# INTERNATIONAL MONETARY FUND

Concluding Statement of the 2013 Article IV Consultations with Israel

December 16, 2013

1. **The Israeli economy is growing at a moderate pace.** Overall growth is projected to remain flat in 2013 at 3½ percent and moderate slightly to around 3¼ percent in 2014. Inflation pressures remain contained, with both headline and underlying inflation (CPI excluding energy) at the middle of the target range, and unemployment is low. House prices, however, continue to increase despite policy measures aimed at curbing such rise. The external position is strong. The shekel has been under intermittent appreciation pressure—owing to an easing of geopolitical risks, prospects of a natural resources bonanza, and large FDI inflows—contributing to weakening the competitiveness of the tradable sector. Abstracting from the impact of new large-scale gas production, growth in 2013 is projected to be only 2½ percent.

2. **Risks to the economic outlook are tilted to the downside.** Externally, the main risks pertain to a prolonged period of sluggish growth in Europe and the United States and growth disappointments in emerging economies. Domestic risks include a further weakening of the tradable sector, a correction in the housing market, and the reemergence of regional geopolitical tensions, which would bear upon sentiment. Risks to the upside could arise from faster-than-expected recovery in Israel's major trading partners and growth spillovers from the emerging natural gas sector.

***The key policy challenge is to support near term growth, while preventing the build-up of imbalances, strengthening resilience to shocks, and ensuring long-term sustainability.***

3. **The challenge for monetary policy is to balance growth concerns against the risk of macroeconomic imbalances.** The BoI should be prepared to respond nimbly to changes in the economic environment.

- With inflation firmly anchored within the target band and moderate underlying growth at risk from a strengthening of the shekel and weak external demand, there is justification for maintaining the current stance of monetary policy. Activity in the export sector (which accounts for 40 percent of GDP) has weakened, and continued shekel appreciation would further worsen the prospects for exports. As some of the appreciation pressures could be temporary, exchange rate policy should be attuned to mitigating the risk of the shekel deviating from levels consistent with fundamentals.

- The low interest rate environment could, however, fuel further house price increases. If house prices continue to rise, macroprudential measures, notably those which directly restrict the size and risk of mortgages, should be further tightened. Consideration should also be given to increasing temporarily the property purchase tax for non-primary residences. Most importantly, however, concerted efforts should be made toward alleviating supply-side constraints, including by implementing the recommendations of the Housing Committee.

- If growth turns out to be much stronger-than-expected or if appreciation pressures on the shekel ease, including because of policy tightening in major advanced economies, the BoI should gradually normalize monetary policy.

4. **Notable progress has been made in improving the fiscal position, but public debt and the structural deficit remain high.** The government is committed to fiscal consolidation, with the deficit path aimed at bringing public debt down to 60 percent of GDP by 2020, although a more ambitious medium-term path of deficit reduction would be justified to provide a buffer against potential shocks.

- The overall fiscal deficit in 2013 is expected to come in below the revised target announced in the Budget. This is welcome. Planned fiscal consolidation in 2014 is appropriate, but a strict adherence to the expenditure ceiling and announced revenue measures is imperative for meeting this target and reducing the structural deficit. However, if growth weakens significantly, automatic stabilizers should be allowed to operate fully.

- For 2015 and beyond, additional fiscal adjustment will be necessary to put public debt firmly on a downward trend**.** This should include a reduction in expenditure growth, as spending levels implied by the current expenditure rule are very high. However, given the low levels of non-interest civilian expenditures in Israel, relying solely on reducing expenditure growth (by modifying the expenditure rule) will compromise long-term growth and sustainability. Therefore, additional revenue measures will be needed.

- In reducing expenditure growth, spending that boosts the economy's productive capacity and reduces the social gap—such as on education and infrastructure—should be protected. Additional revenues can be mobilized through less distortionary measures, including a broadening of the tax base, notably by eliminating tax exemptions, increasing indirect taxes (e.g. VAT), and introducing new taxes that reduce externalities, such as a congestion and pollution tax, or that reduce inequality (such as raising the property tax).

5. **A further strengthening of the fiscal framework is needed**. Fiscal rules and targets have often been missed and revised. This is because of both revenue shortfalls and expenditure commitments that are not consistent with the expenditure rule. Against this backdrop, the current fiscal rules should be embedded within a fully-fledged medium-term fiscal and expenditure framework, to enhance credibility and promote fiscal discipline, transparency, and accountability. Moreover, the fiscal rules should be developed to have a more clearly defined debt objective, a better link between the objective and the deficit target and expenditure ceiling, and to allow more flexibility to deal with shocks. Finally, building on the role currently played by the BoI and following the establishment of a medium-term fiscal framework, consideration should be given to instituting an independent fiscal council, both as a disciplining and monitoring mechanism and to evaluate the consistency of overall fiscal policies with the fiscal rules.

6. **The mission welcomes ongoing initiatives to strengthen financial sector resilience.** Bank capital is being bolstered, exposure limits have been tightened to reduce concentration risk, and measures have been taken to contain risks arising from increased mortgage lending. Further efforts are ongoing, including the implementation of Basel III capital and liquidity requirements. In the insurance area, a Multilateral Memorandum of Understanding with the IAIS will be in place soon, which would facilitate international cooperation and information exchange. Furthermore, work on introducing the Solvency II directive is underway. In the context of rapidly growing lending by non-banks, ongoing efforts to tighten regulations of their credit risk management should be expedited.

7. **Further bolstering the resilience of the financial system to shocks is imperative.** A correction in the housing market and the associated feedback loops could undermine banks' asset quality and profitability, and pose financial stability risks. Moreover, despite progress in addressing concentration, risks concerning the financial viability of some large highly-leveraged corporates (holding companies and real estate and construction firms in particular) remain. It is therefore important that monitoring of risks to the financial sector continues on an ongoing basis, along with periodic stress testing.

8. **Progress needs to be expedited in addressing some key issues identified by the IMF's Financial Sector Assessment Program (FSAP) update.** The mission engaged actively with all the relevant stakeholders on the modalities for establishing a Financial Stability Committee (FSC), and welcomes the ongoing internal dialogue and efforts.

- Efforts to establish an FSC need to be intensified, with a clear focus on macroprudential policies in normal times (including risk identification, diagnosis, and issuing "warning" and making "recommendations" on remedial measures). The BoI should play the leading role in the FSC, consistent with its financial stability mandate, with the Governor serving as the Chairperson. The governance structure of the FSC (such as voting arrangements and the composition of the committee, including non-executive members) should be carefully designed to ensure its autonomy, credibility, and effectiveness in information collection, risk identification, and decision-making, while ensuing the autonomy of the financial regulators.

- At the same time, consistent with the FSAP recommendations, consideration should be given to establishing a separate Crisis Management Committee, focusing on crisis preparedness and management, with the MoF playing the leading role.

- Legal reforms to strengthen the BoI's toolkit for early intervention and resolution, while clarifying the policy for emergency liquidity assistance and protecting the bank from quasi-fiscal activity, should proceed apace. The mission welcomes the ongoing progress in preparing a draft law. All remaining issues need to be addressed expeditiously, with the aim of submission of the draft law to the Knesset as soon as practicable.

9. **Advancing the structural reform agenda will be critical for raising long-run sustainable growth.** To ensure strong, sustainable and balanced growth, more concerted action is required to improve the business climate and boost competition, especially in the non-tradable sector. In addition, given Israel's demographic profile, addressing low labor participation rates of Haredi and Israeli Arab communities is important to bolster the economy's productive capacity and long-term growth, as well as to reduce poverty and inequality. The mission welcomes the new initiatives that are under consideration by the government, particularly in the areas of education, to address the needs of these minority populations. At the same time, more progress is needed in other areas, such as public infrastructure, transportation, child-care services, and enforcement of labor regulations.

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We would like to thank our counterparts for the exceptional warmth of the welcome that we were accorded during our visit to Israel.