INTERNATIONAL MONETARY FUND

Concluding Statement of the 2009 Article IV Mission
December 14, 2009

Israel has had a good "great recession"

1. In the face of global crisis, Israeli output growth was amongst the last to fall below trend, among the mildest hit—with output projected flat overall in 2009, and amongst the earliest to stage a recovery—with output up in both Q2 and Q3 2009. Though bonds and equities fell sharply in late 2008, there was no melt down in markets, even without the full swathe of emergency financial stabilization measures typical elsewhere. Indeed, since early 2008 Israel appeared to acquire safe haven status, experiencing sharp increases in net capital inflows and real exchange rate appreciation, despite sustained foreign reserve accumulation. And in September 2009, the Bank of Israel (BoI) was the first central bank globally to raise policy rates for over a year, one of several steps it took then to begin the exit from the monetary measures that had been adopted in response to the global crisis.

2. Though output was shielded from the global downturn by the composition of trade, the absence of housing or bank credit booms, and high household savings rates, the strength of output in Israel also owes much to the public debt reduction and structural reforms of the past decade, as well as the specific policy responses to the crisis. In particular, the decisive relaxation in the monetary stance including "unconventional" measures, the accommodation of the automatic stabilizers in 2009 and its expression in the adoption of a two year budget for 2009-10, and suitably focused measures to stabilize credit flows were all both timely and appropriately strong.

But the economy has not been unscathed

3. While output, consumption, and confidence are in the neighborhood of their Fall 2008 levels, exports, imports, and fixed investment are far from fully recovered. Unemployment has edged up to some 8 percent, and the stock of bank credit to corporates has fallen through much of the year with inflation above target for much of that time. And though safe haven factors that earlier put upward pressure on the currency appear to have eased along with global financial sector stabilization, concerns with the strength of the shekel have not entirely been put to rest.

4. On the policy side, automatic stabilizers took a heavy toll on hitherto steady progress of deficit reduction, taking the deficit close to 5 percent of GDP in 2009. The earlier well-established framework of fiscal rules—comprising ceilings on deficits and on the growth of real spending—was abandoned, appropriately, to accommodate this, but it is unclear if the credibility of the ceilings which replaced them has been fully established. And the BoI's programmed foreign exchange purchases have been replaced on a transitional basis by a regime of discretionary intervention. This will shift the IMF classification of the exchange rate regime from "free floating" to "floating".

So although Israel is a global exit frontrunner, it is not yet out of the woods

5. Public debt is back on an upward track, heading towards 80 percent of GDP by end-2010. And external uncertainties remain elevated: though the WEO central projection shows global growth of 3 percent in 2010, this is subject to 90 percent confidence margins ranging from ½ to 5½ percent. The corresponding range for projected growth in Israel in 2010 is 0 to 4 percent. Further ahead, significant reductions in the growth of potential output of the major economies will likely lower Israel's medium-term potential growth rate by some ½ a percentage point annually to 3-3½ percent.

Accordingly, the challenge ahead is to implement an effective exit strategy

6. In this context, our core advice is to strengthen the policy frameworks to anchor long run expectations and reinforce policy credibility, thereby both securing greater flexibility to address short run shocks and supporting long-term growth. This approach is reflected in advice in the fiscal, monetary, and the financial stability areas.

The authorities have already moved in this direction

7. The declining path for ceilings on fiscal deficits, supported by annual caps on real spending growth, the renewal of the program of US guarantees on public debt, and steps to early entry to the OECD all aim to anchor long run expectations. These steps are reflected in the "two year budget" which envisages unfettered automatic stabilizers—which are projected to lower the deficit in 2010 if growth picks up and to provide fiscal support if not. On the foreign exchange regime, the shift from preprogrammed to discretionary intervention is a transitional step anticipating a free float. Progress towards adoption of the BoI Law strengthens the outlook for the long-run monetary framework, and the recent policy rate rises are measured and balanced steps to tighten the stance of monetary policy as recovery takes hold. And though the various emergency financial sector support initiatives remain in place, take up has been limited and is expected to remain so. Various actions to strengthen the content of supervision are in process, including establishment of a financial stability unit in the BoI, and proposals by the Hodak committee and regulators to strengthen due diligence practices, bond structures, remuneration arrangements, and investment portfolio guidelines.

Given global uncertainties, these actions could be significantly strengthened

8. A key message that needs to be underscored to the public is that the global environment places a high premium on avoiding actions which might compound downside risks. This concern precludes early commitments to sizeable permanent remuneration increases, notwithstanding the encouraging economic performance so far. In particular, wage settlements for public sector employees due in 2010 should be tightly restrained. This would send an appropriate signal to private sector wage setters, help keep inflation and interest rates low as output strengthens, and thus promote continued good economic performance.

9. A further key message is that high public debt represents an enduring vulnerability—and far from being eased, this problem is likely aggravated by the recent elevation of public deficits and debt internationally and the associated pressures on global savings. In periods of market stress, costs of financing for high debt countries like Israel tend to rise particularly

sharply, curbing scope to allow fiscal support to cushion shocks—a concern reflected in Israel's decision in 2009 to raise the VAT rate to cap the headline deficit. And high debt attenuates—and may even more than completely negate—the stabilizing impact on output of fiscal support in downturns. Given Israel's particular exposure to global and geopolitical shocks, these are primary concerns. Public debt needs to come down decisively.

10. Both concerns are compounded by the likely decline in potential output growth globally—and therefore in Israel—in the wake of the global crisis and by the likely loss of windfall revenues associated with the prior global financial boom. For these reasons, the difficulty of securing public debt reduction has increased. Accordingly, efforts to do so need to be redoubled, anchored by adoption of a formal long-term anchor for policies targeting public debt reduction, strengthened budget procedures, and efforts to improve supply side efficiencies, including through liberalized planning rules and competitive privatization.

Fiscal frameworks and policy could be more robust and flexible

11. An immediate step towards these goals is to reconcile aggregate spending caps with commitments on its component parts. Without this, the credibility of the current or any alternative framework of fiscal rules is compromised.

12. Alongside, the case for adjusting the fiscal rules warrants review by Spring 2010, when fiscal outturns, immediate prospects for global demand, and the outlook for capital flows are likely to have clarified somewhat.

13. If staff central or upside global scenarios are being realized, then policy should aim to deliver deficit outturns considerably lower than the 2010 and 2011 ceilings. Accordingly, those ceilings could be replaced in the framework of rules with a target for public debt to provide a medium-term anchor for fiscal policy. In this context, a target of 60 percent of GDP by 2020, anticipating further reductions thereafter, with an interim ceiling of 70 percent of GDP by the middle of the coming decade would be appropriate. This framework should be supported by annual publication of three year ahead fiscal projections detailing how policies are consistent with the debt objectives, and be formally contingent on the strength of global supply over the medium-term. Policies should target debt ratios below these ceilings in "central case" scenarios to anticipate uncertainties.

14. On the other hand, some adjustments to this approach may be needed in early 2010 if the downside near-term global demand scenarios appear more likely. In that case, if investor demand for Israeli public debt remains resilient, full accommodation of stabilizers would be appropriate, even if that causes a breach of the current 2010 and 2011 deficit ceilings. And the target dates for the debt and interim objectives may have to be extended further out. But if, in this adverse context, financing conditions prove challenging, a more ambitious fiscal stance and consolidation path even than currently anticipated might prove to be unavoidable.

15. This contingent approach to reform of the fiscal rules and the 2010-11 budgets has several advantages. In the case where near-term global demand is strong, the framework anticipates doubt about the persistence of the global upswing and so applies the associated fiscal windfall to deficit reduction. This helps to strengthen policy credibility given the

change of fiscal rule because fiscal deficits for 2011 and 2012 would be below the current ceilings. And by thus capitalizing on the windfall, a strong commitment to the 2020 debt ceiling and the interim objective is signaled by provision of the first down payment towards those goals. In the case where near-term global demand is weak, the shift from deficit ceilings to the long-term debt anchor provides additional scope for accommodation of fiscal stabilizers. And in that context, contingent specification of the dates for the debt ceilings reduces the risk of commitment to a fiscal consolidation path that is unduly ambitious.

Public spending limits and tax policy objectives should be set in this context

16. In any of these global scenarios, a debt objective should be accompanied by ceilings on expenditures over the medium term. This would best be expressed as a cap on nominal spending, rather than as a cap on real expenditure growth, to strengthen transparency and the counter-cyclical properties of the fiscal rule. The adoption of a two year budget is a most welcome move towards these goals, and could be taken further with the adoption of rolling three year ahead ceilings on nominal spending, abolition of the automatic correction mechanism for inflation surprises, and a strengthening of medium-term planning procedures underpinning the ceilings.

17. Whichever specific fiscal rules are adopted, their credibility is critical. In that light, the planned medium-term caps on public spending raise concerns because the implied compression of already low non-security outlays may prove to be unsustainable. As planned reductions in headline income tax rates assume this further spending compression, this is a vulnerability for public debt reduction. This should be avoided. If precommitments to tax reductions cast doubt over the pace of debt reduction, the supply side gains will be offset—and given Israel's high debt, possibly more than completely offset—by the consequent increased risk premia and cost of financing for firms. To avoid this, tax reductions should follow debt reductions consistent with the debt target and interim ceiling; precommitments to tax cuts which assume such debt reduction may unduly compound Israel's vulnerabilities.

Monetary policy has provided an appropriately measured anti-inflation signal

18. Headline inflation is towards the top end of the target band, and there are no serious imminent risks of deflation either in headline or underlying terms in any of the measures of inflation expectations or forecasts. Alongside, a resumption of economic growth has become increasingly evident, with the moderation of the earlier downturn likely to imply a similarly moderated upswing. Given this context, the history of high inflation, and global uncertainties, the balanced approach to weighing the risks of over- and undershoots of the inflation target that is implicit in the decisions to raise the policy rate by 25bp for September and again for December, is appropriate.

19. As recommended globally, withdrawal from "unconventional measures"—notably foreign exchange intervention in Israel—should be phased. Given that policy rates had hit their effective floor, strong intervention was an appropriate tool to maintain a stimulative monetary stance in Israel, leaning against excessive appreciation in the face of strong capital inflows. As the appropriate monetary stance tightens and the policy rate rises, so the role of unconventional measures in pursing monetary policy objectives should be reduced. In this

light, the decision to shift from preprogrammed to discretionary intervention is an appropriate step, beginning the exit while still retaining the option for continued use of the instrument for a transitional period should it prove necessary to secure a sufficiently accommodative stance of monetary policy.

20. But as with all unconventional measures, risks arise. In particular, this transitional phase of discretionary intervention risks compromising the clarity of the BoI's objectives. To restore the free floating regime, discretionary intervention should be formally terminated when the policy rate is well above its effective floor on a sustained basis.

21. Until then, further sustained real appreciation of the shekel would remain a concern. Though the evidence on competitiveness is now somewhat mixed, protracted upward pressures on the exchange rate would tilt the balance of concerns more decisively. If capital inflows surge, discretionary intervention should not constitute the main policy response. Rather, scope to raise reserve requirements and consumer protection rules should be considered, with adoption of a stronger than currently planned fiscal stance a further option. Capital controls and taxes on inflows would be inappropriate alternatives.

22. The uncertain environment also reinforces the case to adopt the proposed draft BoI Law promptly. It will appropriately increase independence, establish a committee with power to set monetary policy, and a separate management committee to manage the bank's administration.

The financial sector passed through the crisis relatively well

23. While the bond market and equity valuations suffered heavily at the peak of the global financial crisis, banks have proved remarkably resilient despite support measures considerably less extensive than were applied elsewhere. In the context of proactive supervision and a conservative bias, banks have mostly eschewed exposure to structured instruments, remain heavily deposit funded, and are backed by a strong comprehensive government guarantee. In these circumstances, their risk-weighted capital ratios, also reflected in strong raw capital, represent an adequate standard for bank capitalization. This should be reflected in the determination of the level and types of capital to be set in the Basel II standards in the coming year.

But various steps to strengthen the banking prudential framework are recommended

24. A significant upgrade of macro-prudential and financial stability analysis is needed. Priorities for the new unit in the BoI should include comprehensive banking stress tests to provide a better understanding of risks to regulators and banks. Scenarios could include the lower bounds of staff's 90 percent confidence intervals for the global and the associated Israeli projections. In addition, the BoI should begin publication of a financial stability report, preferably semi-annually, and consideration could be given to including stress test results. Over the longer term, the BoI should also work with the other regulators to broaden the analysis to cover the entire financial system and its macroeconomic linkages. Further consideration should also be given to introduction of an explicit deposit insurance scheme to

provide additional options to deal with the resolution of non systemic banks, as well as to clarify banks' liability for funds used in payouts.

And the difficulties in non-banks call for their supervision to be reinforced

25. Given global stabilization and increased evidence that Israel has proven resilient to the recent global shock, asset valuations have recovered significantly from their mid-crisis troughs. But the particular severity of the declines in the peak of the financial crisis, the closure of the corporate bond market in that context, and the decline of several insurance companies' solvency ratios to below their regulatory floors are indicative of underlying fragilities in these institutions and markets. Various steps, including the Hodak committee proposals and initiatives by the Israeli Securities Authority (ISA) are underway to address the difficulties.

26. Beyond these steps, however, a more fundamental strengthening of the budget, staffing, and autonomy of the non-bank regulators is appropriate. To this end, the ISA should be given full operational independence, and the Capital Markets, Insurance and Savings Division (CMISD) of the Ministry of Finance should be given formal autonomy, in line with international best practice. Such changes should maintain the full flow of information to other supervisors and to the monetary and fiscal authorities and coordination of strategic priorities among the various regulators should be reinforced. Concurrently, the CMISD and ISA should significantly strengthen their transparency, going well beyond the provision of data, through the publication of timely analysis of developments, issues, and risks. Finally, an assessment should be made of the risk that even the relatively targeted emergency support measures for the nonbank sector has given rise to moral hazard there and, if so, this should be reflected in the content of supervisory guidelines to be adopted.

* * * *

We are highly appreciative of the warmth of the welcome that is always accorded to us during our missions to Israel.