

INTERNATIONAL MONETARY FUND

ISRAEL

Article IV Consultation—Concluding Statement of the Mission
November 29, 2010

Summary

Israel passed through the global recession swiftly, the fruit of decisive policies and strengthened macrofinancial policy frameworks. The challenge now is to sustain growth and low inflation while boosting medium-term prospects—in the context of continued global uncertainty, capital outflows from advanced countries, shekel appreciation, and a housing market that is overheating.

In our view, buoyant activity and employment alongside incipient inflation pressures calls for the overall stance of policies to be tightened more quickly than planned. But the onus for the accelerated effort should fall mainly on fiscal rather than monetary policy. This shift in the policy center of gravity will help to contain inflation, reduce upward pressure on the shekel, and support the new fiscal rule. Alongside, monetary policy should focus on inflation and move further towards a neutral stance. In so doing, it should continue to respond to shocks to global demand, and foreign exchange intervention should become more symmetric. Steps to rebalance housing supply and demand can support these efforts.

To secure Israel's medium-term prospects, greater coordination between the authorities responsible for the stability of the financial system, enhanced procedures governing medium-term public spending, and sharply accelerated efforts to integrate minorities into the labor force will be essential.

1. **Output growth is strong by industrial country standards.** It rose by 0.8 percent in 2009, and is set to grow around 4 percent in 2010. And unemployment is already back down to around 6 percent, close to its historic low.
2. **This reflects good preparation and a firm policy response**--including pre-crisis fiscal consolidation, low leverage of households, and decisive policy adjustments to the global downturn. The latter comprised cuts in policy interest rates to ½ a percent, pre-programmed foreign exchange intervention, accommodation of large automatic stabilizers taking the budget deficit to 5 percent of GDP, and steps to contain financial sector stress.
3. **Strong crisis policies were complemented by strengthened policy frameworks**—adoption of a strong Bank of Israel Law, increased bank capital requirements, a reinforced tripartite arrangement, entry into the OECD, and underpinning all these, a new fiscal rule targeting debt reduction. In addition, in a constructive innovation, Israel initiated a “two-year” budget framework, which helped to stabilize expectations in mid-crisis, and established an important precedent for the future.
4. **With the resumption of strong growth, withdrawal of policy stimulus has begun.** The Bank of Israel (BoI) policy rate has been raised in steps to 2 percent, and forex intervention has been reduced and is now discretionary. With tax revenues buoyed by economic activity, the headline fiscal deficit is back on a downward track, heading below 4 percent of GDP in 2010. This package is supported by the recent cautious and consensual public wage settlement for 2010-12. And several macroprudential steps have been taken, focusing on the housing market. Nevertheless, with real interest rates negative and the budget in structural deficit, the overall policy stance remains expansionary.
5. **This performance has, however, come at a cost.** Buoyed by global capital movements, the shekel appreciated by some 15 percent in real terms relative to pre-crisis levels, and is still rising. Competitiveness has been adversely affected, and this may already be reflected in loss of export market share in 2010, falling FDI inflows, and in recent months, outright falls in exports and flat employment. The strong shekel has, however, helped to contain inflation, which recently returned into its 1-3 percent target range after a lengthy period just above it. But private sector nominal wage growth has picked up, and inflation expectations across the medium term have risen to the top of the target band, all in the context of an output gap that has, in our view, all but closed. Alongside, and in an echo of advanced countries in the early 2000s, nominal house prices took off in 2008 after years of stagnation, rising over 40 percent in just two years.
6. **Thus, looking ahead, policy faces several challenges.** With inflation expectations elevated, emerging strains on capacity, and a high public debt ratio, policy tightening is needed. But this should be done in a way that minimizes the impact on competitiveness, given that capital inflows are expected to persist as long as low growth induces capital outflows from advanced countries. And with the WEO 90 percent confidence interval for

global growth as wide as 2—6 percent, policy also has to be calibrated with a close eye on external uncertainties.

7. **Fiscal consolidation is the cornerstone.** Given the concerns with the erosion of competitiveness associated with further monetary tightening, this fiscal action will help to secure stable inflation and lower domestic absorption, and so ameliorate the impact of capital inflow pressures. It will put public debt back on its downward track and leave monetary policy the task of adjusting to global developments.

8. **The authorities' plans therefore mark an essential step in the right direction.** In the context of the forecast temporary deceleration in the global economy in 2011, the authorities plan reductions in the headline fiscal deficit in their two-year budget to 3 and 2 percent of GDP in 2011 and 2012 respectively, anticipating further reductions to 1 percent of GDP from 2014. On our estimates, this implies a structural consolidation of some 1½ percentage points of GDP over the next two years. Alongside, further increases in the BoI policy rate of 75-100 basis points are anticipated during 2011. In this context, growth is projected to slow to 3½ percent in 2011 before rising again in 2012.

9. **But given sustained capital inflows, the announced fiscal trajectory still leaves monetary policy with too stark a choice between addressing inflation concerns and sustaining competitiveness.** Both need to be secured.

10. **Accordingly, fiscal deficit reduction needs to be more rapid than planned.** A strengthening of the planned fiscal stance for 2011 and beyond—by some 1 percentage point of GDP in structural terms—is recommended. This action would dampen demand growth, lowering inflation pressures, thereby allowing a slower rise in BoI rates than would otherwise be needed. In turn, this would ease upward pressure on the shekel.

11. **A mix of expenditure and tax actions is recommended.** The latitude under the budget operation mechanisms to hold spending below budgeted authorizations—including by retention of all the various reserves in the budget—should be applied. But if this greater-than-planned structural consolidation is to be secured, risks on the revenue side—arising from generous official estimates—may also need to be addressed. With discretionary spending restraint already assigned to strengthen the deficit, action may be needed on indirect taxes.

12. **Alongside, steps to cool the housing market may be required.** The pace of house price inflation cannot continue without risk of broader instability—notably in the banking sector. Given uncertainty about when stabilization will occur, prompt measures to check the momentum of prices should focus on actions needed anyway to establish a healthy housing sector for the long run. Building on such measures already taken, this focus will also be to the particular benefit of young home buyers. Possible measures include further relaxation of land supply and licensing constraints, and reduced exemptions in the taxation of capital gains on housing and rental income to establish level playing fields in both areas.

13. **The recommended fiscal action and strengthened medium-term spending procedures will also boost overall fiscal credibility.** Faster consolidation would underscore commitment to the new fiscal rules—targeting deficit reduction and capping real expenditure growth over the medium-term. But the credibility of the rules will require reinforcement in other ways also—notably because outstanding bottom-up spending commitments exceed the ceilings over the medium term. This longstanding issue highlights the need for a coordinated review of medium-term expenditure priorities. Indeed, discipline over such commitments and, eventually, systematic medium-term spending reviews should support the biannual budget system in securing both continued fiscal discipline and high quality public spending.

14. **In this medium-term context, a review of the taxes on non-renewable resources—notably natural gas—and arrangements for spending of the proceeds is appropriate.** Thus, the establishment by the Ministry of Finance of a commission to review the current tax arrangement is most welcome. Its general intention to raise the “tax take” from these activities to advanced country norms is fully appropriate; in part as a fair tax system is also more likely to be stable. We encourage other reforms to adopt international best practice in this area, including appropriate pricing arrangements in the tax and to secure appropriate intergenerational distribution of the proceeds. Accordingly, the first use of such tax receipts should be to reduce public debt, given that overall revenues will be modest on current estimates of the volumes of gas. But if large additional finds are made, revenues should be placed in a sovereign wealth fund.

15. **On the monetary side, with output and employment buoyant and inflation expectations high, further progress towards a neutral stance is appropriate.** If fiscal policy is tightened as recommended, policy rates could rise broadly as is now anticipated. But if not, a faster than anticipated rise in policy rates will be needed—albeit at the expense of competitiveness—to head off risk of higher inflation and the need to correct that later.

16. **But given nominal policy rates already well above the lower bound, monetary policy can also play a key role in responding to global uncertainty.** Policymakers should remain ready to act decisively—swiftly raising policy rates if upside global risks materialize, and vice versa.

17. **With the balance of core policies adjusted in this way to address immediate strains, other policy instruments could also play a supportive role.** Further foreign exchange intervention on both sides could help to sustain orderly market conditions. But given that reserves and central bank sterilization losses are already considerable, and that persistent one-sided use of this instrument undermines the credibility of the floating exchange rate regime, it is ill-suited as the main means of reconciling inflation and competitiveness objectives. Likewise, capital controls could be considered. But any use of them would have to be focused in ensuring effectiveness in the face of sustained pressures, and better options may be available. And accelerated progress towards the eventual Basle III

capital requirements for banks, especially if coupled with countercyclical buffers, could support restraint.

18. **The Bank of Israel Law of 2010 codifies much precedent in Israel and provides a strong foundation for the monetary and exchange rate regime.** To strengthen the framework further, consideration could be given to issuing memoranda of understanding between the Government and the BoI on various aspects of how the new law will be implemented. It would also be useful to clarify the role of the new Monetary Committee in decision-making on macroprudential matters.

19. **A range of regulatory and supervisory measures are underway.** In mid-2010, banks were required to secure core capital of at least 7½ percent by year end. In the non-bank sector, supervisory powers and capacity, transparency by market participants, and risk management by institutional investors are all being strengthened, notably via Solvency II.

20. **In this context, the available indicators of financial stability are reassuring—but limited in scope.** Capital adequacy—including Tier 1 capital relative to risk-weighted assets—and impaired loans have improved and non-bank financial institutions have advanced similarly, both in the context of the upswing. But with stress testing still focused at sub-sector level and in its early stages, and a number of indicators of risk not available, caution is warranted. Though perhaps masked by the cycle, credit quality in the corporate bond market remains a lingering concern following its rapid expansion since 2004, as does the latent threat to banking stability if rapid house price inflation continues.

21. **Accordingly, further progress is needed to strengthen diagnosis and management of risks.** Stress testing procedures need considerable further development, with added focus on systemic risk assessed over longer horizons. Progress in this area, and formulation of the appropriate policy responses, requires full collaboration between and within supervisory institutions. It also requires routine guidance from and feedback to all the authorities responsible for stability, including the BoI and the MoF. Formalization of these arrangements would remain appropriate whatever the final decisions on the location and structure of supervisory bodies. Steps to improve diagnosis and collaboration should not await the anticipated FSAP, but other matters—such as possible need for a deposit insurance scheme and early bank resolution arrangements could be taken up in that context.

22. **Furthermore, the adequacy of resources, capabilities, autonomy and accountability of the non-bank financial supervisors remains of concern.** With the sector still relatively new, the infrastructure of conventions and rules governing markets, issuance, and institutions is still being developed, as reflected in the sector's fragility in 2008-09. This infrastructure needs further development—building on proposals in the “Hodak Committee”—and supervisors need to enhance their monitoring and management of risks. Our view remains that these considerations warrant moving supervision out of the MoF, as is

typical in the OECD, with a number of good options for where it should go—including the option chosen by about half of OECD countries of full independence.

23. **The thrust of our macrofinancial advice hinges on continued structural reform.** This includes progress in education, research, the business environment, and infrastructure. But the highest priority in this area is to fully integrate minority populations into the labor force, so as to lower social spending pressures and to raise the long-run productive potential of the economy.

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We deeply appreciate the candor and exceptional warmth of the welcome we have been accorded during our stay in Israel.