CONCLUDING STATEMENT

Israel: Staff Concluding Statement of the 2020 Article IV Mission

FOR IMMEDIATE RELEASE

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The Israeli economy entered the COVID-19 pandemic from a position of strength, and the authorities mounted a large and rapid response to the crisis. Timely and decisive measures introduced by the Bank of Israel at the outset of the pandemic have helped preserve market and financial stability and access to credit. Fiscal support to the health system, households, and businesses has also helped soften the economic impact of the pandemic.

Real output has contracted less than in other advanced economies in 2020 and is projected to rebound in 2021. Nonetheless, the outlook remains uncertain and dependent on the evolution of the pandemic.

In this challenging environment, policies should continue to provide support to the economy, contain the risks associated with the pandemic, and promote recovery. Fiscal policy needs to become gradually more targeted to maximize the impact of the available fiscal space. Monetary and financial policies need to remain accommodative. Structural policies should aim at mitigating labor market vulnerabilities, limiting the potential long-term impact of the pandemic, and fostering a more inclusive recovery.

The Israeli economy faced the COVID-19 pandemic with strong fundamentals. Real annual GDP growth was around 3¼ percent and the current account averaged 3½ percent of GDP in the last 5 years. Unemployment had reached 3.6 percent at end-2019 —the lowest rate in the last two decades. Public, household, and corporate debt were at comfortable levels, and external debt was below 30 percent of GDP at end-2019. Banks enjoyed strong capital, high asset quality and liquidity. Israel's foreign assets exceeded foreign liabilities by 40 percent of GDP and international reserves reached 33 percent of GDP. The government has been financing in global markets at low rates.

The impact of the pandemic was unprecedented. More than 320,000 people have contracted the disease and 2,700 lives have been lost. Lockdowns introduced in March and September contained the spread of the virus but, together with social distancing, suppressed economic activity throughout 2020.

The authorities mounted a large and rapid response to mitigate the impact of the pandemic. The Bank of Israel launched sizeable measures to provide liquidity, prevent a credit crunch, and ease access to financial services and credit, including for small businesses and households. Besides lower interest rates, wide ranging measures included asset purchase programs for government and corporate bonds and term funding to banks to extend loans to small and medium enterprises. Foreign exchange operations reduced pressures on the shekel. Easing of macroprudential and supervisory requirements allowed the banks to support the economy. Several fiscal stimulus packages reaching 15¼ percent of GDP (of which 10¼ percent of GDP planned for 2020) were also approved, including support for healthcare, benefits for unemployed and furloughed workers, grants for self-employed and households, guaranteed loans for companies, and infrastructure support.

While the measures calmed markets, supported confidence, and limited the economic damage, the outlook remains challenging. With extensive policy support and with resilience stemming from Israel's ICT sector, real output has contracted less than in other advanced economies so far in 2020. Nonetheless, a significant output decline is projected for the year. Unemployment, including those who were furloughed, is likely to remain in double digits. And greater unemployment among lower-income workers is likely to exacerbate Israel's already high income inequality. While the recovery is projected to commence in 2021, social distancing will likely continue to constrain domestic demand and drag GDP growth.

Risks are unprecedented. In the near term, the evolution of the pandemic is expected to have a major impact on the economic outlook. Early wide-spread distribution of an effective vaccine would lead to a faster-than-projected recovery. However, an escalation of the pandemic could require a prolonged use of containment measures and social distancing, bringing further disruptions to economic activity. Extensive fiscal support could limit fiscal space and create financing constraints. Failing to contain the pandemic could drain political capital and raise discontent. Among other risks, geopolitical ones—while significant—have become more balanced, especially after the recent bilateral accords.

Supportive and Targeted Fiscal Policy

An appropriately large fiscal package has aided the economy in 2020. Urgently needed healthcare funding has boosted personnel, equipment and necessary capacity to fight the pandemic. Support for households has mitigated the impact on aggregate demand and income distribution, as low-income workers—who tend to spend a larger proportion of their incomes than do higher income workers—were furloughed at higher rates. Support for businesses has focused on providing liquidity. The fiscal expansion has managed to strike a balance between protecting the economy from a larger downturn and preserving some fiscal space to meet future shocks.

Prompt passage of a 2021 budget would help prioritize spending, position the economy for growth, and reduce economic uncertainty associated with the pandemic. Fiscal policy in the 2021 budget should remain supportive, especially if downside risks materialize. If the pandemic proves persistent and partial lockdown measures extend longer than envisaged, the authorities should consider additional funding for health services, extending unemployment benefits beyond mid-2021, and further grants for the self-employed. The withdrawal of fiscal support should be timed carefully given the challenging outlook.

Fiscal policy should continue to prioritize health spending and gradually become more targeted. Fiscal support for the health sector should remain a priority to ensure adequate hospital capacity, testing and tracing and to address other urgent needs. Beyond health, while blanket transfers and benefits will be appropriately discontinued, plans for bolstering social protection need to be developed. Greater focus on active labor market policies would improve job prospects for the unemployed. Support for businesses needs to target solvent companies. Public investment projects should focus on job-rich and inclusive projects.

Once the recovery is on firmer ground, fiscal effort will be needed to gradually restore pre-crisis buffers. As the economy recovers and stimulus measures expire, the deficit is expected to decline, but higher debt accumulated during the crisis means that the debt trajectory will be more sensitive to new shocks. Further effort would therefore be needed to create fiscal space for a stronger safety net and greater investment spending while also ensuring that debt is more firmly on a downward path. Tax reforms should be at the core of this effort. Improving progressivity of income taxes and eliminating inefficient incentives and exemptions would help raise Israel's revenue ratio and address high income inequality.

Accommodative Monetary and Financial Policies, Keeping Emerging Risks in Check

Decisive monetary policy measures have helped provide market liquidity and sustain the flow of credit to households and businesses. The measures eased early pressures on exchange rates, bond yields, and corporate spreads. Extending the current set of policies remains appropriate given low near-term inflation expectations, output projected to be below potential, and uncertainties on the duration of renewed lockdowns. The emphasis on asset purchases would keep term premia in check and preserve bond market functioning.

Israel's financial system was well prepared to face the COVID-19 shock. Banks have strong capital and profitability positions, supported by conservative business models. Relatively tight macroprudential policies instituted prior to the pandemic provided ample space for policy relaxation, allowing banks to continue supporting the economy. Banks have substantial capacity to face large and prolonged shocks even after the recent release of capital buffers. Nonetheless, unless further downside risks materialize, the level of minimum regulatory capital should not be lowered further, and structural buffers should eventually be restored.

The authorities should keep an eye on asset quality risks as the pandemic continues and borrower support measures are wound down. Alongside monetary accommodation, financial sector support to hard-hit firms and households should continue. However, the modalities of prolonged support may need to be adjusted, conditional on the evolution of the pandemic. Eligibility criteria would gradually have to be tightened to target viable firms. Subject to additional adjustments due to pandemic driven-lockdowns, banks' discretion to defer household loans should also be gradually restored. This would help limit debt overhang and facilitate business adjustment and debt restructuring. In case of a surge in business insolvencies, efficient and effective insolvency procedures, including adequate resources and mechanisms to implement the new Insolvency Law, will be crucial to minimize barriers to corporate restructuring and spur productivity-enhancing capital reallocation.

Macro-Structural Policies Driving a Resilient Recovery

Structural policies should aim to limit long-term scarring, strengthen the resilience of the economy, and promote inclusiveness. The focus should be on labor activation policies and investment in human capital and infrastructure to prepare the economy for post-pandemic transformation.

- **Repairing the labor market.** The pandemic has had a profound impact on the labor market, as businesses in contact-intensive sectors furloughed the majority of their employees, accounting for half of all job losses. Part-time and low-skilled workers were more likely to be furloughed or dismissed. Well-funded labor activation policies could facilitate reemployment, efficiently reallocate workers from sectors and businesses that downsize, and mitigate the negative impact of the pandemic on low-income workers. These policies, including vocational training, should promote reskilling and upskilling, encourage job search and reduce hiring costs.

- **Expanding digitalization.** Despite its high share in output—which has contributed to Israel's resilience during the crisis—the ICT sector is underutilized in many of Israel's economic and social activities. Policies that broaden digital penetration have very high potential to increase knowledge diffusion and productivity, mitigate skill shortages, and improve the reach and effectiveness of government services.

- **Reforming education.** The lockdowns have created educational setbacks that could have lasting productivity and inequality implications. Planning, training, and investment in technology would ensure continuity and sustain the quality of education. Placing greater emphasis on key subjects providing marketable skills (math, sciences, and technology) would prepare students for an increasingly more digitalized marketplace. In the medium term, reforms that raise schooling achievement alongside Israel's already high number of years of schooling would increase human capital, productivity, and living standards.

- **Boosting investment.** Public investment can directly create jobs, mitigate the drop in demand, and encourage private investment, which has declined amidst low business confidence. Public investment projects—particularly in health care, transportation, digitalization infrastructure—can also strengthen crisis resilience. Closing gaps in reforming Israel's government procurement system would enhance public investment management ahead of ramping up pandemic-related investment spending.

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