INTERNATIONAL MONETARY FUND

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ISRAEL

September 2015

2015 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR ISRAEL

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2015 Article IV consultation with Israel, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its September 4, 2015 consideration of the staff report that concluded the Article IV consultation with Israel.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on September 4, 2015, following discussions that ended on June 24, 2015, with the officials of Israel on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 15, 2015.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Statement** updating information on recent developments.
- A **Statement by the Executive Director** for Israel.

The documents listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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INTERNATIONAL MONETARY FUND

COMMUNICATIONS DEPARTMENT

Press Release No. 15/415
FOR IMMEDIATE RELEASE
September 16, 2015

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

IMF Executive Board Concludes 2015 Article IV Consultation with Israel

On September 4, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Israel.

Israel's economy has been doing well and near-term growth prospects are favorable. Following growth of 2.6 percent last year, the economy is expected to expand by around 2.5 percent this year and 3-3.3 percent each year in the medium term. Employment creation has been remarkable—growing by 3.5 percent annually—and unemployment is at multidecade lows. Inflation has been negative, but this reflects temporary external factors and not domestic weakness. Risks are balanced, and the real exchange rate is broadly in line with fundamentals.

The central government met the original deficit target of 2.8 percent of GDP in 2014. However, the government raised the deficit targets for 2015 and 2016 to 2.9 percent of GDP for both years (almost 4 percent of GDP based on international accounting standards), compared with 2.5 and 2.0 percent of GDP previously. Debt has declined to 67 percent of GDP from a peak of 94 percent of GDP in 2003 but is expected to increase for the first time since 2009, following the upward revisions to the deficit targets.

The central bank kept interest rates on hold in August, as inflation is expected to return to the target band next year. Housing prices continue to increase by around 4 percent year-on-year, owing largely to supply constraints. In response, the government has announced a variety of initiatives to boost housing supply. Macroprudential measures have been successful in containing the increase in household leverage and household credit to GDP has remained low at around 40 percent of GDP compared to other advanced economies.

Labor productivity growth and levels are low, weighing on growth prospects, and income inequality is among the highest in advanced countries. Acknowledging the challenges to medium-term growth and poverty, the new government has prioritized boosting competition in

[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.

several sectors and better integrating the rapidly growing Israeli-Arab and Ultra-Orthodox Jewish (Haredi) populations into the labor force.

Executive Board Assessment[2]

Executive Directors welcomed Israel's recent strong economic performance and the favorable near-term outlook. Directors agreed that the main policy challenges ahead relate to reinforcing the foundations for lasting and inclusive growth by bolstering fiscal buffers, mitigating housing market risks, increasing labor productivity, and reducing income inequality.

Directors emphasized the importance of strengthening the fiscal framework. Most Directors noted that sustained budgetary consolidation, consistent with the Deficit Reduction Law, is needed to place the debt-to-GDP ratio on a downward path and broaden fiscal space. At the same time, a number of Directors considered appropriate a path of fiscal adjustment not unduly frontloaded. To achieve the deficit targets, Directors encouraged the authorities to consider a mix of revenue and expenditure measures, emphasizing particularly the need for stronger commitment control of multi-year projects.

Directors noted that headline inflation is currently below the Bank of Israel's target, but agreed that no monetary easing is needed at this point, as low inflation is largely imported and likely to be temporary.

Directors noted the social and financial risks arising from the continued rise in housing prices. They welcomed the government's intention to boost supply through various measures, and encouraged continued use of macroprudential policies to contain household leverage. Close monitoring of the financial sector's exposure to the housing market is also warranted. In this regard, Directors recommended the prompt establishment of the Financial Stability Council to help coordinate macroprudential policies across sectors. Timely adoption of the amendment to the Banking Ordinance to enhance the crisis resolution framework would also be important.

Directors concurred that increasing labor productivity growth remains a policy priority. In this context, they welcomed the authorities' plans to boost competition in several sectors, although they highlighted that banking sector reforms should remain mindful of financial stability concerns. Directors also called for efforts to address infrastructure gaps, reform the product market, improve education, and ease business constraints.

Directors noted that reducing inequality will require concerted efforts from government agencies, stakeholders, and communities. They agreed that boosting labor force participation rates of the Haredi and Arab-Israeli populations is essential—both to reduce poverty rates and safeguard Israel's long-run growth potential.

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[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Israel: Selected Economics Indicator[1]

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
					Prel	Projections					
Real Economy (percent change)											
Real GDP	5.5	5.0	2.9	3.3	2.6	2.5	3.3	3.2	3.0	2.9	2.9
Domestic demand	5.2	5.4	3.4	3.4	3.1	4.6	3.4	2.9	2.8	2.7	2.7
Private consumption	4.8	3.4	2.2	3.9	3.7	4.6	3.3	2.8	2.6	2.5	2.5
Public consumption	2.5	2.4	3.7	4.0	3.3	2.2	3.4	3.0	3.0	3.0	3.0
Gross fixed investment	10.0	14.6	3.6	3.6	-2.0	-1.5	3.2	4.4	4.4	4.4	4.4
Foreign demand (contribution to growth)	0.3	-0.3	-0.5	-0.1	-0.5	-2.0	-0.2	0.3	0.1	0.1	0.1
Potential GDP	3.9	3.6	3.3	3.2	3.1	3.0	3.0	2.9	2.9	2.9	2.9
Output gap (percent of potential)	-0.6	0.8	0.4	0.4	-0.1	-0.6	-0.4	-0.1	0.0	0.0	0.0
Unemployment rate (percent)	8.3	7.1	6.9	6.3	5.9	5.3	5.2	5.2	5.2	5.2	5.2
Overall CPI (percent change, end of period)	2.7	2.2	1.6	1.8	-0.2	0.7	2.2	2.0	2.0	2.0	2.0
Overall CPI (percent change, average)	2.7	3.5	1.7	1.5	0.5	-0.1	2.0	2.1	2.0	2.0	2.0
Saving and investment balance											
Gross national saving (percent of GDP)	21.8	22.5	22.5	23.2	24.3	25.3	25.4	25.2	24.8	24.6	24.7
Foreign saving (percent of GDP)	-3.6	-2.3	-1.5	-3.0	-4.3	-4.6	-4.7	-4.4	-4.0	-3.9	-3.9
Gross fixed investment (percent of GDP)	18.2	20.2	21.0	20.2	19.9	20.7	20.7	20.7	20.8	20.8	20.8
Public Finance (percent of GDP)											
Central government											
Revenues and grants	25.4	25.7	24.7	25.6	25.9	25.8	25.8	25.8	25.8	25.8	25.8
Total expenditure	28.9	28.6	28.7	28.9	28.7	28.7	28.8	28.8	28.8	28.8	28.8
Overall balance	-3.5	-2.9	-4.1	-3.3	-2.8	-2.9	-3.0	-3.0	-3.0	-3.0	-3.0
Cyclically adjusted primary balance 2/	-0.5	-0.5	-1.6	-0.7	0.0	-0.1	-0.2	-0.3	-0.3	-0.3	-0.3
General Government											
Overall balance	-4.6	-3.9	-5.1	-4.1	-3.6	-3.7	-3.8	-3.8	-3.8	-3.8	-3.8
Debt	70.6	68.8	67.9	67.2	67.1	67.2	67.2	67.8	68.6	69.4	70.1
Of which: Foreign currency external debt	11.8	11.8	10.7	9.5	9.7	10.9	11.7	12.4	12.9	13.0	12.9
Balance of Payments (percent of GDP)											
Exports of goods and services 2/	35.0	36.1	36.9	33.2	32.3	28.0	27.7	28.0	28.3	28.5	28.7
Real growth rate (percent)	15.0	8.9	0.9	0.1	1.5	-4.6	4.4	5.5	5.0	5.0	5.0
Imports of goods and services 3/	32.8	35.4	35.6	31.4	30.6	25.7	25.3	25.8	26.3	26.5	26.6
Real growth rate (percent)	15.0	10.4	2.3	0.5	3.0	1.3	4.8	4.5	4.5	4.5	4.5
Goods and services balance	2.3	0.4	0.9	2.0	1.8	2.3	2.4	2.2	2.0	2.0	2.1
Oil imports (billions of U.S. dollars)	10.5	13.6	16.1	14.6	12.8	7.0	7.1	8.0	8.9	9.5	9.9
Current account balance	3.6	2.3	1.5	3.0	4.3	4.6	4.7	4.4	4.0	3.9	3.9
Foreign reserves (end of period, billions of U.S. dollars)	70.9	74.9	75.9	81.8	86.1	88.7	89.5	90.3	90.3	90.3	90.3
Exchange Rate											
NIS per U.S. dollar	3.7	3.6	3.9	3.6	3.6	...	...	...	...	...	...
Nominal effective exchange rate (2005=100)	100.0	101.1	97.1	104.1	106.4	...	...	...	...	...	...
Real effective exchange rate (2005=100)	100.0	101.2	96.2	102.5	103.4	...	...	...	...	...	...

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

1/ Incorporates updated data and projections compared to the staff report.

2/ Percent of potential GDP.

3/ National Accounts data.

INTERNATIONAL MONETARY FUND

ISRAEL

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

July 15, 2015

KEY ISSUES

Context. Israel came through the crisis relatively well, and unemployment has continued to fall to multi-decade lows. But policy makers are confronted with several challenges. The fiscal deficit remains stubbornly high, leaving limited buffers to respond to shocks. Inflation is negative—well below the Bank of Israel's (BOI) target—but housing prices continue to rise, posing financial sector risks. Labor productivity is low and the gap relative to the US is widening. And income inequality is among the highest across all advanced countries.

Policy recommendations

- **Fiscal policy.** The fiscal deficit needs to be reduced to bring debt firmly on a downward path and build fiscal space. A stronger medium-term framework, with an explicit revenue and expenditure plan consistent with the deficit target, is critical.
- **Monetary policy** can be put on hold, as inflation is expected to return to the target band next year. Currently negative inflation is imported and does not reflect domestic weakness.
- **Housing market policy**. Boosting the supply of housing is critical to contain housing price increases, and concerted efforts among relevant ministries and local governments are needed. Macroprudential measures should be the first line of defense against housing-related risks to financial stability.
- **Financial stability.** The financial system appears sound, but risks emanating from exposure to real estate and construction should be carefully monitored.
- **Structural reforms**. Employment growth has been strong, but labor productivity and TFP growth have been very low. Boosting competition, improving infrastructure, and better integrating the rapidly growing Israeli-Arab and Ultra-Orthodox Jewish (Haredi) populations into the labor force will help boost growth and reduce income inequality.

Approved By

P. Gerson and B. Traa

The 2015 Article IV discussions were held in Jerusalem and Tel Aviv during December 3–15, 2014 and June 17–24, 2015. The December team comprised Mr. Bakker (Head, EUR), Mr. Ishi, Ms. Bordon, Mr. Semmelmann, Mr. Thegeya (all EUR), and Ms. Mineshima (FAD). The June team consisted of Mr. Bakker, Ms, Bordon, Mr. Chen (EUR) and Ms. Mineshima (FAD). Ms. Denis and Ms. Jung (both EUR) contributed from headquarters. Mr. Yakhin (OED) attended most meetings. Mr. Snel (OED) attended the concluding meeting. The mission met with Finance Minister Kahlon, Bank of Israel Governor Flug, representatives of the Prime Minister's Office, other senior officials, academics, head of the trade union, and private sector representatives.

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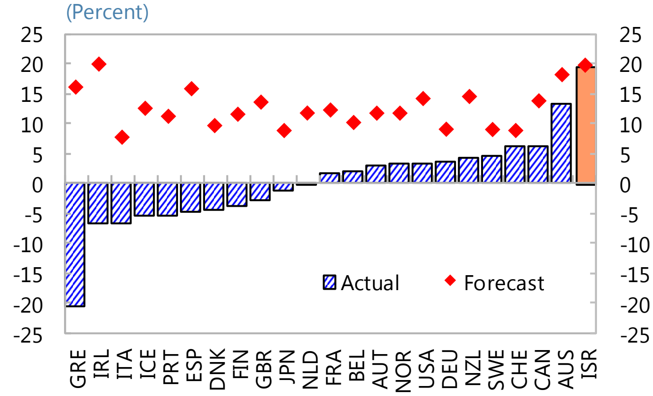
CONTEXT

1. **Israel is a small open economy, well-integrated in the world economy through trade and capital market channels.** Israel's exports account for one third of GDP, with the United States, Europe and emerging Asia its major trade partners. Israel has strong comparative advantages in the high-tech industry, which accounts for more than 40 percent of total manufacturing exports, but economy-wide labor productivity is low, and the poverty rate is among the highest in the OECD.

Real GDP Growth: Forecast vs. Actual, 2007–12
(Percent)

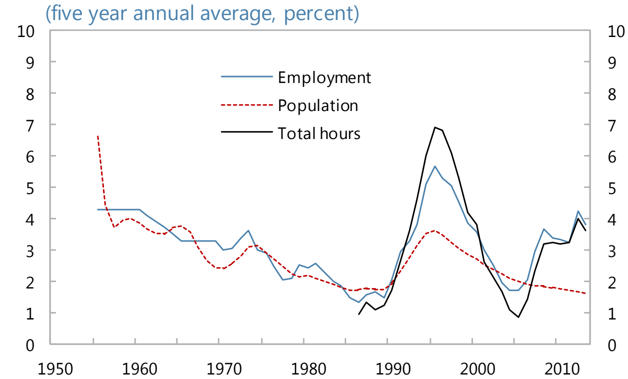


Source: WEO database, October 2007 and October 2014.

2. **Israel was less affected by the 2009 crisis than many other countries,** in part due to the absence of pre-crisis asset and lending booms. It is the only advanced economy where growth has *exceeded* pre-crisis WEO projections (Figure 1).

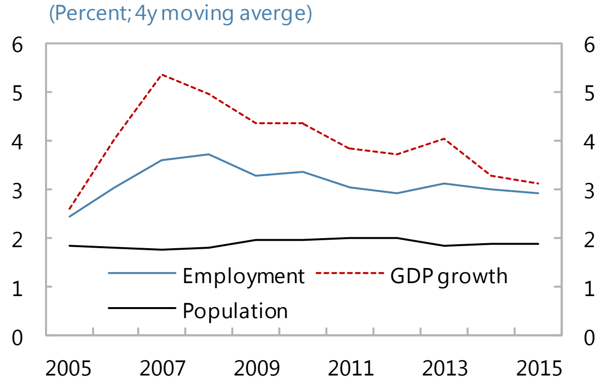
3. **Unemployment has continued to decline**, to 5.3 percent in 2015Q1—a multi-decade low. Thus continues the Israeli employment miracle: in the past 25 years, employment has grown by 3½ percent *annually*.[1]

Employment and Population Growth
(five year annual average, percent)



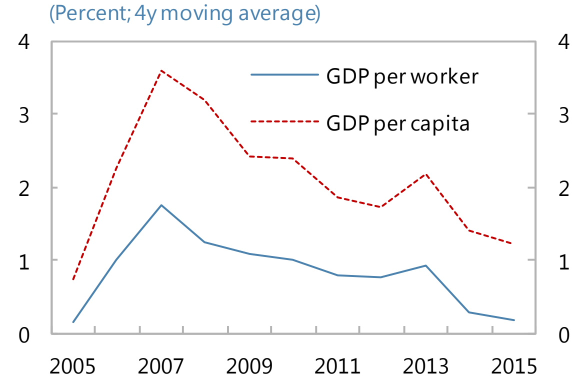
Sources: Total Economy Database; Central Bureau of Statistics; and Haver Analytics.

Israel: Employment, Population, and Growth
(Percent; 4y moving averge)



Sources: Central Bureau of Statistics; and IMF staff calculations.

Israel: GDP per worker and GDP per capita
(Percent; 4y moving average)



Sources: Central Bureau of Statistics; and IMF staff calculations.

[1] By comparison, average annual employment growth in the US during 1990–2014 was 1.2 percent; for the Euro area 0.5 percent (1991–2014).

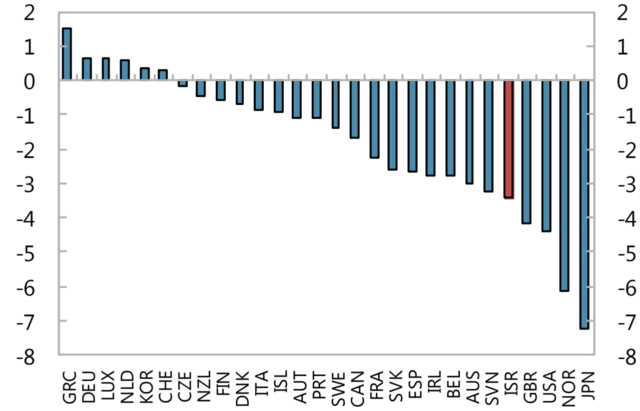
4. Growth has slowed in recent years to around 3 percent. Both potential and actual growth have slowed—the latter held back by sluggish partner country growth, the strong shekel and—in 2014—the conflict in Gaza (Figure 2 and Table 1). In per capita terms, growth is about 1 percent.

5. Policy makers are confronted with several problems:

- **Despite relatively high growth post-crisis, Israel has one of the highest structural fiscal deficits in the OECD.** Repeated upward revisions to fiscal targets have delayed progress in deficit reduction.

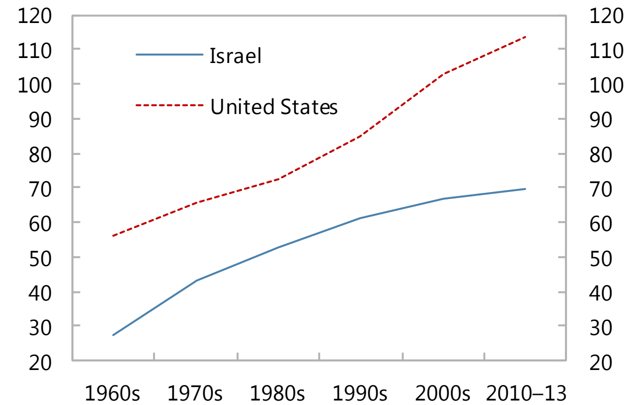
- **Inflation is negative, but house prices keep soaring**. Over the past 3 years, the BOI has cut the monetary policy rate from 3.25 to 0.10 percent. Low energy prices and an appreciating shekel have dampened inflation, although recent data showed an uptick in inflation and inflation expectations. Low interest rates have contributed to a housing price boom, with prices nearly doubling since the beginning of 2007.

Structural Balance in 2014
(Percent of Potential GDP)



Source: IMF's Fiscal Monitor Database, April 2015.

Labor productivity
(Real GDP per worker in US$ thousands; period average)

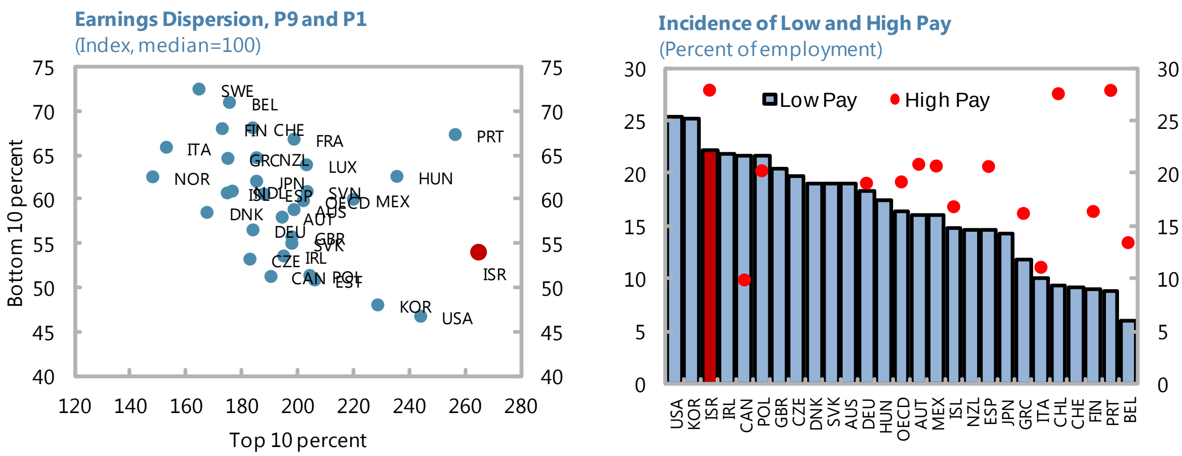


Source: Total Economy Database.

- **Labor productivity is low and the gap relative to the United States is widening.** Productivity will come under further pressure from the rapidly rising share in the population of the Haredi and Israeli Arabs—groups with generally lower-than-average education levels.

- **Income inequality is high**. This reflects both high inequality of *labor*-income, with a high share of both high-paying and low-paying jobs relative to other countries; as well as less *redistribution* through the tax/transfer system than in other countries. Poverty is concentrated among the Israeli-Arab and Haredi populations, which have lower labor force participation rates, less education, and larger families, but even among the non-Haredi Jews, income inequality is higher than in almost all advanced economies.

Israel: Earnings Dispersion



Sources: OECD; and IMF staff calculations.

6. Traction of Fund policy advice. Many policy actions have been in line with Fund advice, including the BOI policy of keeping monetary policy accommodative while tightening macroprudential policy to contain a build-up of risk in the housing market and efforts to increase the labor force participation of the Haredi and Arab-Israeli populations. The record on fiscal policy advice has been weaker, with repeated adjustments of fiscal targets. In the area of financial sector policy, the establishment of a Financial Stability Committee (FSC) as recommended in previous Article IV consultations has yet to materialize.

OUTLOOK

7. Staff expects growth of 3 percent in 2015, as rapid employment growth, falling import prices, and near-zero interest rates boost private consumption (Table 1). Weak partner country growth and strong demand for imports continue to weigh on net exports in the near term. The output gap is near zero, and inflation is projected to recover to around 0.7 percent at the end of the year. Beyond 2015, medium-term growth is projected at around 3–3¼ percent a year—in line with potential GDP growth.

8. Risks to the outlook are balanced. *External* downside risks include disappointing growth in Israel's trading partners, geopolitical tensions in the Middle East, and a renewed appreciation of the shekel resulting from a longer episode of loose monetary policy in large advanced economies. In this context, prospective US monetary tightening could actually help Israel, as it would likely diminish re-emerging appreciation pressures on the shekel, especially if it reflects stronger growth prospects in the United States. Contagion from Greece is likely to be limited, as there are few financial and trade links. *Domestic* risks include a housing price bust, which could affect growth and financial system stability. Upside risks include a faster- and stronger-than-expected recovery in the global economy and a further increase in natural gas investment (Annex I).

The authorities' views

9. The authorities' views on developments and risks were very similar to staff's. They had become more optimistic in recent months on near-term growth and noted that it was increasingly domestically-driven, with strong private consumption growth and relatively weak exports and investment. They estimated potential GDP growth at around 3 percent and thought that the output gap was small. It was difficult to determine the NAIRU, but it had likely been trending down: in the past ten years there had been a sharp increase in participation and a drop in unemployment. They did not believe that global market turmoil would lead to capital *outflows*—past episodes had been associated with safe haven *inflows*. In this context, they noted Israel's strong external position, with current account surpluses and large reserve buffers. In any event, with the financial sector largely domestically financed, they agreed that capital outflows would likely support growth through a weaker shekel.

10. They agreed with the key policy challenges, which include strengthening the economy's resilience to shocks, increasing medium-term growth, and integrating the Haredi and Israeli-Arab populations. They remained committed to reducing fiscal deficits but noted the need to increase investment on infrastructure and education to close the productivity gap with other advanced economies. They recognized the impact of low interest rates on housing prices and welcomed recent indication of easing downward pressures on inflation. On the housing market, they have initiated programs to ease supply constraints. They shared staff's view that potential growth will come under pressure as the share of the Haredi and Israeli Arabs in the population rises rapidly in the near future.

POLICY DISCUSSIONS

A. Fiscal Policy

Israel's fiscal deficit is too high, but reducing it has been challenging, in part because deficit reduction plans have been deferred repeatedly. The new government, facing spending pressures and desiring to keep tax rates low, needs to avoid following past patterns.

Background

11. Israel has a high, structural, and persistent fiscal deficit.

- By international accounting standards, the central government fiscal deficit[2] is almost 1 percentage point higher than the 2½–3 percent reported.[3]

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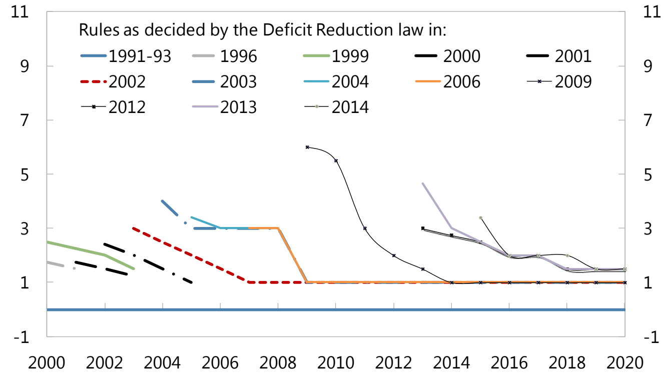
[2] The main difference between the general government and central government deficit is the treatment of interest payments on CPI-indexed bonds. In the general government deficit they are—consistent with international accounting—included *above* the line; in the central government deficit *below* the line. Local governments maintain close to balanced budgets.

[3] In Israel, the inflation compensation of indexed bonds is reported below the line, even though it adds to the debt.

- Israel's deficit is structural. The current deficit originates from tax cuts between 2003 and 2010 that were not offset by sufficient expenditure reductions.[4] It does not reflect cyclical weakness; the output gap is near zero, and employment growth has been strong.

- Efforts to reduce the deficit have repeatedly been deferred. In *theory*, Israel has an expenditure rule and a deficit rule underpinned by a debt target, but they have been revised so often that in *practice* there is no effective fiscal anchor. The deficit ceiling has been revised twenty times since 1991; the expenditure ceiling has been revised 6 times since 2004.

Israel - Central Government Deficit Target Adjustments
(Percent of GDP)



Sources: MoF, Brender (2013), IMF (2014), IMF (2015)

12. This pattern was set to repeat itself last year, but politics got in the way. Planned upward revisions of deficit targets for 2014–18 were interrupted by the fall of the government and early elections. As a result, despite an unpredicted large spending need for Operation Protective Edge (1 percent of GDP in total, of which 0.7 percent of GDP was covered in 2014), the central government deficit met the original target in 2014 (2.8 percent of GDP).

13. The 2015 budget will only be adopted by parliament in November. Until then, monthly expenditure limits are governed by the "1/12-rule"—monthly spending cannot exceed one twelfth of the 2014 budget including debt service (plus inflation). As debt repayments are projected to be much lower this year, the ceiling is not very binding, and spending is expected to grow in line with GDP growth. Overall, the deficit is expected to stay around 2.8 percent of GDP this year, exceeding the target stipulated in the Deficit Reduction Law (2.5 percent of GDP) (Tables 4–5).

Policy discussions

14. The fiscal deficit needs to be reduced. Current levels leave few buffers to deal with shocks, such as a housing price correction, renewed conflicts, or a sharp recession. The debt ratio has practically stabilized after a period of decline and will begin to rise again if deficits are not reduced. The DSA shows that under the baseline, debt would increase gradually to 69 percent of GDP by 2020, while under a growth-shock or sharp housing correction scenario, it could rise well above 75 percent of GDP by then (Annex II).

15. Reducing the deficit will be a challenge. Under the current law, the deficit should be reduced to 2 percent of GDP next year and 1½ percent of GDP in 2019 (on national standards). Achieving these targets would go a long way towards addressing the fiscal problem, with the debt ratio converging to 50 percent of GDP over the longer term. This will, however, require substantial efforts.

[4] Since 2007, the expenditure-to-potential GDP ratio has declined by 2½ percentage points—not enough to offset the decline in revenue-to-GDP ratio (5 percentage points).

- Measures of around 1 percent of GDP will be needed to stick to the current expenditure ceiling. This is because planned initiatives in the coalition agreement and previous commitments would raise spending above the current ceiling.
- Moreover, even if the expenditure ceiling is met, it is not tight enough to bring about the desired deficit reduction. The real growth rate of the expenditure ceiling (around 2.6 percent) is barely below the growth rate of real GDP (3 percent), implying only a modest drop in the spending ratio.[5]

16. This challenge should be addressed upfront, and not put off to the future. Staff advocated for an explicit revenue and expenditure plan for the entire 2016–20 period, consistent with the deficit targets:

- Without a mechanism to ensure that multi-year spending commitments are in line with the expenditure ceiling, the expenditure ceiling will likely need to be revised up. Thus, commitment control of new multi-year projects needs to be strengthened through, *inter alia*, enhancing top-down budgeting, undertaking spending reviews, and improving cost estimates of multi-year projects.
- To achieve the desired deficit reduction, either the expenditure ceiling should be lowered sufficiently to attain the deficit target, or, alternatively, commensurate revenue increases should be explicitly planned.

17. Policymakers need to decide how to reduce the deficit. Consolidation measures should have the minimum possible impact on growth—suggesting in general a preference for cutting current over capital spending and towards indirect rather than direct taxes—and reflect areas where revenues are low or spending is high relative to comparator norms (Figure 3). While civilian spending is low in Israel compared to other advanced economies, there is likely still scope for efficiency gains in both defense and non-defense spending (for example, through better targeting of social benefits). Tax expenditures are also relatively high. Thus, the authorities should consider a mix of revenue and expenditure measures to achieve the deficit targets.

18. Next year's budget should take an important first step in reducing the deficit. The 2015 budget will likely be passed only in November—too late to introduce new measures. As the fiscal deficit for this year is likely to exceed the deficit target in the current law (2¾ percent of GDP rather than 2½ percent), reflecting a boost in defense spending, the original target for 2016 (2 percent of GDP) may no longer be feasible. Nevertheless, the deficit in 2016 should be brought down by at least half a percent, equivalent to the reduction envisaged in the Deficit Reduction Law.

[5] The real expenditure growth target under the latest expenditure rule is calculated by the population growth rate in the preceding 3 years (about 1.8 percent) plus the ratio of 50 (reflecting the long-term debt-to-GDP ratio target) to the actual debt-to-GDP ratio in the previous year.

The authorities' views

19. The authorities intend to reduce the deficit gradually, but not at the pace indicated in the Deficit Reduction Law. They emphasized that Israel's fiscal position is significantly stronger than a decade ago, when debt was above 90 percent of GDP and the general government deficit around 7½ percent of GDP. They think that accommodating high-priority growth-enhancing spending (e.g., education, key infrastructure projects) is important and justifies amending the Deficit Reduction Law to slow the pace of fiscal consolidation.

20. Views differed on the composition of fiscal adjustment. The Ministry of Finance (MoF) noted that while the level of civilian expenditures in Israel is relatively low compared to other OECD countries, economic "outcomes" associated with such spending are high, as evidenced by low mortality and high life expectancy. In addition, they argued that there remains further scope for improving government efficiency and reducing administrative spending without lowering social and welfare spending. Accordingly, the MoF indicated that fiscal adjustment should come mainly from expenditure cuts, but did not preclude revenue mobilization efforts including broadening the tax base by rationalizing tax exemptions and introducing new taxation (e.g., estate tax). By contrast, the BOI was more cautious about reducing the size of the civilian budget and emphasized the scope for revenue gains from rationalizing tax exemptions.

21. The authorities plan to undertake steps to strengthening the medium-term fiscal framework. The MoF intends to prepare a fiscal policy statement prior to the publication of the upcoming budget, including the size of the consolidation needs in the medium term with possible measures to satisfy the need. In addition, they aim to initiate spending reviews in the coming year.

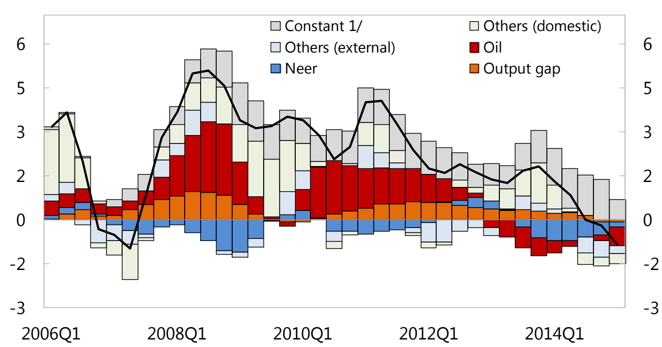
B. Monetary and Exchange Rate Policies

While inflation is currently negative, this does not reflect domestic weakness. The tapering off of the energy price declines, the lagged impact of the shekel depreciation in the second half of 2014, and strengthening of the domestic economy will likely bring inflation back to the target band in 2016. The shekel is broadly in line with fundamentals.

Background

22. Inflation is currently negative—well outside the BOI's target band of 1–3 percent (Figure 4–5)**.** Low inflation is in large part imported, the result of low inflation in partner countries, the appreciation of the shekel (between the summer of 2012 and the summer of 2014, the shekel appreciated by 17 percent in nominal effective terms) and the drop in oil prices.[6]

Israel: Contribution to CPI Inflation
(Percentage points)



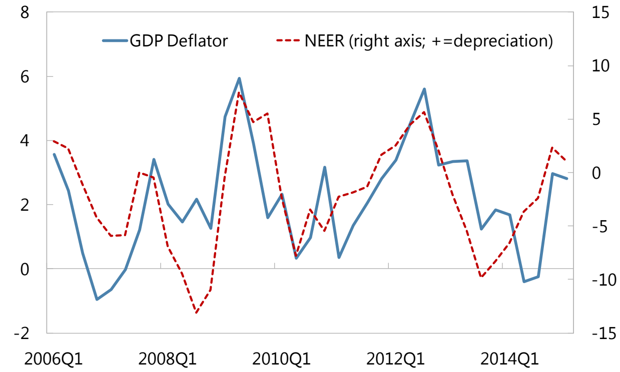
Sources: Bank of Israel; Haver analytics; and IMF staff calculations.
1/ The constant term includes the constants in the regression framework and any insignificant external factors. "Other domestic" are the residuals and base effects from the core and expectations equations, while "Other external" are the base effects and residuals from the non-core inflation equation. See SIP on Low Inflation in Israel -Should We Worry About It?

[6] See SIP on Low Inflation in Israel—Should We Worry About it?

23. The BOI has reduced policy interest rates by 2.4 percentage points since mid-2012 to 0.1 percent in March 2015.[7] Two interest rates cuts in August and September 2014 halted the appreciation of the shekel, and triggered a sharp depreciation against the US dollar. When the shekel rebounded in early 2015, the BOI reduced policy rates once more. The BOI has also intervened in the foreign exchange market aiming to smooth excess volatility.

Israel: GDP Deflator and NEER

(Percent; Y/y change)



Source: Haver Analytics.

Policy discussions

24. Even though inflation is currently outside the band, in staff's view no further monetary easing is needed at this stage.

- Staff analysis suggests that inflation will likely return to within the target band next year. A Philips curve model confirms that the growth pick-up, the shekel depreciation since last summer, and tapering energy price declines will bring inflation back to within the band.

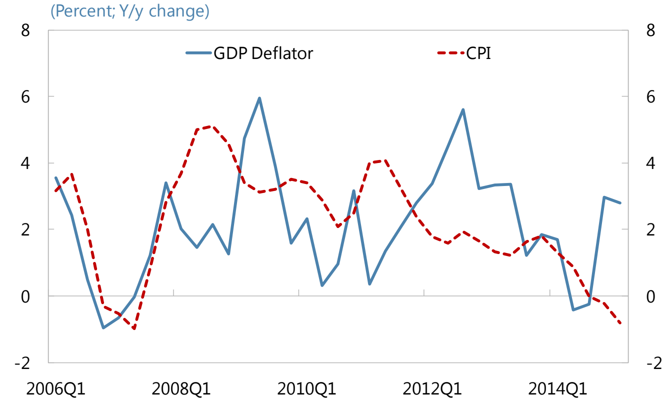
- Markets also expect the low CPI inflation to be temporary, as longer-term inflation expectations have remained well-anchored.

- Indeed, GDP inflation has already bounced back to 2¾ percent y/y in the first quarter; CPI inflation has not followed suit because of the strong terms of trade gains.

- The overall policy mix is already very accommodative, with near-zero interest rates, and broadly neutral fiscal policy. The output gap is small at best and unemployment has come down sharply in recent years.

Israel: GDP Deflator and CPI

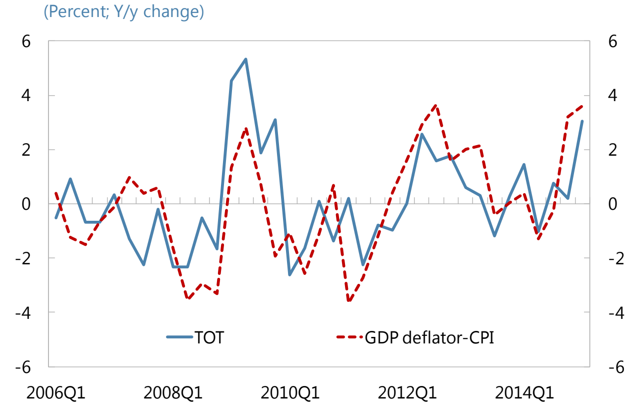
(Percent; Y/y change)



Source: Haver Analytics.

Israel: Terms of Trade and GDP Deflator-CPI Difference

(Percent; Y/y change)

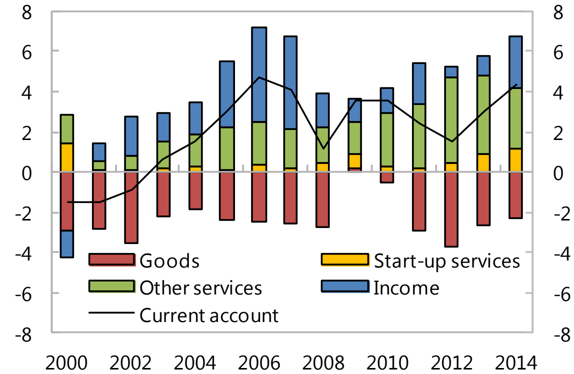


Source: Haver Analytics.

[7] The BOI's objectives are (1) to maintain price stability; (2) support growth, employment and the reduction of social gaps; (3) support the stability and proper functioning of the financial system.

25. In staff's views, at current levels, the shekel is broadly in line with fundamentals. Evidence from exchange rate models is mixed, but the average of three existing estimates suggests the shekel is around its fundamental value:[8]

Israel's Current Account
(Percent of GDP)



Source: Haver Analytics.

- The IMF external balance assessment (EBA) macroeconomic balance approach suggests the shekel is undervalued in 2014, reflecting that the current account in 2014 (4.3 percent of GDP) was well above the EBA estimated norm (-0.2 percent of GDP).[9] However, in staff's view the EBA current account norm is too low, as it does not take into account some important structural shifts including the expansion of mandatory household pension saving in 2008. A modified EBA macroeconomic balance approach—adding a fixed effect dummy and pension contributions as share of GDP as additional variables—suggests a current account norm of 2 percent of GDP, suggesting that the shekel was undervalued by about 9 percent in May 2015.[10]

- The EBA-like REER regression approach suggests that the shekel was 0.1 percent above its fundamental value in 2014, implying an overvaluation of 0.5 percent as of May 2015.

- Finally, a CGER REER panel regression type model suggests an overvaluation in the medium term of 6.8 percent.

The authorities' views

26. The BOI shared the view that low inflation was mostly imported, and agreed with staff that no additional monetary easing was required at this stage.The BOI forecasts that inflation will reach the lower end of the target band in 2016Q1. Inflation would be further strengthened by tightening in the domestic labor market which would lead to an increase in wage costs. Thus, the BOI sees less of a need for unconventional monetary policy measures, even as these tools remain part of the toolbox.

27. Monetary policy committee members noted that interest rate decisions reflected difficult trade-offs. Rising housing prices suggested that higher interest rates were needed to

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[8] See SIP on Exchange Rate Assessment.

[9] The EBA assessment, done in March 2015 when the 2014 current account surplus was estimated at 3 percent of GDP, suggested an undervaluation of 14 percent. More recently, the 2014 current account surplus was revised up to 4.3 percent of GDP.

[10] The modified EBA model takes the revisions to the current account balance into consideration.

contain associated financial risks, but—given its impact on growth and inflation—committee members could not ignore the impact of monetary tightening on the exchange rate. They also noted that to a considerable extent upward pressure on the exchange rate had not been the result of 'fundamentals,' but reflected spillovers from other countries' loose monetary policies.

28. In BOI's view, the shekel is somewhat overvalued. This was most visible in sluggish exports, even after accounting for the impact of weak world trade. The current account surplus had increased in 2014 (to 4.3 percent of GDP), but this had been the result of a sudden drop in the repatriation of multinational firm profits and the decline in oil prices, not improved competitiveness. The current account surplus further reflected transfers from the US government (about 1 percent of GDP annually) and the replacement of imported energy with domestic gas production.

C. Housing Sector Policy

To contain further housing price increases, supply needs to be boosted. Concerted efforts among relevant ministries and local governments are needed. To contain the increase in leverage, macro-prudential measures should be used.

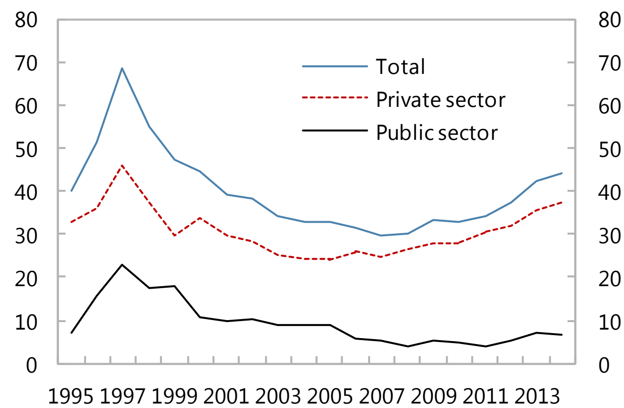
Background

29. Both demand and supply factors have contributed to the housing price boom (Figure 7).

- Demand has been boosted by the decline in interest rates, the increasing population, and growing household incomes. While the real estate tax system in Israel is broadly in line with global standards, distortions from the tax system and an underregulated rental market also create a bias towards homeownership.[11]

- Demand increased just when housing supply had dropped to a post-immigration boom low. Boosting supply has been hard: Israel's supply elasticity to prices is low compared to other advanced economies—the result of a highly centralized approach to land development (the state owns 93 percent of Israel's land), the long process of obtaining licenses and building permits, and lack of support from local governments for high density projects.

Israel: Completion of Residential Dwellings
(Thousand)



Sources: Central Bureau of Statistics; Haver Analytics.

[11] See SIP on the Residential Real Estate Tax System in Israel.

30. Macroprudential measures taken by the BOI have contained the increase in household leverage. Since 2009, the BOI has introduced a wide range of macroprudential tools to address vulnerabilities and boost banks' loss absorption capacity (Annex III). As a result, household credit to GDP has remained low compared to other advanced economies. Nevertheless, the exposure of banks to real estate and construction has increased (section D).

31. Staff estimates suggest housing prices are currently some 30 percent overvalued. A housing price correction could depress consumption through its wealth effects, and would particularly affect those that have bought a house in recent years.

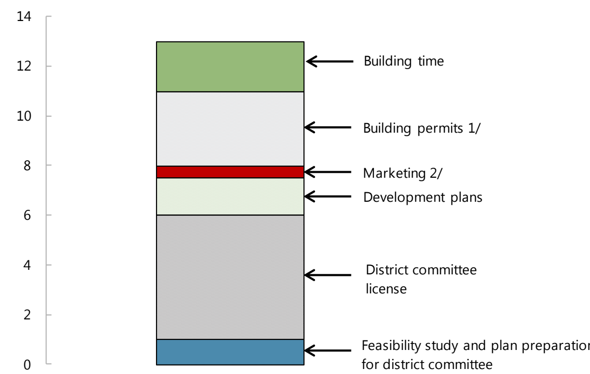
Policy discussions

32. To contain housing price increases, supply will need to be boosted.

- **Planning procedures should be simplified.** Planning procedures are cumbersome, and the time between initiating new building initiatives and finishing construction can range between 8 and 21 years.

- **The zoning of available land and its release for development should be accelerated.** This would allow the private sector to respond more effectively to rising demand. Moreover, the authorities could consider eliminating restrictions to building in big cities, adopted to discourage urbanization, and instead implementing incentives for greater investment in infrastructure, education, and job creation in the periphery.

Duration of Construction Process in Israel
(Years)



1/ Permit from the local committee.
2/ Tender publication and decision regarding the winner.
Source: Taub Center, State of the Nation Report 2014.

- **Local governments should be given the means to support the construction of high density residential buildings.** Since property tax rates are lower for residential properties and for smaller units, local governments prefer commercial properties and luxury buildings over high density residential buildings. Thus, local authorities are reluctant to support large projects, further delaying construction. Higher intergovernmental transfers should be considered to help finance the cost of additional infrastructure and services required by new residential developments.

33. Macroprudential policy should continue to be actively used to contain housing-related risks to financial stability. Options include further tightening limits on loan-to-value (LTV) and payment-to-income (PTI) ratios or accelerating the implementation of the recently-announced measure to gradually increase capital surcharges by 1 percent of outstanding mortgage lending.

The authorities' views

34. The authorities pointed to a variety of initiatives to boost housing supply. The central government has been signing agreements with local governments to facilitate central government financing of infrastructure needed for new development. A committee to identify land for development and expedite the planning process has been established. Power to approve building plans has been decentralized to local committees. The new government has also put several authorities involved in the process, such as the Israel Land Authority and the Planning Committee, under the command of the MoF to improve coordination and shorten the planning process.

35. The authorities also noted that macroprudential measures have effectively reduced the riskiness of new mortgages. The average LTV and PTI ratios of new loans have declined significantly to low levels (52 and 26 percent, respectively). Analysis of mortgages initiated between 2010 and 2013 by income decile also suggests that most mortgages were taken out by high income households, who are typically more resilient to shocks.

D. Financial Sector Policy

The financial system appears sound and the role of the non-banking sector has increased. Risks from exposure to real estate and construction, and from overly compressed corporate bond spreads, should be carefully monitored.

Background

36. In the past decade, Israel's financial system has changed substantially (Figures 8–10 and Tables 9–12).

- **The role of the non-bank financial sector has increased**. The Bachar reform that began in mid-2005 forced banks to divest most noncommercial banking activities such as insurance, pension, and provident funds. Partly as a result, the nonbank financial sector has grown rapidly; its assets now comprise about half of all financial sector assets.

- **An active market in corporate bonds has developed.** The outstanding stock of corporate bonds grew from 5 percent of GDP in 2004 to 27 percent in 2013.

37. Banks came through the crisis relatively well, but both the corporate bond market and non-bank financial institutions were hit hard. Corporate bond yields rose sharply, some long-terms saving products suffered significant losses; and mutual and provident funds faced large redemptions. This led to the establishment of the Hodak committee, which in 2010 presented a set of recommendations to the government to improve market transparency, conduct, and the governance of institutional investors.

38. Israeli banks are well capitalized and liquid.

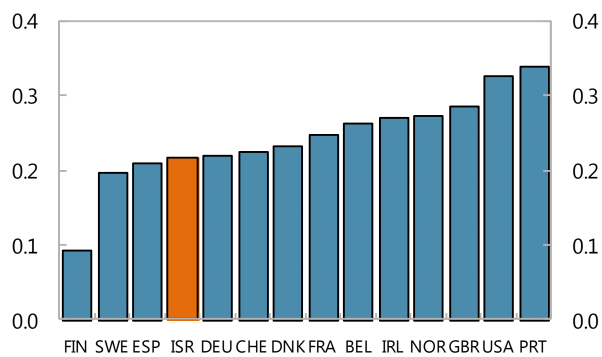
- Since early 2015, all banks have met the new minimum core Tier 1 capital ratio of 9 percent.[12] As the prescribed risk weighting is conservative, the leverage ratio (7 percent) is high compared with other advanced countries.

- Banks have limited exposure to the wholesale funding market, as reflected in loan-to-deposit ratios well below 100 percent. Guidelines for the gradual implementation of a liquidity coverage ratio have been enforced from the beginning of 2015.

39. Banks also fared well in the BOI's recent stress test. The stress scenario assumes a severe economic recession, with busts in housing, real estate, and construction sectors and a sharp increase in unemployment and Israel's risk premium (as a result of heightened geopolitical tensions). Banks' profitability (return on equity) would fall from around 7¼ percent to -4 percent, but all banks would be able to maintain capital ratios above 6 percent (down from 9½ percent).

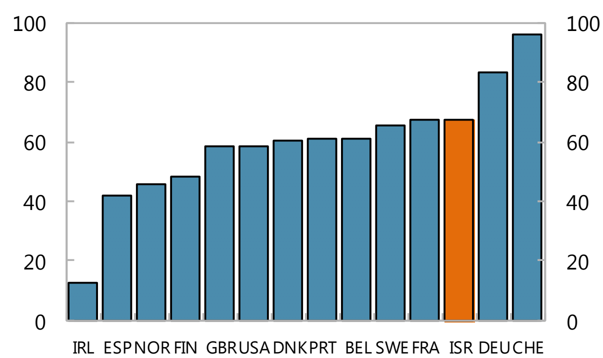
40. Bank concentration is relatively high. Five banking groups account for 95 percent of banking sector assets. However, a cross-country comparison of the Lerner index suggests that banking sector competition in Israel is broadly in line with the average of other advanced economies. Nevertheless, banks are not very efficient as their cost-to-income ratio is relatively high, although this can also be explained by high labor costs.

Banking Sector Lerner Index, 2010 1/



Sources: Global Financial Development and Bankscope.
1/ The Lerner index measures market power in the banking sector. It compares output pricing and marginal costs. An increase in the index indicates a deterioration of the competitive conduct of financial intermediaries.

Bank Cost-to-Income Ratio, 2010 1/



Source: Global Financial Development and Bankscope.
1/ The ratio is calculated as operating expense as a share of the sum of net interest revenue and other operating income.

Policy discussions

41. Risks from exposure to real estate and construction should be carefully monitored. Banks are not just exposed to mortgage loans (which account for 31 percent of bank credit) but also to the highly-leveraged real estate/construction sector (13 percent of bank credit, despite an

[12] By the beginning of 2017, the two largest bank will have to meet a core Tier ratio of 10 percent.

increasing reliance on the corporate bond market). Risk diagnoses should be done on an ongoing basis, taking into account macro-financial feedback loops and spillovers to other sectors, especially given the construction sector's strong link to the rest of the economy.

42. Non-bank financial institutions are exposed to a potential correction in the corporate bond market. Spreads on corporate bonds have declined sharply and may no longer reflect risk appropriately. Recent bond issuances have been from the real estate/construction sector—many of which have lower ratings and are backed by lower quality collateral. A correction that raises bond yields rapidly will hit mutual funds and institutional investors hard and, in turn, weaken household balance sheets.

43. Progress with the 2012 FSAP recommendations lags in two areas.

- **A formal Financial Stability Committee (FSC), which will coordinate and set macroprudential oversight, has yet to be established.** Currently there are three supervisors (one for banks; one for the securities sector; and one for the insurance and pension sector). Coordinated oversight is important given that the system is highly inter-connected and financial activities are evolving across various segments of institutions and instruments. As discussed in the 2013 Article IV report, staff maintains the view that an independent FSC should be established with the BOI Governor taking the leading role in macroprudential policies in normal times. This should help coordinate macro-prudential policies across sectors and reduce the risk of regulatory arbitrage. The members of a future FSC have already started to meet regularly but informally.
- **The ongoing legislative amendment to the Banking Ordinance to enhance the crisis resolution framework**—aiming at strengthening the BOI's toolkit for early intervention and resolution—should be completed by sending the draft legislation to the Knesset at the earliest possible time.[13]

The authorities' views

44. The new government is concerned that high banking concentration has limited access to and raised the cost of credit for small and medium enterprises. The MoF noted that the banking sector is not efficient relative to peers in other advanced economies, possibly reflecting high concentration. The BOI acknowledged that there are gains to raising competition but is concerned about the potential impact on financial stability. In addition, they believed that the absence of a credit bureau could be contributing to small firms' limited access to credit. A committee, with representatives from the central bank and the MoF, has been formed to propose measures to reduce credit costs for SMEs.

[13] Technical work for drafting an amended law has been complete with technical assistance from the Fund TA mssion.

45. The regulators agreed that financial sector vulnerabilities to a possible house price correction should be monitored closely. Acknowledging the rising exposure of banks to mortgages, the banking regulator introduced additional capital requirement amounting to 1 percent of outstanding housing loans last September. The authorities are equally concerned about nonbanks' housing exposure—either via direct loans or potentially underpriced corporate bonds—but noted that this risk stems from a low interest environment (Israel's sovereign bond spreads vis-à-vis the United States have turned negative). All supervisors are running stress tests and sensitivity analyses but concurred that these need to be enhanced.

46. Differences continued to delay the formation of an FSC. There is now broad agreement that the committee should focus on macroprudential policies in normal times, with the BOI playing the leading role and its chairmanship assigned to the Governor, with a separate crisis management committee (headed by the MoF) to operate in exceptional circumstances. This is staff's preferred option. However, new disagreements on the number of representatives each organization should have in the FSC have arisen, potentially delaying again its establishment.

E. Structural Policy

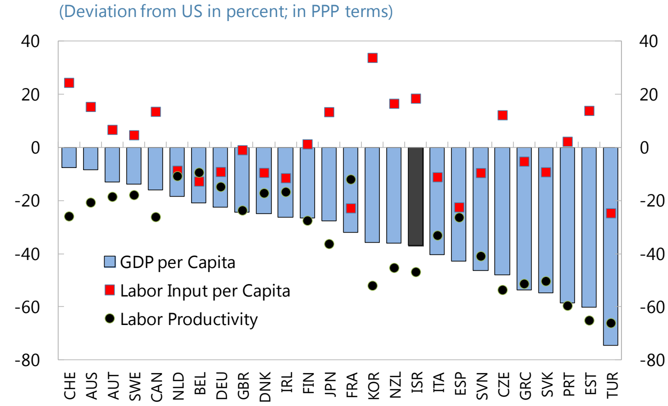
To reduce poverty and safeguard future growth, the labor force participation rates of the Haredi and Israeli Arabs need to increase. Boosting competition would further help raise productivity.

Background

47. In the past few decades, employment has grown very rapidly. As a result, the employment to population ratio has increased, from 36 percent in 1990 to 48 percent now (Figure 11).

48. At the same time, labor productivity has been low—both in levels and growth rates. Labor productivity for the economy as a whole has fallen from 70 percent of the US level in the early 1990s to 60 percent today, despite the presence of competitive high-tech industries (including R&D and start-ups).

Real GDP per capita and contributors, 2013
(Deviation from US in percent; in PPP terms)

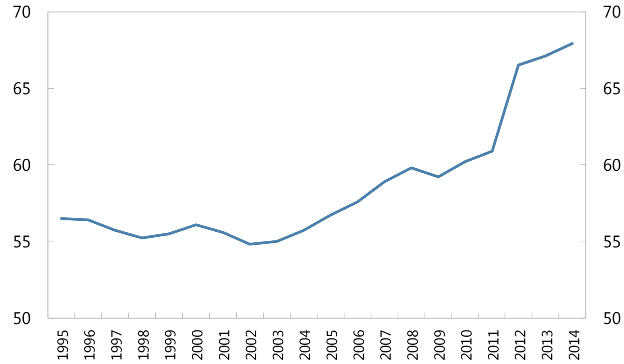


Source: Total Economy Database.

- **Productivity is partly low for benign reasons**: sharp increases in the labor force, reflecting both growth in the working age population (fueled by high birthrates and immigration) and an increase in the labor force participation rate, have kept production labor-intensive and thus contained labor productivity growth.[14] The capital-to-labor ratio in Israel is well below that in other advanced countries.

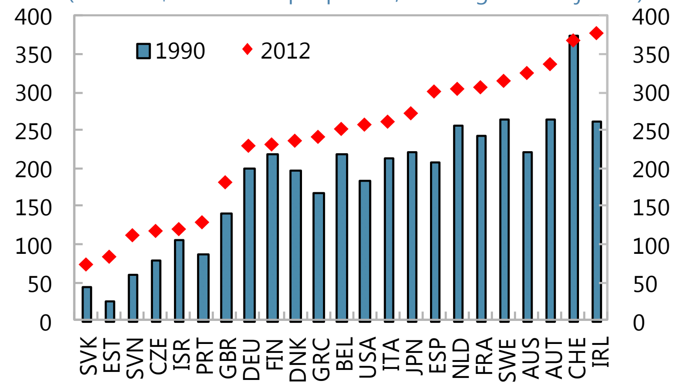
[14] See SIP on Productivity in Israel.

Employment Rate
(Percent of working age population aged 15-64)



Source: OECD Short-term Labour Market Statistics.

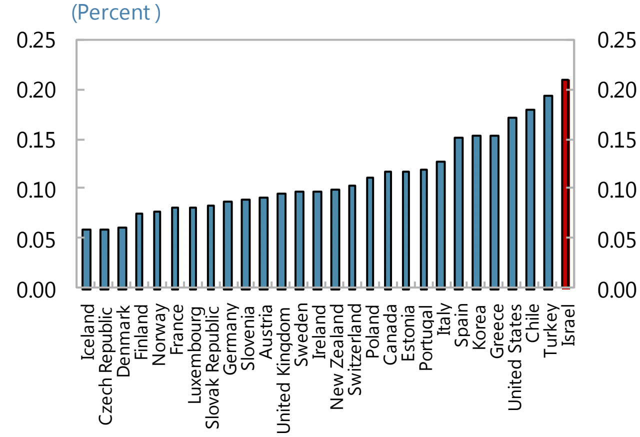
Capital per worker
(2005 US$ thousands per person; exchange rate adjusted)



Sources: Haver Analytics; and Bank of Israel. Constant 2005 net capital stock; data adjusted to 2012 US$ exchange rates.

- **However, TFP growth has also been sluggish, which may reflect a lack of competition**. Israel's product market regulation is more restrictive than in any of its peers, both in terms of economy-wide regulation as well as sectoral product market restrictions. Competition is further reduced by the small size of the economy—in many ways, Israel is like an island economy.

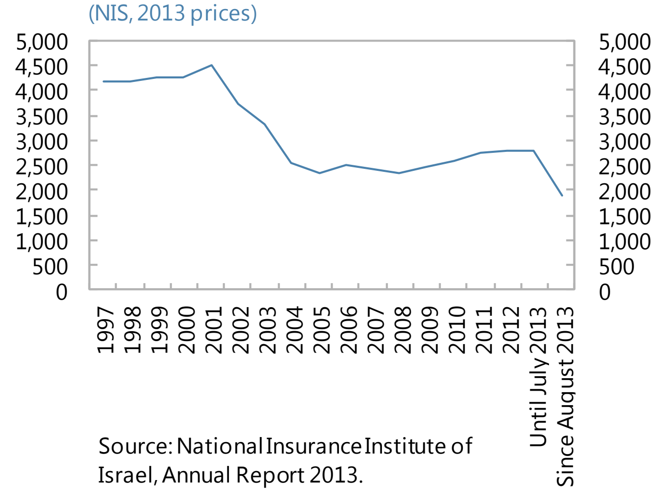
Poverty Rate in 2011
(Percent)



Source: OECD.

49. The poverty rate in Israel is near 20 percent—among the highest in OECD countries.[15] Much of this high poverty incidence is accounted for by low earning capacity and labor participation in Haredi and Arab-Israeli communities, and is further exacerbated by their large family size.

Average Annual Allowance per Child, 1997–2013
(NIS, 2013 prices)



Source: National Insurance Institute of Israel, Annual Report 2013.

50. Sharp reductions in child allowances have increased incentives to work—but also increased poverty. After large cuts in 2003, and some smaller ones thereafter, child allowances are now 60 percent lower than in 2002. This has boosted labor participation rates, which has contributed to a decline in market-income

15 See SIP on Income Inequality in Israel.

inequality. However, post tax and transfer inequality has increased, as have poverty rates.[16]

Policy discussions

51. **Without an increase in labor productivity growth, GDP growth will slow in the future**. In the past two decades, much of Israel's growth has come from the use of additional labor. With the increase in the labor force participation rate likely to level off and unemployment already at record lows, future employment growth will likely slow to that of the working age population—some 1½ percent. If productivity does not pick up, GDP growth will slow accordingly.

52. **Raising productivity should therefore become a priority.** Israel has a lot of macro-flexibility—it has managed to absorb an incredible increase in the labor force. But what Israel needs is more *micro-flexibility*, that is, more competition at the micro level. According to OECD product market restrictions indicators, Israel has too much regulations and restrictions, and not enough competition. The authorities have initiated some measures to ease business constraints—such as shortening the time required for business registration and making the process of insolvency resolution easier by amending the company law. These efforts should continue, focusing on the areas identified by the OECD and the World Economic Forum as particularly weak, such as policies pertaining to competition and anti-monopoly policies, property registration, construction permits, and contract enforcement.

53. **Efforts should also continue to address infrastructure gaps, notably those pertaining to railroad, port, and air transport facilities**. Improving education will also be critical to boost human capital quality (PISA scores are poor); if not addressed, poor education quality could undermine Israel's strength in high-tech industries.

54. **Boosting labor force participation rates of the Haredi and Arab-Israeli populations is essential—both to reduce poverty rates and safeguard Israel's long-run growth potential**.[17] The share of the Haredi and Arab-Israeli population is projected to exceed 40 percent of the total population in twenty years—from 32 percent currently.[18] Labor force participation rates are particularly low for Haredi men (who often spend their 20s and 30s pursuing religious studies and only enter the labor market in their 40s)[19] and Arab-Israeli women.

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[16] According to OECD data, public spending in 2011 on family benefits in cash, services, and tax measures amounted to 2.32 percent of GDP. This was below the OECD average of 2.55 percent, even though the ratio of children under 20 to working age persons was almost twice the OECD average.

[17] For the long-run impact of the demographic changes on growth and the public finances, see Chapter 1 in IMF Country Report No. 12/71.

[18] With 6.8 children per woman, the share of the Haredi population doubles every 15 years.

[19] The low participation rate of Haredi men is a relatively recent phenomenon. In the 1970s, their participation rate was still comparable to that of non-Haredi Jews, as there was a limit of 400 yeshiva students that were exempt from military service. After the ceiling was removed in 1977, the participation rate of Haredi men started to fall.

55. Reducing poverty requires concerted efforts from across government agencies, stakeholders, and communities. The government has initiated a number of actions, including the expansion of Haredi units in the defense forces and the opening of public employment centers in Arab-Israeli towns. Preliminary evidence suggests that participation of these populations in the labor force is rising. But given the severity of the problem, more action would be needed, and in this light, a comprehensive poverty reduction strategy could usefully be formulated. The strategy should address critical structural problems hindering the effective inclusion of these populations in society and the labor market, including rural infrastructure and transportation, education, and civil and military service arrangements.

The authorities' views

56. The authorities agreed on the importance of boosting labor force participation rates of the Haredi and Arab-Israelis. They saw an increase in employment rate as important not just for growth but also as a key tool to reduce poverty. The new government planned to raise child allowances, but only to undo the cuts in 2013—there was no intention to bring allowances back to the pre-2003 level.

57. They also agreed on the importance of boosting productivity. They were less concerned about the low productivity growth in recent years, which in their view was partly the result of the new labor force participants' low skills and lack of education.

58. Boosting competition is a priority for the new government. Several sectors have identified, where competition should be increased, including transportation, food, commodity imports, and banking. At the time of the mission, there were not yet concrete proposals, but committees had been installed to come up with suggestions.

STAFF APPRAISAL

59. The economy has been doing well and near-term growth prospects are favorable. Employment creation has been remarkable and unemployment is at multidecade lows. Inflation has been negative, but this reflects temporary external factors and not domestic weakness. Inflation is expected to return to the target band next year and no further monetary easing is needed. Risks to the outlook are balanced, and the real exchange rate is broadly in line with fundamentals.

60. Nevertheless, policy makers are confronted with a number of challenges. The fiscal deficit remains stubbornly high, leaving limited buffers to respond to shocks. Housing prices continue to rise, and could pose risks to the financial system. Labor productivity growth and levels are low, weighing on growth prospects, and income inequality is among the highest in advanced countries.

61. The high, structural, and persistent fiscal deficit needs to be reduced. Adherance to the Deficit Reduction Law—with a deficit target of 1½ percent of GDP by 2019—would set debt on a firmly downward path and create buffers for shocks. While achieving the target is challenging, the government should address this challenge upfront, and not defer on the hard choices regarding how to reduce the deficit to future years. An explicit revenue and expenditure plan consistent with the deficit targets for the entire 2016–20 period should be produced. Commitment control of new multi-year projects should also be strengthened in order to avoid a deviation from the expenditure ceilings.

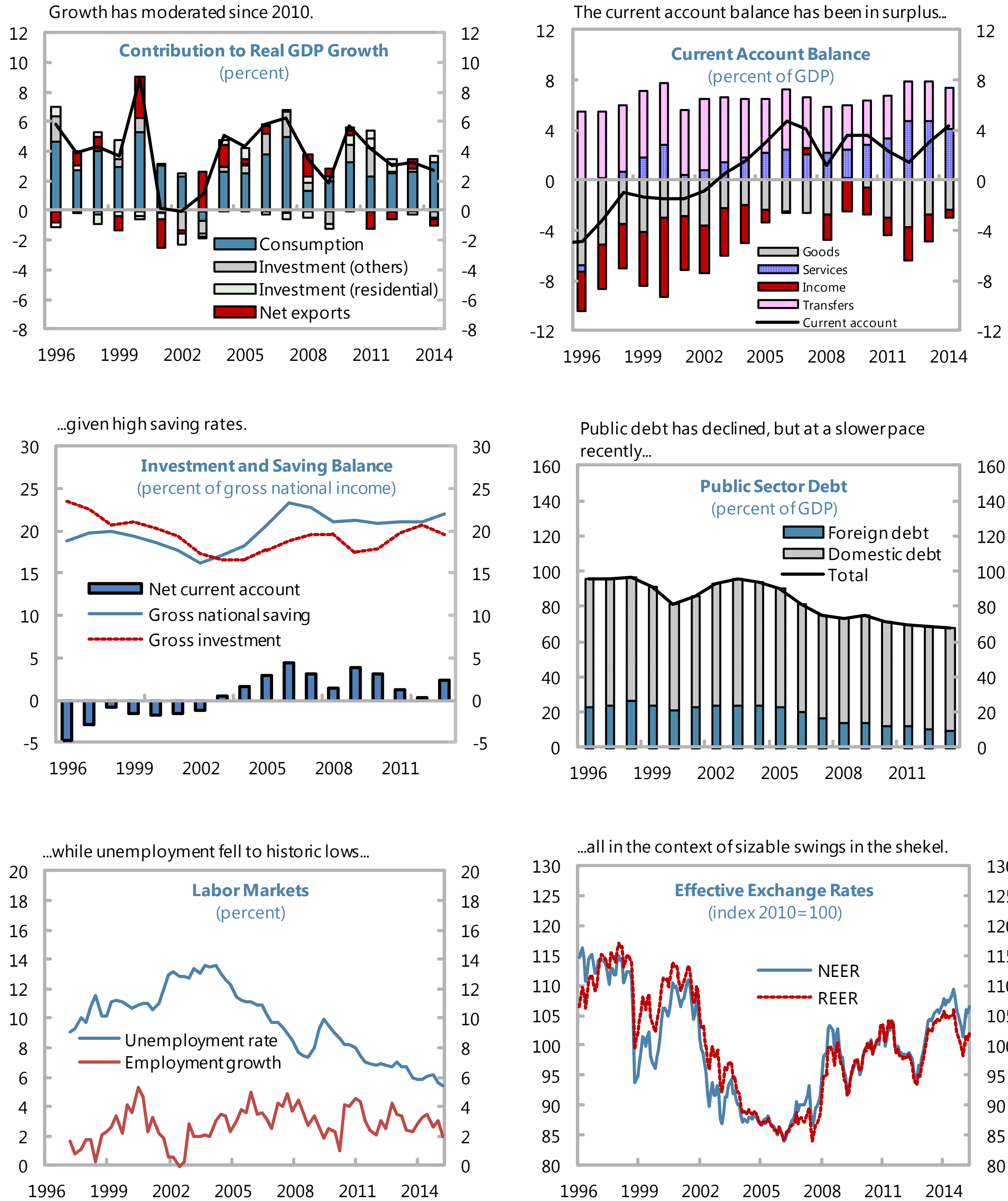
62. Boosting supply would help contain social and financial risks from rising housing prices. The intentions of the new government to boost supply through various measures are welcome. Macroprudential measures have so far been effective in containing household leverage, and should continue to be used. An independent FSC should be established soon to help coordinate macroprudential policies across sectors. Risks from the financial sector's rising exposure to the housing market must be closely monitored.

63. Raising productivity should become a priority. In the past two decades, much of Israel's output growth has come from steady employment growth. But with unemployment already at historic lows, maintaining strong GDP growth will require boosting output per worker. Israel has a lot of *macro-flexibility*—it has managed to absorb an incredible increase in the labor force without high unemployment, but needs more *micro-flexibility*, that is, more competition at the micro level. The new government's intention to boost competition in several sectors is welcome—although efforts to increase banking sector competition should ensure that financial stability remains paramount. Efforts should also continue to address infrastructure gaps and improve education.

64. Reducing inequality requires concerted efforts from across government agencies, stakeholders, and communities. A comprehensive poverty reduction strategy could be formulated to address critical structural problems that hinder the effective inclusion of the Haredi and Israeli-Arab populations in society and the labor market. These include poor rural infrastructure and transportation and low quality of education.

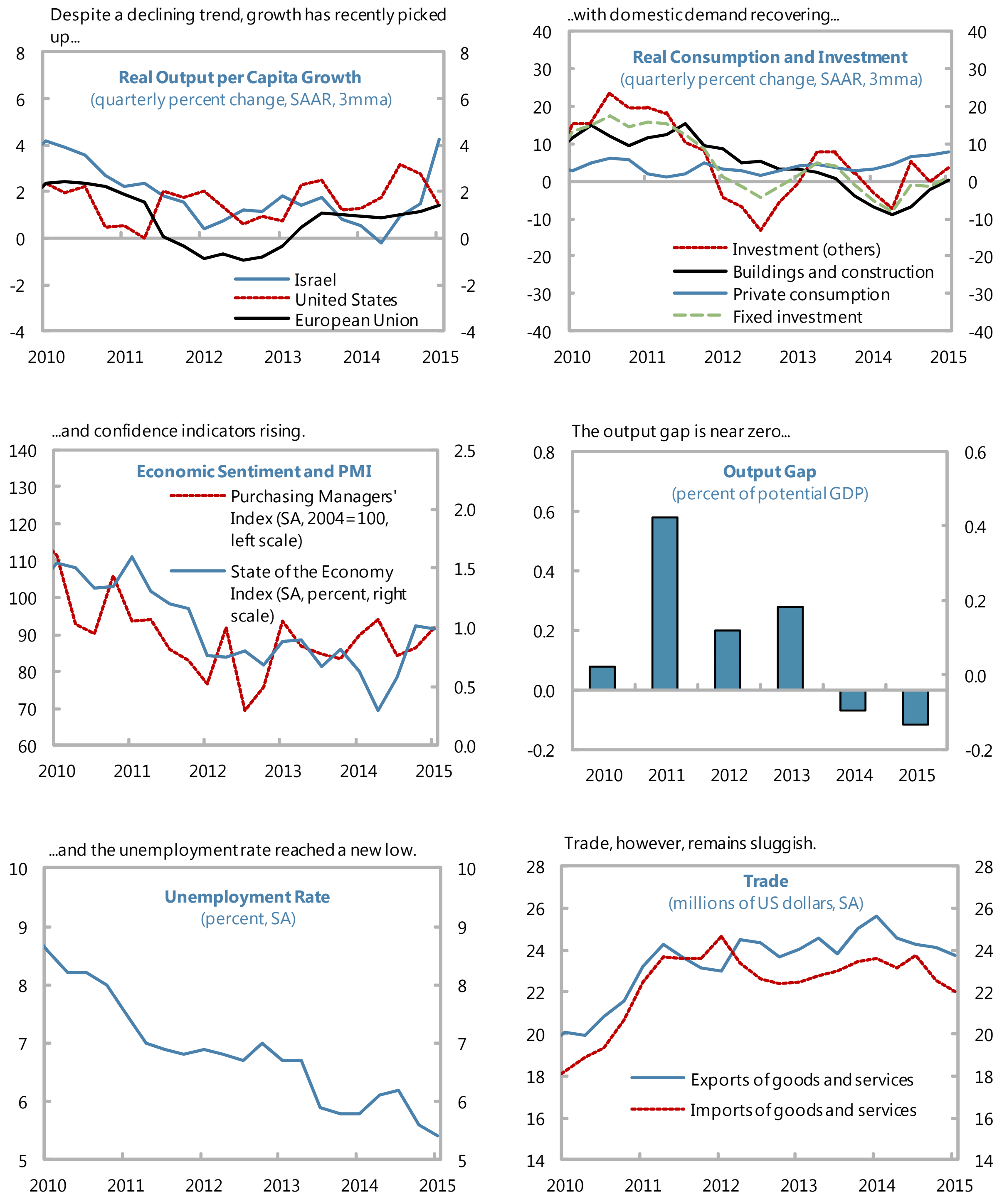
65. It is recommended that the next Article IV consultation with Israel be held on a standard 12-month cycle.

Figure 1. Israel: The Long View, 1996–2014



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

Figure 2. Israel: Recent Economic Developments, 2010–15

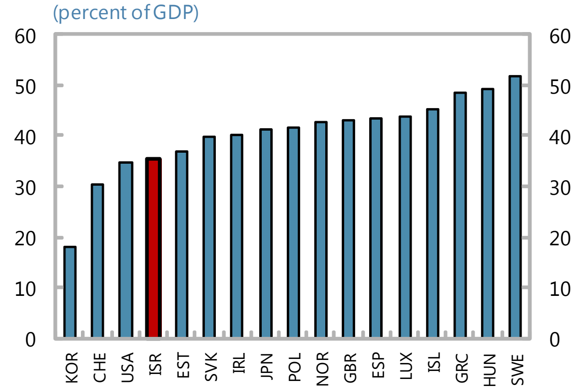


Sources: Bank Hapoalim/Israeli Purchasing and Logistics Managers Association; Bureau of Economic Analysis; Central Bureau of Statistics; Statistical Office of the European Communities; and IMF staff calculations.

Figure 3. Comparisons of Key Fiscal Indicators

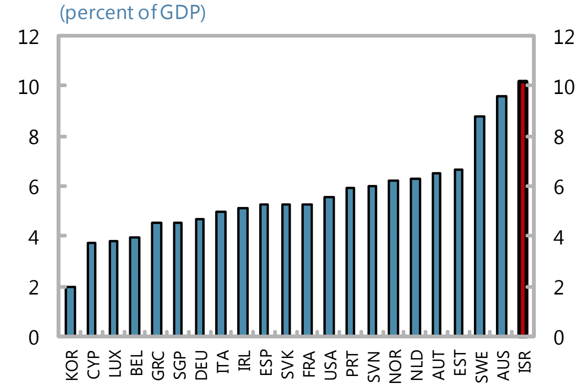
The non-defense budget is relatively low…

Non-Defense Expenditure, 2013 1/
(percent of GDP)



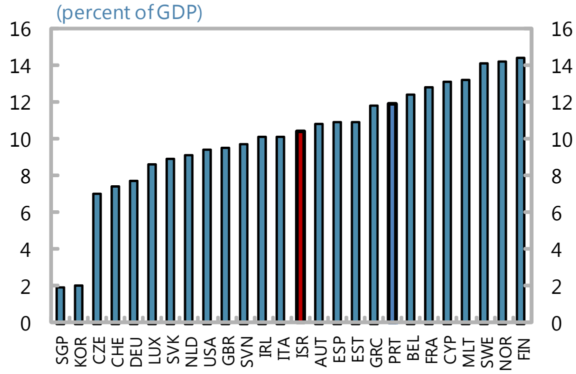
…but G&S, including defense, is the highest among AEs.

Goods and Services, 2014
(percent of GDP)



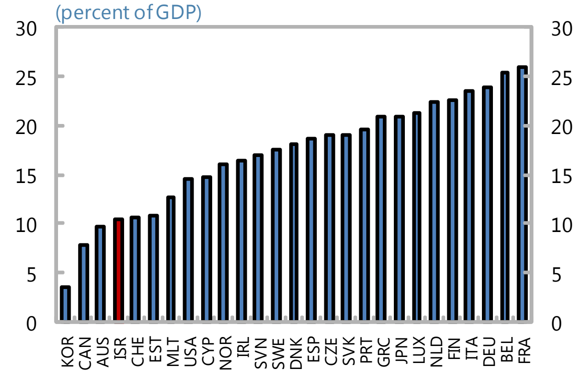
The moderately high wage bill suggests scope for savings.

Compensation of Employees, 2014
(percent of GDP)



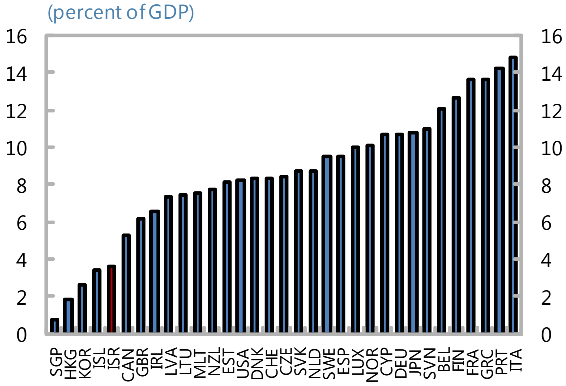
Social spending is low, but further reduction could be achieved through better targeting.

Social Expenditure, 2014
(percent of GDP)



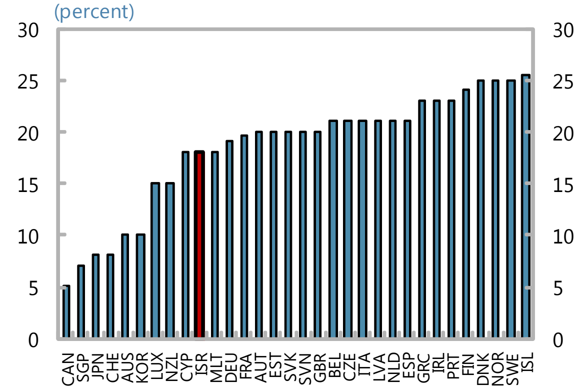
Reforms reduced pension spending, but raising female retirement age could save further.

Public Old-Age Pension Spending, 2015 2/
(percent of GDP)



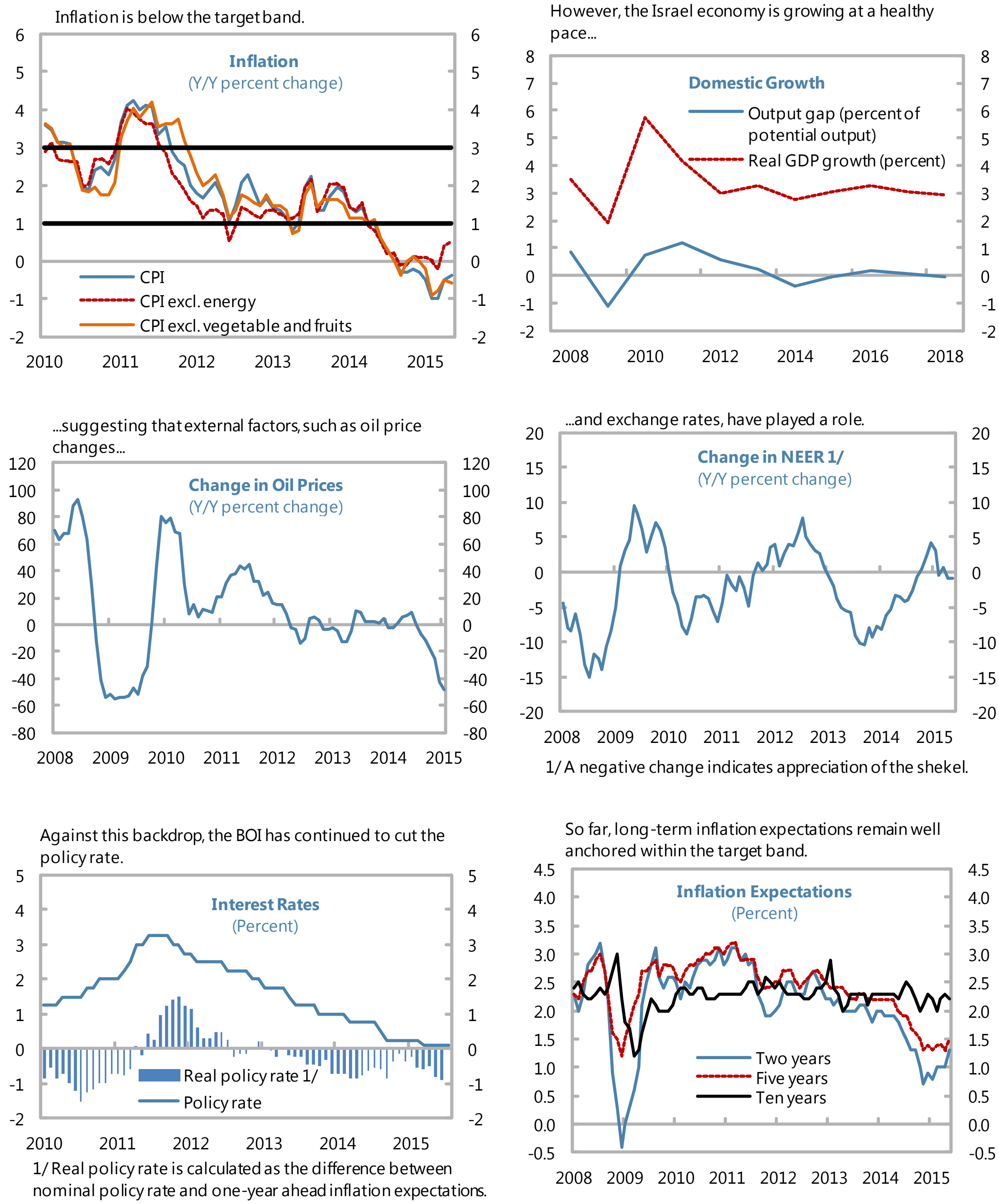
The VAT rate, at 18 percent, is below the AE median.

Standard VAT Rate, 2014
(percent)



Sources: IMF's Fiscal Monitor Database; International Bureau of Fiscal Documentation; and OECD database.
1/ Data for Greece, Iceland, Korea, Poland, and Switzerland are for 2012.
2/ Projections from April 2015 *Fiscal Monitor*.

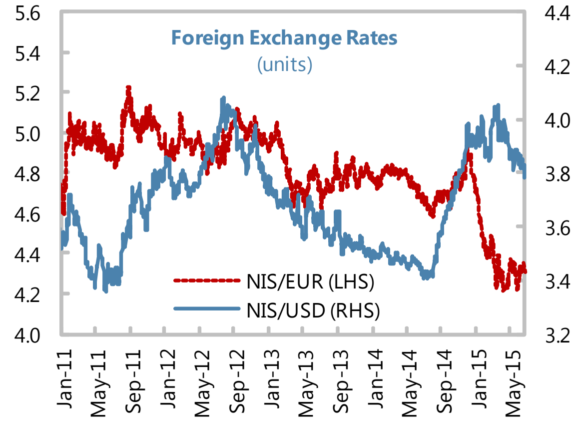
Figure 4. Israel: Selected Monetary Indicators



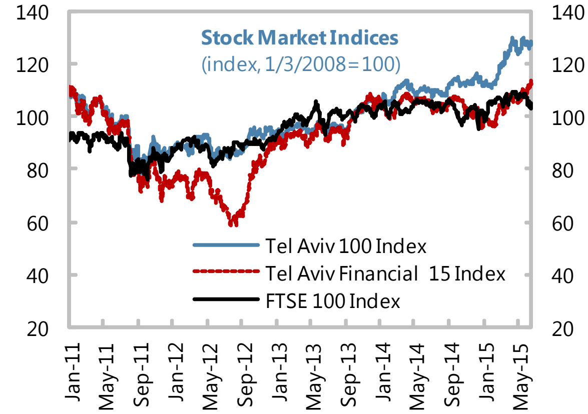
Sources: Bank of Israel; Haver Analytics; and IMF staff calculations.

Figure 5. Israel: Selected Financial Indicators, 2011–15

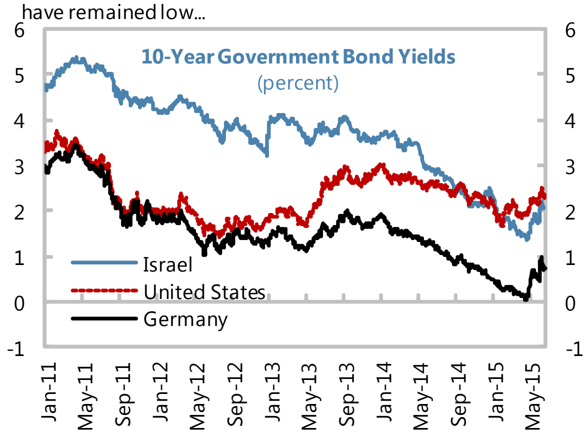
Shekel values against major currencies have diverged.



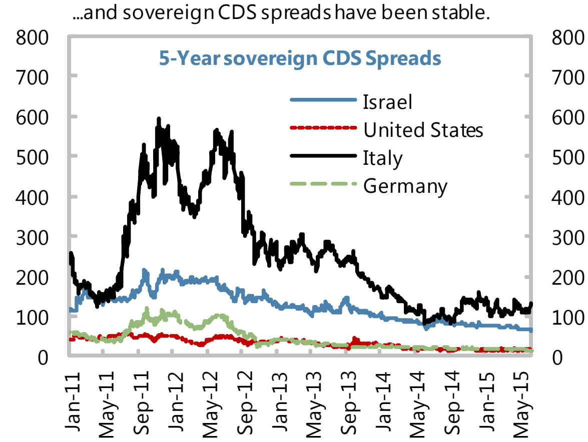
The stock market has shown signs of growth...



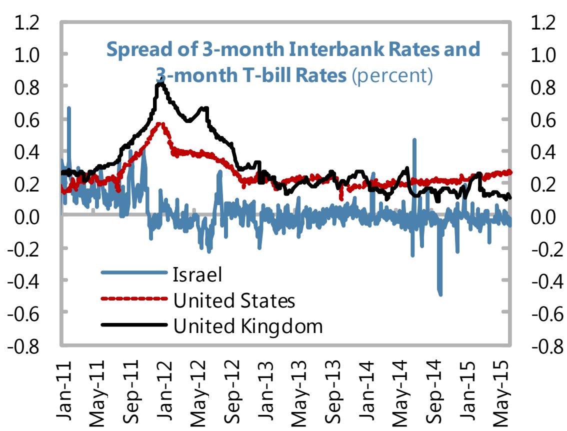
...while sovereign bond yields --despite the recent uptick-- have remained low...



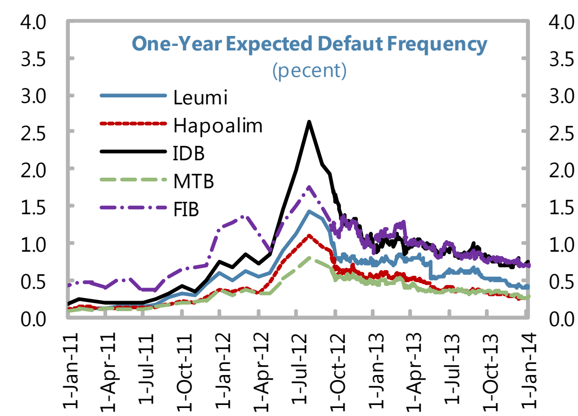
...and sovereign CDS spreads have been stable.



Interbank spreads have hovered near zero.

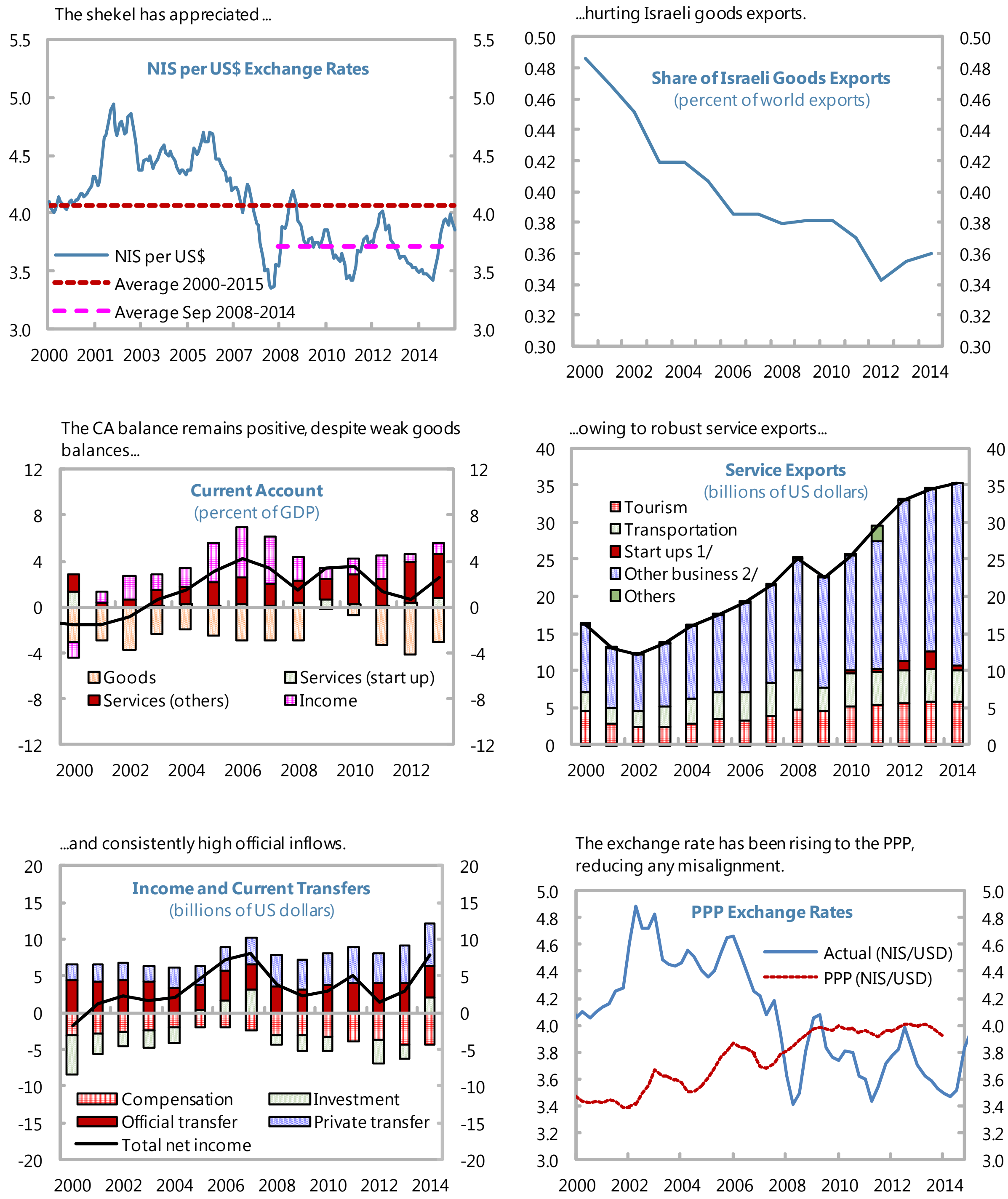


Default probabilities have fallen.



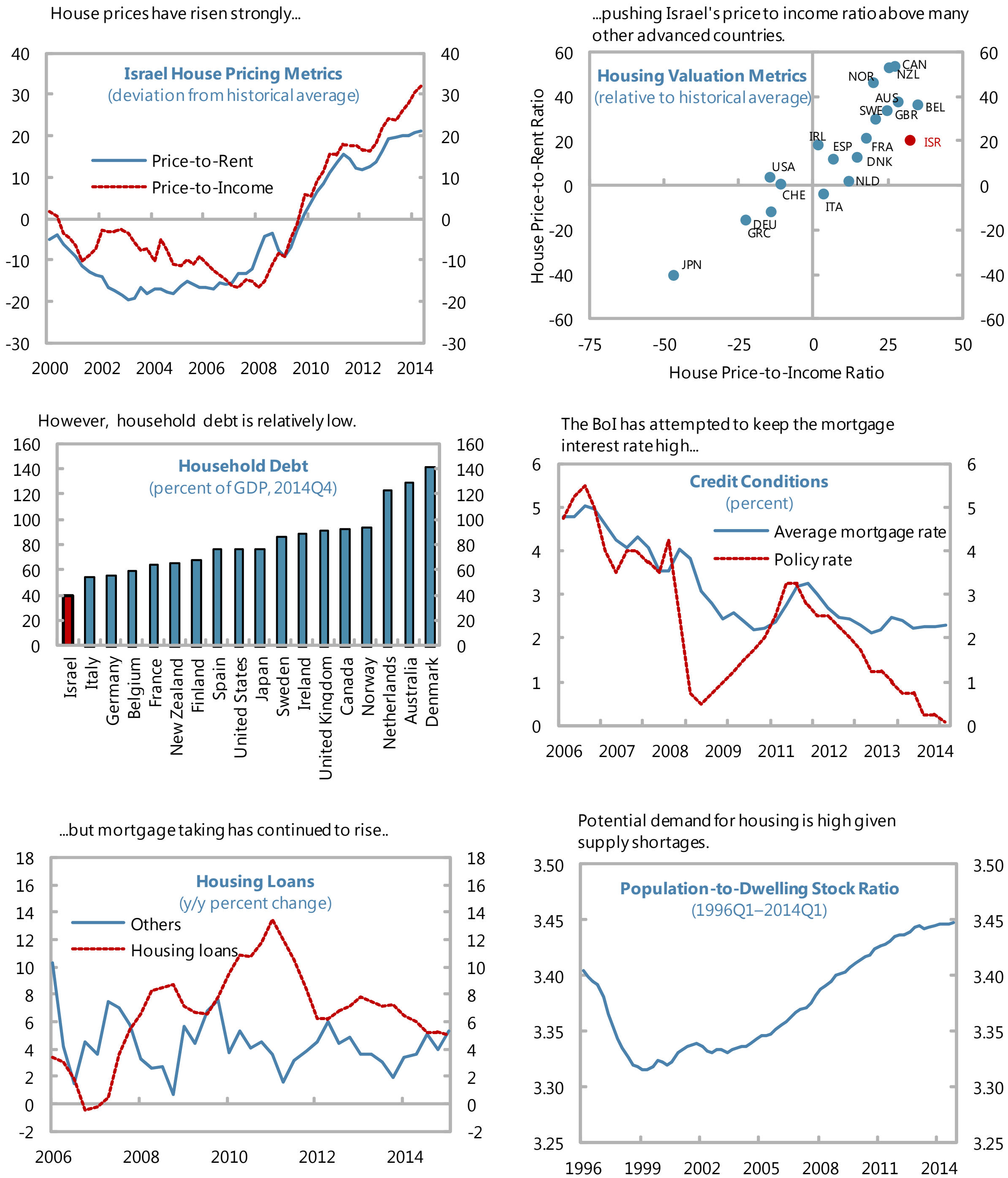
Sources: Bloomberg; Datastream; and Moody's KMV.

Figure 6. Exchange Rates and BOP, 2000–15



Sources: Bank of Israel; Central Bureau of Statistics; Haver Analytics; OECD; and IMF staff calculations.
1/ Start ups are included only from 2010.
2/ Includes medical services, communications, R&D, and IT services.

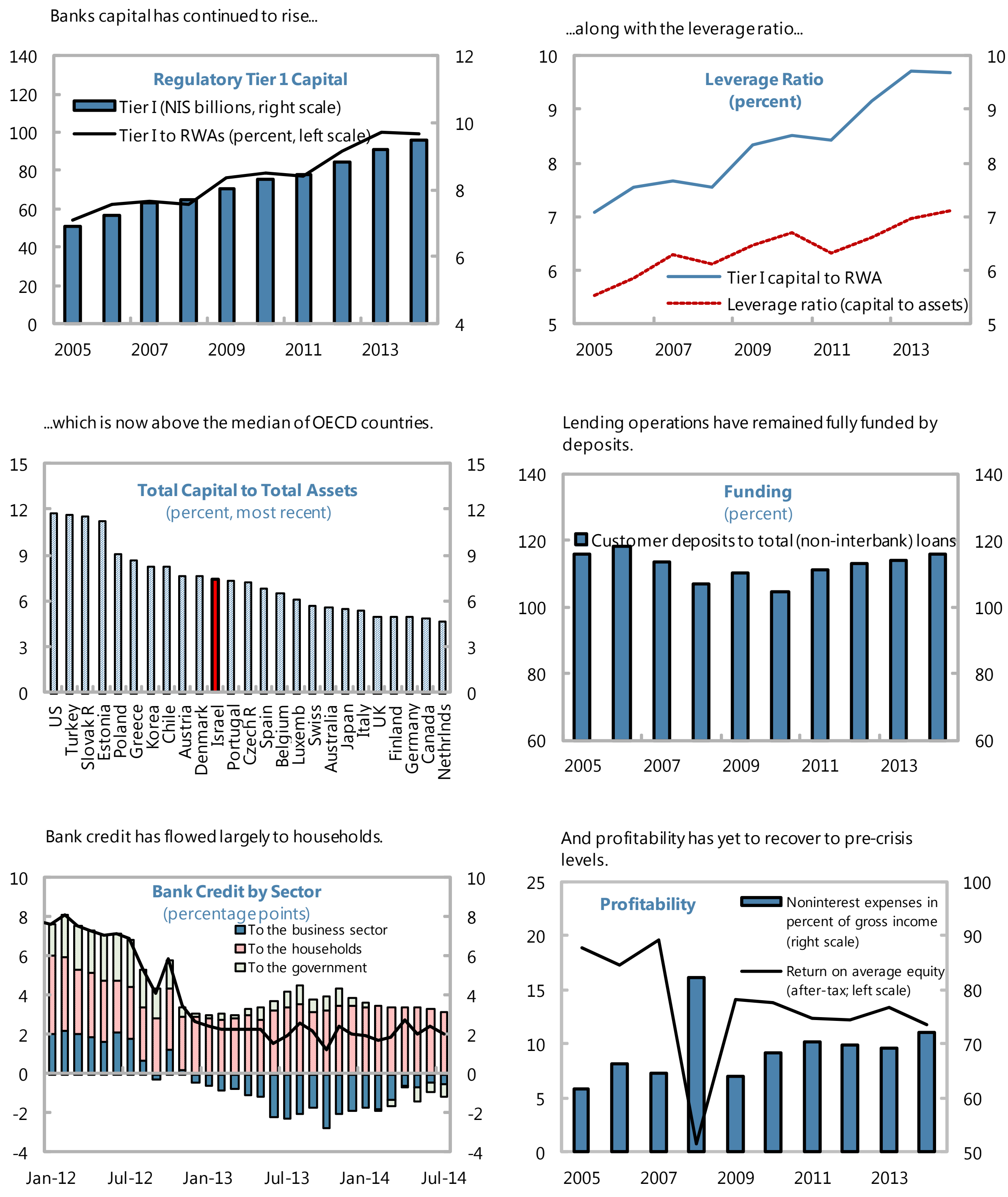
Figure 7. Israel: Housing Market, 1996–2014



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

Figure 8. Israel: Performance of the Israeli Banking System, 2005–14

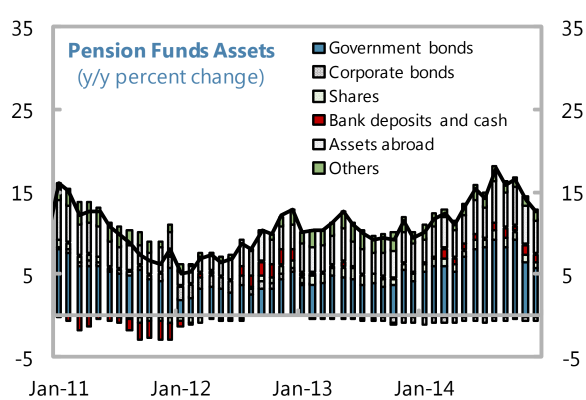
(Percent, unless otherwise indicated)



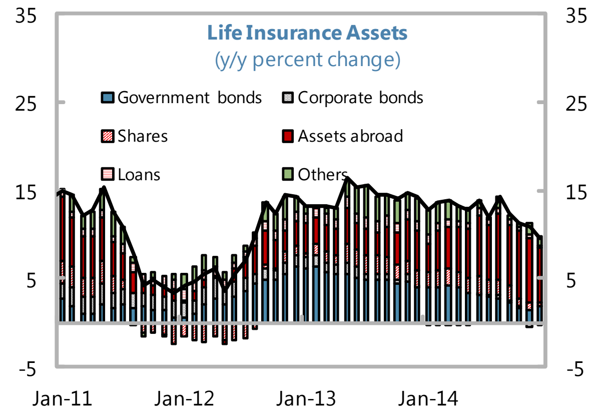
Sources: Bank of Israel; and IMF's Financial Soundness Indicator Database.

Figure 9. Israel: Performance of Non-Bank Financial Sector, 2006–14

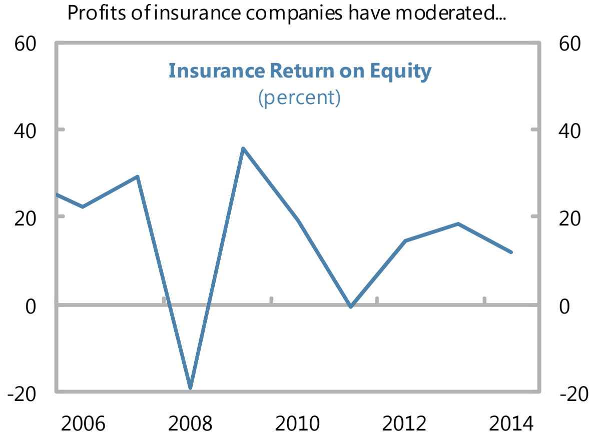
Pension fund assets have continued to grow..



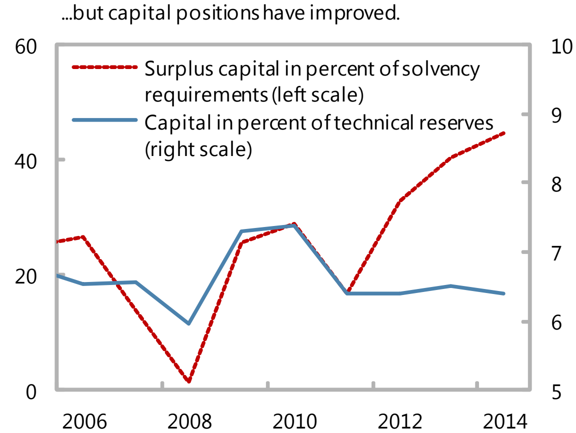
...as have life insurance assets.



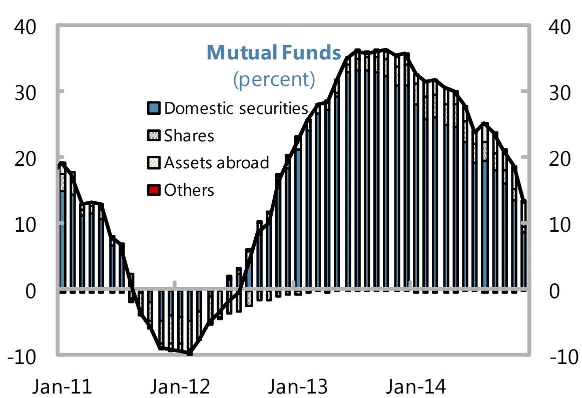
Profits of insurance companies have moderated...



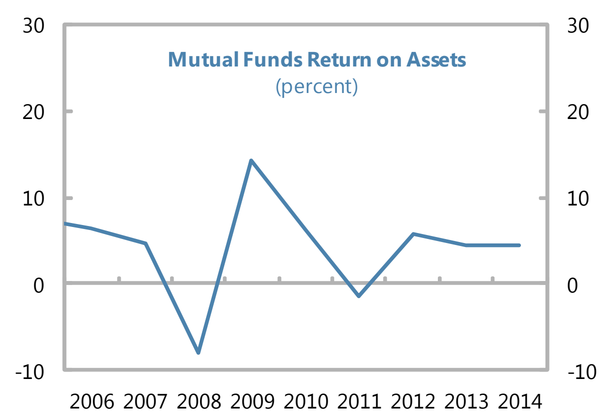
...but capital positions have improved.



Mutual fund assets growth have slowed...

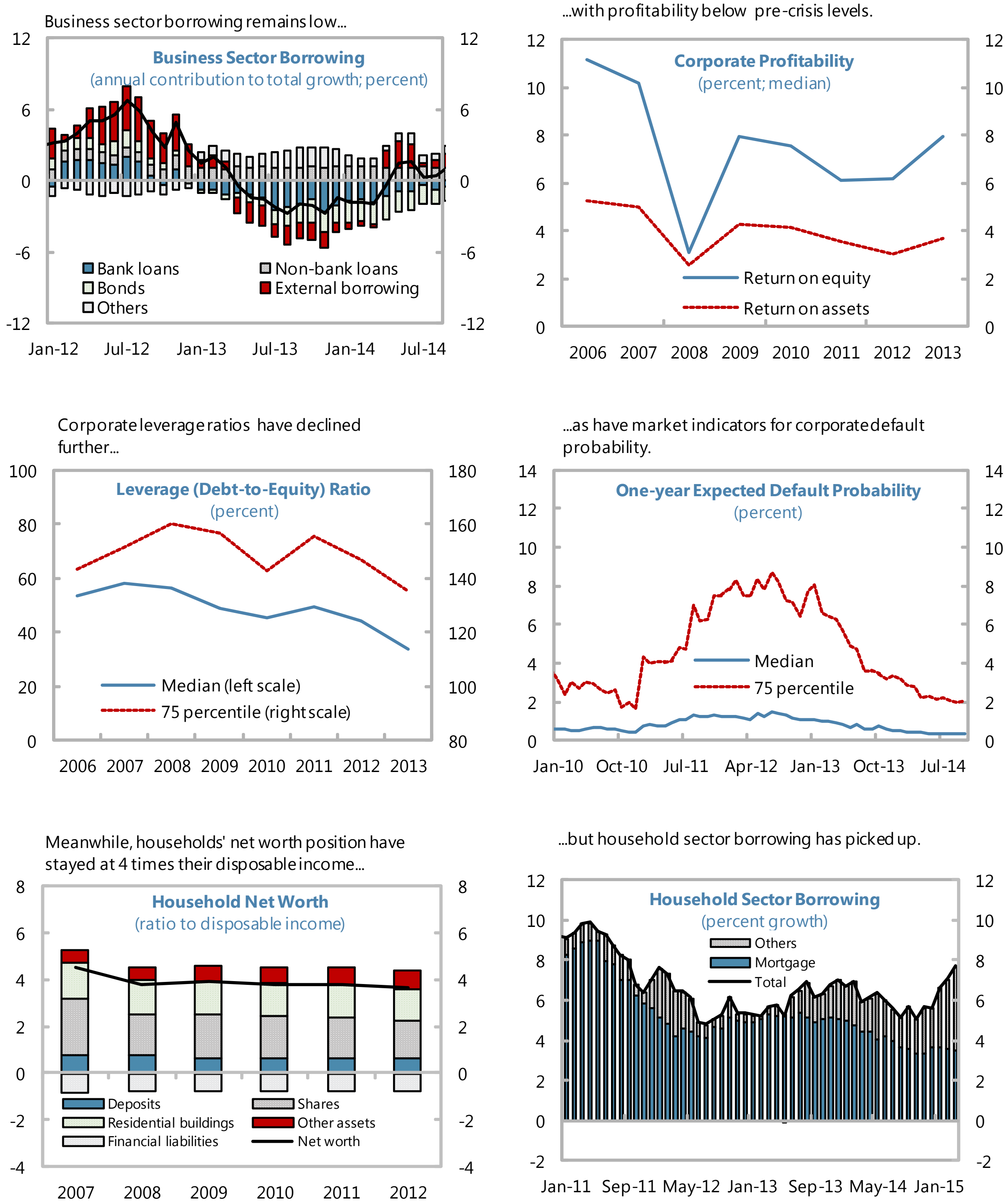


...and asset returns have been flat.



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

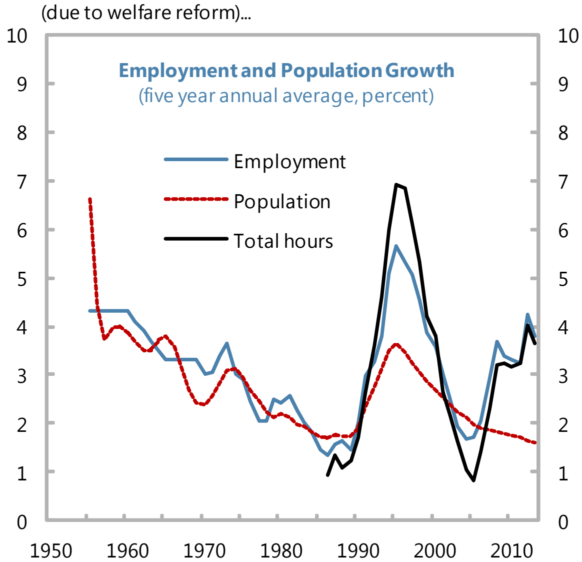
Figure 10. Israel: Corporate and Household Sector, 2006–14



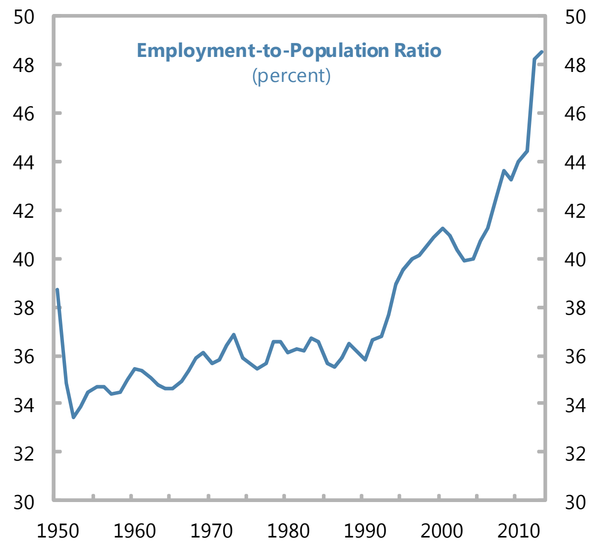
Sources: Bank of Israel; Israel Central Bureau of Statistics; Haver Analytics; and IMF staff calculations.

Figure 11. Israel: Per Capita GDP and Employment

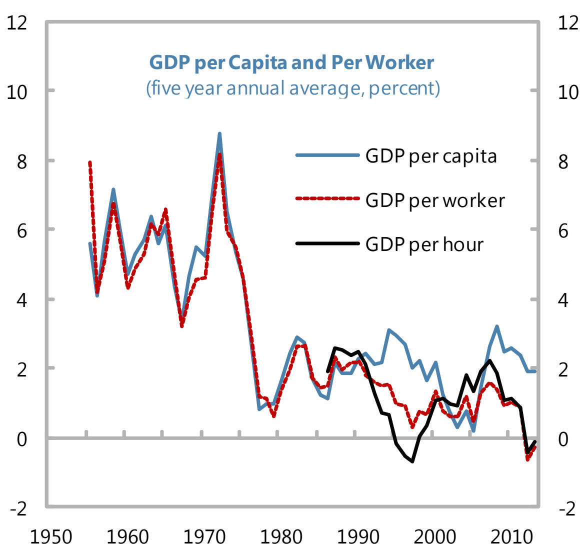
Employment and population grew strongly in the mid-1990s (due to immigration booms) and in recent years (due to welfare reform)...



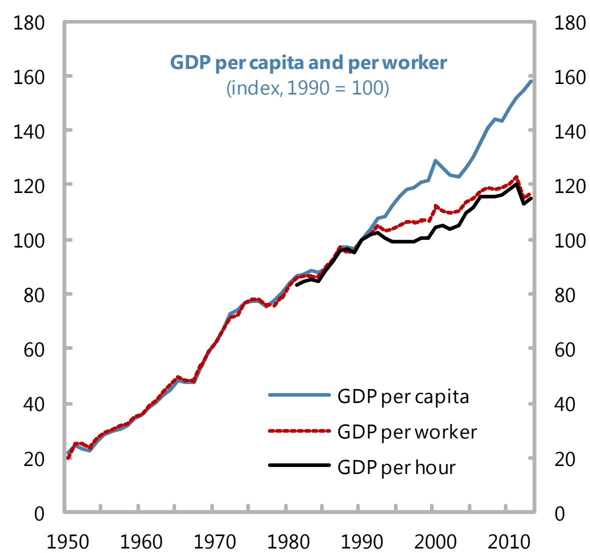
...with employment growing at a much faster pace than population.



But productivity growth has slowed...



...and GDP per hour has been nearly flat.



Sources: Total Economy Database; Central Bureau of Statistics; and Haver Analytics.

Table 1. Israel: Selected Economic Indicators, 2010–20
(Percent change, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
					Prel			Projections			
Real Economy (percent change)											
Real GDP	5.8	4.2	3.0	3.2	2.8	3.0	3.3	3.2	3.0	2.9	2.9
Domestic demand	5.4	5.5	3.5	2.7	3.2	4.9	3.2	2.8	2.8	2.7	2.7
Private consumption	4.6	2.9	3.1	3.3	4.1	5.7	3.1	2.7	2.6	2.5	2.5
Public consumption	2.8	2.7	3.6	3.5	4.2	2.8	3.3	3.0	3.0	3.0	3.0
Gross fixed investment	10.2	14.5	3.2	1.1	-2.8	0.0	3.5	4.5	4.4	4.4	4.4
Foreign demand (contribution to growth)	0.3	-1.2	-0.5	0.6	-0.5	-1.8	0.0	0.3	0.1	0.1	0.1
Potential GDP	4.0	3.7	3.4	3.2	3.1	3.1	3.1	3.0	3.0	3.0	2.9
Output gap (percent of potential)	0.1	0.6	0.2	0.3	-0.1	-0.1	0.0	0.2	0.1	0.0	0.0
Unemployment rate (percent)	8.3	7.1	6.9	6.3	5.9	5.4	5.2	5.3	5.5	5.5	5.5
Overall CPI (percent change, end of period)	2.7	2.2	1.6	1.8	-0.2	0.7	2.2	2.0	2.0	2.0	2.0
Overall CPI (percent change, average)	2.7	3.5	1.7	1.5	0.5	-0.1	2.0	2.1	2.0	2.0	2.0
Saving and investment balance											
Gross national saving (percent of GDP)	21.2	21.9	22.6	22.4	23.3	22.7	22.6	22.6	22.4	22.5	22.5
Foreign saving (percent of GDP)	-3.4	-1.5	-1.8	-2.8	-4.3	-3.7	-3.6	-3.5	-3.2	-3.2	-3.2
Gross fixed investment (percent of GDP)	17.8	20.4	20.8	19.6	19.0	19.0	19.1	19.1	19.2	19.3	19.3
Public Finance (percent of GDP)											
Central government											
Revenues and grants	25.5	26.0	24.9	25.7	26.0	25.9	25.8	25.8	25.8	25.8	25.8
Total expenditure	29.1	28.9	29.0	29.0	28.8	28.7	28.8	28.8	28.8	28.8	28.8
Overall balance	-3.5	-3.0	-4.1	-3.3	-2.8	-2.8	-3.0	-3.0	-3.0	-3.0	-3.0
Cyclically adjusted primary balance 1/	-0.7	-0.5	-1.5	-0.6	-0.1	-0.1	-0.4	-0.3	-0.2	-0.2	-0.1
General Government											
Overall balance	-4.6	-3.9	-5.1	-4.1	-3.6	-3.6	-3.8	-3.7	-3.6	-3.6	-3.6
Debt	71.1	69.7	68.3	67.6	67.1	67.2	67.5	67.8	68.3	68.8	69.2
Of which : Foreign currency external debt	11.9	11.9	10.6	9.6	9.7	10.8	11.8	12.6	12.9	12.9	12.6
Balance of Payments (percent of GDP)											
Exports of goods and services 2/	35.0	35.5	36.2	32.9	31.8	29.4	29.6	29.8	30.0	30.2	30.3
Real growth rate (percent)	15.1	6.5	0.9	1.5	1.1	0.4	4.7	5.5	5.0	5.0	5.0
Imports of goods and services 2/	33.0	36.0	36.1	31.6	30.5	27.9	28.3	28.5	28.7	28.9	28.9
Real growth rate (percent)	15.1	10.7	2.5	-0.1	2.4	5.8	4.5	4.5	4.5	4.5	4.5
Goods and services balance	2.2	0.6	1.3	1.8	1.6	1.5	1.3	1.3	1.3	1.3	1.4
Oil imports (billions of U.S. dollars)	10.5	13.6	16.1	14.6	12.8	8.0	9.1	9.8	10.5	11.0	11.3
Current account balance	3.4	1.5	1.8	2.8	4.3	3.7	3.6	3.5	3.2	3.2	3.2
Foreign reserves (end of period, billions of U.S. dollars)	70.9	74.9	75.9	81.8	86.1	87.7	88.5	89.3	89.3	89.3	89.3
Exchange Rate											
NIS per U.S. dollar	3.7	3.6	3.9	3.6	3.6	...	...	...	...	...	...
Nominal effective exchange rate (2005=100)	100.0	101.1	97.1	104.1	106.4	...	...	...	...	...	...
Real effective exchange rate (2005=100)	100.0	101.2	96.2	102.5	103.4	...	...	...	...	...	...

Sources: Bank of Israel; Central Bureau of Statistics; Haver Analytics; and IMF staff estimates and projections.
1/ Percent of potential GDP.
2/ National Accounts data.

Table 2. Israel: Balance of Payments, 2010–20
(In billions of U.S. dollars; unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
					Prel.			Projections			
Current account balance	7.9	3.9	4.5	8.1	13.0	11.6	11.3	11.3	10.6	10.3	10.6
Merchandise	-1.4	-7.5	-8.8	-8.4	-7.9	-3.3	-4.1	-4.5	-4.8	-4.6	-4.5
Exports, f.o.b.	56.8	65.0	62.8	62.7	63.3	57.4	58.9	60.4	62.0	60.5	62.1
Imports, f.o.b.	58.2	72.5	71.6	71.1	71.2	60.8	63.0	64.9	66.9	65.1	66.6
Services	6.6	9.1	12.1	13.6	12.9	7.9	8.2	8.8	9.0	8.8	9.0
Exports	25.4	29.4	32.9	34.5	35.4	33.6	34.5	36.2	37.5	37.0	38.5
Imports	18.8	20.3	20.8	20.8	22.5	25.7	26.4	27.4	28.5	28.2	29.4
Primary income	-5.2	-3.6	-6.7	-6.3	-2.0	-2.5	-2.5	-2.6	-3.3	-3.6	-3.6
Receipts	6.4	7.9	7.7	8.2	9.1	9.3	9.5	9.7	10.0	9.7	10.0
Payments	11.4	11.3	14.4	14.5	11.1	11.8	12.0	12.3	13.3	13.2	13.6
Secondary income	8.1	8.6	8.0	9.1	10.0	9.6	9.8	9.7	9.7	9.7	9.7
Receipts	10.7	11.1	10.4	11.6	12.4	12.0	12.2	12.1	12.2	12.2	12.2
Payments	2.5	2.5	2.4	2.5	2.4	2.5	2.5	2.5	2.5	2.5	2.5
Capital account	1.2	1.5	0.8	1.8	2.6	2.2	2.4	2.3	2.3	2.3	2.3
Financial account 1/	-1.3	8.4	6.6	5.2	8.6	12.2	12.9	12.9	12.9	12.7	12.9
Direct investment, net	2.3	0.4	-5.2	-6.9	-3.1	-5.0	-4.0	-4.5	-4.3	-4.4	-4.3
Foreign direct investment abroad	8.6	9.2	3.3	5.5	3.7	4.6	4.1	4.4	4.2	4.3	4.3
Foreign direct investment in Israel	6.3	8.7	8.5	12.4	6.7	9.6	8.2	8.9	8.5	8.7	8.6
Portfolio investment, net	0.2	8.8	10.9	7.6	0.8	4.2	2.5	3.3	2.9	3.1	3.0
Financial derivatives, net	0.0	0.0	-0.3	-0.5	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
Other investment, net	-3.7	-0.8	1.3	5.0	11.3	13.5	14.9	14.5	14.8	14.4	14.7
Change in reserves	11.9	4.5	-0.2	4.4	7.4	1.6	0.8	0.8	0.0	0.0	0.0
Errors and omissions	1.6	7.6	1.1	-0.4	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:											
Current account balance (percent of GDP)	3.4	1.5	1.8	2.8	4.3	3.7	3.6	3.5	3.2	3.2	3.2
Terms of trade (percent growth)	-6.0	-5.9	5.3	1.4	-3.9	8.5	-1.3	-1.4	-1.3	-0.8	-0.6
Gross external debt (percent of GDP)	48.0	42.3	39.7	34.9	31.6	29.0	27.1	26.0	26.0	28.4	30.4
Foreign reserves (billions of US dollars)	70.9	74.9	75.9	81.8	86.1	87.7	88.5	89.3	89.3	89.3	89.3
GDP (billions of U.S. dollars)	232.9	258.4	257.2	290.6	304.2	309.8	315.9	324.0	331.8	323.1	331.7

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

Table 3. Israel: International Investment Position, 2007–14

(In percent of GDP)

	2007	2008	2009	2010	2011	2012	2013	2014
Net Investment	-0.1	7.4	5.7	10.4	16.3	20.5	21.5	21.3
Direct investment	0.4	2.9	0.6	3.3	2.1	-2.1	-3.9	-4.5
Portfolio investment	-25.6	-17.8	-22.2	-19.7	-10.6	-3.3	-1.5	-5.2
Financial derivatives	0.0	0.0	0.0	-0.1	-0.1	-0.1	0.0	-0.1
Reserve assets	16.2	19.9	29.4	30.4	29.0	29.5	28.2	28.3
Other investment	8.9	2.4	-2.0	-3.7	-4.0	-3.4	-1.1	2.8
Total Assets	111.9	91.0	110.0	111.9	102.7	107.5	107.7	110.2
Direct investment	28.2	25.4	27.8	29.6	27.4	27.7	26.4	26.2
Portfolio investment	23.8	15.6	23.9	26.7	24.1	29.6	32.9	34.9
Reserve assets	16.2	19.9	29.4	30.4	29.0	29.5	28.2	28.3
Other assets	43.7	30.1	28.9	25.1	22.3	20.8	20.3	20.9
Total Liabilities	112.0	83.6	104.3	101.4	86.3	87.0	86.2	88.9
Direct investment	27.8	22.6	27.2	26.3	25.3	29.8	30.3	30.7
Portfolio investment	49.4	33.4	46.2	46.4	34.8	33.0	34.4	40.1
Other liabilities	34.8	27.7	30.9	28.8	26.3	24.3	21.4	18.2

Sources: Central Bureau of Statistics; and Haver Analytics.

Table 4. Israel: Summary of Central Government Operations, 2010–15[1]

(In percent of GDP; unless otherwise indicated)

	2010	2011	2012	2013	2014 Est.	2015 Proj.
Revenue and grants	25.5	26.0	24.9	25.7	26.0	25.9
On income and profits	10.7	11.2	10.8	11.5	11.5	11.4
VAT and customs	11.1	11.1	10.6	10.9	11.3	11.3
Fees	0.6	0.6	0.5	0.6	0.6	0.6
VAT on defense imports	0.1	0.1	0.1	0.1	0.1	0.1
Interest	0.2	0.2	0.1	0.1	0.1	0.1
Loans from NII	1.3	1.5	1.4	1.3	1.3	1.3
Grants	1.0	0.9	0.9	0.8	0.8	0.7
Other	0.4	0.4	0.3	0.4	0.3	0.5
Expenditure	29.1	28.9	29.0	29.0	28.8	28.7
Administrative Departments	4.1	4.0	4.1	4.1	4.0	4.0
Social Departments	11.2	11.3	11.4	11.4	11.2	11.4
Economic Departments	2.0	2.2	2.1	2.5	2.5	2.4
Defense Expenditure	6.7	6.4	6.3	6.2	5.6	5.8
Other Expenditures	0.3	0.3	0.4	0.2	0.7	0.6
Reserve	0.0	0.0	0.0	0.0	0.0	0.0
Interest	4.0	3.9	3.8	3.7	3.7	3.5
Repayment of Principal to NII	0.9	0.9	0.9	0.9	0.9	1.0
Budget deficit	-3.5	-3.0	-4.1	-3.3	-2.8	-2.8
Unsettled Payment Orders 2/	-1.1	-1.0	0.1	-0.1	0.0	0.0
Financing	2.5	2.0	4.2	3.2	2.8	2.8
Foreign (net)	-0.1	0.0	-0.1	0.0	-0.1	0.0
Loans	1.4	0.6	1.2	1.2	0.9	0.9
Repayment	-1.5	-0.6	-1.3	-1.1	-1.0	-1.0
Domestic (net)	2.0	1.3	4.3	3.1	2.8	2.4
Loans	8.0	9.3	11.4	10.2	9.2	6.1
Repayment	-6.0	-8.1	-7.1	-7.1	-6.4	-3.7
Sale of assets (net)	0.6	0.7	0.1	0.1	0.1	0.4
Memorandum items:						
Primary spending	25.1	25.0	25.1	25.4	25.2	25.2
Primary balance (PB)	0.2	0.8	-0.4	0.2	0.8	0.6
Cyclically adjusted balance (percent of potential GDP)	-4.6	-4.2	-5.2	-4.2	-3.6	-3.5
Cyclically adjusted PB (percent of potential GDP)	-0.7	-0.5	-1.5	-0.6	-0.1	-0.1
Deficit limit 3/	...	3.0	2.0	4.0	2.8	2.5
Real expenditure growth (in percent)	0.3	2.1	5.6	4.4	2.5	4.6
Ceiling on the real expenditure growth (in percent)	...	2.7	3.2	4.6	3.0	...
Public debt to GDP	71.1	69.7	68.3	67.6	67.1	67.2
Nominal GDP (in billions of NIS)	871	925	992	1,049	1,088	1,142

Sources: Israeli Ministry of Finance; and IMF staff estimates and projections.
1/ Data as per the Ministry of Finance definition, on a cash basis, covering the budgetary sector and the National Insurance Institute.
2/ Registered spending but for which the equivalent cash has not yet been disbursed, hence it does not appear in financing.
3/ Budget.

Table 5. Israel: General Government Operations, 2008–14

	2008	2009	2010	2011	2012	2013	2014
				(In billions of NIS)			
Revenue	303.4	296.5	325.2	349.7	361.9	389.5	407.4
Total expenditure	329.0	347.0	365.2	386.1	413.0	432.4	446.5
Expense	327.3	345.9	364.0	383.9	411.4	428.3	445.2
Net acquisition of nonfinancial assets	1.6	1.1	1.2	2.2	1.6	4.1	1.3
Overall balance	-25.6	-50.5	-40.0	-36.4	-51.1	-42.9	-39.1
				(in percent of GDP)			
Revenue	39.5	36.5	37.3	37.8	36.5	37.1	37.4
Taxes	26.4	24.4	25.0	25.4	24.4	25.3	25.8
Taxes on income, profits, and capital gains	10.9	9.2	9.3	9.7	9.4	9.9	10.0
Taxes on payroll & workforce	1.2	1.2	1.2	1.2	1.2	1.1	1.2
Taxes on property	2.7	2.7	2.7	2.7	2.6	2.1	2.1
Taxes on goods & services	11.2	11.1	11.5	11.5	11.1	11.9	12.3
Taxes on international trade & transactions	0.3	0.3	0.3	0.3	0.3	0.2	0.3
Other taxes	0.0	0.0	0.0	0.0	0.0	0.1	0.0
Social contributions	6.3	6.0	6.1	6.2	6.0	6.0	6.0
Grants	1.3	1.0	1.2	1.1	1.2	1.0	1.0
Other revenue	5.6	5.1	5.0	5.1	4.9	4.8	4.6
Of which: Interest income	0.8	0.7	0.6	0.6	0.5	0.5	0.4
Total expenditure	42.9	42.7	41.9	41.8	41.6	41.2	41.0
Expense	42.6	42.6	41.8	41.5	41.5	40.8	40.9
Compensation of employees	11.2	11.1	11.0	11.1	11.0	10.5	10.5
Purchases/use of goods & services	12.2	12.0	12.0	12.0	11.9	10.2	10.5
Consumption of fixed capital (CFC)	1.4	1.4	1.3	1.3	1.3	1.3	1.3
Interest	4.9	4.7	4.5	4.3	4.3	4.1	4.0
Subsidies	0.7	0.8	0.7	0.7	0.7	0.8	0.9
Grants	0.1	0.1	0.0	0.0	0.0	0.1	0.1
Social benefits	8.9	9.3	9.1	9.1	9.1	10.5	10.6
of which: Social security benefits	5.5	5.8	5.7	5.7	5.7	6.2	6.2
Other expense	3.3	3.4	3.1	3.0	3.1	3.3	3.1
Net acquisition of nonfinancial assets	0.2	0.1	0.1	0.2	0.2	0.4	0.1
Overall balance	-3.3	-6.2	-4.6	-3.9	-5.1	-4.1	-3.6
Memorandum item:							
Primary spending (Billions NIS)	291.0	309.0	325.8	346.3	370.7	389.7	403.4
Primary balance (percent of GDP)	0.8	-2.2	-0.7	-0.2	-1.4	-0.5	-0.1
Public debt to GDP	72.7	75.0	71.1	69.7	68.3	67.6	67.1
Real GDP growth (percent)	3.5	1.9	5.8	4.2	3.0	3.2	2.8
Inflation (percent)	4.6	3.3	2.7	3.5	1.7	1.5	0.5
Exchange rate (NIS to US$)	3.6	3.9	3.7	3.6	3.9	3.6	3.6
Nominal GDP (Billions NIS)	767.5	811.9	870.8	924.6	991.8	1,049.1	1,088.5

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

Table 6. Israel: Financial System Structure, 2005–13

	2005			2008			2010			2013				
	Number of	Total assets		Number of	Total assets		Number of	Total assets		Number of			Total assets	
	Institutions/ funds	NIS billions	Percent of GDP	Institutions /funds	NIS billions	Percent of GDP	Institutions /funds	NIS billions	Percent of GDP	Institutions /funds	Branches	Employees	NIS billions	Percent of GDP
A. Banks														
Five major banks, consolidated	**5**	**859.2**	**135.6**	**5**	**1,012.8**	**132.0**	**5**	**1,068.8**	**122.7**	**5**	**1,235**	**47,287**	**1,245.8**	**118.8**
Bank Leumi Le Israel	1	272.8	43.0	1	310.8	40.5	1	328.2	37.7	1	322	13,307	374.4	35.7
Bank Hapoalim	1	273.3	43.1	1	306.8	40.0	1	320.9	36.8	1	304	13,202	380.2	36.2
Israel Discount Bank	1	154.8	24.4	1	182.2	23.7	1	185.8	21.3	1	249	9,834	200.5	19.1
Mizrahi Tefahot Bank	1	86.3	13.6	1	114.0	14.9	1	133.3	15.3	1	177	5,767	179.6	17.1
First International Bank of Israel	1	71.9	11.3	1	98.9	12.9	1	100.7	11.6	1	183	5,177	111.1	10.6
Other Israeli banks	**3**	**42.1**	**6.6**	**3**	**49.0**	**6.4**	**3**	**52.8**	**6.1**	**3**	**58**	**1,851**	**61.8**	**5.9**
Foreign bank branches	…	…	…	…	…	…	…	…	…	**4**	**4**	…	**16.0**	**1.5**
B. Non-bank financial institutions		**667.7**	**105.4**		**765.2**	**99.7**		**1,068.0**	**122.6**				**1,390.2**	**132.5**
Provident and severance pay funds	104	165.6	26.1	87	145.4	18.9	66	194.1	22.3	75	…	…	204.2	19.5
Advanced study funds	…	72.0	11.4	…	72.6	9.5	…	112.0	12.9	…	…	…	142.8	13.6
Old pension funds	18	142.5	22.5	18	237.2	30.9	18	287.2	33.0	18	…	…	347.6	33.1
New pension funds	18	44.7	7.1	13	71.0	9.2	10	111.3	12.8	13	…	…	185.6	17.7
Mutual funds	918	124.6	19.7	1,185	98.1	12.8	1,247	156.6	18.0	1,247	…	…	230.8	22.0
Assured yield life insurance plans	…	47.3	7.5	…	54.9	7.2	…	66.1	7.6	…	…	…	77.6	7.4
Profit sharing life insurance plans	…	71.1	11.2	…	86.1	11.2	…	140.7	16.2	…	…	…	201.5	19.2
Total financial system (A+B)	…	**1,526.9**	**240.9**	…	**1,778.0**	**231.7**	…	**2,136.8**	**245.4**	…	…	…	**2,636.0**	**251.3**
Memorandum items:														
GDP (NIS billions)	…	…	633.8	…	…	767.5	…	…	870.8	…	…	…	…	1,049.1

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

Table 7. Israel: Financial Soundness Indicators: Banks, 2008–14

(End-period, in percentage points)

	2008	2009	2010	2011	2012	2013	2014
Capital Adequacy							
Regulatory capital to risk-weighted assets 1/	11.3	13.7	14.1	14.0	14.9	14.6	14.3
Regulatory Tier I capital to risk-weighted assets 1/	7.6	8.3	8.5	8.4	9.2	9.7	9.7
Capital as percent of assets (leverage ratio)	6.1	6.5	6.7	6.3	6.6	7.0	7.1
Asset quality and exposure							
Nonperforming loans to total gross loans	…	…	…	3.4	3.5	2.9	2.2
Nonperforming loans net of loan-loss provisions to capital	…	…	…	12.3	13.0	9.0	4.7
Sectoral distribution of bank credit (percent) 2/							
Industry	13.0	11.1	10.5	9.6	8.9	8.5	…
Construction and real estate	16.9	16.8	16.7	16.6	16.4	16.2	…
Commerce	8.5	7.5	7.5	6.4	6.5	6.7	…
Finance services	12.5	11.8	11.7	8.0	7.5	7.5	…
Households	32.8	37.1	38.3	35.2	36.7	38.5	…
Of which: mortgages	19.8	22.8	24.2	17.7	19.0	20.4	…
Borrowers with activity abroad	…	…	…	13.0	12.6	11.6	…
Others	16.3	15.7	15.2	11.3	11.4	11.1	…
Large exposures as percent of regulatory capital	521.1	399.8	397.2	395.0	364.8	356.1	…
Earnings and profitability							
Return on average assets (before tax)	0.0	0.9	0.9	0.8	0.8	0.9	0.8
Return on average equity (before tax)	0.7	14.1	13.8	12.3	12.2	13.4	11.7
Interest margins to gross income	59.4	59.5	63.5	65.2	60.7	58.7	58.2
Trading and fee income to gross income	8.8	8.0	8.0	7.1	6.4	6.1	6.7
Noninterest expenses to gross income	82.2	64.0	68.4	70.3	69.8	69.2	72.0
Personnel expenses to noninterest expenses	58.5	56.2	57.3	59.0	58.2	59.5	57.9
Liquidity							
Liquid assets as percent of total assets	…	…	…	…	…	14.2	15.7
Liquid assets as percent of short-term liabilities	…	…	…	…	…	25.7	27.7
Customer deposits as a percent of total (non-interbank) loans	107.2	110.4	104.7	111.3	113.0	113.9	115.8
Foreign exchange risk							
Net foreign exchange open position to capital	-9.5	-41.3	-43.7	-44.6	-43.7	-56.0	-55.2
Foreign currency-denominated loans as percent of total loans	24.9	21.7	16.2	16.6	14.9	13.1	13.2
Foreign currency-denominated liabilities as percent of total liabilities	35.6	32.9	29.6	29.7	27.7	26.8	29.3

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

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

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Table 8. Israel: Financial Soundness Indicators: Non-Banks, 2008–14

(End-period, in percentage points; unless otherwise indicated)

	2008	2009	2010	2011	2012	2013	2014
Insurance sector							
Return on equity	-19.0	35.9	19.3	-0.5	14.4	18.3	11.9
Net premiums as percent of capital	302.6	204.1	192.5	224.5	213.2	201.3	194.0
Capital as percent of technical reserves	6.0	7.3	7.4	6.4	6.4	6.5	6.4
Surplus capital as percent of required solvency 1 capital	1.5	25.5	28.8	16.6	32.7	40.4	44.8
Liquid assets as percent of total assets	41.4	49.5	52.4	51.2	51.9	53.4	56.0
Households							
Household assets as percent of disposable income	456.5	463.9	455.4	453.5	443.1	439.6	...
Of which: residential buildings	148.2	138.8	138.7	139.8	140.0	139.2	...
Household debt as percent of disposable income	76.4	75.4	74.1	77.4	76.0	75.2	...
Corporate sector							
Non-financial sector borrowing to GDP ratio	82.1	79.8	79.2	78.4	74.6	70.5	...
From residents	66.0	64.8	65.4	63.9	61.2	58.2	...
From non residents	16.1	15.0	13.8	14.5	13.4	12.2	...
Debt to equity ratio							
All nonfinancial corporate	2.6	2.2	2.2	2.3	2.2	2.0	1.9
Of which: Manufacturing sector	1.3	1.1	1.1	1.5	1.4	1.2	1.2
Construction corporate	4.1	3.8	3.0	2.9	2.4	2.3	2.1
Net income to equity ratio							
All nonfinancial corporate	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Of which: Manufacturing sector	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Construction corporate	-0.2	0.0	0.0	0.0	0.1	0.1	0.1
Earning before interest and tax to equity ratio							
All nonfinancial corporate	0.1	0.1	0.2	0.2	0.2	0.2	0.2
Of which: Manufacturing sector	0.1	0.1	0.2	0.2	0.1	0.1	0.1
Construction corporate	0.0	0.1	0.2	0.2	0.2	0.2	0.1
Equity markets							
Tel Aviv Stock Exchange Index 75 (annual percent change)	-67.5	149.8	15.7	-25.9	4.8	24.7	-9.8
Equity prices of financial institutions (annual percent change)	-55.7	126.9	9.3	-34.0	23.1	18.8	-7.7
Equity prices of real estate firms (annual percent change)	-80.0	125.2	15.4	-23.2	14.1	26.0	0.9
Equity prices of banks (annual percent change)	-55.5	114.0	6.8	-34.6	22.9	16.3	-5.6
Market capitalization in percent of GDP	52.9	88.1	92.6	64.9	60.9	67.3	71.7
Corporate bond markets							
Corporate bond yields over government bond yields (in basis points)							
Real estate and construction	20.0	9.7	4.8	8.1	5.7	3.1	3.8
Manufacturing	7.5	3.6	3.1	4.8	4.2	4.9	4.4
Corporate bond outstanding (in billions of NIS)	185.6	217.3	240.1	238.7	260.7	270.7	263.4
Average daily turnover (in billons of NIS)	0.9	0.9	0.9	0.9	1.0	1.0	1.0
Real estate markets (prices; annual percent change)							
Average prices of owner occupied dwelling	6.5	22.4	17.0	0.0	5.8	7.4	8.4
Jerusalem	13.3	15.5	14.7	8.6	0.6	2.0	6.0
Tel Aviv	10.7	34.1	16.9	-4.8	-9.2	36.1	10.2
Memorandum items							
GDP (year on year percent change, constant prices)	3.5	1.9	5.8	4.2	3.0	3.2	2.8
Nominal GDP (in billions of NIS)	768	812	871	925	992	1,049	1,088
Total financial sector assets (in billions of NIS)	1,778	2,002	2,137	2,258	2,439.8	2,636.0	...
Of which: Five major banks (in percent of total financial assets)	57.0	52.1	50.0	52.1	50.0	47.3	...
Total financial sector assets (in percent of GDP)	231.7	246.6	245.4	244.2	246.0	251.3	...
of which: Five major banks (in percent of GDP)	132.0	128.4	122.7	127.2	123.1	118.8	...

Sources: Bank of Israel, and IMF staff estimates.

Table 9. Israel: Credit by Financial Sector and Nonresidents, 2005–14
(In percent of GDP)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Financial Sector Credit										
Banks	91.4	87.0	87.5	89.2	84.3	84.9	86.2	82.5	79.6	79.2
Of which to:										
Business sector	53.1	49.4	49.5	50.3	44.5	44.1	43.6	40.3	36.6	35.1
Households	28.7	27.8	28.4	30.0	31.3	32.8	33.9	33.9	34.8	36.3
Government	9.7	9.7	9.6	8.8	8.5	8.0	8.7	8.3	8.1	7.9
Institutional investors	59.0	57.9	57.3	51.7	53.6	52.9	51.1	53.2	54.1	54.4
Of which to:										
Business sector	12.7	16.8	21.1	13.5	15.8	15.3	14.4	14.5	14.3	13.7
Households	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.7	0.7	0.8
Government	45.6	40.5	35.6	37.6	37.3	37.0	36.1	38.1	39.1	39.9
Credit card companies	0.4	0.6	0.7	0.8	1.0	1.1	1.1	1.1	1.1	1.3
Of which to:										
Business sector	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.2	0.1	0.2
Households	0.4	0.5	0.6	0.7	0.8	1.0	1.0	1.0	1.0	1.1
Total financial sector credit	150.8	145.5	145.5	141.7	138.9	138.9	138.4	136.8	134.8	134.9
Nonresidents Credit to:										
Business sector	17.3	20.1	18.7	17.8	17.2	16.5	17.7	17.0	15.7	16.6
Households	-	-	-	-	-	-	-	-	-	-
Government	22.3	20.5	16.7	13.8	13.4	11.5	12.9	11.4	9.5	10.3
Total nonresidents credit	39.6	40.5	35.5	31.6	30.6	28.1	30.6	28.4	25.1	26.9
Government Credit to:										
Business sector	1.6	1.4	1.1	0.7	0.5	0.5	0.4	0.5	0.4	0.5
Households	7.5	6.7	6.2	5.6	4.9	4.0	3.3	2.6	2.2	1.8
Total government credit	9.1	8.2	7.3	6.3	5.4	4.5	3.7	3.1	2.6	2.2
Households and Nonfinancial Corporations Credit to:										
Business sector	3.4	3.6	5.1	4.2	8.3	9.4	7.7	8.0	8.6	8.2
Government	13.9	12.6	14.7	16.4	20.5	19.3	16.4	16.6	16.3	16.1
Total HH and NFC credit	17.2	16.2	19.9	20.6	28.8	28.6	24.1	24.7	24.9	24.3
Total Credit	216.7	210.4	208.1	200.2	203.6	200.2	196.8	193.0	187.3	188.4

Source: Haver Analytics.

Table 10. Israel: Business and Household Sector Borrowing, 2007–14
(In percent of GDP)

	2007	2008	2009	2010	2011	2012	2013	2014
Total business sector borrowing	100.1	98.3	91.8	89.3	86.7	82.0	76.1	74.6
Bank loans	52.4	53.5	47.8	47.0	43.9	40.3	36.8	35.1
Institutional investor loans	1.5	1.4	1.7	2.0	2.6	3.4	4.2	4.5
Bonds	20.8	19.5	15.7	13.7	13.7	12.3	10.4	9.5
External borrowing	18.7	17.8	17.2	16.5	17.7	17.0	15.7	16.6
Others	6.6	6.1	9.4	10.1	8.9	9.0	9.1	8.9
Total household sector borrowing	36.7	37.5	38.3	39.0	39.3	38.6	39.0	40.2
Mortgage	24.1	24.8	25.2	26.3	26.8	26.8	27.2	27.6
Others	12.6	12.8	13.1	12.7	12.5	11.8	11.9	12.7

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

Annex I. Israel: Risk Assessment Matrix

(Scale—low, medium, and high)

Source of risks	Relative Likelihood	Impact	Israel's Preparedness
Globally-sourced risks			
1. A surge in financial volatility	**High**	**Low/ Medium**	**High** Israel has strong buffers to external shocks with foreign reserves amounting to 200 percent of short-term external debt, a current account surplus, and a positive net international investment position. The US government-guarantee program provides additional assurance. In addition, prospective US monetary tightening could weaken appreciation pressures and benefit Israel.
2. Protracted period of slower growth in key advanced and emerging economies	**High**	**Medium**	**Medium** Renewed appreciation of the shekel will hurt manufacturing exports but service exports, supported by IT start ups, will be less affected. Monetary policy can be eased further, potentially introducing unconventional policy measures. Fiscal policy stance can be eased by allowing automatic stabilizers to operate fully.
Domestically-sourced risks			
3. Financial imbalances from a protracted period of low interest rates continue to build, and eventually lead to a sharp reversal of a housing boom	**Medium**	**High**	**Medium** If house prices fall sharply, macroprudential policies that the BOI has implemented in recent years can be reversed. If house prices continue to rise, tighter macroprudential policies can be implemented.
4. Further delays in fiscal consolidation, reversing the downward trend in government debt.	**Medium**	**Medium**	**Medium** General government debt is low relative to other OECD economies. However, the downward trend has stalled. The medium-term fiscal and framework is weak, and there is substantial scope to strengthen commitment to fiscal rules.
5. Failure of systemically important financial institutions	**Low**	**Medium-High**	**Medium** Bank capital and liquidity requirements have been strengthened. A formal macroprudential oversight mechanism has yet to be established. The legislation of a new bank resolution is underway.
6. Heightened geopolitical risks in the Middle East	**High**	**Medium/ High**	**N/A**

Annex II. Israel: Debt Sustainability Analysis 2015

Public debt sustainability has substantially improved, with the debt-to-GDP ratio decreasing from 94 percent in 2003 to 67 percent in 2014.[1] *The debt structure would help to assure resilience to shocks, with debt maturity averaging around 7 years and debt held by non residents around 15 percent of the total. Nevertheless, high interest payments and elevated gross financing needs still place the country in a vulnerable position. Although most indicators are below early warning benchmarks, Israel's debt profile appears to be highly vulnerable to growth shocks.*

1. **Under staff's baseline scenario, public debt-to-GDP ratio is projected to keep increasing gradually to 69 percent of GDP by 2020 (Figures A2.1–A2.3).** The path is worse than the authorities' implicit goal of reducing public debt to 60 percent of GDP by 2020 and eventually to 50 percent of GDP over a longer horizon. The DSA covers debt of the general government. The baseline scenario is underpinned by the following assumptions:

- Real GDP is projected to grow at 3 percent for 2015 and 3.3 percent for 2016 then stay around 3 percent afterwards. The output gap is expected to be broadly closed throughout the projection period.[2]

- CPI inflation is expected to rise to 2 percent in 2016 and remain around 2 percent throughout the projection period.

- The budget deficit is expected to be at 2.8 percent of GDP in 2014 and 2015. Thereafter, it is projected to expand to around 3 percent of GDP in 2016 as various government projects would commence, then stay at 3 percent of GDP through 2020. The general government deficit is assumed to be larger than the budget deficit by 0.8 percentage points of GDP annually through 2020.

- Primary expenditure is projected to stay around 37 percent of GDP through 2020.[3]

- The effective interest rate is projected to slowly decline from about 6 percent in 2014 to about 5¼ percent in 2020 due mainly to the lagged effect of declining interest rates in recent years and continued favorable borrowing conditions—facilitated by comfortable sovereign ratings (A+ and A1) and the U.S. debt guarantee program (about 15 percent of external debt until 2016)—remain favorable. Interest rates on new borrowing are assumed to increase gradually during the projection period.

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

[2] Staff's scenario does not assume a boom-bust scenario presented in Figure A2.2.

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

- However, the level of interest payments would remain elevated throughout the projection period, partly because of designated bonds guaranteeing certain investment returns to pension funds. Gross financing needs will decline to 6.7 percent of GDP in 2015, and then increase to 12 percent of GDP by 2019.

2. **Risks to the baseline are broadly balanced.** On one hand, if the government manages to adhere to the targets under the Deficit Reduction Law, debt would decline to around 61 percent of GDP by 2020. On the other hand, there are risks of larger fiscal slippages due, for example, to unforeseeable geopolitical shocks, the collapse of the housing market, or disappointing returns to public investment.

Shocks and Stress Tests

3. **A range of stress tests indicate that debt sustainability is particularly susceptible to growth, interest rate, and combined macro-fiscal shocks** (Figures A2.4—A2.6).

- *Growth shock*. Lower real GDP growth rates (by 1 standard deviation for 2 years starting in 2016) would lead to a deterioration of the primary balance, as revenues fall (while expenditure remains unchanged). Financing needs would increase by 2 percent of GDP to 13 percent of GDP by 2017 and keep increasing gradually through 2020. The debt-to-GDP ratio would rise to above 73 percent by 2020.

- *Interest rate shock*. A geopolitical shock might raise market concerns about medium-term debt sustainability, pushing up borrowing costs by 200 basis points. Financing needs would increase marginally by ½ percent of GDP by 2020. The impact on public debt would also be very small: less than 1 percent of GDP higher by 2020 compared to the baseline.

- *Combined macro-fiscal shock*. A shock that combines exchange rate depreciation, an expansion of the primary deficit, and a decline in real GDP would raise financing needs to above 14 percent of GDP and debt to above 75 percent of GDP by 2019.

4. **Finally, a tail risk scenario, combining sharp correction in the housing market with a geopolitical shock, is considered.** Under the scenario, public debt would rise to above 75 percent of GDP by 2018 and keep increasing gradually to around 77 percent of GDP by 2020. Gross financing needs would increase to close to 15 percent of GDP by 2017 then stay around the level through 2020. The scenario assumes that:

- Real GDP contracts by 3½ percent and remains below potential in 2016.

- House prices drop by 20 percent in 2016.

- The shekel/dollar exchange rate depreciates by 15 percentage points in 2016 and 10 percentage points in 2017 compared to the baseline.

- Inflation increases by 3 percentage points in 2016 and 1 percentage point in 2017 compared to the baseline.

- Interest rates increase by 200 basis points in 2016 and 150 basis points in 2017 compared to the baseline.

The revenue-to-GDP ratio is assumed to decline—due to the automatic stabilizer and worsened tax compliance—by ½ percentage points of GDP in 2016 and ¼ percentage points in 2017 compared to the baseline while expenditure in nominal term is assumed to remain unchanged from the baseline for 2016–17 (therefore expenditure-to-GDP ratio increases compared to the baseline).

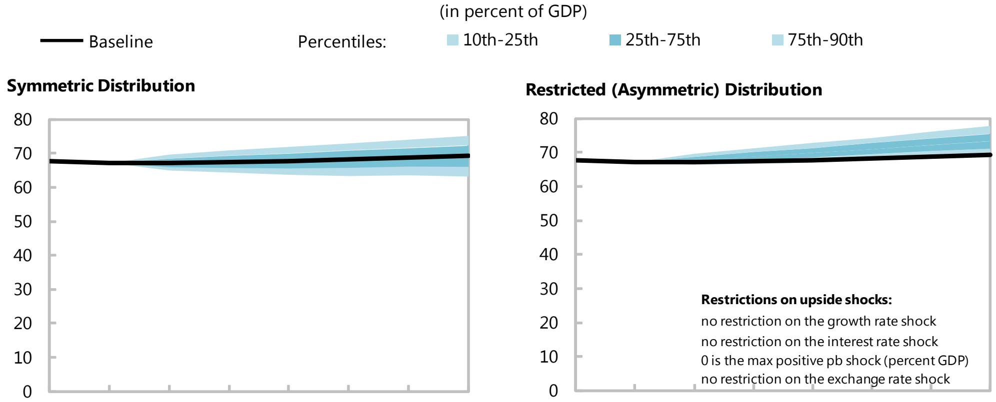
Figure A2.1. Israel: Public DSA–Risk Assessment

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

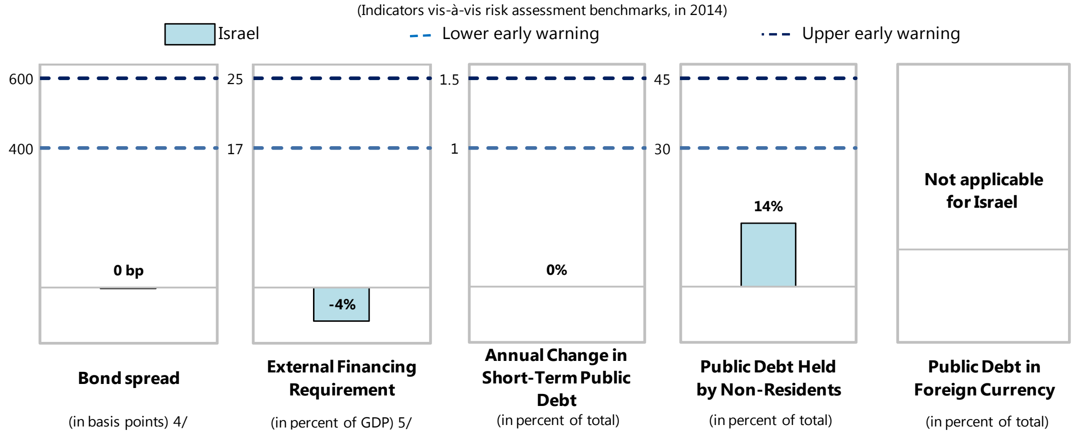
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2014)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

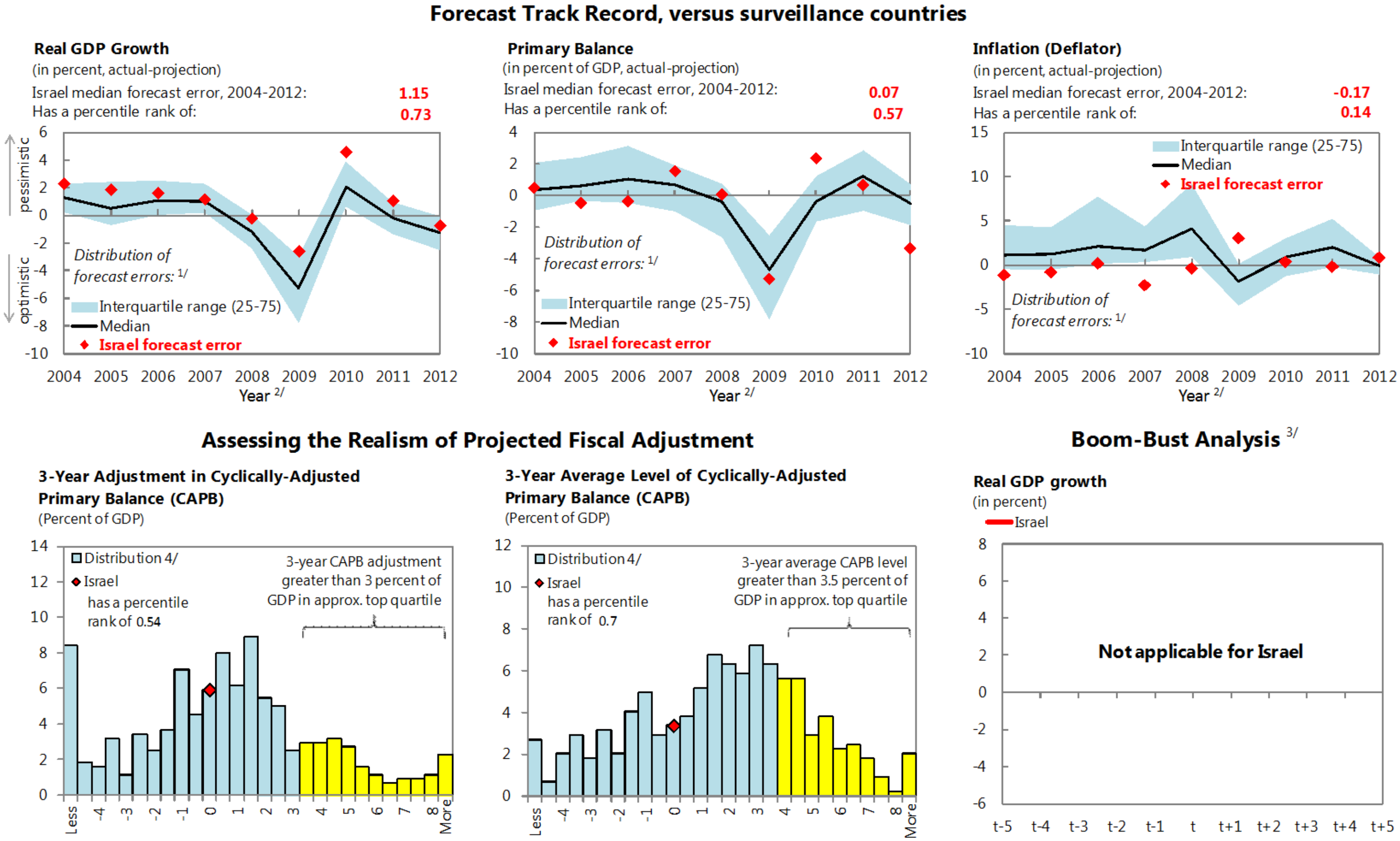
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant,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

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ Long-term bond spread over U.S. bonds, an average over the last 3 months, 04-Feb-15 through 05-May-15.

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

Figure A2.2. Israel: Public DSA–Realism of Baseline Assumptions



Source : IMF Staff.

1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Israel, as it meets neither the positive output gap criterion nor the private credit growth criterion.

4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure A2.3. Israel: Public Sector Debt Sustainability Analysis (DSA)–Baseline Scenario

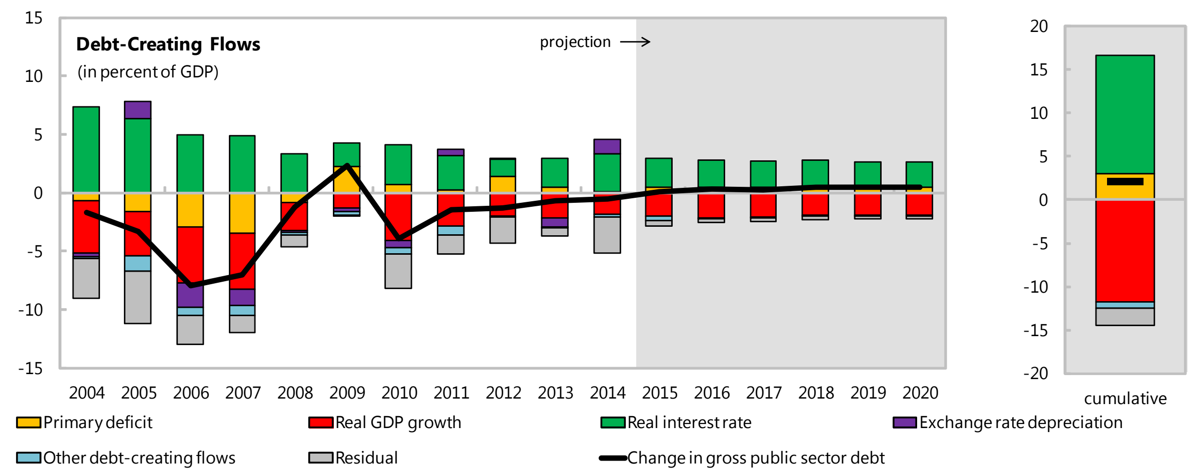
Debt, Economic and Market Indicators [1]

	Actual			Projections					
	2004-2012 [2]	2013	2014	2015	2016	2017	2018	2019	2020
Nominal gross public debt	77.0	67.6	67.1	67.2	67.5	67.8	68.3	68.8	69.2
Public gross financing needs	11.6	12.5	12.1	6.7	9.7	10.8	11.3	12.0	12.3
Real GDP growth (in percent)	4.4	3.2	2.8	3.0	3.3	3.2	3.0	2.9	2.9
Inflation (GDP deflator, in percent)	1.8	2.5	1.0	1.8	1.8	1.8	1.8	1.9	1.9
Nominal GDP growth (in percent)	6.3	5.8	3.8	4.9	5.1	5.1	4.8	4.8	4.8
Effective interest rate (in percent) [4]	7.2	6.3	6.1	5.7	5.5	5.4	5.4	5.3	5.3

As of May 05, 2015		
Sovereign Spreads		
Spread (bp) 3/		-1
5Y CDS (bp)		72
Ratings	Foreign	Local
Moody's	A1	A1
S&Ps	A+	A+
Fitch	A	A+

Contribution to Changes in Public Debt

	Actual			Projections							
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	-2.8	-0.7	-0.5	0.1	0.3	0.3	0.5	0.5	0.5	2.1	
Identified debt-creating flows	-0.7	0.0	2.6	0.6	0.6	0.6	0.8	0.8	0.7	4.1	
Primary deficit	-0.5	0.5	0.1	0.5	0.5	0.5	0.5	0.5	0.5	2.9	0.2
Primary (noninterest) revenue and grants	38.8	36.6	37.0	36.7	36.7	36.7	36.7	36.7	36.7	219.9	
Primary (noninterest) expenditure	38.3	37.1	37.1	37.2	37.1	37.1	37.1	37.1	37.1	222.9	
Automatic debt dynamics [5]	0.4	-0.4	2.7	0.5	0.2	0.2	0.4	0.3	0.3	1.9	
Interest rate/growth differential [6]	0.7	0.3	1.5	0.5	0.2	0.2	0.4	0.3	0.3	1.9	
Of which: real interest rate	4.1	2.4	3.3	2.5	2.3	2.2	2.3	2.2	2.2	13.7	
Of which: real GDP growth	-3.4	-2.1	-1.8	-1.9	-2.1	-2.0	-1.9	-1.9	-1.9	-11.8	
Exchange rate depreciation [7]	-0.3	-0.8	1.2	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.5	-0.1	-0.2	-0.4	-0.1	-0.1	-0.1	-0.1	-0.1	-0.8	
Privatization (negative)	-0.5	-0.1	-0.2	-0.4	-0.1	-0.1	-0.1	-0.1	-0.1	-0.8	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt flows (incl. ESM and Euroarea loans)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8]	-2.2	-0.7	-3.1	-0.5	-0.3	-0.3	-0.3	-0.3	-0.3	-2.0	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over U.S. bonds.

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

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi (1+g)$ and the real growth contribution as $-g$.

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

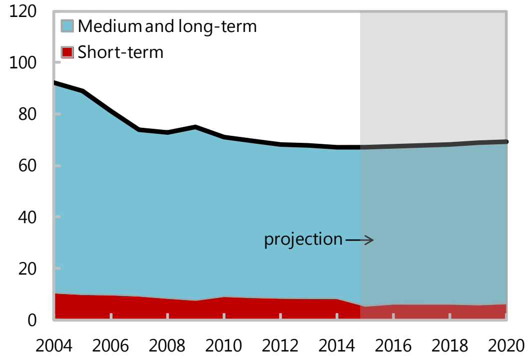
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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

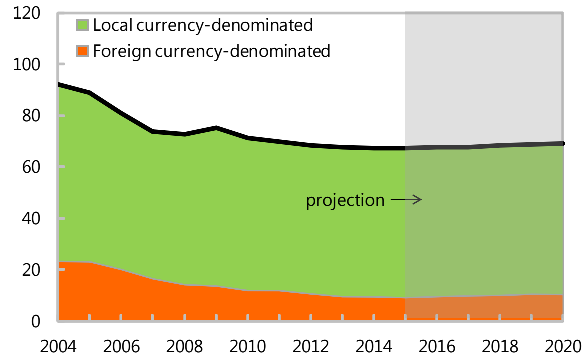
Figure A2.4. Israel: Public DSA–Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



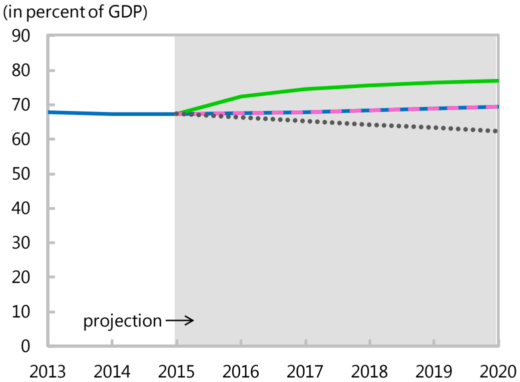
By Currency
(in percent of GDP)



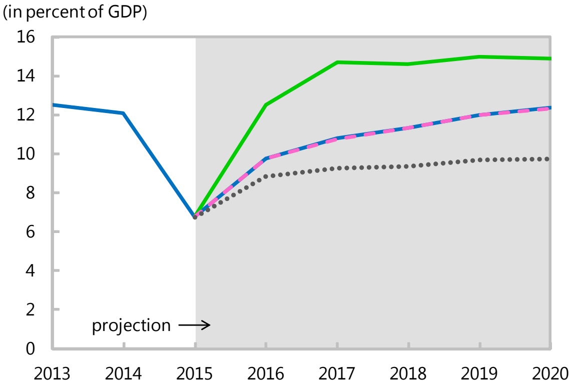
Alternative Scenarios

Baseline
Historical
Constant Primary Balance
Sharp House Price Correction

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

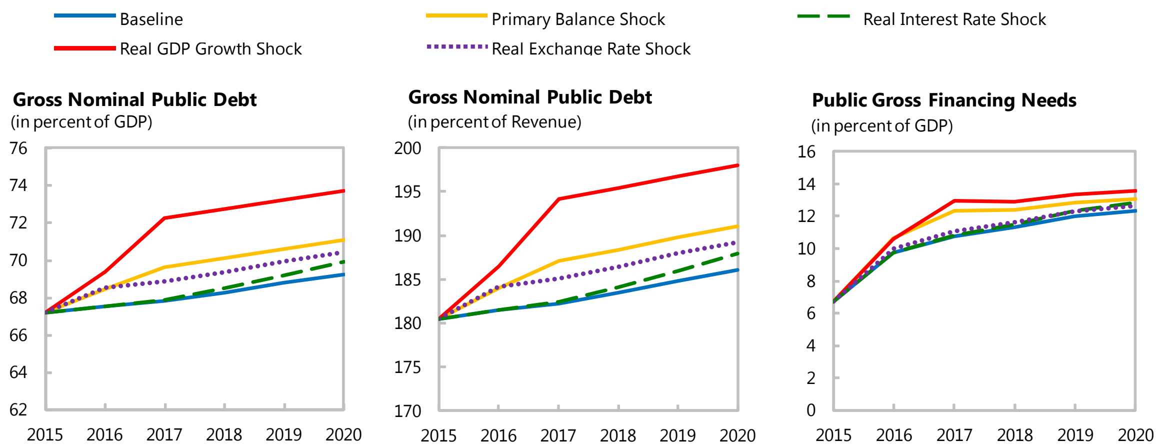
Baseline Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	3.0	3.3	3.2	3.0	2.9	2.9
Inflation	1.8	1.8	1.8	1.8	1.9	1.9
Primary Balance	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5
Effective interest rate	5.7	5.5	5.4	5.4	5.3	5.3
Constant Primary Balance Scenario						
Real GDP growth	3.0	3.3	3.2	3.0	2.9	2.9
Inflation	1.8	1.8	1.8	1.8	1.9	1.9
Primary Balance	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5
Effective interest rate	5.7	5.5	5.4	5.4	5.3	5.3

Historical Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	3.0	4.1	4.1	4.1	4.1	4.1
Inflation	1.8	1.8	1.8	1.8	1.9	1.9
Primary Balance	-0.5	0.4	0.4	0.4	0.4	0.4
Effective interest rate	5.7	5.5	5.5	5.6	5.6	5.6
Sharp House Price Correction						
Real GDP growth	3.0	-3.5	2.2	3.0	2.9	2.9
Inflation	1.8	4.7	2.8	1.8	1.9	1.9
Primary Balance	-0.5	-2.5	-2.3	-1.0	-0.8	-0.5
Effective interest rate	5.7	5.6	5.5	5.5	5.4	5.4

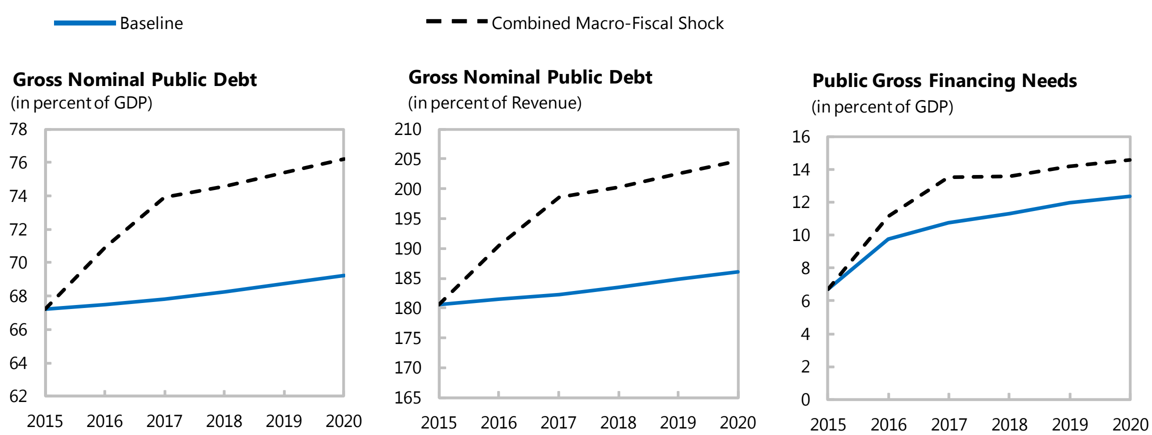
Source: IMF staff.

Figure A2.5. Israel: Public DSA–Stress Test

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

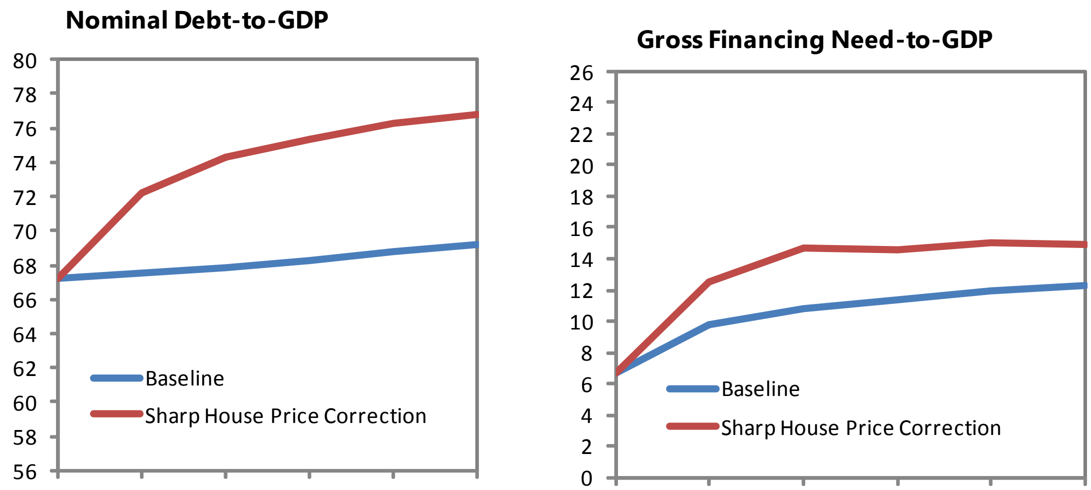
(in percent)

Primary Balance Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	3.0	3.3	3.2	3.0	2.9	2.9
Inflation	1.8	1.8	1.8	1.8	1.9	1.9
Primary balance	-0.5	-1.4	-1.4	-0.5	-0.5	-0.5
Effective interest rate	5.7	5.5	5.3	5.3	5.3	5.3
Real Interest Rate Shock						
Real GDP growth	3.0	3.3	3.2	3.0	2.9	2.9
Inflation	1.8	1.8	1.8	1.8	1.9	1.9
Primary balance	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5
Effective interest rate	5.7	5.5	5.5	5.6	5.6	5.7
Combined Shock						
Real GDP growth	3.0	1.8	1.7	3.0	2.9	2.9
Inflation	1.8	1.4	1.5	1.8	1.9	1.9
Primary balance	-0.5	-1.4	-1.8	-0.5	-0.5	-0.5
Effective interest rate	5.7	5.6	5.5	5.6	5.7	5.7

Real GDP Growth Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	3.0	1.8	1.7	3.0	2.9	2.9
Inflation	1.8	1.4	1.5	1.8	1.9	1.9
Primary balance	-0.5	-1.2	-1.8	-0.5	-0.5	-0.5
Effective interest rate	5.7	5.5	5.3	5.3	5.3	5.3
Real Exchange Rate Shock						
Real GDP growth	3.0	3.3	3.2	3.0	2.9	2.9
Inflation	1.8	2.2	1.8	1.8	1.9	1.9
Primary balance	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5
Effective interest rate	5.7	5.6	5.4	5.4	5.3	5.3

Source: IMF staff.

Figure A2.6. Israel: Public DSA - Customized Scenarios House Price Correction



Underlying Assumptions

(in percent)

	2015	2016	2017	2018	2019	2020
Real GDP growth	3.0	-3.5	2.2	3.0	2.9	2.9
Inflation	1.8	4.7	2.8	1.8	1.9	1.9
Primary balance	-0.5	-2.5	-2.3	-1.0	-0.8	-0.5
Effective interest rate	5.7	5.6	5.5	5.5	5.4	5.4

Source: IMF staff.

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

Macroprudential policy response while tightening monetary policy

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

Macroprudential policy response while loosening monetary policy

- July 2012: a 100 percent capital surcharge was imposed on groups of borrowers, who buy new built residential properties collectively, and who also engage with third parties to execute the construction and development of residential projects.
- November 2012: LTVs for housing loans were capped at 70 percent —excluding first-time buyers, for whom a maximum LTV of 75 percent was imposed. In addition, the LTV for mortgage loans for investment purposes was capped at 50 percent.
- February 2013: To restrict the supply of mortgages, capital requirements and provisioning for mortgages was tightened. For loans with an LTV between 45 and 60 percent capital risk weights were raised from 35 percent to 50 percent. For loans with an LTV above 60 percent, the risk weight was raised to 75 percent. The allowance for credit losses from housing loans was raised — such that the ratio between the group allowance and the balance of housing loans is at least 0.35 percent.
- August 2013: To restrict the supply of risky mortgages the debt service-to-income ratio (DSI) of new loans was capped at 50 percent; capital surcharges were imposed on mortgages with DSI between 40–50 percent; the maximum repayment period was set to 30 years; and the floating component of mortgages was capped at two-third of the loan. This applies to all mortgages with an adjustable rate component, and comes in addition to the limitation imposed in May 2011.
- September 2014: a draft directive is issued, aimed at requiring banks to increase capital requirements by 1 percent of the outstanding mortgage lending gradually by January 1, 2017 to build buffers against mortgage credit risks.

INTERNATIONAL MONETARY FUND

ISRAEL

July 15, 2015

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

The European Department
(In Consultation with Other Departments)

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FUND RELATIONS

(As of June 30, 2015)

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

General Resources Account:

	SDR Million	Percent Quota
Quota	1,061.10	100.00
Fund holdings of currency	799.96	73.50
Reserve position in Fund	281.15	26.50
Lending to the Fund		
New arrangements to Borrow	47.91	…

SDR Department:

	SDR Millions	Percent Allocation
Net cumulative allocations	883.39	100.00
Holdings	829.79	93.93

Outstanding Purchases and Loans: None

Financial Arrangements: None

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

	Forthcoming				
	2015	**2016**	**2017**	**2018**	**2019**
Principal					
Charges/Interest	0.02	0. 04	0. 04	0.04	0. 04
Total	0.02	0. 04	0. 04	0.04	0. 04

Implementation of HIPC Initiative: Not applicable

Safeguards Assessments: Not applicable

Exchange Rate Arrangement:

[1] For purposes of Fund relations, the West Bank and Gaza (WBG) fall under Israeli jurisdiction in accordance with Article XXXI, Section 2(g) of the Articles of Agreement.

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

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

Last Article IV Consultation:
The last Article IV consultation was concluded on February 10, 2014. Israel is on the standard 12-month consultation cycle.

ROSCs:

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

Technical Assistance:
The Fund has been providing policy advice and technical assistance to the Palestinian Authority (PA) since the 1993 Oslo Accords, and presently has a senior resident representative based in Jerusalem. The Fund's work in the West Bank and Gaza (WBG) has intensified since 2007, with a focus on the macroeconomic, fiscal, and financial areas. Staff missions to the WBG have been assisting the PA in the design and implementation of its macroeconomic and fiscal framework in line with the objectives set out in the Palestinian Reform and Development Plan (PRDP) presented at the Paris international donors' conference in December 2007. The most recent progress report on that framework was presented at the Ad-Hoc Liaison Committee (AHLC) meeting of donors held in Brussels on May 27, 2015. Technical assistance has also been stepped up since 2007, in particular in the areas of public expenditure management, banking supervision and regulation, and macroeconomic statistics.

Recent technical assistance to Israel covered issues on systemic risk assessment and stress testing as well as the medium-term budget framework.

Resident Representative:

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

STATISTICAL ISSUES

(As of July 8, 2015)

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

Table of Common Indicators Required for Surveillance

	Date of latest observation (For all dates in table, please use format dd/mm/yy)	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items: Data Quality – Methodological soundness[8]	Memo Items: Data Quality – Accuracy and reliability[9]
Exchange Rates	Same day	Same day	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Jun-15	7-Jul-15	M	M	M		
Reserve/Base Money	May-15	8-Jul-15	M	M	M	LNO, LO, NO, LO	O, O, O, NA, NA
Broad Money	May-15	8-Jul-15	M	M	M		
Central Bank Balance Sheet	May-15	8-Jul-15	M	M	M		
Consolidated Balance Sheet of the Banking System	Q1-2015	…	Q	Q	Q		
Interest Rates[2]	Same day	Same day	D	D	D		
Consumer Price Index	May-15	15-Jun-15	M	M	M	O, O, O, O	O, O, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2014	13-May-15	A	A	A	O, LO, O, LO	LO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Jun-15	7-Jul-15	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q1-2015	30-Jun-15	Q	Q	Q		
External Current Account Balance	Q1-2015	14-Jun-15	Q	Q	Q	NA	NA
Exports and Imports of Goods and Services	May-15	11-Jun-15	M	M	M		
GDP/GNP	Q1-2015	16-Jun-15	Q	Q	Q	O, O, O, LO	LO, O, LO, O, LO
Gross External Debt	Q1-2015	16-Jun-15	Q	Q	Q		
International Investment Position[6]	Q1-2015	16-Jun-15	Q	Q	Q		

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

Statement by the Staff Representative on Israel
Executive Board Meeting
September 4, 2015

This statement provides information that has become available since the issuance of the staff report (SM/15/192). The information does not alter the thrust of the staff appraisal.

1. **Initial estimates suggest growth slowed in Q2.** Real GDP increased by 2.1 percent year-on-year, down from 2.9 percent in Q1.[1] The slowdown was the result of weaker consumption growth and a sharper decline in exports, while gross investment accelerated. Growth continues to be driven by domestic demand, with consumption growing by 4.9 percent y/y and exports declining by 6.6 percent, the latter reflecting persistently weak world trade and a stronger shekel.

2. **These figures may be revised, however, as employment growth *accelerated*, and unemployment continued to decline.** Employment growth rose to 2.8 percent year-on-year in the second quarter from 2.0 percent in the first quarter, and unemployment fell from 5.4 percent in the first quarter to 5.0 percent in the second. Taking this information into account, staff will likely revise down its 2015 growth estimate by around ½ percentage point from 3.0 to 2.5 percent.

3. **The central bank kept interest rates unchanged in August.** Year-on-year CPI inflation has increased from -1.0 percent in February to -0.3 percent in July. Low CPI inflation is imported: the GDP deflator in the second quarter was 3.4 percent higher than a year earlier. Meanwhile, housing prices continue to increase by around 4 percent year-on-year.

4. **As expected, the Cabinet increased the fiscal deficit targets for 2015 and 2016 to nearly 3 percent of GDP (almost 4 percent of GDP on international accounting standards).** In August the cabinet approved a draft budget for 2015 and 2016, raising the fiscal deficit targets for both years to 2.9 percent of GDP, compared with 2.5 and 2.0 percent of GDP previously. The debt ratio is expected to increase for the first time since 2009. Medium-term deficit targets will also decline more gradually, reaching 1½ percent of GDP in 2021, two years later than in the current Deficit Reduction Law. The draft budget needs to pass through three votes in Parliament by November 19 to be approved.

[1] Quarter-on-quarter, real GDP expanded by an annualized 0.3 percent—below consensus forecast of 2.7 percent, and down from 2.0 percent in the first quarter. Quarterly growth rates in Israel are volatile, and are often revised subsequently.

Statement by Menno Snel, Executive Director for Israel and
Yossi Yakhin, Senior Advisor to the Executive Director
September 4, 2015

On behalf of the Israeli authorities we would like to thank the Article IV mission team for an excellent report and for the candid, constructive and friendly dialogue. The authorities broadly agree with the analysis and recommendations in the report. They recognize that further reducing the debt-GDP ratio in the medium term in a slower potential growth environment, and raising labor productivity growth are among their main macroeconomic challenges. In the following comments we provide some details and updated data, and elaborate on the views of the authorities.

Economic Activity

The Israeli economy grew 2.6 percent in 2014 (latest estimate), 0.8 percentage points higher than the average growth in advanced economies. The economy weathered the global financial crisis relatively well and experienced only a short-lived slowdown in 2009. Nevertheless, after a strong rebound in 2010-11, the economy's growth rate has been moderating to roughly 2 percentage points below its pre-crisis level of 2004-2008. The recent slowdown in growth is accompanied by a shift in the composition of aggregate demand, mainly from exports to private consumption. First estimates for the first half of 2015 point to a continuation of the weak growth at 2.6 percent SAAR (seasonally adjusted at annual rate) with additional weakness in the second quarter, although it is partly accounted for by temporary factors (work disruptions in the chemicals industry and a correction in durable consumption).

In 2014 a military conflict in the Gaza Strip had a temporary adverse effect on economic activity during the third quarter of the year. Overall, it is estimated that the conflict reduced growth by 0.3 percentage points in 2014. Learning from past conflicts, which since 2006 have unfortunately occurred every 2-3 years, the effect on economic activity typically concentrates on private consumption and tourism services. Private consumption is quick to rebound, but the recovery in tourism is sluggish and as of July 2015 tourist arrivals to Israel have not recovered to their pre-conflict level. The tourism sector accounts for 1.6 percent of GDP, but its share in employment is larger and it employs low-skilled, low-wage employees.

Medium-Term Fiscal Framework

The authorities broadly agree with staff's assessment, and in particular they recognize the need to strengthen the medium-term fiscal framework. While budget execution in each current year typically meets the fiscal objectives, medium-term targets are revised too often. When consolidation measures are necessary for the current budget, expenditures are often postponed to future years; however, without a binding accountability mechanism, the result is a rise in future expenditure commitments without properly identifying the resources to finance them, and when the time comes fiscal targets are revised.

The debt-GDP ratio declined persistently in the past decade – from 93.8 percent in 2003 to 67.0 percent in 2014. Nevertheless, the authorities concur with staff that at current deficit levels and with potential growth around 3 percent, the debt-GDP ratio would inevitably start to rise. The decline in the ratio since 2003 was supported by high growth rates, but with potential growth moderating, a further reduction in the debt-GDP ratio is most challenging and requires reducing future deficits.

We note that in March the Ministry of Finance benefited from TA that focused on strengthening the medium-term budget framework, and first steps toward the implementation of its recommendations are already in progress. In early August the new government approved a biennial budget for 2015-2016 which incorporates some measures in that direction (the budget still requires the approval of the parliament). These measures require: adjusting the government's medium-term expenditure commitments to the legislative constraints, upon the approval of each annual budget; publishing a semi-annual report of the government's expenditure commitments and expected sources of revenue for the current year and for the following three years; concentrating government decisions that involve future budgetary commitments to designated bi-monthly meetings; and conducting a spending review that would help to systematically prioritize past programs and make space for new ones (expected to start in 2017). Ongoing deliberations also consider requiring the government to identify budgetary sources for new future expenditure commitments and revenue cuts whenever these commitments are expected to violate budgetary legislative constraints. In addition, for 2016 the budget incorporates cuts of 40 percent in the cost of the coalition agreements, and an across-the-board reduction of 4.5 percent in the budget of all offices.

As indicated above the authorities largely share staff's assessment, but they do have a few reservations. First, they emphasize that although Israel's deficit is high by international standards, Israel's GDP growth rate is higher than in other advanced economies. This suggests that for equal long-term targets of the debt-GDP ratio, the benchmark deficit target in Israel should be higher. Second, they note that the recent discoveries of natural gas reservoirs in the Mediterranean and the expected accumulation of assets in a wealth fund would provide an additional buffer to the economy against future shocks. An evaluation of the appropriate debt level should factor in such assets. Finally, regarding staff's recommendation to increase tax revenues through indirect taxes (paragraph 17), the authorities point out that the tax composition is already tilted toward indirect taxes and a further increase may adversely affect inequality as these taxes are typically regressive. Their preference is to raise tax revenues by cancelling ineffective tax exemptions.

Inflation, Exchange rate, and Monetary Policy

In the face of a slowdown in exports, a low inflation environment, a strong Shekel and low interest rates in the global economy, the monetary policy stance is very expansionary with the policy interest rate at a historic low of 0.1 percent. Monetary policy also uses foreign exchange interventions.

As of July, headline inflation over the previous 12 months has been –0.3 percent. However, the Bank of Israel's decomposition of the CPI to its tradable and non-tradable components indicates that the negative inflation rate is mainly driven by the price of tradable goods, as over the same period tradable inflation was –1.5 percent, while non-tradable inflation was 0.5 percent. This is consistent with staff's analysis, as presented in the selected issues paper, indicating that external factors, such as the fall in oil prices and the appreciation of the exchange rate were the main drivers of headline inflation recently. That said, domestic inflation, although positive, is also below desirable levels.

We note that while headline inflation deviates significantly from the official target range of 1-3 percent, inflation expectations for the next 12 months from the financial market and private sector forecasts have increased since the beginning of 2015, and until recently both hovered around the lower bound of the target range. However, weakness in economic activity during the second quarter (first National Accounts estimates were published in August) and a renewed decline in commodity prices have recently pushed inflation expectations and forecasts downward.

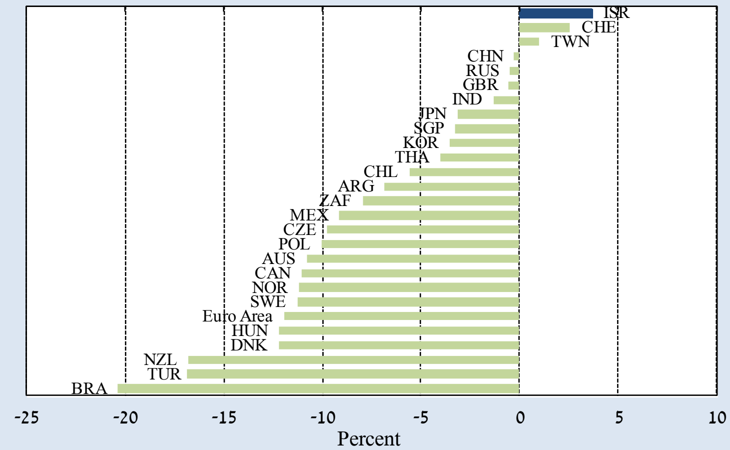
The Bank of Israel constantly monitors the developments in the markets and stands ready to use additional tools, if necessary, to lift inflation and boost demand. Such tools may include quantitative easing, further reduction of the policy rate and measures in the foreign currency market. However, with the current monetary stance already extremely expansionary, headline inflation driven mainly by external factors and expectations for a first rate hike in the US by the end of 2015, the authorities have not found additional expansionary measures to be appropriate so far.

The exchange rate has been under appreciation pressures for several years. The strengthening of the US dollar together with aggressive interest rate cuts reversed that trend only temporarily towards the end of 2014. The fundamental pressures for appreciation stem from a persistent basic current account surplus (i.e. the current account plus foreign direct investment), which partly originates from domestic gas production that has substituted for energy imports. The Bank of Israel counteracts the effect of gas production on the current account by purchasing foreign currency at the same amount, and this operation is expected to continue until a wealth fund will start to operate. Also, domestic institutional investors diversifying their portfolios abroad have typically hedged their positions against exchange rate risk in recent years, thereby neutralizing the potential offsetting effect their capital outflows could have had on the exchange rate.

Appreciation pressures, that are not always consistent with fundamentals, often originate in the financial markets, and as a small open economy they may have significant effect on the exchange rate. Since the beginning of 2015, for example, the Shekel appreciated against the US dollar while most currencies depreciated (see enclosed figure) and Israeli export was losing steam (8.6 percent SAAR *contraction* during the first half of 2015). The authorities estimated the Shekel to be overvalued during that period, and when such episodes occur, the Bank of Israel steps in and purchases foreign currency.

The appreciation rate of selected currencies against the US Dollar during 2015*

(July 2015 average rate vs the average of December 2014)



* Adopted from the Bank of Israel Monetary Policy Report for the first half of 2015.

The Housing Market

Housing prices have nearly doubled since end 2007 (97 percent nominal, 69 percent real), though from a low base after a decade-long real price depreciation of nearly 25 percent. Staff assesses that housing prices are currently overvalued by 30 percent. We stress, however, that staff's estimate is based on deviation from a *long-run* equilibrium and that to a large extent it is explained by supply-side shortages; therefore, staff's estimate should NOT be interpreted as *current* price misalignment or as deviation from the fundamental value. The authorities would appreciate more careful and accurate communication on this point.

The recent rise in housing prices is driven both by low interest rates and by supply shortages. The pace of completion of dwellings has increased persistently since 2007; however, only since 2013 it has started to match household growth. This was mirrored in moderation in housing price inflation, although it is still quite high – around 4 percent annually. Improving housing affordability is among the highest priorities of the government, with some measures already being implemented and others underway on both demand and supply fronts. In addition the Bank of Israel has launched a series of macro-prudential measures to safeguard financial stability.

As stated above, the government has stepped up its efforts to reduce housing prices. In addition to the measures mentioned in the report (paragraph 34), aimed mainly at expediting the planning process, we also note the following: (1) State-owned land auctions are shifting from a highest bidder system to a system where the offer with the lowest marketing price of finished apartments wins the auction. (2) A purchase tax for owners of more than one apartment has recently increased, and the government also considers cancelling the exemption from betterment tax on apartments that were inherited. The latter would incentivize heirs to sell those apartments, thereby increasing supply. (3) Urban renewal projects receive tax benefits in order to increase density in urban areas. And (4) mobilization of large army bases from the center of the country to the periphery is expected to release valuable land for the development of adjacent cities.

The Financial Sector and Macroprudential Measures

The authorities share the staff's concerns regarding the banks' exposure to real estate and the construction industry, and since 2009 the Bank of Israel has launched a series of macro-prudential measures mainly targeting the mortgage market (see Annex III of the staff report for the list of measures). These measures are aimed at safeguarding financial stability rather than reducing housing prices by means of constraining demand as they mostly target the marginal mortgages with the riskiest profile, not the average mortgage. Risk indicators suggest that these efforts are fruitful; for example, following Banking Supervision directives the share of mortgages with payment-to-income ratio higher than 40 percent has fallen over the past four years from 23.8 percent to 0.9 percent, and the share of mortgages with loan-to-value ratio higher than 75 percent has fallen from 9.7 percent to 2.0 percent.

As for the construction industry, the authorities recognize its higher risk profile relative to other industries as the production process and financial exposure are longer and it has a legacy of realization of credit risks. Nevertheless, problematic credit risk in this industry has gone down from 6.1 percent in 2011 to 3.7 in 2014 and sectoral exposure regulations prevent banks' exposure to the construction industry from exceeding 20 percent of their total credit. The authorities monitor this risk closely through both off-site and on-site examinations, and by attempting to identify areas of vulnerability prior to the realization of risks.

As staff indicates, the road to establishing a Financial Stability Committee (FSC) is indeed rocky. Nevertheless, some progress has been made recently, and on June 28 the government passed a resolution to circulate within 180 days a draft law for the establishment of a FSC. The authorities note, however, that regardless of the holdups in the establishment of the FSC, the three financial regulators (banking supervision, capital market supervision and the securities authority) meet regularly in an informal coordination committee.

The Labor Market and Productivity

The labor market is strong. Unemployment is at a multi-decade low while the participation rate is rising. These trends are supported by over a decade-long of measures incentivizing employment, e.g. earned income tax credit at low levels of income, and disincentivizing unemployment and labor market detachment, e.g. stricter eligibility criteria for unemployment benefits and reducing child allowances. However, they are accompanied by a prolonged sluggish productivity growth and a rise in inequality and poverty rates.

The authorities recognize the challenges of raising productivity growth and making growth more inclusive. They note, however, that to a large extent the weakness in labor productivity is driven by rising participation rates of groups that are loosely attached to the labor market, especially the Haredi (ultra orthodox Jews) population and Arab women. New workers from these groups typically have weaker labor market skills, thereby reducing average labor productivity. The challenge is therefore to keep raising their participation rate while equipping them with stronger skills for the labor market. This would help boosting labor productivity and support more inclusive growth. The authorities note that several programs are already in place to address these issues.[1] Nevertheless, they recognize that this is one of the greatest long-term challenges for the economy as the growth rate of these population groups is higher than that of the general population.

The authorities agree with staff that increasing competition is key to raising Total Factor Productivity (TFP). They note that negative TFP gaps against OECD averages are particularly noticeable in industries with low export shares, where firms face weaker competition. A reform in cellular communication has increased competition significantly in that industry, and a reform in the food market is currently underway. As indicated by staff, boosting competition is a priority for the new government and several sectors are being targeted, but work on this front is still at its early stages and more has to be done.

[1] For the Haredi population these include: full financing of academic education in selected fields (such as engineering, computer science and natural sciences), providing living allowances for the duration of the studies and assistance in job placement; operating placement centers and providing vocational training in accordance with Haredi customs and special needs; operating placement centers specific for Haredi women; and providing vocational training and gaining professional experience through a military service.
Programs for the Arab population include: subsidizing child care to incentivize Arab women to enter the labor force; supporting business and technological entrepreneurship; financial support and general guidance in gaining academic education; vocational training and help in job placement for academics in the high-tech industry; and vocational training targeting specifically the Bedouin population.