CONCLUDING STATEMENT

Israel: Staff Concluding Statement of the 2022 Virtual Article IV Mission

FOR IMMEDIATE RELEASE

Washington, DC – February 6, 2022: *Israel managed the pandemic exceptionally well, with a successful vaccination campaign and timely and effective government and central bank support to the economy.*

The economy is recovering rapidly, but risks to the outlook remain significant; economic policies will therefore need to remain agile. While the phasing out of pandemic-related measures is timely, targeted fiscal support and monetary easing may still be needed in the event that downside risks materialize.

The 2022 fiscal stance is appropriate. In the medium term, revenue reforms are needed to support productivity-enhancing spending and to rebuild fiscal buffers.

Inflation pressures call for vigilance; monetary policy should be tightened if these become more salient. Emerging financial sector risks, especially in the housing market, should be carefully managed.

As the impact of the pandemic is receding, long-standing challenges are re-emerging. Medium-term policies should seek to address labor market bottlenecks, reduce product market barriers, support infrastructure spending, and advance climate objectives.

Israel managed the pandemic exceptionally well. Its world-leading vaccination campaign boosted confidence and helped mitigate the impact of the pandemic in the face of new, virulent variants. Government and central bank support were prompt and ample, underpinned by Israel's strong economic fundamentals. The Bank of Israel's (BOI) monetary and prudential measures provided liquidity, kept credit flowing, and prevented undue tightening of financial conditions. Fiscal measures (7.6 percent of GDP in 2020 and 4 percent of GDP in 2021) supported households, businesses, and the public health system.

After a mild downturn in 2020, the economy recovered quickly in 2021. Real GDP exceeded its pre-pandemic level, and with growth around 6.5 percent in 2021, the rebound was stronger than in other advanced economies. The high-tech sector led the recovery and private consumption gained speed. Inflation—while remaining within the BoI's target range—surged due to global factors and a rebound in domestic demand. The 2021 fiscal deficit was significantly smaller than expected due to buoyant tax revenues on the back of fast-growing domestic and global equity markets and gradual tapering of COVID-related support. Banks' solid capital, liquidity, and asset quality allowed them to support the economy amidst low household and corporate leverage. Unemployment declined significantly, and job vacancies are high across all sectors.

The economic recovery is projected to solidify in 2022 and over the medium term. Growth will be supported by strong private consumption, investment, and net exports. With temporary factors winding down, inflation is projected to ease and stay within the BOI's target band over the medium term. Managing downside risks and longstanding challenges would help secure the recovery. Vaccination efforts have been successful, but new variants could present a threat to economic growth. Geopolitical risks remain and might potentially cause socioeconomic and political disruption. Tightening of global financial conditions could lead to a stock market fall, lower government revenues, and a rise in the cost of capital. Long-standing challenges of fostering increased productivity, labor force participation, and human and physical capital have also resurfaced.

The policy mix should remain agile in the face of high growth and still significant uncertainty.

Recalibrating fiscal policy priorities

The planned 2022 fiscal stance is appropriate, and the medium-term fiscal path aims to put debt on a downward path. In 2022, pandemic support should target the most affected sectors and vulnerable population groups. With the expiration of this support, the authorities' medium-term fiscal policy is refocusing on reducing public debt and rebuilding pre-pandemic buffers. This is appropriate given Israel's specific needs. However, the planned consolidation relies on future expenditure restraint that may be challenging given Israel's already low civil spending. In this regard, conducting a review of public spending efficiency would be useful. Moreover, there is scope to increase tax revenues. The tax system could be made more progressive and the tax base could be broadened, including by reducing pension tax exemptions and personal and corporate tax incentives for selected groups.

Greater fiscal revenues would also support policy priorities to build resilience in the economy. There is a need for greater spending on active labor market policies, the ongoing reforms of the education system, infrastructure, and to support the authorities' climate goals.

Israel's fiscal framework needs to be strengthened. A review of the fiscal framework should assess the appropriateness of the fiscal rules, the necessary size of fiscal buffers, and the ability to face exceptional events. It should also consider the potential usefulness of establishing an independent fiscal council to strengthen the framework's effectiveness.

Keeping an eye on inflation

Accommodative monetary policy has helped provide continued support to the recovery. At the outset of the pandemic, with the policy rate already low, the BOI reinforced its policy tools with ample liquidity provision (near 8 percent of GDP) through government and corporate bond purchases, and programs to incentivize lending to small and medium enterprises. As rising appreciation pressures on the shekel threatened to cause a significant decline in the rate of inflation, possibly to negative rates, in January 2021, the BOI also deployed a sizeable pre-announced program of foreign exchange intervention (6.5 percent of GDP). Now, amidst fast growth, orderly markets, and healthy private sector balance sheets, the recent halting of liquidity support programs has been timely. The program of preannounced foreign exchange purchases has also ended.

While contained, inflation has risen, calling for vigilance and potential tightening of monetary policy. Inflation remains within the BOI's target range and the appreciation of the shekel continues to restrain price growth. Nonetheless, rising service prices, a high rate of capacity utilization, and rising wages in some sectors show incipient signs of underlying inflationary pressures. One- and two-year ahead inflation expectations—while remaining within the target band—have also risen quickly in line with consumer price growth. This calls for continued close monitoring of inflation developments. If underlying upward pressures become more salient, the BOI should be ready to tighten monetary policy. In such a case, foreign exchange purchases should taper off, allowing the shekel to be determined by market forces, without precluding future purchases should appreciation pressures threaten to move inflation or inflation expectations below the target band.

Stemming emerging financial sector risks

The financial system has navigated the COVID-19 crisis smoothly. Macroprudential easing, BOI's additional measures, and solid balance sheets allowed banks to expand credit to the economy, resulting in robust business and mortgage lending growth in 2021. The rapid economic recovery protected banks' asset quality and boosted their profitability. The unwinding of COVID-19 support measures and the removal of restrictions on bank dividend distribution have thus been timely.

However, housing prices and affordability are a significant concern. The rapid rise in housing prices rekindled concerns of price misalignment, stressing the need to advance structural measures to ease housing supply. With the house price-to-income and price-to-rent ratios at high levels, the BOI has appropriately reversed the easing of the loan-to-value limit and the capital requirement for housing loans. Further tightening of macroprudential measures—e.g., lowering the debt-service-to-income limit—could help stem banks' exposures to housing market risks and prevent potentially unsustainable borrowing.

Israel's financial regulatory architecture has served the economy well during crises. A conservative regulatory approach has protected the financial system from excessive risk-taking. However, the push for greater competition and financial innovation will test the agility of this approach. The establishment of a committee to review the financial supervision architecture is thus welcome.

Addressing longstanding productivity challenges

Well-targeted structural reforms could improve productivity, foster reallocation in the labor market, and prevent further widening of inequality. Contact-intensive sectors suffered disproportionately large job losses during the pandemic, while the high-tech sector continued expanding, given its adaptability to remote working and greater demand for its products. Skill and knowledge gaps could make labor reallocation across sectors challenging and costly and could affect unevenly the employment and wages of different demographic groups. Policies should focus on facilitating job creation and reallocation, removing product market barriers, and improving infrastructure:

- **Addressing skill gaps.** Active labor market policies should seek to expand vocational training to disadvantaged adults and encourage private support and enhanced quality of training programs. Recent measures to incentivize students to acquire marketable skills are welcome. A greater adaptation of the different education streams will be needed to help align student qualifications with increasingly digitalized-labor market needs. This will require an improvement of the core curriculum of Haredi students, greater Hebrew knowledge among Arab students, greater investment in basic education, and strengthening teacher quality at schools in disadvantaged communities.
- **Furthering product market reforms.** Continued efforts to reduce tariff and non-tariff trade barriers would be key to promote efficient allocation of resources, investment, and innovation. It would also help boost competition and reduce costs of trade, especially for smaller firms.
- **Improving infrastructure.** Infrastructure spending needs to accelerate further if Israel is to close the infrastructure stock gap relative to other OECD countries. Infrastructure improvements are particularly pressing in transportation to ease traffic congestion and improve job accessibility. Upgrading digital infrastructure to expand access to digital networks in poor communities will be key in supporting labor reallocation.

The authorities have strengthened their commitment to address climate change. They have made significant progress in developing policies to achieve their targets, including a gradual phase-in of excises on coal and other fuels between 2023–28 and a phase-out of coal energy production by 2025. However, further efforts will be needed. Options include larger increases in carbon prices and providing greater regulatory and fiscal support for Israel's innovative green technologies.

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