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IMF Executive Board Concludes 2013 Article IV Consultation with Israel

On February 10, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Israel.

Israel's economic fundamentals remain strong. GDP growth is solid, unemployment is low, and inflation remains firmly anchored within the 1–3 percent target range. The financial sector is in good health and the external position is strong.

However, excluding the impact of a new large-scale natural gas production, growth momentum is expected to remain moderate, as planned fiscal tightening and a further strengthening of the currency will weigh on the economy and offset, in part, the pick-up in demand in Israel's major trading partners. The economy also faces other important challenges: public debt remains high despite a noticeable decrease over the past several years; rapid house price inflation, if it persists, poses risks to financial stability; and the large employment and productivity gaps between the general Jewish population, the Ultra-Orthodox Jewish (Haredi) and Israeli-Arab communities, if sustained, could undermine the economy's long-run growth potential.

Given the still uncertain global environment, as well as the headwinds to growth from fiscal tightening and exchange rate appreciation, monetary policy should stay the course. But the Bank of Israel should respond nimbly to changes in the economic environment. A further tightening of macroprudential measures may be needed to alleviate risks of a boom-bust cycle in the housing market. On the fiscal side, the likelihood of slippages in meeting the deficit target should be minimized by firm adherence to the expenditure ceiling and full implementation of announced revenue measures. In addition, to put public debt firmly on a downward trend, further adjustment is required in 2015 and beyond, along with a strengthening of fiscal institutions. This policy mix,

[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.

combined with structural reforms to boost productivity, should help alleviate appreciation pressures on the shekel and boost competitiveness.

In line with the recommendations of the 2012 Financial Sector Assessment Program (FSAP) Update, a Financial Stability Committee should be established, led by the Bank of Israel and focusing on macroprudential policies in normal times. Legal reforms aimed at strengthening the bank resolution framework should be legislated as soon as practicable.

On the structural front, concerted action is required to boost competition in the non-tradable sector, while it is imperative to promote the participation of Haredi and Israeli-Arab populations in the labor force to reduce poverty and inequality and bolster the economy's long-run productive capacity.

Executive Board Assessment[2]

Executive Directors welcomed the Israeli economy's resilience through the global crisis, which has been underpinned by sound macroeconomic and financial fundamentals. They also welcomed the progress made in reducing public debt and the government's commitment to fiscal discipline.

Directors noted that growth would continue to be moderate, but the outlook is vulnerable to external and longer-term domestic risks. Weak external demand and appreciation pressures on the shekel are a drag on growth, house prices continue to rise rapidly, public debt is high, and growth is not inclusive. Against this backdrop, Directors underscored that policies should aim at ensuring sustainable growth, preventing the build-up of imbalances, and deepening structural reforms to bolster the economy's productive capacity and to reduce poverty and inequality.

With inflation well anchored within the target range, a still uncertain external environment, and headwinds to growth from the planned fiscal tightening and a stronger currency, Directors agreed that monetary policy should maintain the current stance. Should growth prospects improve more than anticipated, the monetary stance would need to be gradually normalized. Directors considered that the risks ensuing from rapid house price increases should be addressed through a further tightening of macroprudential measures.

Directors commended the authorities for the bold fiscal consolidation measures embedded in the 2013–14 budget. They noted that strict adherence to the expenditure ceiling and full implementation of the announced revenue measures will be necessary to meet the fiscal targets.

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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.

Directors concurred that achieving the deficit targets and ensuring debt sustainability would require further fiscal adjustment in the medium term through efforts on both the expenditure and revenue fronts.

Directors considered that embedding the current fiscal rules within a fully-fledged medium-term fiscal and expenditure framework would strengthen the budgetary and fiscal institutions. Most Directors agreed that establishing an independent fiscal council would enhance the credibility and transparency of fiscal policy while a few other Directors were of the view that the current framework has served the economy well.

Directors noted that the mix of accommodative monetary and tight fiscal policies, alongside reforms aimed at boosting productivity, would alleviate appreciation pressures on the currency and improve competitiveness. In this context, Directors saw merit in the Bank of Israel continuing their program of pre-announced foreign exchange intervention, aimed at alleviating risks of appreciation pressures emanating from promising prospects of large-scale natural gas production. Directors recognized that discretionary intervention may be needed to stem excessive exchange rate volatility.

Directors welcomed the authorities' ongoing initiatives to buttress the financial system. They underscored that progress could be expedited on the key issues identified by FSAP Update. In particular, they encouraged the authorities to establish a Financial Stability Committee with a clear mandate and operational independence, and to legislate the draft bank resolution law as soon as practicable.

Directors noted that low labor participation of the Arab-Israeli and Haredi populations exacerbates inequality and poverty concerns and would undermine the economy's long-run growth potential. They welcomed recent reforms and encouraged the authorities to promote further the integration of these groups in the labor market.

Israel: Selected Economic and Social Indicators, 2009–14
(Percent change, unless otherwise indicated)

	2009	2010	2011	2012		2013		2014
						Staff est.		Staff proj.
Real economy								
Real GDP	1.2	5.7	4.6	3.4		3.4		3.4
Domestic demand	0.4	5.7	5.6	3.8		3.9		3.4
Private consumption	2.2	5.0	3.8	3.2		4.2		3.2
Public consumption	3.1	3.3	2.5	3.2		3.6		3.0
Gross capital formation	-8.0	11.2	15.3	6.3		3.2		4.3
Foreign demand (contribution to real GDP growth)	0.6	0.0	-0.9	-0.5		-0.5		0.0
Output gap (percent of potential)	-1.3	0.3	1.0	0.6		0.2		0.1
Output gap excl. gas impact (percent of potential)	…	…	…	…		0.2		-0.1
Unemployment rate (percent)	8.8	7.9	6.9	6.9		6.4		6.7
Overall CPI (end period)	3.9	2.7	2.2	1.6		1.8		2.0
Saving and investment balance								
Gross national saving (percent of GDP)	19.2	17.0	21.4	21.0		21.2		21.3
Foreign saving (percent of GDP)	-3.8	-3.1	-1.3	-0.3		-0.6		-0.7
Gross domestic investment (percent of GDP)	15.4	13.9	20.2	20.7		20.6		20.7
Money and interest rates								
M3 (period average)	14.1	2.3	7.1	8.9		…		…
Bank of Israel policy rate (percent, end year)	1.00	2.00	2.75	2.00		1.00		…
10-year government bond yield (percent, average)	5.07	4.70	4.98	4.33	#	3.85		…
Public finance (percent of GDP)								
Central government								
Revenues and grants	26.5	25.7	26.0	24.9		25.6		25.7
Total expenditure	31.5	29.2	29.0	28.9		29.1		28.5
Overall balance	-5.0	-3.6	-3.0	-4.1		-3.5		-2.8
General government								
Overall balance	-6.3	-4.6	-4.2	-3.9		-3.5	3/	-3.0
Debt	75.3	71.5	69.7	68.2		67.5		66.6
Of which: foreign currency external debt	13.6	12.0	11.9	10.6		7.8		7.0
Balance of payments (percent of GDP)								
Exports of goods and services 1/	33.6	35.0	35.5	36.2		33.7		33.0
Real growth rate (percent)	-11.7	14.2	7.3	0.9		-2.3		2.2
Imports of goods and services 1/	30.8	33.2	36.0	36.0		33.8		32.4
Real growth rate (percent)	-13.7	15.1	10.5	2.3		-1.0		2.1
Trade balance	2.8	1.7	-0.5	0.2		0.0		0.4
Oil Imports (billions of U.S. dollars)	8.1	10.4	13.6	16.1		16.5		17.0
Current account	3.8	3.1	1.3	0.3		0.6		0.7
Foreign reserves (end period, billions of U.S. dollars)	61	71	75	76		82		85
Exchange rate								
Exchange rate regime	Free floating							
NIS per U.S. dollar	3.9	3.7	3.6	3.9		3.6		…
Nominal effective exchange rate (2005=100)	109.8	115.1	116.4	111.8		…		…
Real effective exchange rate (2005=100)	109.9	115.4	116.8	111.0		…		…

Social Indicators (reference year)

GDP per capita (2012): $32,265; Population density (2011): 359 people per sq. km; Poverty rate (2008)[2/]: 19.9 percent; Fertility rate (2009): 3.0 per woman; Life expectancy at birth (2009): 79.7 (male) and 83.5 (female); Infant mortality rate (2009): 3.4 per 1,000 births; Physicians (2007): 3.6 per 1,000 people; CO2 emissions (tons per capita, 2007): 9.3.

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

1/ National Accounts data.
2/ Poverty rate from National Insurance Institute of Israel.
3/ The preliminary outturn for the fiscal deficit in 2013 is estimated at 3¼ percent of GDP.