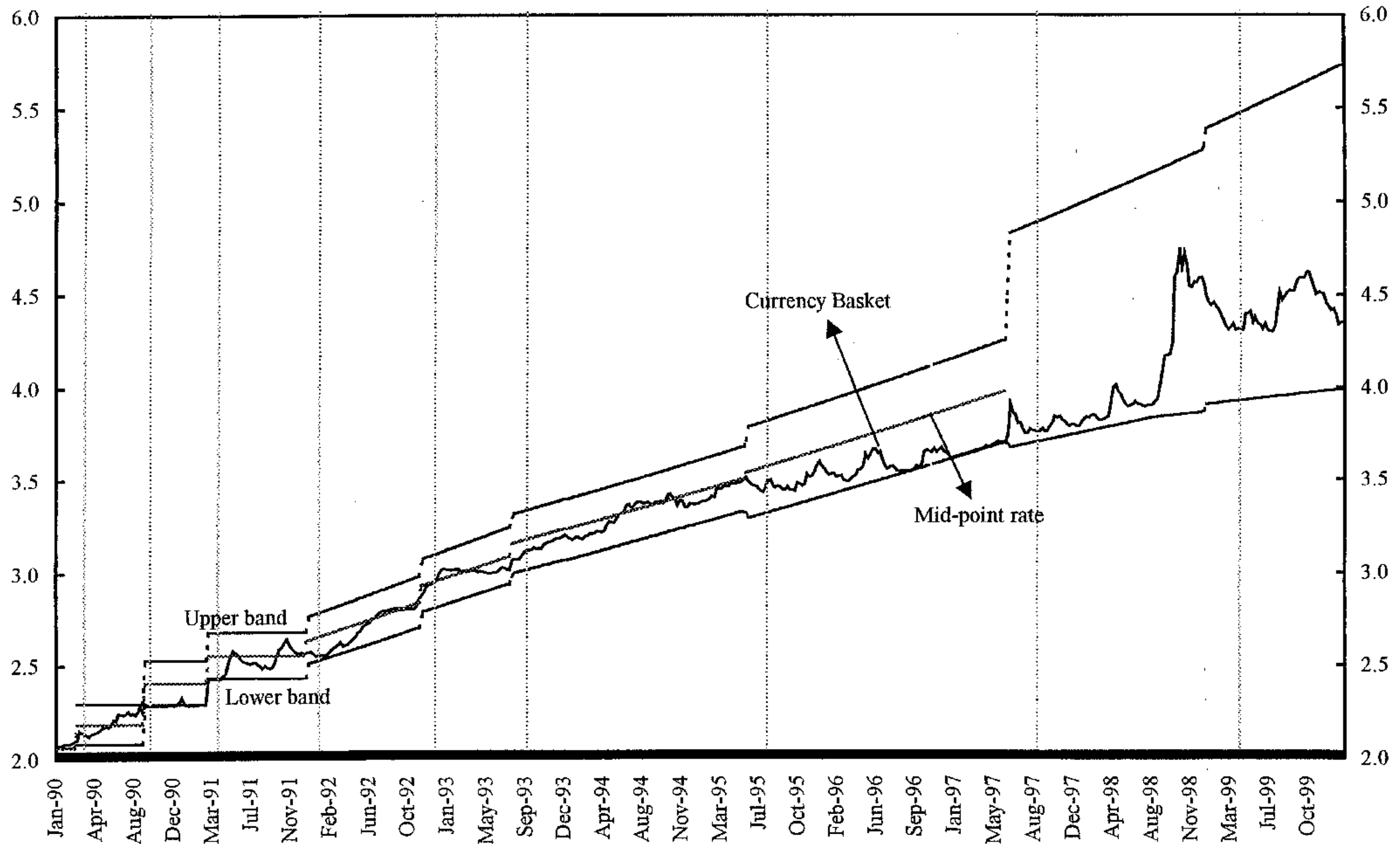
[8] The Israeli exchange rate band is defined in terms of a currency basket that gives weights of approximately 63 percent to the U.S. dollar, 22 percent to the Euro, 9 percent to sterling, and 6 percent to the yen. As of early February 2000, the exchange rate band ranged from a floor of NIS 3.99 per unit of the currency basket to a ceiling of NIS 5.74 per currency basket, implying a mid-point rate of NIS 4.87, and the actual exchange rate was about 7 percent above the minimum rate. As the floor of the band will depreciate by 2 percent in 2000, while the ceiling will depreciate by 6 percent, the width of the band will increase from about ±18 percent around the mid-point rate in late 1999 to ±19 percent around the midpoint rate by late 2000.

[9] Although Israeli employers have to make mandatory contributions to the National Insurance Institute (NII) on behalf of all their workers, it is estimated that only about 40 percent of Palestinian workers in Israel are registered with the NII, and only about one-half of them have work permits.

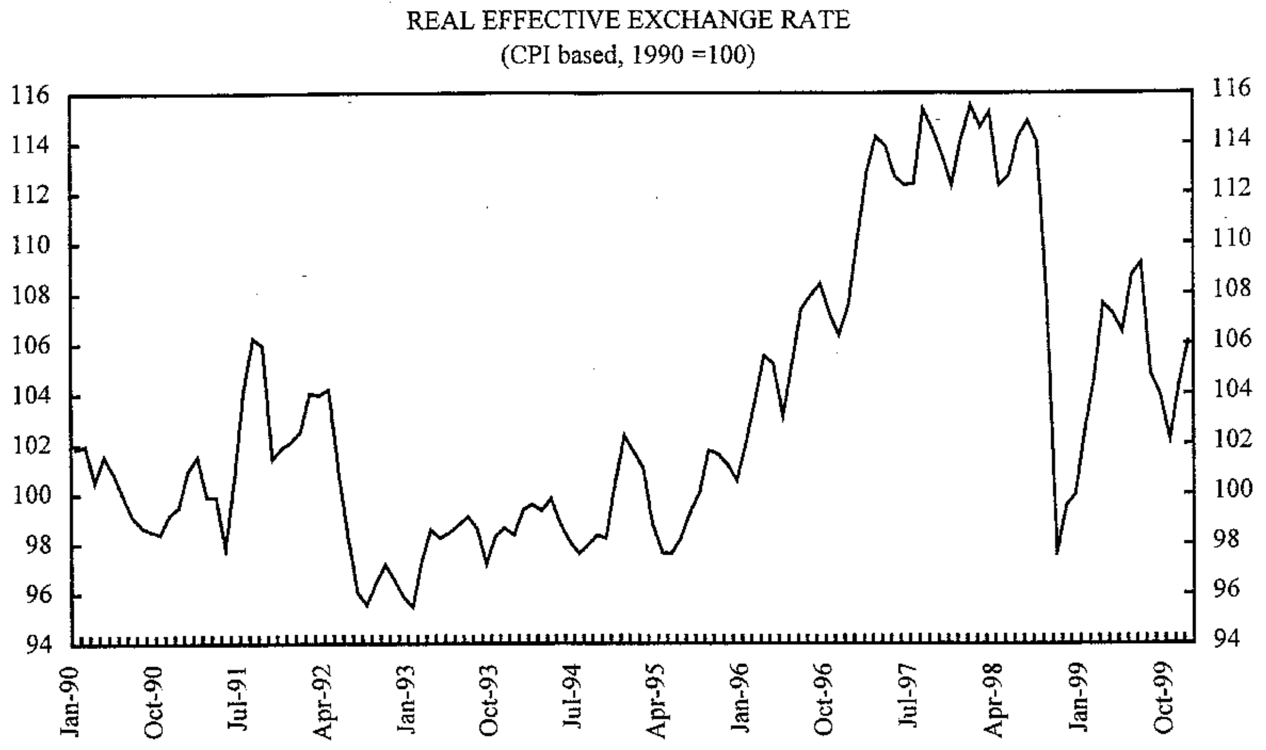
Figure 8. Israel: NIS Rate Vis-a-Vis the Currency Basket, 1990-2000 1/

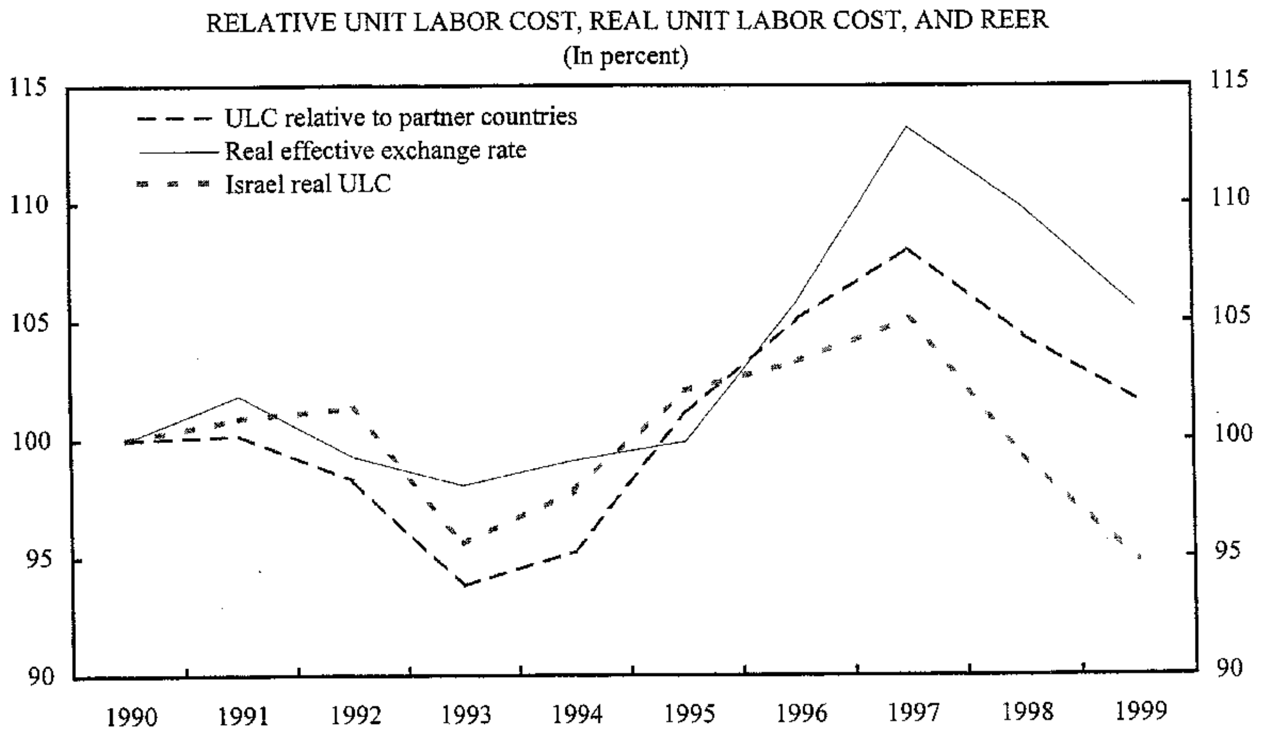


Sources: Israeli authorities.

1/ Weekly average of daily rates.

Figure 9. Israel: Competitiveness Indicators, 1990-99





Source: Data provided by the Israeli authorities.

for some restriction in the movement of labor between the rest of Israel and the West Bank and Gaza Strip areas.[10]

B. Medium-Term Projections

11. **The modest economic recovery now underway is expected to strengthen over the next two years**. The staff's projections (Table 6) are based on the assumptions of a modest decline in real interest rates and a fiscal stance consistent with the Budget Deficit Reduction Law (see paragraph 15). The projected rate of output expansion of 3.8 percent for 2000 is in line with current market forecasts and with the fact that some of the strength of investment in 1999 appears to have been transitory. Growth is expected to be led by exports, which should strengthen given the continued development of the export-intensive high technology sector and the faster pace of expansion in the world economy. Consumption growth is expected to strengthen to 3–4 percent as a result of improved confidence and slightly lower real interest rates. In 2000, progress on the peace process and the millennium celebrations are expected to attract a large number of tourists, which should benefit both activity and the current account.

Table 6. Israel: Economic Outlook, 1996-2001

(Percentage change or percent of GDP)

	1996	1997	1998	1999	2000	2001
GDP growth	4.6	2.9	2.2	2.2	3.8	3.5
CPI inflation (eop)	10.6	7.0	8.7	1.3	3.3	1.7
CPI inflation (average)	11.3	9.1	5.4	5.2	2.7	2.5
Current account/GDP	-5.6	-3.4	-0.7	-1.8	-1.4	-1.7
Fiscal balance/GDP 1/	3.7	2.7	2.3	2.3	2.5	2.3

Sources: Data provided by the Israeli authorities; and Fund staff projections.
1/ Operational balance.

12. **On current policies, the trend towards low inflation observed in 1999 is expected to continue in the next few years**. A more or less constant unemployment rate and output gap should continue to put downward pressure on inflation. Reflecting these factors, the market measure of inflation expectations for 12 months ahead has recently declined from around 5½ percent to around 2 percent, which is below the lower bound of the 2000–01 inflation target set by the government—note that the exceptionally low end-of-period

[10] For more details on developments in WBGS, see the recent Fund study entitled *West Bank and Gaza Strip: Economic Developments in the Five Years Since Oslo* (IMF, 1999).

inflation in 1999 is the counterpart of the depreciation-induced price shock of late 1998, and as such is not expected to be maintained.

13. **Medium-term growth is expected to remain below potential on unchanged policies up to 2002 (upper panel of Table 7), leading to a widening of the output gap from its current level of about 3½ percent of potential output to 4 percent. Thereafter, a declining rate of growth of potential output, resulting from years of investment growth below its historical norm and slower labor force growth, would reduce the output gap to slightly less than 3½ percent.** With slow progress in fiscal consolidation and continued relatively tight monetary policy, output expansion would be driven by continued strength in exports and is projected at about 3½ percent, compared to a potential growth rate of 4 percent in 2000–01 and 3.4 percent on average in 2002–05.[11] On the other hand, inflation is projected to be below the official target, roughly in line with that in industrial countries. Under this baseline scenario real interest rates could be reduced somewhat without jeopardizing the inflation target. Of course, more rapid progress in reducing the fiscal deficit and the debt stock would also help to lower real interest rates and would provide some scope for an easier monetary policy.[12] The staff has therefore prepared an alternative, illustrative scenario (Table 7, lower panel), based on a policy mix of tighter fiscal and easier monetary policy. Under this scenario, the output gap would be closed by 2005, while the operational fiscal deficit would be zero in 2003, compared to a deficit of 1½ percent of GDP in the baseline scenario. This alternative scenario assumes a decline in real interest rates to 4½ percent at the end of the projection period, compared to 6 percent in the baseline scenario, and potential output growth at about 4 percent throughout the projection period. Major risks for both scenarios include the possibility of a derailment of the peace process and a dramatic decline in foreign (especially, U.S.) equity markets, either of which could provoke a collapse of confidence (and an increase in the risk premium) and investment in Israel.

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[11] These projections are based on estimates of potential output growth in Israel for 1996–98 presented by Fabio Scacciavillani and Phillip Swagel in "Measures of Potential Output: An Application to Israel" in IMF Working Paper 99/96. The projection of a 4 percent rate of potential output growth in 2000–01 is based on the estimated growth rate of potential output in 1996–98 (after the immigration wave had subsided) and the historical rate of growth of factor inputs in the Israeli economy.

[12] Research by the Bank of Israel has documented the impact of fiscal policy on the inflation rate; for example, Azoulay and Elkayam, *A Model to Assess the Effect of Monetary Policy on Inflation in Israel, 1988 to 1996* (1999), Bank of Israel mimeo. Empirical results in this model suggest that in the medium term (two to three years), a reduction of 1 percent of GDP in government expenditure would create scope for a reduction of about 1 to 1½ percentage points in real interest rates without affecting the inflation target.

II. Report on the Discussions

14. **The discussions were marked by general agreement on the main challenge facing the Israeli economy: the need to both safeguard the gains achieved in the fight against inflation and create conditions supportive of the nascent economic recovery and thereby stimulate employment growth**. The discussions focused on the appropriate mix of monetary and fiscal policies in the coming year and in the medium term to achieve these objectives. In the main, the authorities recognized both that high real interest rates could be a drag on the economy, and that too rapid a decline in rates could have a destabilizing effect on the foreign exchange market and inflation. While agreeing with these concerns, the mission indicated that there was some scope for a cautious lowering of interest rates in the near term without jeopardizing the inflation target and that a more ambitious medium-term path of fiscal adjustment would also contribute to lower real interest rates.

A. Fiscal Policy

15. **The authorities stated that the overall goal of fiscal policy was to create an environment conducive to private sector-led growth. This entailed preserving macroeconomic stability and reducing the size of the public sector and its debt.** Medium-term fiscal policy objectives were established in the Budget Deficit Reduction Law. The Law originally specified deficit targets of 2 percent of GDP for 1999, 1¾ percent for 2000 and 1½ percent for 2001, but these targets were subsequently modified to 2½ percent of GDP in 2000 and 1½ percent no later than 2003. The authorities saw these revised targets as balancing the medium-term need for further fiscal consolidation and debt reduction against the immediate needs arising from Israel's cyclical position. They added that these deficit targets entailed significant compression of current expenditure because they planned to increase investment spending significantly in coming years to offset a shortfall in infrastructure that they believed had constrained activity. The authorities acknowledged that explicit deficit targets could result in a procyclical fiscal policy, but noted that expenditure ceilings expressed relative to actual GDP could have the same effect, opening the door to large increases in real expenditure in years when growth was very rapid. However, the authorities' intention is to reduce central government expenditure to 40 percent of GDP (from a current 45 percent) over the next four to five years. The authorities also noted that the Deficit Reduction Law allowed for an acceleration of the deficit reduction path if future growth rates exceed current projections.

16. **The mission indicated that given the large public debt and the still very large deficit when conventionally measured (7½ percent of GDP in 1999), a faster pace of medium-term fiscal consolidation was warranted**. At the time of the mission, the deficit forecast of 3 percent of GDP for 1999 implied that the fiscal impulse in the 2000 budget was negative. However, given the estimated outturn of a deficit of only 2¼ percent in 1999, the staff now estimates that the impulse in the 2000 budget would be broadly neutral (see Table 5), while the deficit target for 2001 would imply a return to a contractionary fiscal stance, albeit one more modest than in 1997–99. More generally, Israel's effort at fiscal consolidation appears to have slowed somewhat since 1993–94, even though the deficit

(conventionally measured), government spending, and the public debt are very high compared with some industrial countries (see Table 8). In the mission's view, a policy of continued consolidation in 2000 and beyond would help promote the crowding-in of private sector spending that the government seeks and help reduce the vulnerability of the Israeli economy to domestic and foreign shocks. Finance Ministry officials expressed skepticism about the possible effects of fiscal consolidation on interest rates (see Box 1). Moreover, they estimate that with reasonably rapid output growth, and under a medium-term commitment to fiscal responsibility, Israel would reach the 60 percent of GDP Maastricht debt/GDP ratio in about ten years, which they saw as an appropriate trajectory and target.

17. **The authorities pointed out that fiscal adjustment was constrained both by the structure of the budget and by institutional factors**. Spending on subsidies and transfers (16.3 percent of GDP in the 1999 budget), defense (9 percent of GDP) and the real interest bill (5.9 percent of GDP) together account for about 70 percent of state budgetary expenditure (Table 9), suggesting that given Israel's political circumstances and debt service obligations, it would be difficult to achieve a rapid reduction in a large fraction of government spending. In order to begin to address rigidities in expenditure, the government has curtailed some mandatory spending and has closed loopholes in the unemployment benefit scheme. The authorities were also concerned by a lack of fiscal responsibility at the local level, viewing pressure to increase transfers to local authorities, along with social demands for increased spending on the health sector, as the greatest threats to achieving the 2000 budget targets. Reflecting its concern about local governments, the Ministry of Finance introduced legislation aimed at hardening local authorities' budget constraints, including measures to deter bank lending to municipalities. (Since 1988, annual transfers to local governments from the central government, another source of financing for municipalities, have increased from 1½ percent of GDP to nearly 2½ percent of GDP). Measures are also being considered to limit administrative expenditures of local governments. In addition, a possible peace agreement with Syria might lead to unforeseen relocation/military spending up to US$18 billion in the not too distant future.[13] However, a large portion of this expenditure—should it in fact occur—was expected to be financed by foreign grants.

18. **The authorities rejected the staff's suggestion that with inflation close to the levels prevailing in other industrial economies, it would be appropriate to move to a more conventional measurement of the budget deficit**. In the first place, they argued that, because only real interest expenditure contributes to aggregate demand, the operational deficit is a more appropriate measure of the impact of fiscal policy than is the conventional deficit. They added that the substantial decline in the conventional deficit that has occurred in recent years because of the drop in inflation would tend to overstate the degree of fiscal consolidation that had actually occurred, complicating the process of persuading the public to continue deficit-reduction efforts. The mission noted that the current large conventional

[13] Such spending would be required to close military installations and to compensate property owners who would be resettled from the area.

deficit had more to do with Israel's substantial public sector debt (see Table 8) than with inflation, given the current low rate of price increases.

Box 1: Determinants of Real Interest Rates in Israel

Real interest rates in Israel have been high, both relative to their past levels and to rates now prevailing in other advanced economies. However, they are at about the same level as in other emerging-market countries. In 1996–98, real short-term deposit rates in Israel were on average about 4 percent per year, compared with about 2 percent prevailing in a set of advanced economies—see Table 10. At the beginning of the 1990s, real deposit rates were significantly negative in Israel; were positive and increasing, on average, in the set of emerging-market economies; and were about 3 percent in advanced economies. The same trends can be observed in real lending rates, which averaged 9 percent in Israel in 1996–98, compared with slightly less than 6 percent in advanced economies and about 8 percent in emerging markets.

Several factors, *besides* tight monetary policy, may well have contributed to the high real interest rates that have been observed in Israel in recent years:

- capital account liberalization has strengthened the linkage between Israeli and international real rates, which were higher in 1997–98 than in the mid-1990s,
- Israel's ratio of public debt to GDP, although lower than in the past, is still more than 100 percent, and must exert some pressure on real borrowing rates. This "structural" fiscal impact on real rates is probably enhanced in periods when fiscal policy becomes expansionary, as in 1994-1995.
- reduced private savings and a temporary investment boom may have contributed to the increase in real interest rates through 1996 and into 1997.

While these non-monetary factors determine underlying real interest rate trends, it should be noted that in recent years, with resumed fiscal consolidation, falling investment, moderation of consumption growth, and slower export growth, tight monetary policy has been the major factor behind the increase in rates—see the background paper on the determinants of real interest rates in Israel in the forthcoming Selected Issues paper.

Table 10: Real Short-Term Interest Rates in Israel and Selected Groups of Countries, 1991-98

(In percent per year)

	Real Deposit Rates				Real Lending Rates			
	Israel	Basket 1/	Spread 2/	Emerging Markets 3/	Israel	Basket 1/	Spread 2/	Emerging Markets 3/
1991	-4.2	2.5	-6.7	0.7	6.3	5.6	0.8	1.0
1992	-0.8	1.4	-2.2	1.8	6.9	4.6	2.4	1.8
1993	-0.4	0.8	-1.2	2.5	5.0	4.3	0.7	4.0
1994	-0.1	1.8	-1.9	3.3	4.6	5.1	-0.5	4.5
1995	3.6	2.5	1.1	4.8	9.1	6.1	3.0	8.4
1996	2.9	1.9	1.0	3.3	8.5	5.5	3.0	5.5
1997	3.7	2.2	1.5	5.4	8.9	5.7	3.2	7.2
1998	5.3	2.9	2.4	7.8	10.2	6.4	3.9	11.3

Source: Fund staff estimates based on *IFS* data.

Note: Monthly average ex-ante real interest rates. Inflation expectations assumed to equal a three month centered moving average of actual annualized CPI inflation.

1/ Weights as in the Israeli currency basket.

2/ Difference between Israeli real rates and currency basket real rates.

3/ Unweighted average of real deposit rates and lending rates, respectively (when available) in Argentina, Brazil, Hong-Kong S.A.R., Korea, Mexico, and Singapore.

B. Monetary, Exchange Rate and Financial Policies

19. **While recognizing that inflation in 1999 would undershoot the annual target and that real interest rates appeared to be relatively high (Table 10), officials at the Bank of Israel adopted a cautious attitude about the scope for a significant easing of monetary policy in 2000**. They noted that any reduction of interest rates would need to be undertaken gradually, and should take into account that a low-inflation environment had not yet become entrenched in Israel. The authorities also indicated that the low inflation at end-1999 was partially a result of transitory factors, reflecting a base period effect due to the exceptionally high inflation observed in the last few months of 1998 and the impact on prices of the exchange rate appreciation early in 1999. Moreover, the authorities indicated that in their view the economic recovery could begin to exert some inflationary pressure by mid to late 2000. Potential budget overruns posed another risk to the inflation outlook. While it was true that market-based inflation expectations had declined to a 3–4 percent range, they added that this was a rather recent occurrence and that this measure has been volatile. For most of 1999, market-based inflation expectations had been in the neighborhood of 4–6 percent. Given the past volatility of inflation expectations, this measure could easily rise in the near future. For its part, the staff felt that so long as inflation remained muted, the still-fragile state of the economic recovery, the risk that continued appreciation of the sheqel could erode the competitiveness of the Israeli economy, and the large output gap (see paragraph 13)

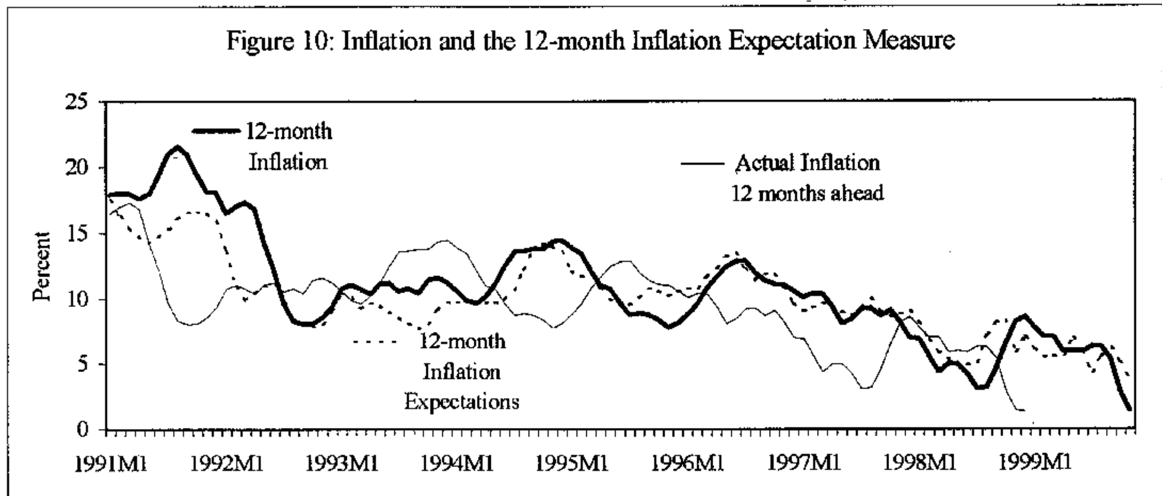
constituted a strong case for a somewhat more ambitious, though still gradual, approach to reducing interest rates.

20. **The mission asked whether the relatively high volatility of official interest rates might reflect problems in the implementation of the inflation targeting framework.** Might it not help, for example, to change the inflation target from an annual to a biannual or longer horizon? While agreeing that this would have the advantage of allowing monetary policy to become less reactive to relatively high frequency shocks to the inflationary process, the authorities expressed concern that a more distant inflation target could increase pressures to adopt an accommodative monetary policy by reducing accountability for near-term inflation. They also stated that the case for adopting longer horizons is usually based on the experience in other industrial countries, where monetary policy operates with long lags. In Israel, they argued, the sensitivity of inflation expectations to changes in monetary instruments (in large part a legacy of the high inflation of the past) means that the transmission mechanism is much more rapid. As evidence, they pointed to the rapid impact the October–November 1998 interest rate rise had on the exchange rate and inflation. As a tightening of monetary policy could arrest inflationary pressures relatively rapidly, a long horizon for the inflation target was less appropriate in Israel. While the staff agreed that the monetary policy transmission process in Israel is relatively short, they nonetheless advocated that a longer horizon would contribute to increase the stability of monetary policy.[14]

21. **As regards the rather volatile measure of inflation expectations derived from the bond market, the Bank of Israel stated that it was only one of several indicators employed when making interest rate decisions.** Officials at the Bank of Israel understood that basing interest rate decisions exclusively on market-derived inflation expectations may create an unstable environment, a point that was emphasized by the mission—see the background paper "Monetary Policy Procedures in Israel" in the Selected Issues paper. They also recognized that at least in Israel such measures seem to be very adaptive and to follow developments in actual inflation, thus providing less forward-looking information (Figure 10). Nonetheless, as these inflation expectations were derived from actual transactions conducted by private agents in the financial markets, their information content ought not to be ignored. The authorities stressed, however, that in addition to the measure of inflation expectations, they relied on a broad range of other indicators in forming their views on interest rate policy, including trends in M1, the composition of M2, the behavior of domestic credit, the term structure of interest rates, and developments in international capital markets, capital flows, and output. The weights assigned to each of these indicators vary over time as well as among each of the relevant senior Bank of Israel staff, so that a single set of weights does not emerge from the process. After broad internal consultation, the governor decides whether to change interest rates. Given the country's high inflation history, the

[14] For more details on the transmission mechanism of monetary policy, see "Effects of Monetary Policy in Israel" in the forthcoming Selected Issues paper.

authorities acknowledged that their bias is to err on the disinflationary side in order to minimize the risk of jeopardizing past gains in disinflation.



22. **The authorities agreed that greater transparency of monetary policy was advisable, but they thought that such a change would be appropriate only when they had gained greater experience in forecasting inflation and when the public had fully adapted to the low inflation environment.** The mission suggested that the Bank of Israel could take a more prominent role in the formation of the public's outlook on inflation through a more comprehensive presentation of its own analysis of prospects for inflation. The authorities stressed, however, that Israel's volatile economic environment makes inflation forecasting extremely difficult; in the end decisions on interest rate policy come more from subjective judgments based on experience than from the results of econometric models that could be published.

23. **The mission strongly supported the Bank of Israel in calling for quick implementation of a thorough revision to the Bank of Israel Law.** In December 1998 an advisory commission (the Levin Committee) presented a report to then-Prime Minister Netanyahu with two main recommendations. First, that interest rate decisions should no longer be the exclusive province of the Governor of the Bank of Israel but should instead be made by a monetary committee. Second, that the principal objective of the Bank of Israel should expressly be to achieve and preserve price stability.[15] The authorities indicated that a

[15] Under the current charter, the Bank of Israel's main objectives are to pursue price stability, exchange rate stability, growth, and investment into Israel.

draft law encompassing these recommendations—which has the strong support of the Bank of Israel—would be introduced to the Knesset early in 2000. Nevertheless, some supporters of the government in the Knesset have at the same time pushed for an amendment that dilutes the powers of the Governor but would not give preeminence to the price stability goal.

24. **One aspect of the conduct of monetary policy where views differed in Israel is the possible role of foreign exchange intervention in the context of a gradual reduction in nominal interest rates**. On the one hand, the Ministry of Finance and some in the private sector believe that the Bank of Israel's ability to cut interest rates is constrained by the possibility of a shift out of sheqel deposits (the "sheqel mountain") into foreign currency, and that intervention by the Bank of Israel could smooth out any excessive depreciation. Officials at the Bank of Israel, on the other hand, maintained that such an action was not necessary, as a shift towards intervention would send confusing signals to the market and would risk undermining the credibility of monetary policy. The mission agreed with the Bank of Israel that a policy of gradual and cautious interest rate cuts would, in the absence of major external shocks, lead to portfolio adjustments without causing undue pressure on the currency. It should be noted that the recent appreciation of the sheqel has occurred as official interest rates have been reduced in Israel, suggesting that the risk of excessive depreciation from further gradual interest rate cuts is not very large.

25. **While Israel has made substantial progress towards capital account liberalization in the 1990s, significant capital controls remain, particularly the prohibition on foreign investment by pension funds and insurance companies and the limits on foreign investment by provident funds**. The authorities acknowledged that these controls generally did not exist for prudential reasons but instead were designed to limit possible capital outflows. In this regard, the staff urged the authorities to complete the process of capital account liberalization after assessing the robustness of the financial sector and to streamline the tax treatment of domestic versus foreign investment, which discriminates against acquisition of foreign assets and distorts private sector portfolio decisions.

C. Structural Policies and Other Issues

26. **The authorities have unveiled an ambitious structural reform agenda aimed at increasing economic competition and enhancing the private sector's ability to absorb resources released by fiscal retrenchment**. The authorities stressed that these reforms were targeted at areas that had largely been overlooked by previous administrations, including an increase in investment in transport infrastructure from about ¾ of 1 percent of GDP in 1999 to about 1 percent of GDP in 2000; the elimination of barriers to land use and housing; increased competition in domestic telecommunications, electricity supply, fuel refining and transport; an enhanced competitive environment in agriculture, retailing of motor vehicles, aviation services, and communications; and an increased alignment of domestic and international technical regulations and standards, with a view to facilitating trade. In December, 1999, relevant legislation was passed or introduced in several areas, including shortening the maximum term of unemployment compensation for young adults, setting a

ceiling on employers' contributions to pension-type provident funds, opening up to new operators the use of existing public transit stations, requiring the Israeli Standards Institute to adopt internationally accepted technical standards, and introducing greater competition in television broadcasting aimed at lowering the cost of advertising. The mission commended the authorities for the scope of their reform plans, and urged that they be implemented rapidly.

27. **The mission praised the authorities for making efficiency a key objective of their privatization program, but noted that bureaucratic and other delays meant that privatization revenues were likely to have equaled only about one-fourth of the budgeted amount (NIS 4.6 billion) in 1999**. In this regard, the mission suggested that once a proper regulatory framework is in place, privatization in the energy and telecommunications sectors should proceed expeditiously. The mission noted, however, that lack of a proper regulatory environment cannot account for the extremely protracted process of bank privatization. The authorities indicated that they envisaged disposing of the balance of the government's holdings in Bank Hapoalim and of its controlling stake in Discount Bank in the first half of 2000, and that they also planned to sell the state's holding in Bank Leumi sometime in 2000. The authorities plan in the near future to address the issue of whether banks should be made to divest their stakes in provident funds and possibly other financial intermediaries in order to increase competition in the financial sector.

28. **The authorities intend to implement bold tax and capital market reforms aimed at removing distortions and increasing efficiency**. In general terms, the reform is intended to widen the bases of taxes while reducing and rationalizing marginal rates, and is proposed to be revenue neutral (see Box 2). While supporting the general outline of the reforms, the mission cautioned that a reform that was intended to be revenue neutral in the medium term might well turn out to be revenue losing in the short run, and this should be borne in mind during the budget process. The mission also suggested that the tax reform could be used to remove the distortions and asymmetries in the taxation of various financial investments. On a related subject, the mission recommended that the authorities discontinue the practice of offering bonds with guaranteed returns to pension funds, as this distorts asset allocation and limits capital market efficiency.

29. **While in the staff's view some indicators of vulnerability suggested that weaknesses remained in the financial system, the authorities emphasized that the system was basically healthy**. They noted that following the exchange rate shock in the wake of the Russia/LTCM crisis, banks and their customers have increasingly hedged their foreign currency exposure. As a result, bank supervisors indicated that the system could withstand even a significant depreciation of the sheqel without major problems.

30. **The authorities intend to harmonize labor regulations in order to level the playing field for unskilled workers, eliminating the cost advantages associated with hiring foreign and Palestinian workers**. The mission urged that any moves in this regard should be in the direction of more, rather than less, labor market flexibility. In response, the authorities expressed their belief that the labor market has been highly flexible in the past, as

for instance with the rapid absorption of a vast wave of immigrants from the former Soviet Union, and should remain so in the future. Moreover, the authorities indicated that they intend to meet the excess demand for skilled labor in the high-tech sector primarily by improving training of the Israeli workforce rather than granting additional work permits to foreign workers.

Box 2. Tax Reform Initiatives

Since the last major overhaul of the tax system in 1975, many exemptions and provisions have been introduced and for some time there has been a need to simplify the tax system and correct the distortions that have built up within it. At the center of the debate over tax reform is the question of whether the tax burden has been fairly distributed among different income groups and whether the relative taxation on labor and capital income is appropriate. A new committee chaired by Mr. Avi Ben-Bassat, Director General of the Ministry of Finance, is expected to forward a proposal by March 2000.

Currently, the combined tax rate of all taxes based on personal income has a hump shape due to the ceiling on social security contributions: the marginal rate starts at 16 percent and goes to 60 percent for those making below NIS 31,735 per month and drops to 50 percent for those earning above that level. Moreover, the high threshold excludes about 40 percent of wage earners from the income tax. As a result, the direct tax burden falls primarily on a relatively small group of taxpayers, the middle-income wage earners, while those with high incomes have much of their capital income exempted and their wage income taxed at a lower rate.

The differing tax treatment on different types of capital income distorts investment decisions and leads to inefficient resource allocation. Some capital gains arising from similar instruments are taxed differently depending on the status of the investors. Interest income is taxed at differential rates depending on whether it is accrued from domestic or foreign securities. The provident and pension funds and the insurance companies enjoy extensive tax benefits on domestic investments as well as varying degree of government subsidization. This leads institutional investors to invest primarily in various domestic fixed income instruments, to have little exposure in domestic equity markets, and to largely exclude foreign investment from their portfolios. Lack of institutional investors has been one of the major problems hindering the development of the Israeli capital market. Rough estimates suggest that capital income in Israel is taxed at a lower rate than the OECD average.

It is anticipated that the Ben-Bassat committee will recommend reducing the generous tax exemptions and benefits, lowering marginal tax rates on labor income, and stretching out the income tax brackets to broaden the tax base. Discriminatory taxation on capital income is likely to be reduced under the principle that similar instruments should be taxed the same way. In addition, it is expected that the committee will also recommend removing existing tax benefits for provident funds and pension funds and creating an effective set of tax incentives to encourage long-term saving.

31. **While Israel is party to a large number of bilateral free trade agreements, the authorities stated that they see these arrangements as complementary to, rather than substitutes for, multilateral agreements**. The purpose of bilateral agreements was primarily to open new export markets and create additional trade and the authorities saw no evidence that these agreements had led to trade diversion. Among industrial products, only textiles continue to be subject to combined ad valorem and specific duties, but on September 1, 2000, all specific duties on textiles will be eliminated. Tariffication of agriculture began in 1996, but the tariff structure for agriculture remains very complex. Although the mission was told that mandatory standards exist only for sanitary, safety, and environmental reasons, and in no case are used to avoid competition, there is anecdotal evidence that imports from the WBGS

have in some cases been hindered by these standards. The mission urged the authorities to continue progress in liberalizing the trade regime, particularly by simplifying the tariff structure for agriculture, phasing out remaining nontariff barriers in that sector, and removing restrictions on foreign investments by Israeli financial institutions.

32. **Meetings with the main labor union, Knesset members and private sector individuals indicated the existence of a broad consensus in support of the economic reform agenda**. Union officials argued for the introduction of a shorter working week as a way to reduce unemployment, whereas some private sector representatives defended the proposal that the Bank of Israel could use its foreign exchange reserves to "buy space" for ambitious interest rate cuts. The politicians, senior government and opposition members of the Knesset finance committee expressed an awareness of the need for continued fiscal consolidation, although they showed some concern at doing so given the currently high unemployment rate and the economy's growth prospects. Most discussions included a very favorable assessment of the peace process and its potential economic impact, while some concern was expressed regarding the budgetary cost of a final settlement.

III. Staff Appraisal

33. **Following three years of slow growth, Israel is now on the threshold of a marked improvement in economic performance**. Contributing to this positive outlook are the high quality of Israel's workforce, the entrepreneurial prowess of its business leaders, the outward-looking nature of the economy, and the sound legal and institutional framework in which it operates. These underlying factors, together with the peace process, suggest that with an appropriate combination of economic policies and structural reforms, Israel's high long-term growth potential can be realized.

34. **Fiscal and monetary policies in 1999 sustained the impressive gains in disinflation that had been achieved in recent years and laid the basis for economic recovery**. Thus, monetary policy was on a path of cautious, gradual, interest rate cuts, which nonetheless has kept real interest rates at relatively high levels, while fiscal policy achieved a reduction in the cyclically-adjusted operational deficit. The modest recovery now underway is likely to strengthen over the next two years, while inflation should remain at or below the lower end of the target range of 3–4 percent per year. However, under current policies the output gap is unlikely to narrow much in the medium term.

35. **Thanks in large part to the success of past monetary and fiscal policies, the stage is now set for further, gradual cuts in nominal interest rates sufficient to reduce real interest rates as low inflation becomes fully established**. Achievement of the inflation target should remain the paramount objective of monetary policy. However, on current policies inflation will likely come in at or below the lower end of the target range in 2000. This suggests that there is scope to cut interest rates, providing support to economic activity and relieving upward pressure on the exchange rate without compromising the inflation target. More generally, as the environment of low inflation becomes entrenched and with the credibility of the Bank of Israel more firmly established, a more symmetric approach to

monetary policy will be warranted, in which the authorities ensure that inflation does not deviate significantly in either direction from the target. The scope for monetary policy easing is, however, conditional on supportive fiscal policies.

36. **The envisaged shift to a broadly neutral fiscal stance in 2000 marks an unwelcome pause in recent consolidation efforts, given that the fiscal outturn in 1999 was considerably stronger than anticipated at the time of the mission.** Additional fiscal consolidation would have been preferable in 2000 to contribute to lower real interest rates and accelerate the pace of public debt reduction. In this regard, the proposed deficit targets of 2½ percent of GDP in 2000 and 2¼ percent of GDP for 2001 are insufficiently ambitious. Instead, the authorities should take the opportunity presented by a recovery that is stronger than the 3 percent officially-projected growth rate to pursue faster consolidation, ideally by pursuing, *de facto* if not *de jure*, the previous deficit targets of 1¾ percent of GDP in 2000 and 1½ percent of GDP in 2001. A conservative fiscal policy seems all the more necessary in light of possible large future outlays that might result from a final peace settlement with Syria. The conduct of monetary policy would need to duly recognize the demand implications of the fiscal stance.

37. **The exchange rate bands had no impact on monetary policy in 1999, as the sheqel traded in a relatively narrow range close to the midpoint of the band.** Since late 1999, however, the sheqel has begun to drift closer to the more appreciated end of the band and continued appreciation might prompt action by the Bank of Israel to intervene in currency markets. Supposing that interest rates are on a path consistent with achieving the inflation target, the usefulness of such bands would need to be re-assessed with a view to their possible elimination and the establishment of a pure inflation targeting regime. At present, the real exchange rate does not appear to pose competitiveness problems, but continued appreciation would naturally erode some of the gains in competitiveness that have occurred over the last three years.

38. **Passage of a revised Bank of Israel law along the lines recommended by the Levin Commission and endorsed by the Bank of Israel should be achieved as soon as possible.** Price stability should be established as the main goal of the Bank of Israel.

39. **The staff strongly supports the government's structural reform agenda, particularly its focus on increasing competition in several hitherto overly-regulated areas of economic activity.** Israel's shift from an economy dominated by state-owned enterprises operating in uncompetitive markets to a market-oriented and competitive environment integrated into global markets is quite remarkable. Impressively, the reform process has been maintained, albeit with shifts in emphasis, despite changes in political leadership. This broad consensus has contributed to a strengthening of business confidence and has fostered the country's image among international investors. The envisaged reforms clearly point in the right direction and they should be pursued vigorously.

40. **The ongoing initiative to reform the tax system offers an opportunity to enhance the efficiency of capital markets.** Reforms should seek to introduce a simpler and more

uniform treatment of capital income, thereby removing existing distortions. Measures should also be taken to increase competition within the banking system and between banks and nonbank financial intermediaries. Banks should be made to divest not only their nonfinancial subsidiaries, but also provident funds, and the state should withdraw from the banking business as fast as possible. Tax reforms should also address the imperfections in the personal income tax arising from the high exemption level and the hump-shaped marginal tax rate.

41. **Although the economy is now less vulnerable to a financial crisis than in the past, continued vigilance regarding real exchange rate trends, conditions of access to international capital markets, and the health of the banking sector is essential.** Banks and bank supervisors should continue to caution in particular against excessive foreign currency (or foreign currency-linked) credit to firms in sectors that lack natural hedges against currency fluctuations. The authorities' intention to participate in the FSAP/FSSA project is welcome.

42. **The authorities' intention to harmonize labor market regulations is appropriate.** Any revision of regulations should avoid the introduction of measures that might risk reducing the market's flexibility, which was crucial for the successful absorption of immigrants in the 1990s. Given the labor shortages that exist in high tech industries, an increased emphasis on existing retraining schemes—possibly operating in cooperation with the potential employees and organized labor—could contribute to a reduction in the unemployment rate.

43. **The authorities are to be commended for their success in liberalizing Israel's foreign trade and capital accounts, but additional progress in these areas is needed.** Existing controls on foreign investment by Israeli financial institutions distort returns on investment and can lead to a misallocation of savings. These controls should be reviewed in conjunction with the proposed FSAP with a view toward their elimination. The tariff system could be further simplified and the costs of agricultural protection to domestic consumers could be usefully assessed with a view towards phasing out the major elements of this sector's special trade regime, including any non-tariff barriers, over the medium term.

44. **Although data quality is generally adequate for surveillance purposes, the quality of statistical information could be enhanced in a few important areas.** First, the analysis of output growth is hindered by the frequent and large revisions of quarterly GDP estimates. Second, unemployment statistics are available only on a quarterly basis, and higher frequency data would be desirable. Finally, the authorities could usefully improve dissemination of banking sector prudential statistics.

45. **It is proposed that the next Article IV consultation with Israel be held on the standard 12-month cycle.**

Table 1. Israel: Selected Economic and Financial Indicators, 1995-2001

	1995	1996	1997	1998	1999 1/	2000 1/	2001 1/
	(Percent change unless otherwise indicated)						
National account indicators (constant prices)							
Domestic demand	6.5	5.5	1.2	0.9	2.6	3.1	3.8
Private consumption	7.9	5.4	4.2	3.6	3.0	3.2	3.9
Public consumption	-1.0	5.1	1.9	2.0	3.0	3.0	2.5
Gross capital formation	10.6	6.2	-6.8	-8.0	3.0	3.0	5.3
Fixed capital formation	9.1	7.7	-2.4	-4.0	2.9	2.9	5.2
External sector (net contribution to growth)	-0.8	-1.7	1.5	1.2	-0.9	0.3	-0.7
Exports of goods and services	8.8	6.6	7.7	6.3	9.8	12.1	10.0
Imports of goods and services	7.5	8.2	1.9	1.7	9.0	8.2	9.1
Real GDP	6.8	4.6	2.9	2.2	2.2	3.8	3.5
Labor market indicators							
Israeli civilian labor force	3.5	2.2	2.5	2.8	2.8	2.5	2.5
Employment	5.2	2.5	1.3	1.6	2.4	2.7	2.9
Unemployment rate (in percent)	6.8	6.7	7.7	8.6	8.9	8.7	8.3
Real wages							
Total economy	2.2	1.6	2.4	2.2	0.8	...	...
Business sector	0.6	1.5	3.5	3.0	1.9	...	...
Public sector	5.7	1.9	0.0	-2.2	-1.1	...	...
Prices							
Overall CPI (end period)	8.1	10.6	7.0	8.7	1.3	3.3	1.7
Overall CPI (period average)	10.0	11.3	9.1	5.4	5.2	2.7	2.5
Underlying CPI (excluding housing, fruit and vegetables, end period)	8.8	10.1	6.7	8.5	1.7	3.3	2.7
Interest rates (average, in percent)							
Nondirected credit in new sheqalim 2/	20.2	20.7	18.7	16.2	16.5	...	...
Self-renewing overnight deposits 3/	13.3	13.8	12.2	10.3	10.9	...	...
Discount rate	14.4	15.1	13.6	11.8	12.2	8.2	7.5
Money and credit (period average)							
Net domestic credit	26.2	21.6	18.2	17.7	19.4	...	...
Narrow money (M1)	8.4	14.9	14.3	12.1	11.4	7.0	6.9
Broad money (M3)	25.5	24.0	25.3	22.1	21.8	18.5	16.9
Public finance (percent of GDP)							
Central government revenue	41.5	42.1	41.8	41.2	42.6	40.9	40.4
Central government expenditure	45.6	45.8	44.5	43.5	44.8	43.4	42.7
Central government balance	-4.1	-3.7	-2.7	-2.3	-2.3	-2.5	-2.3
General government balance	-4.4	-5.6	-4.0	-3.6	-3.6	-3.8	-3.6
Public debt	109.0	107.0	106.0	111.0	112.4	110.4	108.1
Balance of payments							
Trade balance (percent of GDP)	-8.7	-7.5	-5.2	-3.3	-5.0	-5.4	-5.0
Current account (percent of GDP) 4/	-6.0	-5.6	-3.4	-0.7	-1.8	-1.4	-1.7
Foreign reserves (end of period., in US$ billion)	8.3	11.6	20.3	22.7	22.5	22.5	22.5
Reserve cover (in months of imports)	2.8	3.7	6.6	7.6	6.6	6.0	5.4
Exchange rate and terms of trade indices							
NEER (1990=100)	-6.1	-2.7	0.2	-6.4	-7.7	...	...
REER (1990=100)	0.8	5.9	7.0	-3.0	-3.8	...	...
Terms of trade (1990=100; index level)	103.1	103.6	107.3	111.5	...	...	...

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

1/ Staff estimates and projections.
2/ For 1999, averages through November.
3/ For 1999, averages through October.
4/ Revised data for 1993-98, excludes travel expenditures by residents domiciled abroad.

Table 2. Israel: Current Indicators, 1998-99

	1998	1999				1999											
	Q4	Q1	Q2	Q3	Q4	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
1. Activity and employment 1/																	
Private consumption	-1.0	1.6	0.6	2.4	2.1	...	...	...	...	...	...	...	...	...	...	...	...
Public consumption	-0.3	-0.8	4.9	1.2	2.0	...	...	...	...	...	...	...	...	...	...	...	...
Gross capital formation	3.7	1.2	7.5	-0.7	0.9	...	...	...	...	...	...	...	...	...	...	...	...
Fixed capital formation	1.3	-2.1	-0.1	4.0	-3.9	...	...	...	...	...	...	...	...	...	...	...	...
Exports of goods and services	0.3	1.9	3.5	5.1	1.3	...	...	...	...	...	...	...	...	...	...	...	...
Imports of goods and services	-0.9	5.6	6.4	4.5	4.4	...	...	...	...	...	...	...	...	...	...	...	...
Real GDP	0.2	-1.1	2.0	1.1	1.1	...	...	...	...	...	...	...	...	...	...	...	...
Business sector gross product	0.6	-0.5	-1.2	2.3	1.5	...	...	...	...	...							
Industrial production index	0.4	-2.0	0.8	0.6	3.8	-2.7	0.5	1.2	0.1	-0.9	1.2	1.4	2.2	3.2	-3.8	0.5	2.1
State-of-economy index	0.0	-0.6	0.7	2.2	0.9	-0.9	-0.3	0.6	0.2	0.2	0.0	0.6	1.7	1.3	-0.1	-0.6	-0.2
Business sector employee posts	1.3	1.0	0.1	0.2	...	0.3	0.2	0.6	-0.5	0.3	-0.2	-1.0	1.1	0.9	-0.3	0.4	...
Unemployment rate (in percent) 2/	8.2	8.7	8.9	9.1	8.9	8.6	8.7	8.5	8.7	9.0	8.7	8.7	8.7	9.3	9.3	9.1	8.9
2. Prices																	
Overall CPI	5.1	-0.6	0.3	0.4	1.8	-0.5	-0.8	-0.2	0.3	0.5	0.3	0.3	0.5	0.5	0.7	-0.2	0.0
Percent change (Y/Y) 3/	7.8	7.3	5.9	5.1	1.9	7.8	7.0	7.0	5.9	6.0	5.9	6.3	6.3	5.3	2.9	1.4	1.3
Underlying CPI	4.7	0.9	0.4	0.1	1.2	-0.1	-0.1	-0.2	0.4	0.2	0.1	0.0	0.1	0.2	0.7	0.2	0.3
Percent change (Y/Y) 3/	7.2	8.3	6.9	6.2	2.6	8.3	8.4	8.2	7.4	6.9	6.3	6.4	6.5	6.1	4.1	2.1	1.7
3. Financial indicators (period average)																	
Narrow money (M1)	3.1	-1.3	2.7	2.3	6.6	1.5	-3.8	4.0	1.0	0.0	1.3	5.6	0.0	0.4	-1.1	0.4	8.8
Broad money (M3)	5.4	5.8	4.6	1.4	8.0	3.7	0.8	1.3	1.8	2.0	0.6	1.5	2.1	1.3	1.5	1.4	1.8
Nondirected credit (including foreign currency)	7.9	2.9	2.8	1.0	1.1	1.8	-0.2	0.4	1.5	1.5	0.4	1.2	1.7	1.4	2.1	0.9	1.5
Interest rates (in percent)																	
Discount rate	12.8	13.3	12.2	12.0	11.4	13.5	13.5	13.0	12.5	12.0	12.0	12.0	11.5	11.5	11.5	11.5	11.2
Nondirected credit in new sheqalim	16.2	17.5	16.5	16.4	...	17.7	17.7	17.2	16.7	16.4	16.4	16.3	15.7	15.8	15.7	15.6	...
4. External sector (period average)																	
Current account balance (in US$ billions)	1.1	-0.7	-0.9	-0.9	...	...	...	...	...	...	...	...	...	...	...	...	...
Trade balance (in US$ billions) 4/	-1.4	-1.8	-1.9	-1.7	...	1.8	1.6	2.0	1.6	1.9	1.9	2.0	1.8	2.1	2.0	2.3	2.2
Foreign reserves (in US$ billions, end of period)	22.7	22.0	21.9	22.1	22.5	22.6	22.2	22.0	22.1	21.6	21.9	22.1	21.8	21.9	21.7	21.3	22.5
In months of imports (goods and services, projected)	7.6	6.5	6.5	6.5	6.6	6.7	6.5	6.5	6.5	6.3	6.5	6.5	6.4	6.4	6.4	6.3	6.6
Ratio of foreign reserves to M1	3.7	3.6	3.6	4.6	4.5	3.7	4.1	4.0	3.6	3.9	3.9	3.6	3.8	3.7	3.8	3.7	3.5
Ratio of foreign reserves to short-term debt	1.0	1.1	1.1	1.0	...	...	...	...	...	...	...	...	...	...	...	...	...
NEER (1990=100) 5/	-15.1	5.8	2.8	-2.3	-1.3	2.5	2.4	2.9	0.1	-0.9	1.8	0.0	-4.3	-1.1	-1.2	2.3	1.8
REER (1990=100) 5/	-11.4	5.6	2.4	-1.4	-1.7	2.2	2.0	2.9	-0.4	-0.7	2.1	0.4	-4.1	-0.8	-1.7	2.2	1.6
NIS / currency basket (in NIS, average rate)	4.60	4.40	4.35	4.35	4.52	4.47	4.40	4.33	4.34	4.39	4.33	4.33	4.49	4.55	4.60	4.51	4.46
NIS / US$ (in NIS, average rate)	4.20	4.06	4.09	4.10	4.23	4.08	4.07	4.03	4.06	4.12	4.09	4.10	4.20	4.25	4.26	4.23	4.19

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

1/ Seasonally adjusted data; percentage change over previous period.
2/ Unemployment statistics are released quarterly; the monthly figures are interpolated data.
3/ (Y/Y) refers to percentage change from the corresponding period one year earlier.
4/ Unlike annual and quarterly data, monthly data are drawn from customs data and exclude ships and aircraft.
5/ IMF convention; an increase indicates appreciation and vice versa.

Table 3. Israel: Balance of Payments, 1995–2000

2/29/00 1:19 PM	1995	1996	1997	1998	1999 1/	2000 1/
	(In billions of U.S. dollars)					
Current account balance	-5.2	-5.3	-3.4	-0.7	-1.7	-1.4
Trade balance	-7.6	-7.2	-5.2	-3.2	-4.7	-5.5
Exports, f.o.b.	19.3	21.2	22.7	23.0	25.2	27.6
Imports, f.o.b.	26.8	28.4	27.8	26.2	30.0	33.1
Civilian imports	25.5	26.8	26.1	24.3	27.9	31.0
Military imports	1.3	1.7	1.8	1.9	2.1	2.1
Services balance	-3.4	-4.4	-4.4	-3.6	-3.5	-2.3
Of which:						
Nonfactor Services 2/	-0.6	-1.2	-1.0	-0.8	-0.5	0.8
Factor Services	-2.8	-3.2	-3.5	-2.8	-2.9	-3.1
Net transfers	5.8	6.3	6.2	6.1	6.5	6.5
Capital and financial account balance 3/	5.6	7.7	11.6	3.3	1.6	1.4
Capital account	2.0	2.1	2.2	1.8	1.8	1.8
Financial account	3.5	5.6	9.4	1.5	-0.2	-0.4
Direct investment	0.6	0.3	0.8	1.0	2.5	2.0
Portfolio investment	1.8	3.5	3.4	1.9	1.5	1.5
Other investment	1.1	1.8	5.2	-1.4	-4.2	-3.9
Errors and omissions	0.7	1.0	1.1	-0.7	0.0	0.0
Change in reserves 4/	-1.1	-3.4	-9.3	-1.9	0.2	0.0
Memorandum items:	(In percent of GDP)					
Current account balance	-6.0	-5.6	-3.4	-0.7	-1.8	-1.4
Civilian trade balance	-7.2	-5.8	-3.5	-1.4	-2.8	-3.4
Gross external debt	51.0	49.2	51.5	55.2	60.0	59.0
Net external debt 5/	21.9	18.5	14.5	11.7	12.0	10.9

Sources: Central Bureau of Statistics, *Monthly Bulletin of Statistics;* and Fund staff estimates.

1/ Staff projection.

2/ Revised: tourism expenditures excludes outlays by Israeli citizens that reside overseas.

3/ Excludes reserve assets.

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

5/ Net external debt subtract out of gross external debt the foreign reserve asset holdings of the Bank of Israel, the commercial banks, and other monetary institutions.

Table 4. Israel: Indicators of External and Banking Sector Vulnerability, 1994-99
(In percent of GDP, unless otherwise indicated)

2/29/00 1:37 PM	1994	1995	1996	1997	1998	Estimate 1999
Financial indicators						
Government debt	115.0	109.0	107.0	106.0	111.0	112.4
Broad money (percent change, 12-month basis)	31.1	25.2	26.3	20.5	21.4	22.7
Private sector credit (percent change, 12-month basis)	27.1	20.6	18.8	16.1	19.0	17.6
One month T-bill yield (Makam; nominal)	13.0	15.4	15.6	14.1	12.3	12.6
One month T-bill yield (Makam; deflated by 12-month CPI, end of period)	-1.3	6.8	4.5	6.6	3.3	11.1
External Indicators						
Exports (percent change, average in US$)	16.6	12.0	10.2	6.6	1.4	9.8
Imports (percent change, average in US$)	10.8	17.9	5.9	-2.1	-5.8	14.4
Terms of trade (percent change, average) 1/	3.1	10.2	-3.1	-7.8	-1.5	-1.4
Current account surplus	-4.5	-6.0	-5.6	-3.4	-0.7	-1.8
Capital and financial account balance	4.6	6.4	8.1	11.7	3.3	1.6
Of which: Inward portfolio investment (debt securities etc.)	3.1	2.1	3.7	3.5	1.9	1.5
Other investment (loans, trade credits etc.)	-0.6	1.3	1.9	5.2	-1.4	-4.4
Inward foreign direct investment in the form of debt or loans	-0.4	0.7	0.4	0.8	1.0	2.6
Gross official reserves (in US$ billions; end of period)	6.9	8.3	11.6	20.3	22.7	22.5
Central bank short-term foreign liabilities (in US$ billions)	0.3	0.2	0.1	0.1	0.1	0.1
Short-term foreign assets of the financial sector (in US$ billions)	12.0	12.4	13.3	11.2	13.4	14.7
Short-term foreign liabilities of the financial sector (in US$ billions)	13.6	15.0	15.5	17.5	19.2	20.4
Official reserves in months of imports GNFS	2.7	2.8	3.7	6.6	7.6	6.6
Ratio of foreign reserves to broad money	0.2	0.2	0.3	0.4	0.5	0.4
Ratio of foreign reserves to short-term debt	0.4	0.4	0.6	1.0	1.0	0.9
Total gross external debt/GDP (in percent)	55.5	51.0	49.2	51.5	55.2	60.0
Of which: Government debt/GDP (in percent)	30.4	27.6	26.7	26.7	28.1	30.3
Total gross external debt to exports GNFS (in percent)	174.2	165.7	162.0	165.8	170.5	161.5
External gross interest payments to exports GNFS (in percent)	9.9	10.7	9.9	10.0	14.1	12.8
External amortization payments to exports GNFS (in percent)	9.7	8.5	9.1	8.9	4.9	4.4
Ratio of short-term debt to total debt (in percent)	44.1	44.9	40.9	41.5	41.2	42.1
Country risk ratings (S & P/Moody's)	BBB+	A- / A3	A- / A3	A- / A3	A- / A3	A- / A3
Spread of foreign bonds relative to U.S. Treasury Bonds (in basis points)	50	40	30	50	100	100
Exchange rate (per US$, period average)	3.0	3.0	3.2	3.4	3.8	4.1
REER appreciation (-) (12-month basis)	4.0	-1.7	7.0	6.5	-12.3	5.7
Increase in relative unit labor costs 2/	1.5	6.2	3.9	2.8	-3.4	...
Change in stock market index (in percent)	-39.4	14.0	-1.0	35.2	3.0	64.4
Banking sector indicators (all in percent)						
Risk-based capital asset ratio (capital over risk-weighted assets, end of period)	9.8	9.6	9.7	10.2	9.5	9.7
Share of foreign exchange credit in total credit to the public (end of period)	15.9	26.2	27.0	32.1	35.3	41.4
Share of foreign deposits in total deposits of the public (end of period) 3/	31.7	31.4	29.0	28.9	31.5	36.8
Share of foreign currency liabilities in total liabilities (end of period) 3/	25.6	26.3	24.4	25.8	28.3	36.3

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

1/ According to WEO GEE trade deflators.

2/ Unit labor costs in U.S. dollars weighted according to Israel's currency basket.

3/ Data up to June 1999.

Table 7. Israel: Medium-Term Scenarios, 1997-2005

2/29/00 1:46 PM	1997	1998	1999	2000	2001	2002	2003	2004	2005
	(In percent unless indicated otherwise)								
Baseline scenario 1/									
GDP growth rate	2.9	2.2	2.2	3.8	3.5	3.5	3.5	3.5	3.5
Inflation (average)	9.1	5.4	5.2	2.7	2.5	2.5	2.3	2.0	2.0
Real effective interest rate 2/	5.7	7.2	7.5	6.5	6.0	6.0	6.0	6.0	6.0
Fiscal deficit/GDP									
Official definition	2.7	2.3	2.3	2.5	2.3	2.0	1.5	1.5	1.5
Conventional estimate 3/	10.9	7.6	7.4	5.8	5.4	5.0	4.4	4.1	4.1
Public debt/GDP (end of period)	106.0	111.0	112.4	110.4	108.1	105.7	103.2	100.8	98.5
Gross investment/GDP	20.3	18.2	19.1	19.0	19.4	19.5	19.6	19.5	19.4
Public saving/GDP	-0.5	-0.5	-1.2	-1.5	-1.2	-1.0	-0.6	-0.6	-0.7
Private saving/GDP	17.4	18.0	18.5	19.1	19.0	19.4	19.5	20.0	20.5
Foreign saving/GDP	3.4	0.7	1.8	1.4	1.7	1.2	0.7	0.1	-0.5
Foreign reserves in months of imports of goods and nonfactor services	6.6	7.6	6.6	6.0	5.4	5.1	4.8	4.5	4.3
Foreign debt as percent of GDP	51.5	55.2	60.0	59.0	58.0	56.5	54.6	52.2	49.3
Memorandum items (growth rates):									
Aggregate domestic demand	1.2	0.9	2.6	3.1	3.8	3.0	2.9	2.8	2.8
Private consumption	4.2	3.6	3.0	3.2	3.9	3.0	3.0	3.0	3.0
Public consumption	1.9	2.0	3.0	3.0	2.5	2.5	2.3	2.3	2.3
Gross capital formation	-6.8	-8.0	3.0	3.0	5.3	4.1	3.7	2.9	2.9
Exports of goods and services	7.7	6.3	9.8	12.1	10.0	7.1	6.8	6.7	6.5
Imports of goods and services	1.9	1.7	9.0	8.2	9.1	5.2	4.8	4.6	4.7
Real GDP index (1994=100)	115.1	117.6	120.2	124.8	129.2	133.8	138.6	143.5	148.5
Potential output index (1994=100)	116.2	119.8	124.5	129.4	134.6	139.6	144.5	149.2	153.7
Output gap (in percent of potential output)	-1.0	-1.8	-3.5	-3.6	-4.0	-4.1	-4.1	-3.8	-3.4
Alternative Scenario 4/									
GDP growth rate	2.9	2.2	2.2	3.8	3.8	5.0	5.0	5.0	5.0
Inflation (average)	9.1	5.4	5.2	2.7	2.8	2.8	2.6	2.5	2.5
Real effective interest rate 2/	5.7	7.2	7.5	6.5	5.5	5.0	4.8	4.5	4.5
Fiscal deficit/GDP									
Official definition	2.7	2.3	2.3	2.5	1.1	0.6	0.0	0.0	0.0
Conventional estimate 2/	10.9	7.6	7.4	5.8	4.4	3.7	3.0	2.8	2.7
Public debt/GDP (end of period)	106.0	111.0	112.4	110.4	107.0	101.7	96.3	91.2	86.4
Gross investment/GDP	20.3	18.2	19.1	19.0	19.7	20.2	20.7	21.0	21.4
Public saving/GDP	-0.5	-0.5	-1.2	-1.5	-0.1	0.5	1.0	1.0	1.0
Private saving/GDP	17.4	18.0	18.5	19.1	18.4	18.9	18.9	19.2	19.6
Foreign saving/GDP	3.4	0.7	1.8	1.4	1.4	0.8	0.7	0.8	0.7
Foreign reserves in months of imports of goods and nonfactor services	6.6	7.6	6.6	6.0	5.5	5.1	4.7	4.3	4.0
Foreign debt as percent of GDP	51.5	55.2	60.0	59.0	58.3	56.2	54.2	52.3	50.5
Memorandum items (growth rates):									
Aggregate domestic demand	1.2	0.9	2.6	3.1	3.6	4.5	4.9	5.1	4.8
Private consumption	4.2	3.6	3.0	3.2	3.3	4.8	5.5	6.0	5.5
Public consumption	1.9	2.0	3.0	3.0	1.8	1.8	1.8	1.8	1.8
Gross capital formation	-6.8	-8.0	3.0	3.0	7.1	7.4	7.3	6.5	6.5
Exports of goods and services	7.7	6.3	9.8	12.1	9.4	8.2	8.4	7.0	7.2
Imports of goods and services	1.9	1.7	9.0	8.2	7.6	6.4	7.6	6.8	6.5
Real GDP index (1994=100)	115.1	117.6	120.2	124.8	129.6	136.1	142.9	150.0	157.5
Potential output index (1994=100)	116.2	119.8	124.5	129.4	134.6	139.9	145.5	151.3	157.4
Output gap (in percent of potential output)	-1.0	-1.8	-3.5	-3.6	-3.7	-2.7	-1.8	-0.9	0.0

Source: Fund staff estimates.

1/ Based on assumption of unchanged monetary and fiscal policy stance.
2/ Nominal effective discount rate of the Bank of Israel deflated by current CPI inflation.
3/ Official definition plus the inflation component of domestic interest payments.
4/ Based on assumption of faster fiscal consolidation and easier monetary policy from 2001.

Table 8. Fiscal Policy Indicators in Israel and Selected Groups of Countries, 1987-99

(General government data in percent of GDP unless noted otherwise)

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Israel													
Primary balance	10.3	6.7	3.1	3.6	2.9	3.6	4.1	5.5	3.9	1.9	3.1	2.7	2.3
Conventional balance 1/	-18.9	-17.1	-23.4	-19.5	-19.9	-12.6	-10.8	-10.3	-10.4	-14.1	-10.9	-7.6	-7.4
Central government balance 2/	-3.4	-8.0	-4.0	-4.3	-6.1	-3.6	-2.5	-2.3	-4.1	-3.7	-2.7	-2.3	-2.3
Interest expenditure 3/	11.1	10.0	9.9	9.4	8.6	7.9	7.4	6.9	6.7	6.1	6.1	6.3	6.3
Total expenditure 4/	62.5	60.9	60.2	59.3	59.6	57.8	55.7	55.1	56.1	55.7	54.4	54.7	56.0
Gross debt	155.0	147.0	143.0	132.0	127.0	124.0	122.0	115.0	109.0	107.0	106.0	111.0	112.4
G-7													
Primary balance	0.2	0.9	1.6	0.7	0.3	-0.6	-1.2	-0.9	-0.7	-0.1	1.3	1.5	1.0
Central government balance	-3.3	-2.6	-2.3	-2.8	-3.0	-4.1	-4.0	-3.5	-3.2	-2.9	-1.6	-1.1	-1.1
Interest expenditure	4.6	4.5	4.6	4.6	4.6	4.7	4.5	4.4	4.6	4.6	4.3	4.1	3.9
Total expenditure 4/	38.2	37.3	36.8	38.5	38.9	40.1	40.1	39.4	39.9	39.6	38.2	38.1	38.0
Gross debt	60.6	60.8	59.8	60.4	61.9	65.2	69.5	71.6	75.1	76.5	76.7	77.3	77.6
Euro-11													
Primary balance	-0.5	-0.3	0.9	0.0	-0.2	0.2	-0.5	-0.3	0.0	0.9	2.0	2.0	2.0
Central government balance	-4.4	-4.2	-3.7	-4.0	-3.9	-4.1	-4.8	-4.4	-3.9	-3.5	-2.2	-2.1	-1.8
Interest expenditure	4.5	4.4	4.6	4.8	5.0	5.5	5.6	5.3	5.6	5.6	5.1	4.6	4.3
Total expenditure 4/	49.6	48.9	48.2	49.2	50.1	51.4	53.0	51.8	51.5	51.1	49.9	48.9	48.6
Gross debt	56.3	56.7	57.0	58.2	58.5	61.7	66.8	69.1	72.3	75.0	74.7	73.4	72.2
Italy													
Primary balance	-3.6	-3.3	-1.6	-2.2	-0.4	1.4	2.1	1.4	3.4	4.1	6.4	5.0	4.3
Central government balance	-11.2	-11.0	-10.7	-10.1	-10.2	-10.3	-9.9	-9.1	-7.1	-6.8	-2.6	-2.8	-2.0
Interest expenditure	7.9	7.9	8.7	9.4	10.1	11.4	12.0	10.9	11.5	11.5	9.5	8.0	7.0
Total expenditure 4/	50.6	50.7	51.6	53.4	53.4	55.5	57.3	54.4	53.1	52.9	50.9	49.2	48.9
Gross debt	90.4	92.6	95.4	97.3	100.6	107.7	118.1	123.8	123.2	122.5	120.1	118.7	115.7
Belgium													
Primary balance	2.8	3.2	4.1	5.0	3.8	3.7	3.5	5.2	5.0	5.4	6.0	6.1	5.6
Central government balance	-7.7	-7.2	-7.0	-6.1	-6.2	-7.1	-6.9	-5.5	-4.6	-3.4	-2.4	-1.7	-1.8
Interest expenditure	10.5	10.0	10.2	10.5	10.1	10.7	10.7	10.0	8.9	8.5	7.8	7.4	7.0
Total expenditure 4/	55.2	52.8	50.7	50.4	51.4	52.3	53.2	51.9	50.5	49.9	49.0	48.2	48.1
Gross debt	128.8	128.8	125.6	125.4	127.2	128.6	135.0	133.1	130.8	126.9	121.9	116.2	114.4
Ireland													
Primary balance	-0.5	2.7	4.7	4.4	4.1	3.6	3.2	3.1	2.1	3.4	4.5	4.9	5.0
Central government balance	-8.0	-2.6	-1.8	-1.6	-0.8	-2.3	-2.0	-1.8	-1.5	-1.0	-0.5	1.3	1.5
Interest expenditure	8.7	8.1	7.3	7.4	7.3	6.7	6.2	5.6	5.0	4.4	4.0	3.1	2.8
Total expenditure 4/	46.7	43.6	37.4	38.2	39.0	39.5	39.4	39.5	37.2	35.2	33.1	31.1	30.0
Gross debt	109.4	106.7	97.4	92.6	94.8	92.0	94.0	88.1	80.8	71.1	62.3	52.6	46.0

Sources: World Economic Outlook Database; Fund staff estimates.

1/ Staff estimates, including the full interest cost on domestic debt.

2/ Operational measure adopted by Israeli authorities, including only the real interest cost of domestic debt.

3/ Net of central government interest payments to the National Insurance Institute.

4/ Includes net lending.

Table 9. Israel: State Budget, 1994-2000

	1994	1995	1996	1997	1998	1999		2000
						Budget	Estimated Outturn	Budget
				(In percent of GDP)				
Revenue	43.4	41.5	42.1	41.8	41.2	42.0	42.6	41.7
Domestic	39.4	38.6	36.9	37.4	36.4	37.4	38.0	36.8
Tax	32.1	31.3	30.5	30.9	30.5	31.2	...	31.1
Of which: on income and profits	14.7	14.3	13.8	14.5	14.4	14.7	...	14.5
on domestic goods and services	15.4	15.2	14.9	15.0	14.9	15.0	...	15.3
Nontax domestic	7.3	7.3	6.4	6.5	5.9	6.2	...	5.7
Of which: loans from NII	2.1	1.9	1.7	1.7	1.5	1.6	...	1.3
Foreign	4.0	3.0	5.2	4.4	4.8	4.6	4.6	4.9
Of which: grants	3.5	1.9	4.2	3.3	3.3	2.9	...	2.9
Expenditure	45.7	45.6	45.8	44.5	43.5	44.0	44.8	44.2
Domestic	41.3	41.8	41.4	40.5	39.4	40.0	40.8	39.9
Current domestic	38.6	39.4	39.0	38.5	37.5	37.7	...	37.6
Of which: wages	9.3	9.6	9.6	9.4	8.7	8.4	...	9.0
interest 1/	4.9	5.2	4.7	4.9	4.9	4.5	...	4.7
subsidies and transfers	16.2	16.1	16.8	16.5	16.3	16.3	...	15.9
repayment	1.0	1.1	1.0	1.1	1.1	1.2	...	1.2
Capital	2.7	2.4	2.4	2.0	1.9	2.3	...	2.3
Foreign	4.4	3.8	4.4	4.0	4.1	4.0	4.0	4.3
Of which: interest	2.0	1.8	1.9	1.6	1.6	1.4	...	1.5
Budget balance	-2.3	-4.1	-3.7	-2.7	-2.3	-2.0	-2.3	-2.5
Domestic	-1.9	-3.2	-4.5	-3.1	-3.0	-2.6	-2.9	-3.1
Foreign	-0.4	-0.8	0.8	0.4	0.7	0.6	0.6	0.6
Financing	2.3	4.1	3.7	2.7	2.3	2.0	2.3	2.5
Domestic	2.3	2.6	2.6	3.2	2.7	1.8	2.3	2.1
Bank of Israel (net)	1.9	-0.5	0.2	0.0	0.1	0.0	–	0.0
Nonbank (net)	-0.1	2.4	2.6	0.2	1.1	0.6	...	1.2
Sale of assets	0.3	0.7	0.1	2.5	1.4	1.1	...	0.8
Other (net)	0.2	0.0	-0.3	0.5	0.1	0.1	...	0.1
Foreign (net)	0.0	1.5	1.1	-0.5	-0.4	0.2	0.0	0.4
Memorandum items:								
Defense expenditure	9.8	10.2	10.0	10.0	10.1	9.0	...	9.2
Primary balance	3.9	1.9	2.1	3.0	3.4	3.9	...	3.7

Source: Israeli authorities.

1/ Includes interest payments to National Insurance Institute.

ISRAEL: FUND RELATIONS
(As of January 31, 2000)

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.

II. **General Resources Account**:

	SDR Millions	% Quota
Quota	928.20	100.0
Fund holdings of currency	862.70	92.9
Reserve position in Fund	65.51	7.1
Operational budget transfers (net)	13.00	

III. **SDR Department**:

	SDR Millions	% Allocation
Net cumulative allocation	106.36	100.0
Holdings	0.91	0.9
Designation Plan	8.00	

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

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund**: (In millions of SDRs; based on existing use of resources and present holdings of SDRs):

	Overdue	Forthcoming				
	01/31/00	2000	2001	2002	2003	2004
Charges/Interest	0.0	4.2	4.3	4.3	4.3	4.3
Total	0.0	4.2	4.3	4.3	4.3	4.3

VII. **Exchange Rate Arrangement**:

Since December 17, 1991, Israel has had a preannounced crawl against a currency basket, reflecting the composition of foreign trade, with a 5 percent band, widened to 7 percent in June 1995. In June 1997, the upper (depreciation) band was raised to 21 percent with the slope unchanged at 6 percent per annum, while the slope of the lower (appreciation) band was reduced to 4 percent per annum. In the last two years the band has been widening, and at the end of 1999 the band had a width equivalent to 43 percent of its lower limit, and no central rate.

VIII. **Article IV Consultation**:

The last Article IV consultations were conducted on November 25–December 2, 1998; reports on these discussions (SM/99/42 and SM/99/50) were discussed by the Board (EBM/99/26), and the consultation was concluded on March 12, 1999.

IX. **Technical Assistance**:

For purposes of the Fund's operational activities, the West Bank and Gaza 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 West Bank and Gaza (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, and pension reform (Fiscal Affairs Department); in the areas of bank supervision, foreign assets management, central bank operations and information technology (Monetary and Exchange Affairs Department); and in the areas of national accounts and monetary statistics (Statistics Department). The Middle Eastern Department has been assisting the PA with quarterly fiscal reporting to donors, in the context of the Ad-Hoc Liaison Committee (AHLC), and with budget formulation in the context of a medium-term macroeconomic framework. Palestinian officials have been participating in training courses offered by the I.M.F. Institute both at headquarters and in the field.

The Fiscal Affairs Department currently has a long-term resident advisor to assist in tax administration and computerization of the revenue system; a resident expert at the treasury, to assist, inter alia, in the design and implementation of the Government Financial Management Information System; and a Budget Advisor. The Monetary and Exchange Affairs Department is currently providing technical assistance and helping in institution building through periodic missions and through its resident experts in the areas of bank supervision and information technology. The Statistics Department is providing assistance in the areas of monetary, balance of payments, and national accounts statistics.

X. **Resident Representative**:

Resident representative in the West Bank and Gaza since early 1996.

ISRAEL: STATISTICAL APPENDIX

Israel has subscribed to the Special Data Dissemination Standard (SDDS). The periodicity, timeliness, coverage, and quality of Israel's economic data are generally adequate for surveillance. Nevertheless, the specific measure of the overall annual fiscal balance that is reported does not conform with the balance in most other countries because interest costs exclude the inflation component of such payments, and there is no within-year monthly report of expenditures broken down by composition. There is also a need for a measure of resource utilization, such as capacity utilization, given the difficulty of using unemployment as a proxy with levels of immigration varying. More regular use of seasonally adjusted inflation measures would also be appropriate. Moreover, quarterly GDP estimates tend to be subject to frequent and substantial revisions, which complicates analysis of short-term macroeconomic developments.

Israel: Core Statistical Indicators

(as of February 29, 2000)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates 1/	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP	External Debt
Date of Latest Observation	2/29/00	Dec. 99	Sept. 1999	Dec. 99	Dec. 1999	Jan. 2000	Jan. 2000	Dec. 1999	Sept. 1999	Dec. 1999	June 1999	Sept. 1999
Date Received	2/29/00	1/10/00	11/01/99	1/15/00	1/15/00	2/29/00	2/15/00	1/16/00	12/15/99	1/15/00	8/24/99	Dec. 1999
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly 2/	Quarterly	Quarterly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Quarterly
Source of Update	Reuters; BoI website	BoI; Reuters	BoI	BoI; Reuters	BoI; Reuters	BoI; Reuters	Central Bureau of Statistics; Reuters	Central Bureau of Statistics; Reuters	Central Bureau of Statistics; BoI; Reuters	MoF	Central Bureau of Statistics; Reuters	BoI/CBS
Mode of Reporting	Electronic	Electronic Mail/ Publication	Mail	Mail/ Electronic	Mail/ Reuters	Mail/ Electronic	Internet/ Mail/ Reuters	Internet/ Mail	Internet/ Mail	Mail/ Reuters	Mail/ Electronic	Mail
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Annually

1/ Market rates are available daily through Reuters.
2/ On a cash basis.
Note: BoI = Bank of Israel; MoF = Ministry of Finance.

Statement by the IMF Staff Representative
March 22, 2000

1. This statement reviews economic and financial developments in Israel since the circulation of the staff report for the Article IV consultation (SM/00/45, 3/1/2000). This information does not alter the thrust of the staff appraisal.

2. According to recently revised Central Bureau of Statistics (CBS) estimates, **GDP grew by 2.2 percent in 1999**, compared with a previous estimate of 2 percent. Real activity in 1999 was led by domestic demand, in particular private consumption and a sharp rebound in nonresidential investment. This estimate implies that for the second straight year per capita income declined slightly, following very rapid per capita growth in the early and mid-1990s.

3. New CBS seasonally adjusted quarterly GDP data indicate that GDP growth was about 5½ percent in annual terms in the second half of 1999, rather than 4½ percent as had previously been estimated. **This suggests that the recovery may be stronger than hitherto estimated, and has led some observers to increase the annual growth rate estimates for 1999 to about 2½ percent. Recently released "Consensus Forecasts" for 2000–01 also indicate an overall improvement in the economy's outlook.**

4. **Consumer prices declined in the first two months of 2000**, continuing a trend that begun in October 1999. The overall consumer price index fell by close to 1 percent in January–February 2000, influenced by a seasonal decrease in the prices of clothing and footwear and the effects of a strengthening sheqel on the exchange rate linked-housing component of the price index. The underlying CPI—which excludes fresh fruits and vegetables, and housing—also declined, albeit just slightly, in the first two months of this year. In the 12-months to February, inflation was 1.6 percent for the overall CPI (1.7 percent for the underlying index). The bond-market derived measure of **inflation expectations** has remained generally below the lower end of the inflation target for 2000 (3 percent) in the first two and a half months of this year.

5. **The central government operational balance posted a NIS 1 billion surplus during January–February of this year, marking a substantial improvement over the NIS 0.8 billion deficit observed in the corresponding period of 1999.** In nominal terms, revenues have risen by about 20 percent relative to the comparable period in 1999, whereas expenditures have increased by about 10 percent. This turnaround largely reflects the difference between current economic activity levels and those observed in early 1999.

6. The **trade deficit** in the first two months of the year was about US$1.4 billion, 12 percent larger than the deficit accumulated in the corresponding period of 1999—but foreign trade was disrupted by a port strike in January 2000. Export growth has picked up

- over -

since the third quarter of 1999 and has been in line with import growth in the last three months.

7. **The sheqel has appreciated by 4.3 percent relative to the U.S. dollar since the end of 1999**, and the exchange rate is now just 4 percent above the lower (appreciated) limit of its 44 percent-wide band. This appreciation has been driven by the still substantial, although diminishing, sheqel-dollar interest rate differential, and has also reflected the strength of portfolio and foreign direct investment inflows primarily into the high-technology sector. The strengthening sheqel and the quiescent behavior of inflation have led the Bank of Israel to cut its discount rate by 160 basis points in the four months since November 1999. These developments support the staff's view that there is scope for further gradual, cautious, cuts in interest rates.

8. **The Tel Aviv Stock Exchange (TASE) general share price index rose by 64 percent in 1999**, and reached record levels at the beginning of March 2000, before declining slightly in the wake of the recent weakness in some of the major international stock exchanges. Last year's strong performance of the TASE has been attributed to the worldwide share price boom, the Israeli economic recovery, declining inflation, and progress on the peace process. It should be noted that real estate prices have increased only modestly, and that there are no signs of a generalized asset price boom in Israel.

9. **In March the government raised US$500 million through a very successful global bond offering.** The offering, which consisted of 10-year notes that were priced at 144 basis points above 10-year U.S. treasuries, came after Moody's and Standard and Poors changed their outlook on Israel to positive from stable. The agencies attributed the improved credit rating outlook to the revitalization of the peace process, and Israel's progress in implementing structural reforms and in reducing inflation and the budget deficit.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 00/33
FOR IMMEDIATE RELEASE
April 24, 2000

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

IMF Concludes Article IV Consultation with Israel

On March 23, 2000, the Executive Board concluded the Article IV consultation with Israel.[1]

Background

Economic policies were tightened in 1997–98 in response to signs of overheating after years of rapid growth. Interest rates were raised and fiscal policy became contractionary. A tight monetary policy led to large capital inflows and a significant appreciation of the sheqel. These factors and a deceleration of immigration contributed both to an economic slowdown and to a decline in inflation from double digits to low single digits between mid-1996 and mid-1998. After a brief period of monetary easing, monetary policy was abruptly tightened again in late 1998 as the authorities sought to contain the inflationary impact of a large depreciation of the sheqel in the wake of the Russian/LTCM crisis. The response to the crisis was successful in arresting currency depreciation and managed to keep inflation on a declining trend.

After the elections held in May 1999, the renewed emphasis on the peace process contributed to greater business confidence. The Israeli economy appears to have turned the corner in 1999, with GDP growing by 5-6 percent in annual terms in the second half of the year, despite high real interest rates. However, recently released preliminary data suggest that growth may have decelerated in the last few months relative to the very rapid pace observed in the latter part of 1999, highlighting the fragility of the recovery. A strong sheqel and a significant output gap have contributed to a *decline* in inflation, which on a 12-month basis ended 1999 at 1.3 percent, significantly below its 4 percent target for the year. Unemployment has remained high, at about 9 percent of the labor force in 1998–99 compared to an average of 6–7 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. In this PIN, the main features of the Board's discussion are described.

in recent decades. An increase in the current account deficit partly reflecting stronger domestic demand was primarily financed by a surge in FDI, especially into the high-technology sector.

The operational fiscal deficit in 1999 is estimated at 2¼ percent of GDP, slightly above the budgetary target of 2 percent.[2] This small underperformance largely reflects the fact that economic growth was slightly lower than assumed in the budget. The negative impact of the 1998 sheqel depreciation on corporate income taxes also contributed to the overrun, although this factor was more than offset by a sharp increase in relatively highly taxed consumer durables imports during the latter part of the year and higher revenue from real estate sales taxes.

With the sheqel trading within very wide bands, monetary policy has been fully geared towards the inflation target. However, despite a gradual series of cuts in the Bank of Israel's discount rate, renewed confidence in the economy and the still-large gap between Israeli and foreign interest rates have put upward pressure on the sheqel in recent months, resulting in a gradual drift toward the more appreciated end of the band.

The authorities have unveiled an ambitious structural reform agenda aimed at increasing competition and creating conditions for the private sector to absorb resources released by the process of fiscal retrenchment. Yet, delays in bank and telecommunications privatization are likely to have resulted in privatization revenues that are only about one-fourth of the expected amount of NIS 4.6 billion.

The fragile economic recovery now underway is expected to strengthen over the next two years. The staff's 3.8 percent growth forecast for this year is in line with current market views and the balance of recently released indicators of economic activity. Growth is expected to be led by exports, which should strengthen given the continued development of the export-intensive high technology sector and the faster pace of expansion in the world economy. On current policies, the trend toward low inflation observed last year is expected to continue.

Executive Board Assessment

Executive Directors commended the authorities for fiscal and monetary policies in 1999 that sustained the impressive gains in disinflation and laid the basis for economic recovery. However, they observed that the envisaged shift to a broadly neutral fiscal stance in 2000 represents an unwelcome pause in the authorities' fiscal efforts. They also stressed that continued commitment to fiscal consolidation would be needed to support the desired, gradual easing of monetary policy. Directors emphasized that such a shift in the policy mix, together with a renewed emphasis on structural reforms, would create the conditions for a substantial acceleration of growth and subsequent welcome reduction in the unemployment rate.

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[2] This measure of the deficit excludes the inflation component of interest payments on domestic government debt.

While welcoming the progress the authorities had made in strengthening central government finances over the last three years, Directors recommended that the authorities adopt a conventional measure of the government budget. On this basis, the deficit is large by industrial country standards. This, together with the very high level of indebtedness, underscored the need to achieve greater fiscal consolidation in 2000 and beyond. In this regard, Directors were encouraged by the authorities' intention to reduce central government spending significantly over the medium term, and by the initiative to restrain local government outlays.

Directors considered that achievement of the inflation target should remain the paramount objective of monetary policy. Noting that inflation had declined broadly in line with the authorities' target, some Directors considered that scope may exist for further cautious and gradual cuts in interest rates, provided fiscal policy is adequately supportive. Some other Directors considered that scope for further reductions in interest rates was limited at this time, given the risk of reigniting inflationary expectations. Directors welcomed the improvements made in the monetary policy framework and considered that the Bank of Israel should further take a more prominent role in shaping the public's inflation expectations through a more comprehensive public presentation of its own analysis of prospects for inflation.

Directors noted that the exchange rate bands had served the economy well in recent years. However, a number of Directors noted that, although the exchange rate band did not constrain monetary policy in 1999, the recent strengthening of the new sheqel could take the exchange rate to the more appreciated limit of the band. They suggested that with a continued appreciation of the new sheqel, and supposing that interest rates remained on a path consistent with achieving the inflation target, the usefulness of the exchange rate bands could be reassessed with a view to their possible elimination and the establishment of a pure inflation targeting regime.

Directors encouraged the authorities to implement expeditiously the Levin Committee's recommendations, specifically by presenting to the Knesset an amendment to the Bank of Israel Law that establishes price stability as the main objective of monetary policy and that ensures the central bank's independence.

Directors observed that Israel had already scored notable achievements in promoting structural reform and praised the authorities for the initiatives to increase competition in some overregulated areas. However, they argued that the pace of change needed to be stepped up in some areas, particularly bank privatization and increasing competition within the banking sector. Directors commended the authorities for the initiative to introduce a substantial tax reform by 2001 and stressed that such a reform should remove distortions in the treatment of capital income while addressing undesirable features in the taxation of personal income. Directors expressed their support for early passage of anti-money-laundering legislation. With regard to the labor market, Directors welcomed the authorities' intention to harmonize labor market regulations for Israeli, Palestinian, and foreign workers. They stressed the importance of preserving labor market flexibility which had served the economy well, particularly in the absorption of large immigrant inflows. They suggested that increased emphasis on retraining could contribute to facilitating the transition of workers from traditional to more dynamic, high

technology sectors, and thus assist in reducing the unemployment rate. Directors commended the authorities for the success in liberalizing Israel's foreign trade and capital accounts, but noted that the existing controls on foreign investment by Israeli financial institutions distorted returns on investment and could lead to a misallocation of savings.

Directors welcomed the fact that, with an investment grade status of sovereign debt, a favorable credit rating outlook, and with declining inflation which created the scope for a reduction in real interest rates, the Israeli economy was less vulnerable to a financial crisis than in the past. Nevertheless, they emphasized that the authorities needed to continue to monitor the real exchange rate trends, conditions of access to international capital markets, the nature of external indebtedness, and the health of the banking sector. They welcomed the authorities' decision to proceed with a Financial Sector Assessment Program in 2000.

Directors praised the overall quality of Israeli economic statistics, but noted that quarterly GDP estimates were subject to large and frequent revisions, while unemployment statistics are only available on a quarterly basis. Moreover, Directors suggested that the dissemination of banking sector prudential statistics could be improved.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. As part of a pilot project, the staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 1999 Article IV consultation with Israel is also available.

Israel : Selected Economic Indicators

	1995	1996	1997	1998	1999 1/
	(Percentage change, unless indicated otherwise)				
National accounts (constant prices)					
Real GDP	6.8	4.6	2.9	2.2	2.2
Private consumption	7.9	5.4	4.2	3.6	3.0
Public consumption	-1.0	5.1	1.9	2.0	3.0
Gross capital formation	10.6	6.2	-6.8	-8.0	3.0
Exports of goods and services	8.8	6.6	7.7	6.3	9.8
Imports of goods and services	7.5	8.2	1.9	1.7	9.0
Labor market indicators					
Israeli civilian labor force	3.5	2.2	2.5	2.8	2.8
Overall employment	5.2	2.5	1.3	1.6	2.4
Unemployment rate (in percent)	6.8	6.7	7.7	8.6	8.9
Prices (end-period)					
Overall CPI	8.1	10.6	7.0	8.7	1.3
Underlying CPI (excluding housing, fruits and vegetables)	8.8	10.1	6.7	8.5	1.7
Money and credit (period average)					
Narrow money (M1)	8.4	14.9	14.3	12.1	11.4
Broad money (M3)	25.5	24.0	25.3	22.1	21.8
Net domestic credit	26.2	21.6	18.2	17.7	19.4
Interest rates (average, in percent)					
Discount rate	14.4	15.1	13.6	11.8	12.2
Nondirected credit in new sheqalim	20.2	20.7	18.7	16.2	16.5
Public finance (percent of GDP)					
Central government balance 2/	-4.1	-3.7	-2.7	-2.3	-2.3
General government balance 2/	-4.4	-5.6	-4.0	-3.6	-3.6
Public debt	109.0	107.0	106.0	111.0	112.4
Balance of payments					
Trade balance (percent of GDP)	-8.7	-7.5	-5.2	-3.3	-5.0
Current account (percent of GDP)	-6.0	-5.6	-3.4	-0.7	-1.8
Foreign reserves (end-of-period, in US$ billions)	8.3	11.6	20.3	22.7	22.5
Exchange rate and terms of trade indices					
Nominal effective exchange rate (1990=100)	-6.1	-2.7	0.2	-6.4	-7.7
Real effective exchange rate (1990=100)	0.8	5.9	7.0	-3.0	-3.8
Terms of trade (1990=100; index level)	103.1	103.6	107.3	111.5	...

Sources: Data provided by the Israeli authorities; and IMF, *International Financial Statistics.*

1/ Staff preliminary estimates, last updated on March 1, 2000. Many of these indicators have been revised since the Board discussion, in particular public debt was revised to 109 and 103 percent of GDP in 1998 and 1999, respectively, the official estimate of the general government balance in 1999 is now -4.8 percent of GDP, and the current account deficit in 1999 is now estimated at 2.6 percent of GDP.

2/ Operational concept, excludes the inflation component of interest payments on domestic government debt.

Statement by J. de Beaufort Wijnholds, Executive Director for Israel
March 22, 2000

1999 was a favorable year for the Israeli economy. Economic activity rebounded and Israel further escalated its pace of macroeconomic stability and structural reform. This stability was strengthened by the continued implementation of a prudent and responsible monetary policy combined with fiscal consolidation efforts. These policies are part of the sustained effort to achieve the economic stability which is the preferred way to promote a sustained favorable performance in a period of globalization and in accordance with the norms of most industrialized economies. Indeed, monetary policy, which has been conducted during the past few years within the inflation targeting framework, brought inflation closer to the target and acted to consolidate the inflation environment. Meanwhile, fiscal consolidation efforts also progressed in accordance with the declining trend in the budget deficit as a proportion of GDP. In the area of structural reforms, further progress was made by the government's adoption of a wide-ranging structural reform agenda, particularly by increasing competition in several previously overly-regulated sectors and through the continued sale of the remaining state holdings of several banks in 2000.

Developments in 1999 and early 2000:

In 1999, the inflation environment[1] returned to the 4 percent level prevailing before the fall of 1998 when the Bank of Israel (BoI) raised its interest rate which was one of the major factors that prevented a renewed inflation acceleration. Prices during 1999 increased by only 1.3 percent, reflecting decreases at the beginning of 1999 which partly offset the exceptional price increases at the end of 1998. With inflation returning closer to the inflation target of 4 percent set for 1999 and the relative calm in the world financial markets, the BoI eased monetary policy and starting in February 1999, consistently decreased its nominal interest rate by a total of 2.3 percentage points through December 1999. In late 1999 and early 2000, inflation declined further and reached a level consistent with the 3 to 4 percent target set for 2000 and 2001. This development enabled the continuation of the process of monetary easing at a faster pace so the BoI could further decrease its interest rates by another 1.3 percentage points during January – March 2000. If inflation persists in its current target range for a longer time, the process of reducing nominal interest rates can continue, thereby also leading to a decline in the real interest rates.

With respect to fiscal policy, the gradual but consistent fiscal consolidation underpinning the government's fiscal policy remained intact. Although the 1999 budget deficit of 2.25 percent of GDP slightly exceeded the government's 2 percent target, the deficit not only was lower than the revised projected deficit but also continued its declining trend as in previous years.

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[1] As based on the combination of actual inflation, inflation forecasts from several banks and other independent private forecasters, and the expected inflation as derived from capital market indicators.

Following the authorities' appropriate response to the recent world financial crises in the fall of 1998 and the liberalization of capital flows in May 1998, Israel successfully became integrated into the global economic and financial systems. Israel withstood the world financial crises by continuing its strategy of non-intervention, a free-floating exchange rate and a prudent monetary policy. In 1999, this strategy not only restored the tranquility of Israel's financial markets, contributed to safeguarding the lower inflation rate already achieved in early 1998 and created a real depreciation, but also significantly enhanced credibility and improved the effectiveness of its monetary policy. Foreign direct investment increased rapidly reaching an all time high, while Israel's credit rating has been stable since 1995 with Moodys and S&P granting a positive outlook last month. The number of foreign banks and financial institutions grew, with Citibank and Merrill Lynch opening branches in Israel and Intel making its largest cash acquisition. In the area of the monetary policy framework, this strategy led to: a shorter period for monetary policy transmissions; a less automatic pass-through from exchange rate changes into prices; a greater accounting by firms of exchange rate risk thereby allowing the monetary authorities to focus on the inflation consequences of exchange rate changes; and enhanced integration of the inflation targeting regime within the public.

These favorable developments, in particular the strengthened macroeconomic stability and the increased outward-looking nature of the economy in addition to the already low current account deficit, the real depreciation that occurred and Israel's sound banking system, have made the Israeli economy fundamentally ready to execute both a lasting renewed growth of output commensurate with its potential and an increase in employment. Developments during the year showed an upturn from the earlier downward trend, in spite of the current attitude of cautious monetary easing. Economic activity has rebounded strongly as expressed by GDP growth from the second half of 1999 and by the expansion in industrial production. This expansion has been driven by domestic demand and non-residential investment. In this regard, the continued increasing trend of hi-tech exports to a peak of 70 percent of industrial exports in 1999 should also be mentioned. Moreover, according to preliminary figures, the demand for workers increased substantially in the last quarter of 1999 and the number of workers employed full time grew markedly, while the number of those employed part time decreased. Because employment is an economic indicator that responds with a lag to economic changes, employment will further increase in the near future.

Policies in year 2000:

Looking ahead, the authorities are determined to continue their cautious macroeconomic policy directed at bolstering their achievements in economic stability. They recognize that in order to sustain and strengthen the nascent economic recovery and increased employment, a macroeconomic policy that is based on long-term considerations is the appropriate approach. The authorities' continued commitment to this long-term approach is reflected in the year 2000 guidelines underlying the fiscal, monetary and structural reform policies.

Fiscal Policy

In light of the slight further decrease in the deficit in 1999 as a percentage of GDP, the government intends in 2000 to use revenues exceeding projections to further reduce the deficit in order to achieve greater progress on the budgetary front than required by the Budget Reduction Law which defines the deficit at its maximum level permissible.

The budget for the year 2000 aims to promote economic activity based primarily on the achievements of the business sector and a reduced government share in the economy through a continued gradual reduction of the budget deficit, government expenditures and government debt as a share of GDP. It also includes a reduction in the current expenditures and increases in investment outlays in the transportation infrastructure by a total of 40 percent, compared to 1998. These investments will be allocated for intensified investment in roads, railways, and public transportation. Additionally, the government plans to rationalize the tax system through extensive reforms by broadening its tax base both to bolster revenue and to improve income distribution. The public committee appointed to deal with this issue is expected to finalize the details at end-April.

Monetary Policy

In the year 2000 and onward, monetary policy will continue to be committed to meeting the inflation target set by the government as part of the authorities' approach to gradually lowering the rate of inflation to the levels of most industrialized countries. The inflation target of 3 to 4 percent set for the years 2000 and 2001 is meant both to achieve further progress towards price stability and to solidify the accomplishments of the last few years in the fight against inflation.

The BoI sees scope for a continued reduction in its interest rate only if the inflation environment for the coming two years remains consistent with its 3 to 4 percent target range for the years 2000 and 2001. The combination of a prospective continued reduction in nominal interest rates and the continued current inflation environment at its target range constitute the preferred setting for the process of lowering real interest rates and thereby this combination is the only way in which monetary policy can increase its support of economic activity.

Monetary policy is being eased while taking into account the existing risks to the inflation outlook that consist of: (1) the remaining uncertainty on the inflation and financial sector fronts regarding a possible abrupt change in the composition of the assets and liabilities portfolio held by the public, especially in view of the continued trend of increasing interest rates worldwide, (2) the risk generated from potential budget overruns and possible excessive wage increases, and (3) the continuing existence of a high inflation culture which indicates that the risk of exceeding the inflation targets is still greater than the downside risk. Firmly establishing inflation in its target range requires adjustments in economic decisions in various areas over a long period of time, particularly in the area of wage policy, the setting of prices apart from indexation considerations, the adjustment of accounting procedures and the composition of the public's portfolios.

On monetary policy and economic recovery, Staff indicates that the economy has "turned the corner..(para. 4 of the Staff report)" and is now growing at 4 to 5 percent. Yet, in para. 19, Staff feels that "the still-fragile state of the economic recovery" and other factors demonstrate the need for a more ambitious, but still gradual, approach to reducing interest rates. The BoI believes that the easing of monetary policy also has to now ensure that the recovery does not exert pressures on the inflationary outlook.

The BoI has further improved its monetary policy framework. It has based its decisions for interest rate changes on a wide spectrum of economic indicators. It has assessed the expected inflation rate for 2000 and 2001 by analyzing different inflation forecasts for one year and beyond, based on a multiple indicator approach. Only developments in those indicators that affect the assessment of the expected inflation rate for the year ahead and beyond are relevant for the purpose of deciding interest rate changes. The relevant multiple indicators consist of the growth rate in M1, exchange rate developments, inflation expectations as derived from the capital markets, price trends abroad, fiscal developments and the economic activity level.

The BoI has also further increased its monetary policy transparency. In addition to the publication of a bi-annual inflation report, it has initiated the publication of the inflation expectation figures which it uses in its decisions. Moreover the BoI in its recent monetary policy announcements, indicated its path for the interest rate and highlighted its interest rate benchmark. These will enhance the ability of the public to form its outlook on inflation, better envision the interest rate path and predict the prospective monetary policy response. Given credible targets and policies, the inflation target and the point estimate of the inflation outlook are by definition identical in a country, such as Israel, adopting an inflation targeting regime. Thus publishing an inflation outlook which differs from the target contradicts the essence of the regime because a deviation between the two should prompt a respective policy reaction to correct it and ensure that the target is met. The possible exception to this statement is a case where the time frame is too short to correct an apparent deviation. Therefore the authorities' inflation outlook over a time frame that allows for policy action is the inflation target and the only way "the BoI could take a more prominent role in the formation of the public's outlook on inflation ... (para. 22 of the Staff report)" is by its continued adherence to meeting the government's inflation targets and through its consequent enhanced credibility.

As Staff has suggested "that the inflation target horizon should be lengthened ..." (para. 20 of Staff report), the horizon of the explicit inflation target from its length of one year to 2 years was extended as in other countries. Although this extension does not change the aim that inflation target should be met for years 2000 and 2001, it further improves the way monetary policy reacts to target deviations, as compared to the one year horizon. Under the extended horizon, a deviation of inflation from its target could prompt a more gradual monetary policy reaction because of the increased credibility that the extended horizon target offers, namely by more strongly anchored inflation expectations over a longer time horizon. In this respect, it should also be mentioned that the government's decision on the target was made an integral part of its fiscal policy decisions for the first time.

The government could further improve the monetary framework by reaffirming the operational autonomy of the BoI in a spirit similar to recent central bank legislation in other

countries. Comprehensive amendments to the current central bank law should be along the lines recommended by the Levin Committee, particularly, emphasizing operational independence as the primary objective of monetary policy and ensuring that the suggested Monetary Policy Commission consist of experts free of political interference or other potential conflicts of interest.

Structural reforms

One of the major objectives of structural reform in Israel is the promotion of higher growth and lower inflation by enhancing the role of the private sector in the economy through increasing competition, improving economic efficiency and accelerating privatization. After successfully implementing reforms in recent years, further progress will be made in this area in the year 2000. The government intends to implement a wide-ranging structural reform agenda in various principal sectors as detailed in para. 26 of the Staff report. The momentum of privatization will continue. The main privatization initiatives include disposing of the remaining state holdings in several banks in the year 2000. The degree of concentration in the financial system will be further reduced particularly through the breakup of the large banking groups and other provident and mutual funds under their control leading to a more competitive environment which will also induce more foreign banks to open branches in Israel.

The banking system in Israel is sound and healthy. Following the exchange rate depreciation in the fall of 1998, banks and their customers have substantially increased the hedge on their foreign currency exposure. At the same time the BoI further enhanced its prudential supervision. It made the reporting requirements on credit denominated in foreign currency more stringent, and in early 1999 it increased the minimum capital adequacy ratio from 8 percent to 9 percent. At end-1999, the actual average ratio held by the five major banking groups was well above the minimum required by regulation.