Israel—2007 Article IV Consultation

Concluding Statement of the IMF Mission

December 10, 2007

1. **The economy is performing exceptionally well, which calls for the continuation of the strong economic policies**. Sound policies have played a major role but so has unprecedented global growth. With the return of good times, the pressures to divide up and consume the fruits of the hard-won prosperity are growing. But more work is needed. In particular, the public debt today is not much lower than before the latest recession and the country's vulnerability to economic shocks remains high. More debt reduction is therefore essential to safeguard the government's ability to help people in difficult times. Furthermore, improvements to the financial sector framework need to be carried forward to enhance the economy's robustness against shocks.

Economic developments and prospects

2. **Economic activity is likely to remain strong, even if less buoyant than in recent years**. Domestic preconditions for continued output growth remain in place. Specifically, GDP growth is broad based; families' real incomes are rising, including those of the poor; corporate profitability and balance sheets have improved; and the cooperation between employers and trade unions is good. Furthermore, the economy's competitiveness is still solid. External conditions, however, are becoming less supportive. The global financial turmoil is proving more damaging than expected, and oil is trading near record highs. As a result, growth prospects for Israel's key export markets are now appreciably weaker than in recent years and the risks lie on the downside. We thus see real GDP growth around 4 percent from 2008, compared with about 5½ percent in 2007.

3. **Given continued solid growth, inflationary pressures would probably mount**. Factors pointing to accelerating domestic prices include rising global inflation; slowing productivity and robust demand for labor; and accelerating prices for housing services. At the same time, wage pressures are still relatively subdued and the appreciation of the sheqel (NIS) against the US dollar (US$) has been restraining prices. However, these factors will probably weaken gradually. In particular, unemployment rates are falling to levels where supply bottlenecks are beginning to appear. Higher wage growth is thus likely. Furthermore, the external current account is retreating from unprecedented highs, implying diminishing medium-run pressures for NIS appreciation; and the strong link between the NIS/US$ exchange rate and prices for housing services is weakening.

Monetary policy developments and framework

4. **Accordingly, higher interest rates are probably needed for inflation to stay within the 1–3 percent target range over the medium run**. At the same time, the uncertainty about external demand and heightened risk premia in corporate bond markets argue for caution in raising rates. Fortunately, well-anchored inflation expectations afford time to gauge better how these cross currents are hitting the domestic economy.

5. **Judging by the stability of inflation expectations, the conduct of monetary policy has been exemplary, but policy and communication challenges remain**. These stem largely from the volatility and high pass-through of the NIS/US$ exchange rate to domestic prices. Accordingly, we welcome moves to publish inflation reports on a quarterly basis and release a model-based inflation and interest rate forecast. This should help keep expectations anchored, but might usefully be supported with greater clarity about the role of these forecasts in the central bank's decision making, the relationship between these forecasts and those for other macroeconomic variables (notably the exchange rate), and about the monetary policy horizon. In addition, swift adoption of the draft Bank of Israel law is particularly important because it would significantly strengthen the economy's institutional foundation.

Fiscal policy challenges and institutions

Shorter-run requirements: maintaining a strong fiscal policy

6. **Fiscal policy has been sound, with clear benefits for the economy**. Higher-than-budgeted tax revenue has rightly been allocated to debt reduction, and expenditure has been well managed. Hence, the central government budget will likely be close to balance by end-2007, implying a general government deficit of roughly 1 percent of GDP on an internationally comparable basis. As a result, the country's sovereign risk rating is developing favorably despite the global financial turmoil. Together with falling public sector borrowing, this has supported a remarkable expansion of the domestic corporate bond market and thus investment and job creation by Israeli companies. Moreover, because of the reduction of the public debt from its 2003 peak, the government has saved some NIS 10 billion in interest payments.

7. **This positive performance needs to be carried forward into 2008 to cement the many benefits, notably those related to the hard-won improvements in international credibility**. In principle, the economic cycle should be left free to allow improvement in the fiscal balance in good times and deterioration in bad times. Clearly, times are good now and widely expected to remain so. We are thus reassured that the 1.6 percent of GDP central government deficit number is a ceiling and not a target. Maintaining a sound fiscal policy stance demands strict compliance with the 1.7 percent expenditure growth ceiling and the allocation of any revenue overperformance to debt reduction. This should help keep the central government budget close to balance.

Longer-run objectives: securing the welfare of younger generations

8. **The central question increasingly is how to carry forward fiscal policy over the longer run, with a view to sustaining social programs amid rising global competition**. At stake is the government's ability to comfortably sustain welfare payments in difficult times as well as in the face of long-run changes in Israel's population profile. The growth rate of the labor force, for example, may well decelerate from around 2½ percent per annum during 2000–05 to around 1½ percent during 2010–15. Some projections suggest that by 2050 only about 2–3 people in the workforce will support each retiree, down from more than 4 people today. These changes are likely to lead to appreciably lower economic growth and upward pressure on public spending.

Making room for solid government social and labor market policies even in difficult times and preparing for these population changes requires staying the course of rapid public debt reduction, not least because debt service today consumes the equivalent of about half of all welfare spending. This would also be consistent with the objectives to raise employment rates and the share of income flowing to the most vulnerable.

9. **Accordingly, we welcome the government's intention to stick with a rules-based approach to fiscal policy that is solidly anchored in longer-run objectives**. Israel is still among the outliers in the group of OECD economies with respect to its 82 percent public debt to GDP ratio. In many less exposed advanced economies, a 60 percent debt ratio is considered an upper limit. In our view, the central objective should be to achieve at least the much safer 60 percent ratio by 2015. This would require keeping the central government accounts in balance, implying a general government deficit of about 1 percent of GDP on an internationally comparable basis through 2015. Essentially, this means not rescinding today's healthy budgetary stance. Furthermore, we believe that debt reduction should be given precedence over tax cuts. Cutting debt today will help avoid higher taxes in the future. Moreover, Israel's tax rates today do not compare unfavorably with those in other advanced economies, although there is scope to simplify the comparatively complex tax system, including by reducing tax exemptions.

10. **Enhanced fiscal transparency and governance are essential to improve the quality of the budget debate and policy making, and to combat pressures to relax fiscal discipline**. Specifically, budget documentation needs to include a multi-year scenario analysis of conjunctural and other risks for public finance objectives. Also, it should contain a long-term fiscal sustainability analysis that considers, for example, future pressures on spending stemming from the changing population profile. Such risk analyses may be particularly important to help the public appreciate the importance of rapid debt reduction. Furthermore, the political economy often puts pressure on policymakers to ignore or amend fiscal rules or to circumvent them with creative accounting. Hence, their implementation should ideally be supported with strengthened fiscal surveillance. A combination of better budget analysis, strong rules, and independent, nonpartisan fiscal evaluation is increasingly considered best practice, and has been adopted by many advanced economies.

Financial sector developments and framework

11. **The ambitious reforms of recent years are fostering the development of a stronger and more diversified financial system but also call for more advanced regulatory frameworks and supervisory practices**. Together with the economic expansion, financial soundness indicators have been improving, although capital and solvency levels remain lower than in many advanced economies. Also, despite the current turmoil in global financial markets, and the system's growing exposure to financial developments abroad, risks of major losses appear low. In the meantime, the recent reforms have unleashed dramatic changes, notably a shift in the growth of financing away from banks to bond markets and institutional investors. Accordingly, the financial system is becoming more developed and complex. This raises the importance of ensuring that Israeli prudential policies and practices match international standards; that collaboration

among domestic regulators and with their international peers is close; and that reporting standards for financial institutions do not deviate unnecessarily from international norms.

12. **The authorities are conscious of the need for change and are working to deliver world class regulation and financial infrastructure**. In particular, banking and insurance regulators are moving to increase capital and solvency levels in preparation for application of international capital and solvency standards (Basel II, Solvency II). In addition, both regulators have decided to introduce risk-based supervision approaches. Insurance regulation is being strengthened considerably to address key market conduct and prudential issues. Similar progress is being made by the securities regulator. Other praiseworthy initiatives include the introduction of a primary dealer system for the government bond market, the work on developing a repo market and securitization, and the introduction of real time gross settlement for payments.

13. **But the challenges ahead are still major and the resources of regulators to meet them are not commensurate**. We see five key issues.

- Of critical importance is the ability of regulators to build the expertise necessary to support the more complex regulatory system now being put in place. This requires greater recruitment flexibility and competitive pay scales, in line with the practice in many advanced countries.

- There is a risk that the rapid pace of regulatory change will prove inconsistent with high-quality implementation. Additionally, all regulatory initiatives carry costs to consumers, firms, and regulators themselves. This calls for submitting major new regulatory initiatives to careful cost-benefit analysis.

- Regulators will also need to strive for the right balance between principles-based and rules-based approaches. The desire for strong rules is understandable but they can stifle market entry, innovation, and the accountability of financial firms. Relying on a combination of principles, market forces, and strong supervisory practices can deliver cheaper and better financial services for the economy.

- With more competition comes more risk and thus the need for a strong capacity to manage and resolve financial stress if and when it emerges. The recent Memorandum of Understanding among the supervisors is a welcome step that needs to be supplemented by other steps, such as financial crisis scenarios, to identify remaining gaps.

- In line with good international practice, the insurance supervisor needs independence to set solvency standards, enforce managerial changes in companies, resolve failing institutions, and powers to perform group-wide supervision.

14. **Israel's formerly closed financial system is opening to the rest of the world and a vision is needed of how this process should continue to unfold**. While some policy adjustments are necessary, the financial system is headed broadly in the right direction. Nonetheless, the experience of other countries suggests that formulating a vision to guide a system's international integration can be very useful. This should be a key task of the newly-formed capital markets committee.