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July 9, 2001

To: Members of the Executive Board

From: The Secretary

Subject: **Israel—Staff Report for the 2001 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2001 Article IV consultation with Israel, which is tentatively scheduled for discussion on Monday, July 30, 2001. At the time of circulation of this paper to the Board, the Secretary's Department has received a communication from the authorities of Israel indicating that they consent to the Fund's publication of this paper.

Questions may be referred to Mr. M. Takeda (ext. 37158) and Mr. Mehrez (ext. 34873).

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Tuesday, July 17, 2001; and to the Organisation for Economic Cooperation and Development, following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

ISRAEL

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives for the 2001 Consultation with Israel

Approved by C. Maxwell Watson and Martin Fetherston

July 6, 2001

- Consultation discussions were held in Jerusalem and Tel Aviv during May 2–14, 2001. For purposes of Fund relations, the West Bank and Gaza Strip continue to fall under Israeli jurisdiction in accordance with Article XXXI, Section 2(g) of the Articles of Agreement. However, the mission focused on the Israeli economy and did not meet with representatives of the Palestinian Authority, as the Middle Eastern Department is undertaking the Fund's work on the West Bank and Gaza Strip.

- The staff team comprised Messrs. Takeda (head), Gerson, and Mehrez and Ms. Bal Gunduz (all EU1). Mr. Azoulay (OED) participated in the meetings. Mr. Fischer (DMD) participated in the concluding meeting. Mr. Coats (MAE) joined in a part of the mission to conduct discussions on the Financial Sector Assessment Program.

- The team met with Minister of Finance Shalom, Bank of Israel Governor Klein, and other senior officials of the government and the Bank of Israel. It also met with representatives of private sector organizations, including financial institutions.

- Israel maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions (Appendix I).

- Israel has subscribed to the Special Data Dissemination Standard, and has accepted the obligations of Article VIII, Sections 2, 3, and 4 (Appendix II).

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I. Introduction

1. **The last Article IV consultation was concluded on March 23, 2000.** Directors commended the authorities for fiscal and monetary policies in 1999 that had sustained the impressive gains in disinflation and laid the basis for economic recovery. They stressed, however, that continued commitment to fiscal consolidation was needed to support a gradual easing of monetary policy, which—together with further progress on structural reforms—would create the conditions for acceleration of growth and a reduction in unemployment.

2. **A negotiation for peace between Prime Minister Barak and Chairman Arafat broke down in summer 2000.** Since September the security situation has become serious with near-term prospects unclear. Likud leader Ariel Sharon won prime ministerial elections in February and formed a coalition government that includes the Labor Party.

II. Economic Background

3. **From mid-1999 until the third quarter of 2000, Israel experienced the best economic performance in many decades.** Real GDP grew buoyantly, accelerating toward the third quarter of 2000, when the growth rate (seasonally adjusted) reached an annualized 9 percent (Figure 1, Tables 1 and 2). On the demand side, growth was led by exports and private consumption, while on the supply side, high-tech industries and tourism expanded very rapidly.[1]

4. **Despite rapid demand growth and the sharp increase in the price of imported oil, the inflation rate continued to decline, reaching zero by September 2000 (Figure 2).** The presence of the output gap, the appreciation of the sheqel in response to record capital inflows to the high-tech sector, and the reduction (from August 2000) in purchase taxes on some consumer durables all contributed to reducing inflation. A sizable increase in the labor force participation rate paralleled strong job growth, keeping the unemployment rate more or less steady and preventing a tightening of labor market—although shortages in some high-tech fields had reportedly emerged by mid-2000 (Figure 3).

5. **Against the background of the outbreak of violence in the region in late September, there was a sudden and decisive end to the rapid growth.** Signs of a slowdown had begun to emerge in the third quarter of 2000, with the fall of the NASDAQ beginning to exert adverse effects on high-tech sector growth, and the appreciation of sheqel pressuring export profitability. Still, the timing and abrupt nature of the slowdown suggest that the direct and indirect effects of the security problem were a major cause. Real GDP shrank by 9.8 percent in the fourth quarter (seasonally adjusted annual rate), with a

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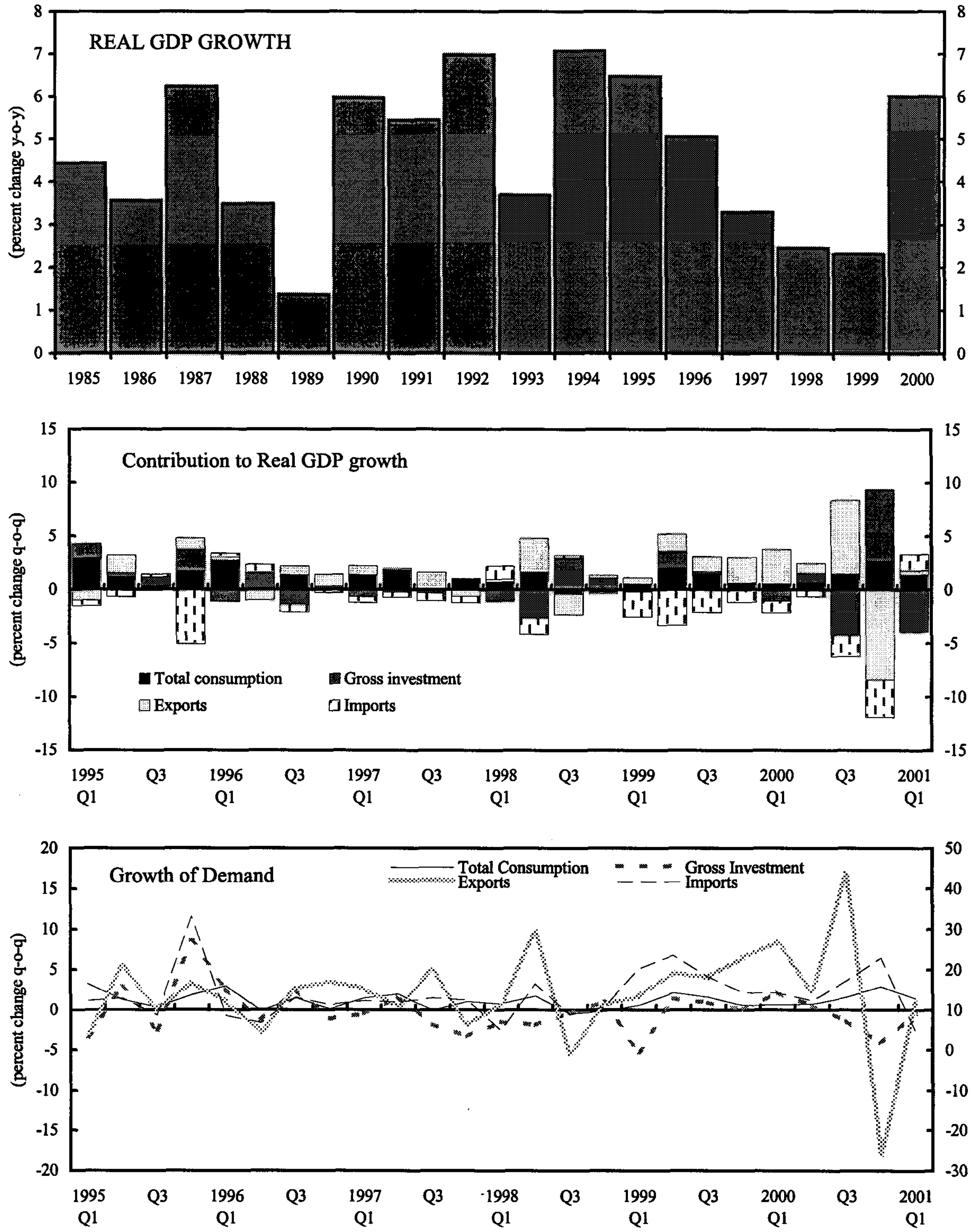
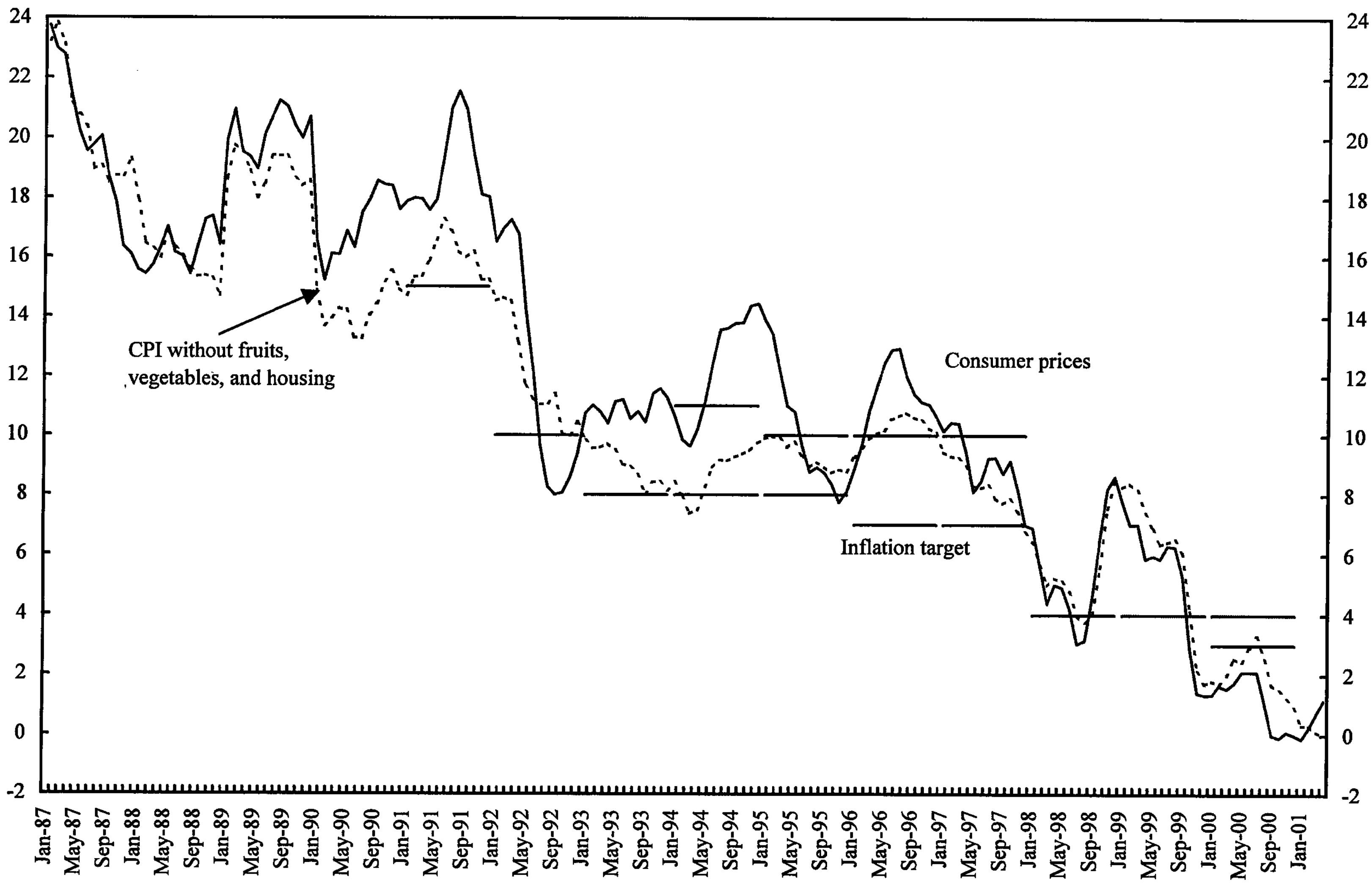
[1] The value created by high-tech start-up companies alone explained 2.1 percentage points of the 6 percent growth in GDP in 2000 (see Box 1 for more on the high-tech sector).

Figure 1. Israel: Demand and Output, 1985-2001



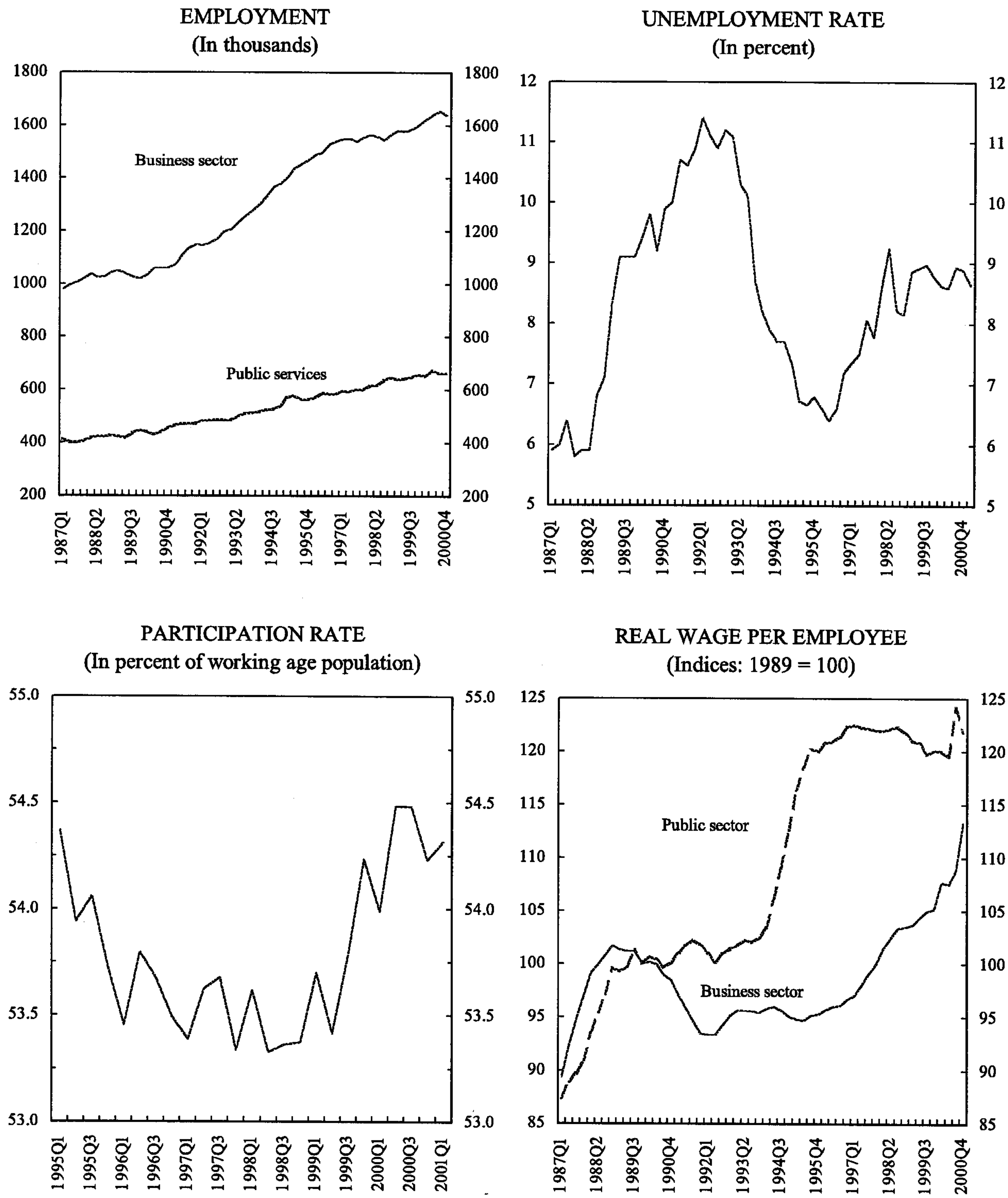
Sources: Central Bureau of Statistics; and Bank of Israel.

Figure 2. Israel: Inflation, 1987-2001
(Percentage change from the corresponding period one year earlier)



Sources: Central Bureau of Statistics; and Bank of Israel.

Figure 3. Israel: Labor Market Indicators, 1987-2000



Source: Bank of Israel.

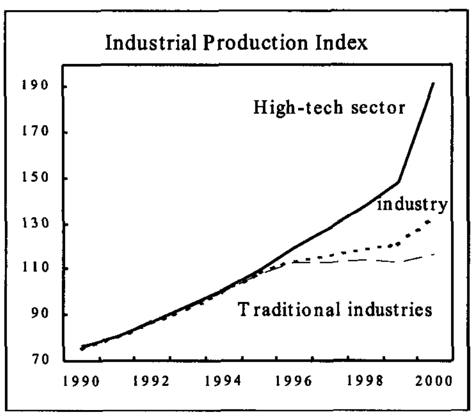
Box 1. High-Tech Sector—The Engine of Economic Growth

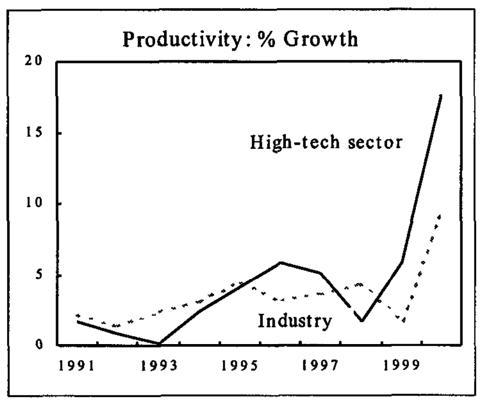
The high-tech sector has become the engine of economic growth in Israel. The sector's expansion relative to the rest of the economy became noticeable from the mid-1990s, but its contribution to growth was particularly remarkable in 2000. The production in the high-tech sector increased by 30 percent, while that in traditional sectors grew only by 2.7 percent. The share of high-tech exports in total industrial exports increased from 28.6 percent in 1999 to 43.6 percent in 2000. Productivity growth enjoyed by the high-tech sector last year was impressive, exceeding 17 percent.

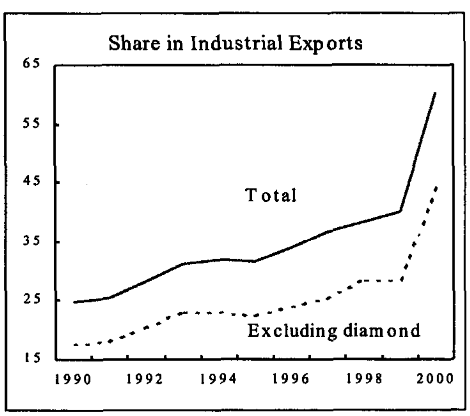
However, due to the fall of NASDAQ and the global pessimism about high-tech businesses, the Israeli high-tech sector is set to experience a difficult time in 2001. An important question is whether the sector can maintain its competitiveness during this period, so as to be able to take advantage of the next high-tech boom. While most observers agree that the answer is basically yes, there are two issues that need to be addressed to strengthen the Israeli high-tech sector's growth prospects.

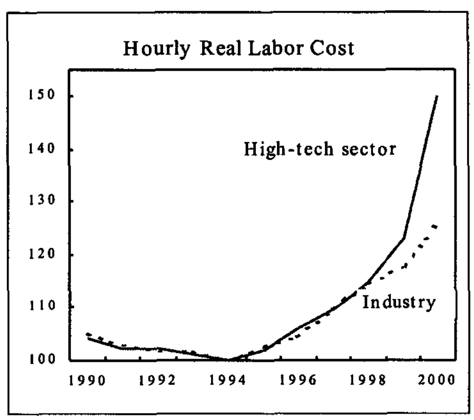
First, during the boom in 2000 the sector faced a serious scarcity of highly qualified labor. The shortage also boosted labor cost in this sector, which had a spillover effect of increasing wage pressures in the traditional industries. The government's systematic efforts to increase the university enrollment in high-tech branches fell short of meeting the immediate needs of companies, but will have at least some positive effect in the future.

Second, there is a tendency for high-tech firms to move out of the country, mainly to the United States. The advantage of being close to a major market is an important reason for this, but the institutional framework has also discouraged Israeli firms from registering in Israel. For example, the antitrust law prevents companies established in Israel from purchasing any company in the same field with a market value less than one-quarter of their own, which has made flexible mergers and acquisitions difficult. High income tax rate and a complicated tax system have been another main motivation for Israeli high-tech firms to move abroad.









12½ percent contraction in fixed capital investment, a 19 percent plunge in exports, and a 55 percent dive in residential construction (all seasonally adjusted annual rates). The sectors hardest hit were tourism, construction, and traditional manufacturers dependent on exports to the West Bank and Gaza. Construction and agriculture also suffered from a shortage of labor, as Palestinian workers—estimated to account for 5 percent of the civilian labor force—have been unable to work in Israel on a regular basis. The output gap narrowed from an estimated 2½ percent in 1999 to zero percent in the third quarter of 2000, but is estimated to have subsequently widened to more than 3 percent.[2] The slide in activity stopped in the first quarter of 2001 when a growth rate of 1.7 percent was recorded, but no monthly indicators are yet showing a sign of rebound (Table 2).

6. **Despite the very serious deterioration in the economic and security environment, key financial market variables have shown remarkable resilience (Figure 4).** This market stability has been explained by an improvement in Israel's economic fundamentals, including disinflation, shrinking budget deficits, lower net external debt and deficits (Table 3), and other generally sound vulnerability indicators (Table 4). The sheqel depreciated by about 2 percent against the currency basket shortly after the beginning of the Palestinian uprising, and by an additional 2 percent in the run-up to the February prime ministerial elections (with this additional change being reversed subsequently).[3] The country risk premium on short-term dollar-denominated debt widened from 80 basis points in September to 140 basis points the following month, but by January 2001 had already recovered to about 100 basis points. Inflation remains moderate, and market-based inflation expectations (derived from the difference between indexed and nonindexed bond yields) point to continued price stability in the future. Major rating agencies have decided to maintain Israel's favorable credit rating despite recent security and economic developments.

7. **Monetary policy remained tight in 2000 (Figure 5).** Nominal interest rates declined steadily, but due to the deceleration of inflation and the appreciation of the sheqel, monetary conditions continued to tighten. Since November 1999, the Bank of Israel (BoI) has cut

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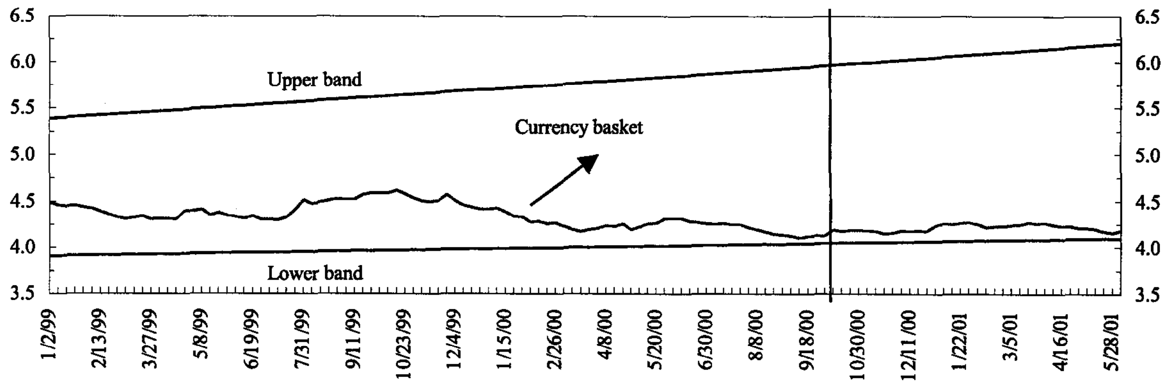
[2] These estimates have been derived from an unobserved components model, the details of which are explained in the forthcoming "Israel: Selected Issues" paper. The model, estimated over the sample period of 1988Q3–2001Q1, indicates that the potential growth rate has been fairly stable, at around 4¾ percent on average. While the level and stability of estimated potential growth are not implausible, it is possible that the impact of the recent surge in high-tech sector activity, which must have raised not only actual but also potential output substantially, is not fully captured in these estimates. Also, the shortage of Palestinian workers is likely to have a considerable impact on potential output (again, not captured in the model). For these reasons, the gap estimates should be taken with caution.

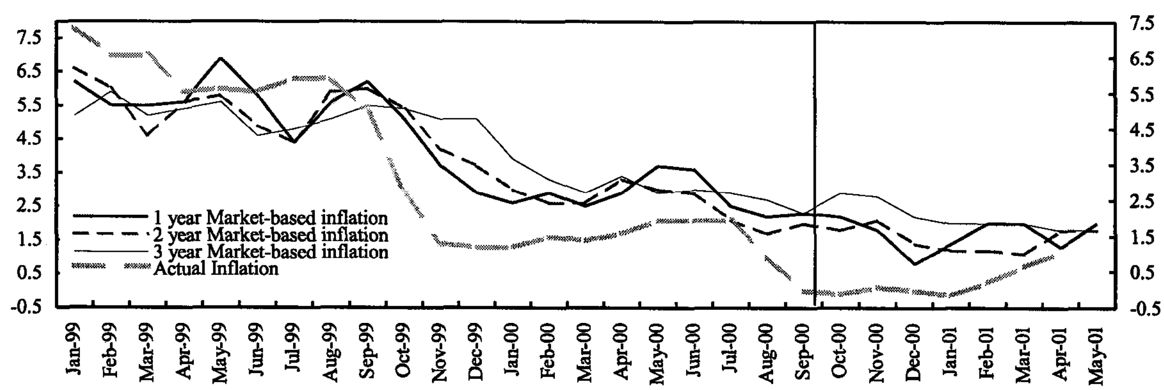
[3] The current basket weights are: the U.S. dollar, 62.55 percent; the euro, 24.57 percent; the pound sterling, 6.85 percent; and the yen, 6.02 percent.

Figure 4. Israel: Financial Market and Exchange Rate Indicators,1999-2001 1/

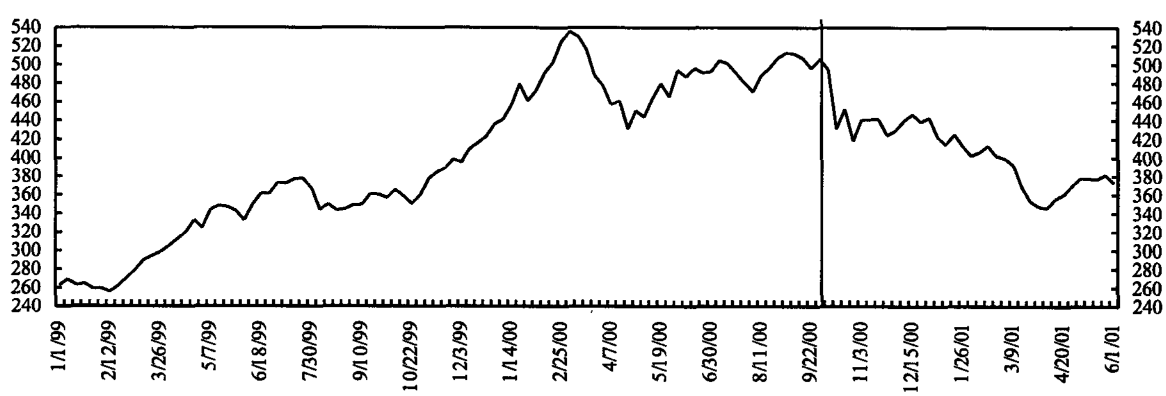
NIS Rate Vis-à-Vis the Currency Basket 2/



Market-based Inflation Expectation



Share Prices 3/



Sources: Bank of Israel; *International Financial Statistics;* and Bloomberg;

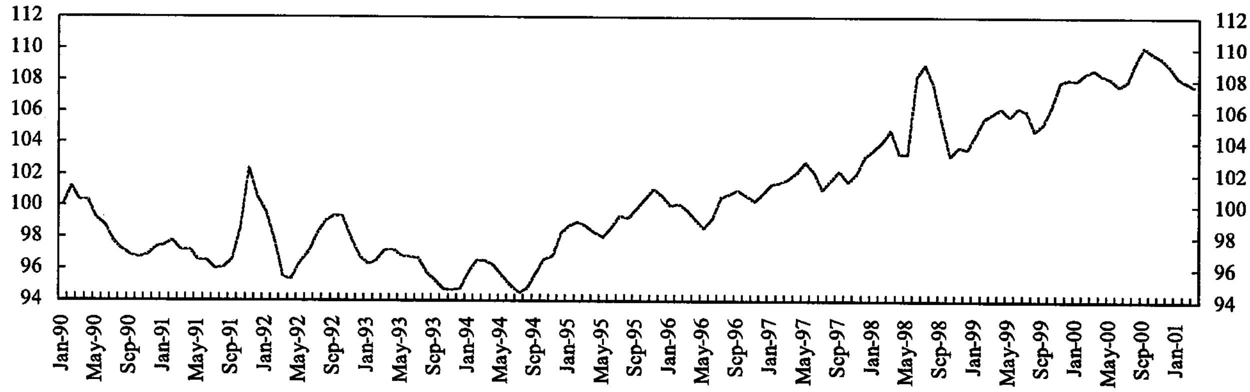
1/ Vertical line at end-September indicates the beginning of the Palestinian uprising.

2/ Weekly average of daily rates. Updated to June 5, 2001.

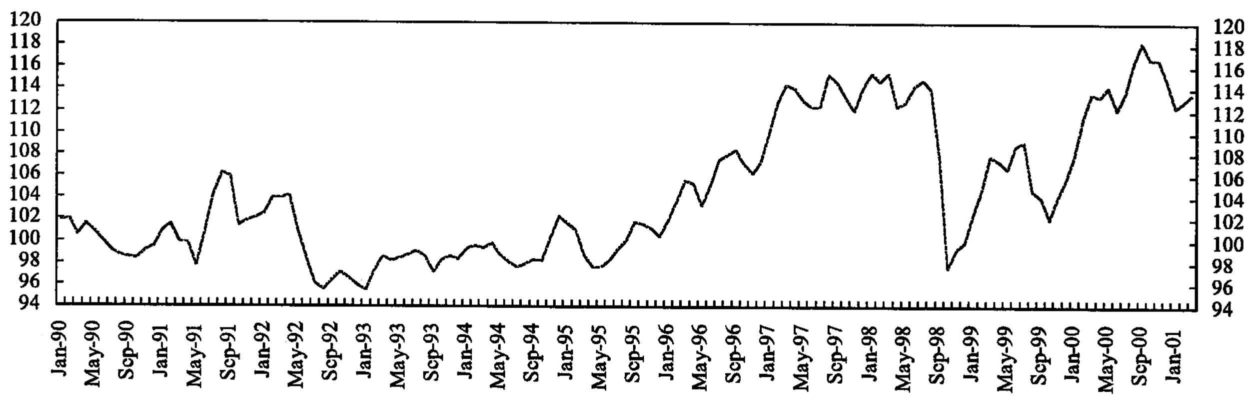
3/ Weekly data; end-of-period.

Figure 5. Israel: Monetary Conditions, 1990-2001

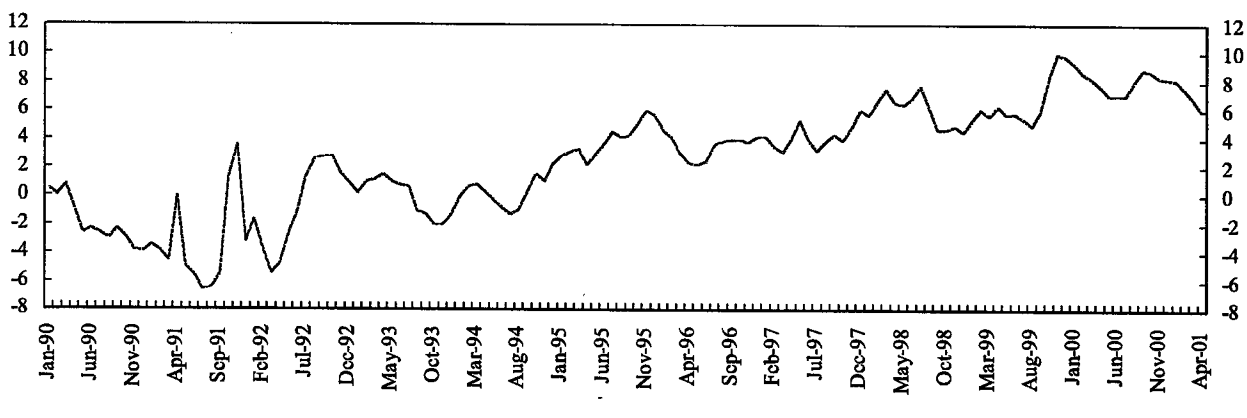
MONETARY CONDITIONS INDEX 1/
(Short-term, NX weights, January 1990 = 100)



REAL EFFECTIVE EXCHANGE RATE
(CPI based, 1990 =100)



REAL INTEREST RATES
(Short-term lending rate, in percent, deflated by overall CPI)



Sources: World Economic Outlook; Information Notice System; and *International Financial Statistics.*

1/ The monetary conditions index is calculated using the trade weighted REER and the real discount rate with the weights 39% and 61% respectively.

policy interest rates by a cumulative 460 basis points (from 11.6 percent to 7.0 percent in May 2001), typically in steps of 20 to 30 basis points. Over the same period, expected 12-month inflation declined by almost 300 basis points, meaning that the fall in real interest rates was only about one-third the nominal decline. End-2000 CPI inflation was zero percent, substantially below the official target of 3–4 percent. Despite the undershooting of the inflation target and the onset of the economic downturn, the pace of monetary easing did not accelerate in the first five months of this year.[4]

8. **Buoyant economic activity during the first three quarters of 2000 contributed to a major improvement in the budget balance (Figure 6 and Table 5).** The central government budget reached operational balance in 2000, substantially bettering the targeted 2½ percent of GDP deficit.[5] The outturn reflected primarily a sharp increase in tax revenues (14 percent in real terms), particularly from income taxes. The government resisted the temptation to spend windfall revenues, and expenditures were well below target. On a cyclically-adjusted basis, the operational balance moved from a deficit of about 1½ percent of GDP in 1999 to a surplus of about ½ percent of GDP in 2000, continuing the process of structural fiscal consolidation begun in the second half of the 1990s.

9. **There has been no significant progress on structural reform over the past year.** The tax reform package proposed in May 2000 was abandoned, and even a weaker version of the reform failed to win Knesset approval in December. No steps have been taken on the proposed revision of the Bank of Israel Law, and bank privatization has been slow. However, some progress has been made in the privatization of the former telecommunications monopolist, Bezeq: preparation for a tender for the company is reportedly in progress, despite the global decline in investor's interest in telecoms.

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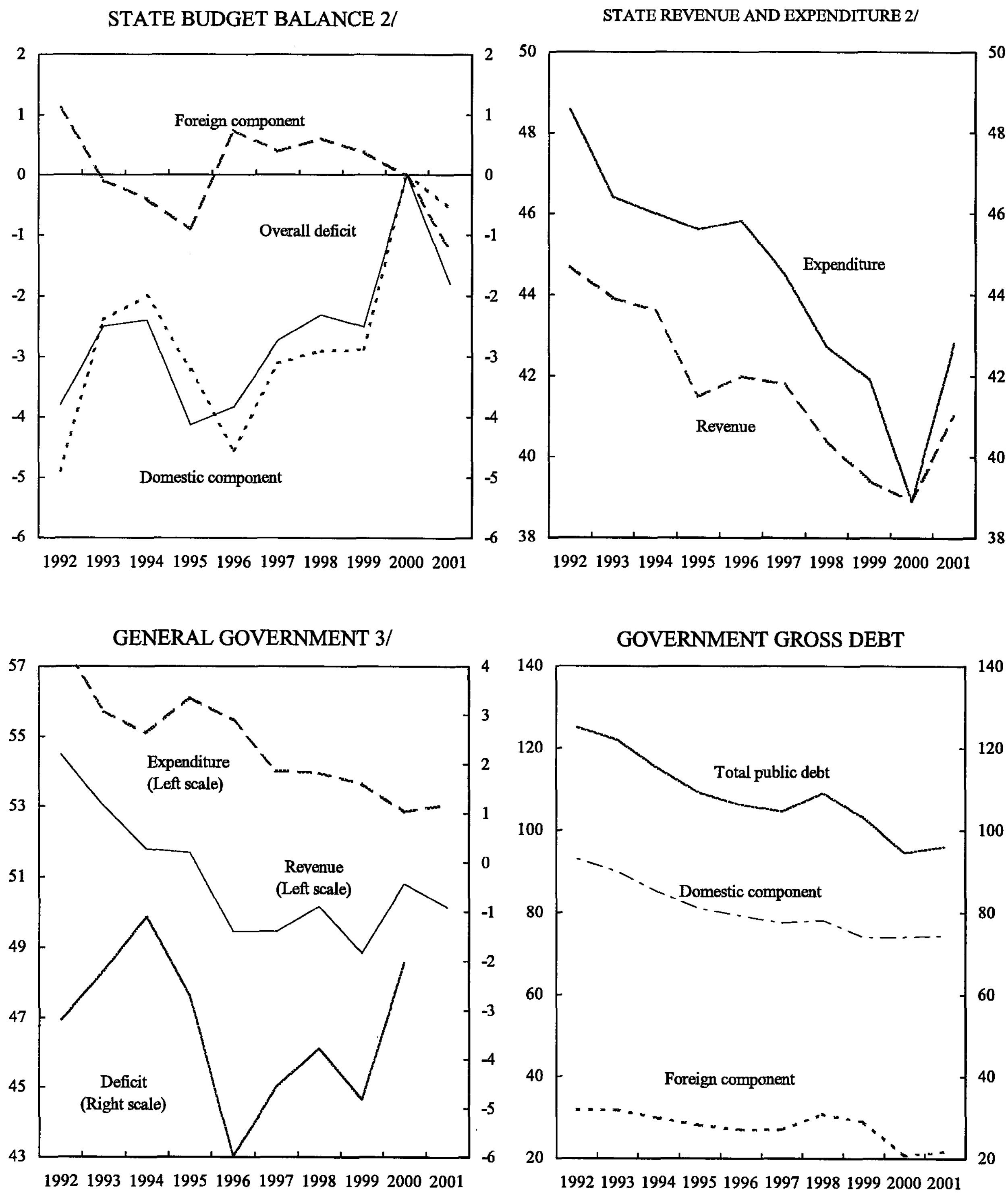
[4] In fact, the BoI skipped a rate cut in April. However, this was not because of a policy judgment, but of a labor dispute within the Bank which, according to its official announcement, made it difficult for it to make a well-informed decision. The dispute ended in mid-June, and shortly after that, the BoI took an unusual step to cut the policy interest rate by 20 basis points in the middle of a month.

[5] The fiscal balance reported by the authorities, that is, the "operational" balance, is a legacy of high inflation, but has some advantages as well. It includes only real interest on CPI-indexed, sheqel-denominated debt. The holders of these instruments—whose outstanding amount is currently about 54 percent of GDP—receive a payment equal to the inflation-adjusted face value of the debt upon maturity. Only the accrued real interest on this debt is included in the budget deficit, and the inflation adjustment paid at maturity goes below the line. Under the conventional budget accounting (on a cash basis), the deficit figure will be distorted by the delayed compensation for past inflation when indexed bonds come to maturity.

Figure 6. Israel: Selected Fiscal Indicators, 1992-2001 1/
(In percent of GDP)



Sources: Israeli authorities; and Fund staff estimates.

1/ Includes only the "real" component of interest payments.
2/ 2000 data reflect budget estimates.
3/ Percent of GNP; national accounts classification basis.

10. **The nature of recent shocks makes short-term forecasting particularly difficult.** The depth and length of the current downturn will depend in large part on the evolution of the security situation, although it will also depend on the behavior of the NASDAQ and of the U.S. economy, given Israel's strong economic ties to the United States. The staff projects growth in 2001at 1¾ percent, down from 6 percent in 2000, but with considerable downside risks.

11. **There is a risk of undershooting the end-year inflation target.** Current inflation on the order of 0–1 percent is well below the end-year target of 2½–3½ percent.[6] The overall economic slowdown will suppress wage and price increases, and the stabilization of imported fuel costs will add further, modest downward pressure. The staff, in common with most private analysts, forecasts that year-end inflation, at most, will likely be equal to the lower end of the target range.

12. **Despite the decline in capital inflows, the external sector is not expected to pose a threat.** Staff forecasts that the current account deficit will rise this year to 3¼ percent of GDP from 1¼ percent in 2000, with a sizable decline in export growth—due to a slowdown of external demand and the security-related decline in tourism—partly offset by a deceleration of import growth, reflecting a fall in fixed capital investment. Capital inflows are forecast to decline substantially this year amid the high-tech slump, though this will not immediately translate into downward pressures on the currency, since funds raised last year and held abroad by Israeli firms are being repatriated. If shrinking inflows were to be combined with a loss of market confidence in the Israeli economy due to the security situation, the sheqel could depreciate, possibly with significant inflationary consequences. Yet, the Israeli economy's sound fundamentals (paragraph 6) should contain this risk.

III. Report on the Discussions

13. **The authorities and the mission broadly agreed on the likely magnitude and causes of the current economic downturn, although there was much less consensus on the appropriate policy response.** On the one hand, given the recent sharp slowdown and the prospects for low inflation, economic policies should be supportive so as to minimize potentially serious downside risks. At the same time, however, the stability so far of foreign exchange and financial markets—which has considerably attenuated the effects of the negative shock—is based in part on the credibility of the authorities' prudent policy stance. Differences in views arose from the different weights attached to these two considerations by various parties.

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[6] In August 2000, the end-2001 target was reduced from 3–4 percent, the end-2002 target was set at 2–3 percent, and a permanent definition of "price stability" to be achieved from 2003 onwards was specified as 1–3 percent.

A. Monetary and Exchange Rate Policy

14. **In light of low inflation and inflationary expectations, as well as the need for medium-term fiscal consolidation in an uncertain economic setting, there was a consensus that monetary loosening should continue.** And the BoI had indeed been steadily cutting interest rates. However, the major question was how rapidly monetary policy should be eased, and how large was the remaining room for such action without disrupting exchange market or rekindling inflation.

15. **While recognizing that the current inflationary environment was benign and that real interest rates appeared to be relatively high, the BoI had a cautious attitude about the speed and scope of monetary easing.** Any reduction of interest rates, they considered, would need to be undertaken gradually, and should take into account that a low-inflation environment had not yet become entrenched in Israel—as evidenced by the pervasive practice of indexation to the CPI and the U.S. dollar in some segments of the economy. The economy was, in their assessment, still very vulnerable to shocks that could cause substantial depreciation and an outburst of inflation, given the fast and large pass-through of exchange rate changes to prices in Israel (Box 2). They indicated also that most of the recent slowdown was due to a fall in aggregate supply as a result of the global high-tech slump and the outbreak of violence—which was affecting mainly tourism and construction. The effectiveness of monetary policy in stimulating economic activity without increasing inflationary pressures was thus limited. Their aim was to stabilize inflation over the medium term; and although end-year inflation might undershoot the target range, their forecast for 2002—based on market expectations and econometric models—was that inflation would be within the target range. They argued that expanding the size of each rate cut would make only a small difference—a matter of a few months to reach any particular level of interest rates—while it might send a wrong signal to the market, destabilizing exchange rate or raising long-term interest rates. They could reverse their policy if and when the latter happened, but their preference was to avoid policy reversals, thus ensuring credibility.

16. **The Ministry of Finance (MoF), by contrast, favored a more aggressive loosening of monetary policy.** While expressing respect for central bank independence, MoF officials pointed out that the BoI had undershot the inflation target by a wide margin for two years in a row, and was running the risk of repeating it this year. They argued that real rates on loans to corporate and mortgage borrowers were very high, and that such rates were also putting upward pressures on the sheqel—aggravating the conditions of export, and import-competing firms. They attributed pervasively high unemployment to tight monetary policy, and did not consider that the single-minded pursuit of an inflation objective was appropriate. They were particularly concerned that tight monetary policy resulted in political pressures on the government to provide ad hoc fiscal relief. While determined to resist these pressures, they hoped nevertheless that, by loosening more aggressively, the BoI could support their efforts to maintain fiscal prudence—an objective of mutual concern.

Box 2. Exchange Rate Pass-Through in Israel

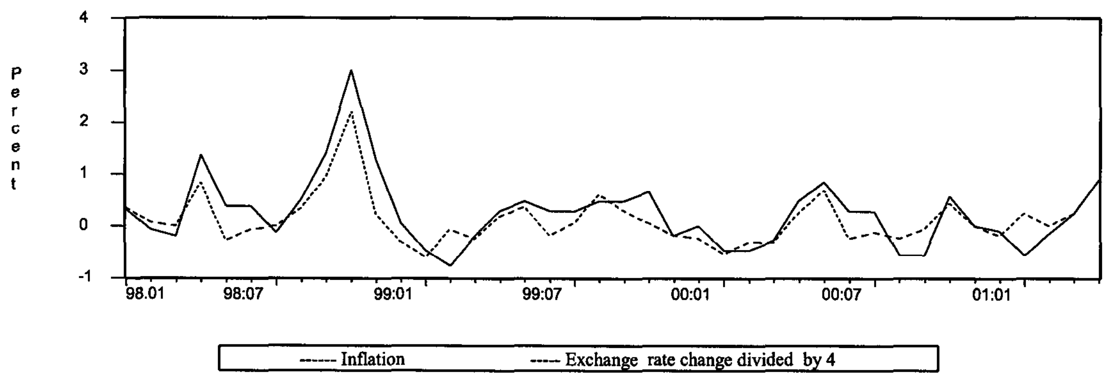
As a result of an extensive period of high inflation, the prices of some Israeli goods and services—notably housing—are denominated in U.S. dollars. This results in an immediate, full pass-through of exchange rate fluctuations into their prices. Housing accounts for more than 20 percent of the CPI basket, so the pass-through stemming from this source alone introduces a substantial contemporaneous correlation between exchange rate and inflation.

The figure below depicts monthly percentage changes in the CPI and the exchange rate from 1998 to 2001 (changes in exchange rate are divided by four for better comparison). Their close relationship is striking. High contemporaneous pass-through brought about by prices of tradables would not be surprising; however, in Israel, the pass-through is primarily due to prices of certain nontradables, which are normally expected to be much less affected by the exchange rate.

This surprising fact might be explained by the nature of the housing market. The housing component of CPI consists of "owner dwellings' services" and "rent", with the former explaining slightly more than 70 percent of the total. Of these, the "rent" part is linked to the U.S. dollar, because rent contracts are usually based on dollars to protect landlords from inflation risk over a (typically long) period of contract. The prices of "owner dwellings' services" are imputed from actual sales prices of houses/apartments. Sales prices are usually quoted in dollars because, here again, a sale often involves a substantial time lag between the contractual agreement and the actual payment. Hence, the close link to the dollar extends to this part as well.

The high sensitivity of inflation to the exchange rate implies that the BoI, in targeting inflation, has to pay close attention to exchange rate developments. However, as inflation declines and so does the need to protect landlords from inflation risk, the pricing tradition of housing services and houses/apartments themselves will become out of line with market equilibrium and will likely change. This should lead over time to a gradual fall in the degree of exchange rate pass-through. There is some evidence that this is already happening,[1] though the fact that stable prices are still a very recent phenomenon makes it difficult to draw a definitive conclusion.

Inflation and Exchange Rate
1998–2001



[1] Leiderman and Baufman ("Surprises on Israel's Road to Exchange Rate Flexibility", Deutsche Bank *Emerging Markets Research*, 23 March 2001) present a VAR model that shows that the cumulative response of prices over ten quarters to a given depreciation of the sheqel has declined substantially in 1995–2000 relative to 1988–1994.

17. **The mission considered that any future monetary policy action should be consistent with inflation targeting, but argued that within this constraint there was room for significant loosening.** In light of an unusually high degree of uncertainty, and in particular, the risk that excessive monetary easing could cause a sudden and sharp depreciation of the sheqel, the mission supported the BoI's general policy of gradual rate cuts. Assuming that inflationary expectations stabilized, future rate cuts would translate more fully into real rate cuts, providing more effective support to economic activity. Nevertheless, given the combination of high real rates and a sharp slowdown, there appeared to be further room for additional rate cuts. The mission also argued that recent developments—the remarkable resilience of financial and foreign exchange markets since last fall, and a related change in the behavior of market participants[7]—suggested that the BoI should be able to take bolder steps without disrupting markets. Gradualism could be compatible with larger cuts than the recent 20–30 basis points. With inflation now at a very low level, the mission urged the BoI to react more symmetrically to the risk of undershooting, as well as overshooting, the inflation target.

18. **While the MoF contended that the sheqel was too strong for many Israeli industries to be competitive, the BoI did not consider this should be its major concern.** The MoF thought that the strong sheqel was jeopardizing profitability and employment in traditional (nonhigh-tech) industries, and attributed this partly to tight monetary policy. The BoI was principally concerned about inflationary consequences of a possible weakening of the sheqel, rather than the sheqel's effect on the real economy. The mission noted, and the MoF agreed, that the exchange rate over the past year or so had been influenced by high-tech exports and FDI inflows, and that this situation would likely continue over the medium term. The Israeli high-tech sector was expected to maintain strong competitiveness in the foreseeable future, and upward pressures on the (real) exchange rate resulting from their activity would inevitably erode competitiveness of other industries. Given the national priority to further develop high-tech industries, a relative decline of traditional ones would be an unavoidable consequence.

19. **The authorities and the mission agreed that there was inconsistency between inflation targeting and the current exchange rate band.** Inflation had come down to a level comparable to that in major industrialized countries, and there was no longer any presumption that exchange rate should depreciate over time. However, under the current regime, the nominal exchange rate must depreciate by at least 2 percent per year once it hits its most appreciated level within the band. This would hardly be consistent with price stability, defined as 1–3 percent inflation (see footnote 6).

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[7] Instead of joining a bandwagon, as it did in the currency crisis of 1998, the nonfinancial business sector reduced its foreign currency position last fall, preventing rather than aggravating the sheqel's slide.

20. **Views differed, however, as to what should be done and when to do it.** The BoI repeated its preference to abolish the band and move to a pure inflation-targeting regime immediately. On the other hand, the MoF considered that the band was still serving a useful purpose, and was clearly against its abolition; and even if the band were to be abolished, a sharp economic slowdown would offer the worst timing to do so—since, with the exchange rate close to the lower (most appreciated) bound, the band's removal would imply depriving a weak economy of insurance against the risk of currency appreciation. The mission made clear that it supported eventual abolition of the band as a means of resolving policy inconsistency, but agreed with the MoF that the present timing was not ideal. It therefore argued that, at a minimum, the band should be modified so that the lower boundary would not constrain the BoI's pursuit of price stability, and also urged the authorities to abolish the band as soon as the current economic downturn was over.

21. **The discussion on the revision of the Bank of Israel Law has subsided, and there was little interest on the side of the MoF in discussing this issue.** The mission urged the authorities to revisit recommendations that the Levin Committee made in its report published in December 1998 with a view to enhancing central bank independence and transparency.

B. Fiscal Policy in the Short and Medium Term

22. **The authorities highlighted the significant reductions in the fiscal deficit that had occurred in recent years.** They stressed the role that fiscal consolidation had played in enhancing the credibility of economic policy and the resilience of the economy to shocks. Since 1995 the operational balance of the central government had moved from a deficit of 4 percent of GDP to zero percent. As growth had been below potential for much of this period, the improvement on a cyclically-adjusted basis was even greater. Furthermore, the authorities had committed themselves to a path of future consolidation by establishing a multiyear budget framework that called for deficits of 1¾ percent of GDP in 2001, 1½ percent of GDP in 2002, and 1¼ percent of GDP in 2003.[8] The 2001 budget was formulated consistently with this framework under the previous government.

23. **Recent events, however, called into question the feasibility of the 2001 budget target without measures.** Having been drafted prior to the outbreak of violence, this budget was based on the assumption of real growth of 4–4½ percent this year. Under updated macroeconomic assumptions, the MoF expected a revenue shortfall on the order of NIS 3½–5½ billion (¾–1¼ percent of GDP), though the fact that the budget had been based on very conservative revenue assumptions might mitigate the extent of the shortfall. The budget also

[8] In addition, the rules for calculating the deficit were changed, so that realized profits on BoI reserves will be excluded from revenues (interest expense of the BoI was already excluded from the budget). The central government deficit in 2000 was 0.6 percent of GDP on this basis.

did not take into account the substantial increase in defense-related expenditures, as much as NIS 5 billion (1 percent of GDP) in 2001, now anticipated as a result of the security situation. Moreover, during Knesset debate on the budget late last year and early this year, a large number of new spending measures were approved outside the budget that, if fully implemented, would increase spending substantially. The government succeeded in postponing most of these new measures, but could not fully eliminate their impact on this year's spending.[9]

24. **The MoF stressed its commitment to maintain the budgeted expenditure levels, a position endorsed by the BoI and the mission.**[10] Any increased spending for defense or other items would be fully offset by cuts in other expenditure categories. Cuts would be targeted to specific expenditure items, such as transfers to families with five or more children that had been increased by a recent private member bill. However, if these cuts were not sufficient to counterbalance the increase in defense spending (the exact amount of which was still under negotiation with the Ministry of Defense), then an across-the-board cut in spending might be necessary. Transfer spending was not very sensitive to the economic cycle, and the slowdown itself would therefore lead to only a very small increase in spending.

25. **However, the MoF and the BoI disagreed on how fiscal policy should respond if revenues fail to meet original projections this year.** The Ministry argued that the automatic stabilizers should be given free rein to operate on the revenue side, with the deficit increasing one-for-one with any shortfall in revenues arising from slower output growth, thus providing support to demand. The Bank, however, expressed concern that a failure to meet the original deficit target could compromise the still relatively fragile credibility of fiscal policy and of the overall macroeconomic framework, perhaps reducing the scope for further, future easing of monetary policy. While a small deviation from the deficit target this year would likely not have serious repercussions, particularly given that the authorities were already committed to lower deficit targets for 2002 and 2003, setting an upper limit to the potential deficit this year would, in the Bank's view, be preferable to avoid a wide deviation that would damage credibility and complicate the scope for monetary easing.

26. **The mission considered that, given economic conditions, allowing the fiscal deficit to be somewhat larger than the target might be warranted.** The MoF's plan to resist an expansion of overall expenditures and accept revenue shortfalls—thereby allowing the deficit to expand beyond the 1¾ percent of GDP target this year—could imply a slightly more than 1 percent of GDP fiscal impulse (see the table below). The mission thought that

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[9] Out of a total of NIS 3 billion in "private member bills" approved by the Knesset, some NIS 2½ billion were postponed, according to the MoF.

[10] Subsequent to the mission, the cabinet formally approved a proposal to limit expenditure to the levels anticipated in the budget.

the economic slowdown justified a limited deviation of the deficit from target, if it came from a revenue shortfall through automatic stabilizers. However, the mission acknowledged the importance of maintaining credibility of fiscal policy, and strongly supported the Ministry's efforts to keep overall expenditures within the original budget. The mission also agreed that in the unlikely event of a substantial revenue shortfall beyond what is currently envisaged, the pursuit of fiscal credibility (and hence the preservation of market confidence) might require measures that would attenuate the resulting deficit expansion.

Fiscal Policy Indicators, 1997–2001
(In percent of GDP)

	1997	1998	1999	2000 (A)	2000 (B)	2001
State budget, operational balance	-2.7	-2.3	-2.5	0.0	-0.6	-2.8
State budget, conventional balance	-8.9	-6.1	-6.0	-0.7	-1.3	-3.4
Output gap	1.6	0.0	-2.5	-1.6	-1.6	-3.6
Cyclically-adjusted balance	-3.4	-2.3	-1.5	0.6	0.0	-1.3
Fiscal impulse	-1.7	-1.1	-0.8	-2.1	...	1.3

Sources: Israeli authorities; and Fund staff estimates. For 2000, column (A) is based on the method of budget presentation used up to 2000 that treated the BoI's revenues and expenses asymmetrically; column (B) is based on the new method (see footnote 8) to enable direct comparison with 2001. The operational balance for 2001 is the targeted deficit of 1¾ percent of GDP plus a revenue shortfall (resulting from slower growth) that is projected at 1 percent of GDP.

27. **Over the medium term, the authorities have committed themselves to achieving the Maastricht criteria on debt and deficits.** The 2001 budget deficit (general government on a conventional basis) should be close to 3 percent of GDP, but gross debt, at 95 percent of GDP, substantially exceeded the 60 percent of GDP objective. The authorities noted that continued, significant reductions in the budget deficit were necessary to allow for a faster reduction in the debt-to-GDP ratio. At the same time, however, they stated that Israel's relatively high debt ratio is misleading, as much of the external debt accrues at relatively low interest rates, either because it benefits from a guarantee by the U.S. government or because it is purchased by members of the Jewish community overseas at concessional rates. Thus, debt service is lower than implied by the debt stock.

28. **The mission endorsed the authorities' medium-term fiscal objectives as providing a transparent benchmark consistent with a sustainable fiscal position.** It noted, however, that moving to overall fiscal balance on a conventional basis would require a further reduction in the deficit of more than 3 percent of GDP over the medium term. With subsidies and transfers, defense, and real interest expenditure accounting for about two-thirds of central government spending, the mission probed how fiscal consolidation on the required scale could be achieved in the near term, particularly given the economic and security situation. More generally, general government expenditure levels in Israel—53 percent of

GDP in 2000—are high by advanced economy standards, although this was partly explained by very large defense spending.[11] This raised the question of how quickly the goal of overall budget balance on a conventional basis, and of a debt-to-GDP ratio of 60 percent, could be achieved. Over the longer term, population aging and income growth would likely put additional pressure on spending, which could also complicate the attainment of long-run sustainability in the public finances.

29. **While acknowledging these concerns, the authorities felt that the scope existed for reducing spending further in the short run.** First, despite the fiscal consolidation that had already occurred, they believed there was still room for additional discipline to increase the efficiency of spending. Second, they believed that a future reform of social spending, which is relatively large in Israel, offered prospects for substantial savings, although such a reform was not currently in the works. Finally, they held out hope for further declines in interest rates as the inflationary environment continues to stabilize. The mission urged the authorities to formulate a well-articulated fiscal program covering the next 5–10 years, so as to indicate clearly to the general public the size of fiscal adjustments likely to be needed and possible strategies for achieving them. The mission noted that while cutting social spending might prove politically difficult given concerns about rising income inequality in Israel, in the long run faster output growth to stimulate employment, and better training and education to allow all Israelis to participate fully in an economy of increasing technological sophistication, are likely to prove more effective than large transfer payments in reducing social and economic gaps.

30. **The authorities and the private sector emphasized the pressing need to introduce tax reform.** The current tax code has two major shortcomings, namely, the very high tax wedge at some income levels and the asymmetric tax treatment given to different forms of capital income that distorts investment flows. Harmonization of the code with the U.S. code, including the treatment of stock options, is necessary to prevent the exodus of high-tech companies. The mission argued that a comprehensive reform along the lines of the original package (see paragraph 9) was necessary, but views differed among the authorities as to the feasibility of and priorities among individual measures. Some agreed with the mission, noting that cherry-picking those measures which are politically easier to introduce would leave many distortions intact, as well as having a negative impact on revenues. Others argued that—given the difficulty in having the whole package approved—focusing on the most salient problems, especially distortions in capital income, would be a more realistic option.

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[11] 8½ percentage points out of 53 percent of GDP are explained by defense and defense imports. By comparison, the general government expenditure/GDP ratio among EU countries is around 46 percent, of which about 2 percentage points are explained by military expenditure.

C. Structural and Other Policy Issues

31. **The authorities expressed concern about increases in the minimum wage and pressure to admit additional foreign workers.** The minimum wage is set every year at 47.5 percent of the average wage. As a result, high productivity growth in particular segments of the work force that pushes up the average wage translates into a rise in the minimum wage paid to workers whose productivity may not be rising at all. This year, the minimum wage has been raised by 10.2 percent reflecting high wage growth in the high-tech industry. With prices roughly stable, this constitutes a substantial increase in the minimum real wage, and could have a major distortive impact.[12] To prevent unskilled labor from being priced out of the market, the mission supported a view, held by some in the authorities, that the minimum wage should be determined based on the CPI or the median wage. The authorities also noted that the absence of Palestinian workers due to the security situation led to a strong pressure to admit additional foreign workers, but they were concerned that this would imply missing an opportunity to reduce unemployment among Israelis.

32. **The authorities stressed that they remain committed to the privatization process, seeing it as one of several tools to generate enhanced competition in domestic markets.** To this end, the Government Companies Authority works closely with the Antitrust Department to ensure that appropriate conditions are in place prior to privatization so that former-public sector entities will not be in a position to implement anticompetitive policies. Five small firms were sold in the first five months of 2001, although more than 100 firms remain within the public sector. Despite the decline in share prices of telecommunications firms, the authorities said they did not plan to delay the privatization of Bezeq, the former telecommunications monopoly; but details of the tender—specifically, whether institutional investors or only potential strategic partners would be allowed to bid—remained to be worked out. The privatization of Bank Leumi was also expected to occur this year, and the authorities hoped to be able to privatize the other large public sector bank, Discount Bank, in 2002.

33. **The authorities noted that they have continued to liberalize their trade regime in accordance with their WTO obligations.** All specific duties on textiles were eliminated by September 2000 as planned, and the dairy sector had been fully liberalized. In addition, by law, product standards could be imposed only for health and safety reasons and not for domestic protection. While a ban on imports of nonkosher meat remains in place (except for organ meats), they emphasized that this was not motivated by a desire to protect domestic producers and thus should not be viewed as a nontariff barrier. Israel recently completed a Free Trade Agreement (FTA) with Bulgaria, and the authorities stated that as the European

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[12] Counterbalancing this effect is low compliance with the minimum wage requirement. It is therefore possible that the actual distortion is more limited than it appears to be.

Union had completed FTAs with all of the major eastern European countries, it was incumbent on Israel to follow suit so as not to see its competitive position eroded.

34. **In June 2000, the Financial Action Task Force (FATF) published a list of 15 "noncooperative" countries and territories in the fight against money laundering, which included Israel.** The FATF noted the absence of anti-money laundering legislation in Israel as well as its failure to comply with a number of FATF standards, such as mandatory suspicious transaction reporting, criminalization of money laundering arising from serious crimes, and establishment of a financial intelligence unit. To address these problems, the Knesset enacted in August 2000 the Prohibition of Money Laundering Law. Israel's efforts were recognized by the FATF in its subsequent statements, which reviewed progresses made by the "noncooperative" jurisdictions—though no action has been taken to remove Israel from the list. The authorities informed the mission that a financial intelligence unit would be established in the Ministry of Justice, and a BoI Governor's Supervisory Order had been issued to banks in January 2001, in order to implement the Law.

IV. Financial Sector Issues

35. **Israel participated in the Financial Sector Assessment Program (FSAP), and a mission visited Jerusalem in September 2000,** to present the FSAP report to the authorities. It was generally well received.

36. **The FSAP found the Israeli financial sector and financial supervision sound.**[13] All key financial sector activities (except payment systems) are well supervised. Israel has both a competent and professional supervisory staff, and a satisfactory legal and regulatory framework. Major Israeli banks are well capitalized and have good risk-management capabilities, and their resilience to shocks is comparable to that of other advanced countries. Stress tests found their exposure to inflation and currency risks to be almost negligible, and that to interest rate risk small, relative to their capital.[14] Credit risk is by far the main source of risk for Israeli banks. However, stress tests applied to the five largest banking groups have shown that their resilience to credit risk, while varying among institutions, was generally strong as of end-2000 in spite of the fourth quarter decline in activity, and in fact had slightly

[13] In order to better reflect the impact of the slowdown in the fourth quarter of 2000 on banks' financial conditions, a stress test was repeated after the mission using end-2000 data. The test yielded a qualitatively similar result.

[14] Even if banks' exposure to market risk is small, their loan customers' exposure may be large, in which case market risk will materialize in the form of credit risk. While this is true in general, one indicator—the business sector's exposure to the sheqel's depreciation—shows that there has been a declining trend over the past few years in the business sector's exposure to currency risk (see Table 4).

improved from end-1999.[15] These results seem to suggest that there is little risk that macroeconomic shocks will be amplified by a deterioration of the banking sector.

37. **Nevertheless, the FSAP identified a number of problems, either current or potential, in the Israeli financial sector**. The most significant shortcoming and source of risk results from the limited coordination of supervision with supervisors abroad and supervisors of other financial services domestically. The financial sector's development has been distorted to some extent by the manner in which certain social safety net programs have been designed, tax distortions, and restrictions on institutional investors.[16] The banking sector is highly concentrated and a large share of financial services is provided by banks or by institutions under the control of banks. One result of these and some other factors is the lack of development of money and bond markets, the thinness of which increases the costs and risks of liquidity management and long-term financing.

38. **The FSAP helped identify areas where improvements were possible and desirable** (see Appendix III for major FSAP recommendations). Some of these require amending laws, such as the call for a revised Bank of Israel Law, or infringe vested interests, and hence are difficult to achieve quickly. Nevertheless, some action is being taken; the BoI is preparing draft legislation that permits the BoI to share supervisory information on individual banks with other supervisory agencies, and similar legislation is being considered by the Israel Securities Authority and the MoF as well. Other progress in line with FSAP recommendations includes the establishment of a payment system monitoring function in the comptroller's office, and steps toward implementing anti-money laundering measures (see paragraph 34 above). Also, discussions are now underway between the BoI and the banks to improve reports to the BoI—another FSAP recommendation.[17]

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[15] For more information on the stress test results, see the forthcoming paper "Israel: Financial Sector Stability Assessment."

[16] Special nontradable indexed government bonds are issued to pension funds at a fixed real yield, and these funds are obligated to hold such bonds no less than a certain, high share of their total assets (93 percent or 70 percent, depending on the funds). This regulation guarantees the return pensioners can enjoy by passing interest rate risks on to the government, and hence works as a safety net. It also means that a potentially major participant in the secondary securities markets has played a very minor role.

[17] Israeli banks do not report collateral values to the supervisors at all. For this reason, any assessment of credit risk and of the adequacy of provisions is inaccurate. Another problem is that nonperforming loans are reported net of loan loss reserves. While this is correct from an accounting point of view, there is a loss of information. The correct way of reporting would be to have both numbers reported, that is, the gross nonperforming loans and the stock of loan loss reserves.

V. Staff Appraisal

39. **Since late 1999, the Israeli economy has experienced the best three quarters in recent memory—featuring both rapid growth and price stability—and subsequently a very sharp deceleration.** The downturn arose primarily from the security problem that particularly affected tourism, construction, and the agricultural sector, as well as a global turnaround of the high-tech boom—on which a considerable part of the preceding growth depended. A critical task confronting the authorities now is to formulate economic policies so as to weather these shocks—maintaining stability, and minimizing economic costs borne by the population—until global economic conditions rebound and the security situation improves.

40. **A notable feature of the slowdown since the fourth quarter of 2000 is the surprising resilience of some financial indicators.** In particular, the exchange rate, inflation, and market-based inflation expectations have exhibited remarkable stability, attenuating the negative effects of the shocks to the economy. This is due, in no small part, to the authorities' success in establishing credibility on both the fiscal and monetary policy fronts, for which they should be highly commended. Looking forward, it is of the utmost importance that the overall macroeconomic policy mix be geared to maintaining the stability of the economy without jeopardizing this hard-won credibility. At the same time, within this requirement, any room to further ease the costs of the current downturn should be exploited. This implies that the policy mix should be appropriately supportive of economic activity, through measured monetary loosening to reduce real interest rates, while maintaining fiscal—and notably expenditure—discipline.

41. **Gradual monetary loosening has been taking place, but the question is how fast and far it should proceed.** The major risk is that of a negative market reaction, especially from the foreign exchange market. If investors' confidence in the sheqel were somehow lost, and large capital outflows occurred, price stability would be immediately threatened. Such a risk cannot be excluded, but at the same time should not be exaggerated. The market resilience noted above is an indication that the economy is much less prone to a depreciation/inflation spiral than in the past, and the reaction of private capital flows has been remarkably different from that in October 1998, when another exogenous shock resulted in a major currency depreciation. Furthermore, the BoI has the advantage, not available in many other countries, that market participants' expectations of future inflation are directly observable in capital markets. These facts should allow more rapid reductions in interest rates now—albeit in the spirit of a gradualist approach.

42. **The cabinet's recent decision that the overall expenditure limits established in the 2001 budget will be maintained is a welcome development.** The decision requires additional spending demands, arising mainly from the security situation, to be offset by cuts elsewhere in the budget. The government's determination to prevent expenditure slippages will send market participants a clear signal of its commitment to fiscal discipline. Measures that would put additional pressure on spending should be avoided. However, if (as seems

likely) revenues fall short of the budgeted amount because of the slowdown, some deviation of the actual deficit from the target should be tolerated, in order not to accentuate the economic downturn.

43. **The design and execution of fiscal policy have improved markedly in recent years, but further progress is needed.** Ratios of general government expenditure and of public debt to GDP remain high relative to those of many other advanced economies. Accordingly, the authorities have committed themselves to a path of fiscal consolidation up to 2003 that calls for continued progress in reducing deficit targets and with them the ratios of debt and spending to GDP. While this commitment is welcome, the path of targeted deficit/GDP ratios would gain in credibility by being presented in the context of a medium-term fiscal framework, together with underlying macroeconomic assumptions and the measures required to achieve the target path—including the budgetary implications of major policy tradeoffs and reform initiatives. The consequences of certain policy tradeoffs or reforms (or lack thereof) will indeed manifest themselves well beyond 2003, so the time horizon of this exercise should cover both the medium and the long term. Such a framework would strengthen the position of the authorities in resisting ad hoc requests to loosen fiscal discipline for short-term gain.

44. **It is also important to make further, steady progress with the structural and institutional reform agenda to create a more efficient and flexible economy and to enhance future growth prospects.** High on the agenda are tax reform, a reconsideration of the exchange rate band, labor market issues (the minimum wage and immigrant workers), privatization, and financial sector reform measures identified by the FSAP mission. In the medium term, a review and reform of social expenditure would also be beneficial.

45. **In many ways, the contrasts between macroeconomic conditions at the time of the last Article IV consultation discussions and those at present could not be more striking.** Dramatic and unfortunate changes in short-term prospects, however, should not be allowed to obscure the fact that the long-term growth prospects for the Israeli economy remain bright, particularly once a lasting solution to the security problem is reached. The authorities' record of skillful management of fiscal and monetary policies, and their commitment to continued structural reform, give cause for optimism that the Israeli economy will emerge from the current downturn with financial stability intact, and poised for a resumption of rapid, sustainable output growth.

46. **Data provision is generally adequate for surveillance purposes, though the quality of some statistics could be enhanced.** Israel began to publish international reserves and foreign currency liquidity according to the new template from October 2000. Improvements in external debt data will be needed to meet the SDDS benchmark by 2003 (i.e., by the end of the transitional period). Unemployment statistics are available only on a quarterly basis, and higher frequency data would be desirable; and data on capacity utilization is unavailable. In addition, the large contribution of start-up companies to GDP had created a complicated and unique technical problem of accounting their activities in the national

accounts, which needs to be properly addressed to capture the high-tech sector's role in the economy more accurately.

47. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

Table 1. Israel: Selected Economic and Financial Indicators, 1996-2002

(Percent change unless otherwise indicated)

	1996	1997	1998	1999	2000	2001 1/	2002 1/
National account indicators (constant prices)							
Domestic demand	5.9	2.0	1.1	4.7	2.5	4.4	4.7
Private consumption	6.0	4.8	3.5	3.4	5.8	5.7	5.2
Public consumption	5.2	2.0	2.7	2.9	1.2	1.9	3.0
Gross capital formation	6.5	-4.5	-7.4	10.7	-4.7	4.1	5.3
Fixed capital formation	9.0	-1.0	-4.8	-2.8	1.2	-4.3	3.0
External sector (net contribution to growth)	-1.7	0.9	1.2	-3.4	2.5	-2.1	-0.9
Exports of goods and services	6.2	7.8	6.3	10.1	23.3	-1.9	11.3
Imports of goods and services	8.0	3.2	1.8	14.6	11.4	2.3	9.9
Real GDP	5.0	3.3	2.4	2.3	6.0	1.8	4.5
Labor market indicators							
Israeli civilian labor force	2.2	2.5	2.6	3.4	3.9	3.2	2.5
Employment	2.5	1.3	1.6	3.1	4.1	3.0	3.0
Unemployment rate (in percent)	6.7	7.7	8.6	8.9	8.8	9.0	8.6
Real wages							
Total economy	1.6	2.4	2.2	2.6	6.5	3.0	...
Business sector	1.5	3.5	2.9	3.7	7.3	4.8	...
Public sector	1.9	0.0	0.4	0.1	4.7	-1.6	...
Prices							
Overall CPI (end period)	10.6	7.0	8.6	1.3	0.0	2.0	2.5
Overall CPI (period average)	11.3	9.0	5.4	5.2	1.1	1.0	2.5
Underlying CPI (excluding housing, fruit and vegetables, end period)	10.1	6.7	8.5	1.7	0.9	2.2	2.5
Interest rates (average, in percent)							
Nondirected credit in new sheqalim	20.7	18.7	16.2	16.5	12.9	...	...
Self-renewing overnight deposits	13.8	12.2	10.3	10.9	8.0	...	...
Discount rate	15.1	13.6	11.8	12.1	9.5	6.5	6.0
Money and credit (period average)							
Net domestic credit	21.6	18.2	17.7	34.9	16.4	...	...
Narrow money (M1)	14.9	14.3	12.1	3.3	11.0	4.6	9.4
Broad money (M3)	24.0	25.3	22.1	21.9	19.8	17.2	14.6
Public finance (percent of GDP)							
Central government revenue	42.0	41.8	40.4	39.4	38.9	41.0	40.5
Central government expenditure	45.8	44.5	42.7	41.9	38.9	42.8	42.0
Central government balance	-3.8	-2.7	-2.3	-2.5	0.0	-1.8	-1.5
General government balance	-5.5	-4.1	-3.6	-4.8	-2.2	-4.0	-3.7
Public debt	107.0	106.0	109.0	103.0	94.6	94.0	89.6
Balance of payments							
Trade balance (percent of GDP)	-7.4	-5.1	-3.3	-4.5	-3.0	-4.3	-2.9
Current account (percent of GDP)	-5.6	-3.7	-1.4	-3.0	-1.3	-3.3	-1.9
Foreign reserves (e.o.p., in US$ billion)	11.6	20.3	22.7	22.5	23.2	22.9	23.1
Reserve cover (in months of imports)	3.7	6.6	7.6	6.6	6.0	5.7	5.3
Exchange rate and terms of trade indices							
NEER appreciation (period average)	-2.7	0.2	-6.4	-7.7	9.1	...	...
REER appreciation (period average)	5.9	7.0	-3.0	-3.8	8.0	...	...
Terms of trade (1990=100; index level)	103.6	107.3	111.5	117.9	119.1	...	...

Sources: Bank of Israel, *Annual Report*; Central Bureau of Statistics; IMF, *International Financial Statistics;* and Fund staff estimates and projections.

1/ Fund staff estimates and projections.

Table 2. Israel: Current Indicators, 1998-2001

	1998	1999	2000	2000				2001	Months												
				Qrt 1	Qrt 2	Qrt 3	Qrt 4	Qrt 1	May-00	Jun-00	Jul-00	Aug-00	Sep-00	Oct-00	Nov-00	Dec-00	Jan-01	Feb-01	Mar-01	Apr-01	May-01
Activity and Employment 1/																					
Private consumption	4.8	3.5	3.4	1.4	2.3	1.7	1.8	2.4	...	...	...	...	...	...	...	...	...	...	...	...	
Public consumption	2.7	2.9	1.2	-1.1	-2.7	1.5	5.4	-0.6	...	...	...	...	...	...	...	...	...	...	...	...	
Gross capital formation	-7.4	10.7	-4.7	-7.0	-0.5	-16.7	28.2	-2.9	...	...	...	...	...	...	...	...	...	...	...	...	...
Fixed capital formation	-4.8	-2.8	1.2	2.2	0.5	-1.4	-4.2	-0.4	...	...	...	...	...	...	...	...	...	...	...	...	...
Exports of goods and services	6.3	10.1	23.3	8.4	2.3	16.9	-17.9	0.9	...	...	...	...	...	...	...	...	...	...	...	...	...
Imports of goods and services	1.8	14.6	11.4	2.1	1.2	3.6	6.4	-2.6	...	...	...	...	...	...	...	...	...	...	...	...	...
Real GDP	2.4	2.3	6.0	1.6	1.8	2.2	-2.5	0.4	...	...	...	...	...	...	...	...	...	...	...	...	...
Business sector gross product	2.6	2.0	7.9	2.5	2.5	2.7	-4.3	0.6	...	...	...	...	...	...	...	...	...	...	...	...	...
Industrial production index	2.7	1.2	9.8	3.2	3.8	0.9	-1.3	0.3	2.3	-1.3	0.5	1.3	-1.0	0.1	-2.2	0.8	1.4	-1.2	-0.4	...	...
State-of-Economy index	3.7	1.0	3.2	0.1	2.1	1.7	0.3	-1.0	0.8	0.3	0.8	0.4	0.8	0.1	-0.4	-0.5	-0.2	-0.4	-0.4	-0.7	...
Business sector employee posts	5.5	6.0	2.1	1.4	1.1	1.0	-0.6	-0.5	0.2	0.2	0.3	0.4	0.8	-0.9	-0.6	0.0	0.0	-0.4	-0.1	...	...
Unemployment rate (in percent) 2/	8.6	8.9	...	8.6	8.6	8.9	8.9	8.6	8.6	8.7	8.8	8.8	8.7	8.7	8.7	8.7	8.6	...	...	...	...
Prices and Wages																					
Overall CPI	5.4	5.2	1.1	-0.9	0.8	0.2	0.0	-0.7	0.9	0.3	0.3	-0.6	-0.6	0.6	0.0	-0.1	-0.6	-0.1	0.2	0.9	0.4
Percent change (Y/Y) 3/	8.6	1.3	0.0	1.5	2.0	1.0	0.0	0.3	2.1	2.1	2.1	1.0	0.0	-0.1	0.1	0.0	-0.1	0.2	0.7	1.2	0.7
Underlying CPI	5.5	6.0	2.1	0.2	1.2	0.1	-0.2	-0.8	0.1	0.6	0.4	-0.6	-0.6	0.5	-0.1	0.0	-0.6	-0.2	-0.1	0.8	0.4
Percent change (Y/Y) 3/			0.9	1.8	2.6	2.5	1.2	0.3	2.5	2.9	3.3	2.5	1.7	1.5	1.2	0.9	0.3	0.3	0.1	0.0	0.3
Nominal wage index (1994=100) 4/	7.7	7.9	7.4	0.9	2.2	2.2	-0.3	0.8	-1.3	6.4	-1.3	-0.6	0.6	-3.2	1.1	6.1	-1.8	-1.7	-1.4	...	...
Percent change (Y/Y) 3/				8.8	7.3	8.6	5.2	5.1	8.4	5.2	7.5	8.4	9.8	9.1	3.4	3.4	5.7	8.1	1.6	...	...
Financial Indicators (period average)																					
Narrow money (M1)	12.1	3.3	11.0	1.9	2.5	3.3	1.6	2.7	-1.0	1.9	1.6	0.9	0.3	0.6	-1.7	4.8	-2.0	1.4	3.5	1.6	...
Broad money (M3)	22.1	21.9	19.8	6.2	3.0	4.0	4.3	5.3	0.3	0.7	2.3	1.0	1.2	2.0	0.7	2.1	2.1	1.4	1.5	0.7	...
Nondirected credit (including foreign currency)	17.7	34.9	16.4	3.2	2.5	2.7	2.6	2.8	0.9	0.7	1.1	0.8	0.8	0.7	1.1	1.0	1.1	0.6	0.8	0.9	...
Interest rates (in percent)																					
Discount rate 5/	11.8	12.1	9.5	10.4	9.6	9.3	8.6	7.9	9.5	9.4	9.4	9.3	9.1	8.8	8.6	8.4	8.2	7.9	7.7	7.4	7.3
CPI deflated				8.8	7.4	8.1	8.6	7.6	7.2	7.2	7.2	8.2	9.1	8.9	8.5	8.4	8.3	7.6	6.9	6.2	6.5
Nondirected credit in new sheqalim	16.2	16.5	12.9	14.1	13.0	12.6	11.8	11.0	12.9	12.9	12.9	12.6	12.3	12.0	11.8	11.5	11.3	11.0	10.8	10.4	...
External Sector (period average)																					
Current account balance (in US$ billions)	-1.4	-3.0	-1.4	-0.4	-0.7	-0.1	-0.2	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Trade balance (in US$ billions) 6/	-3.2	-4.4	-3.4	-0.8	-0.8	-0.8	-1.0	...	-0.5	-0.4	-0.7	-0.8	-0.2	-0.7	-0.6	-0.4	-0.5	-0.8	-0.3	-0.9	-0.5
Foreign reserves (in US$ billions, end of period)	22.7	22.5	23.2	22.7	22.2	22.1	23.2	23.8	22.2	22.2	22.1	22.1	22.1	21.9	21.8	23.2	23.7	23.5	23.8	23.4	23.2
In months of imports (goods and services, projected)	7.6	6.6	6.0	5.8	5.7	5.7	6.0	6.1	5.7	5.7	5.7	5.7	5.7	5.6	5.6	6.0	6.1	6.1	6.1	6.0	6.0
Ratio of foreign reserves to M1	3.7	3.3	3.4	3.9	3.6	3.5	3.4	3.7	3.8	3.6	3.6	3.6	3.5	3.7	3.5	3.4	3.9	3.7	3.7	3.6	...
Ratio of foreign reserves to gross short-term debt	0.82	0.88	0.79	0.85	0.81	0.81	0.83	...	...	...	...	...	...	...	...	...	...	...	...	...	...
NEER (1990=100) 7/	-6.4	-7.7	9.1	7.1	2.0	3.0	1.7	-2.8	0.4	-1.7	1.1	3.1	2.4	-0.5	0.2	-1.6	-1.9	0.0	0.2	...	...
REER (1990=100) 7/	-3.0	-3.8	8.0	6.8	2.0	2.6	0.0	-2.7	0.8	-1.8	1.3	2.5	1.6	-1.3	0.0	-1.7	-2.0	0.5	0.6	...	...
NIS / currency basket (in NIS, average rate)	4.09	4.43	4.22	4.28	4.26	4.18	4.17	4.24	4.27	4.28	4.25	4.17	4.12	4.17	4.17	4.18	4.25	4.23	4.25	4.24	4.19
NIS / US$ (in NIS, average rate)	3.80	4.14	4.08	4.05	4.10	4.06	4.10	4.13	4.15	4.11	4.09	4.05	4.04	4.11	4.11	4.08	4.12	4.12	4.16	4.18	4.14
NIS / US$ (in NIS, end of period rate)	4.18	4.19	4.07	4.03	4.08	4.02	4.04	4.19	4.17	4.08	4.09	4.00	4.02	4.14	4.09	4.04	4.14	4.11	4.19	4.20	4.16
Fiscal Sector (domestic, excluding net credit)																					
Revenues (growth year-on-year)	6.1	8.6	15.1	18.6	23.0	13.1	6.5	-6.2	26.0	15.7	12.0	16.0	11.6	14.5	4.2	-0.1	4.3	0.6	-19.7	7.0	-1.3
Expenditures (growth year-on-year)	6.0	6.8	7.3	8.6	7.6	5.8	7.4	-6.5	12.6	6.4	9.0	11.1	-2.5	13.8	1.5	6.9	1.2	-0.8	-16.6	37.7	13.4
Accumulated deficit as percent of annual budgeted amount	131.0	117.1	19.5	-14.2	-19.9	-24.0	19.5	-20.2	-41.6	-19.9	-23.3	-18.9	-24.0	-27.6	-24.9	19.5	-16.6	-13.5	-14.2	-2.3	1.1

Sources: Bank of Israel; Central Bureau of Statistics; and IMF, *International Financial Statistics*.

1/ Seasonally adjusted data; percentage change over previous period.
2/ Unemployment statistics are released quarterly; the monthly figures are trend data.
3/ (Y/Y) refers to percentage change from the corresponding period one year earlier.
4/ Gross wages, including taxes levied on employees. Not adjusted for the number of hours worked.
5/ The Bank of Israel set the discount rate at 7.2 percent in June.
6/ Unlike annual and quarterly data, monthly data are drawn from customs data and exclude ships and aircraft.
7/ IMF convention; an increase indicates appreciation and vice versa.

Table 3. Israel: Balance of Payments, 1995-2001

(In billions of U.S. dollars)

	1995	1996	1997	1998	1999	2000	2001 1/
Current account balance	-5.2	-5.4	-3.7	-1.4	-3.0	-1.4	-3.7
Trade balance	-7.4	-7.1	-5.1	-3.3	-4.5	-3.4	-4.8
Exports, f.o.b.	19.4	21.3	22.7	23.0	25.6	30.8	30.6
Imports, f.o.b.	26.8	28.4	27.8	26.3	30.1	34.2	35.4
Civilian imports	25.5	26.8	26.1	24.4	28.0	32.3	33.6
Military imports	1.3	1.7	1.8	1.9	2.1	1.9	1.7
Services balance	-3.4	-4.5	-4.6	-4.2	-4.9	-4.7	-5.5
Of which:							
Nonfactor services 2/	-0.6	-1.1	-1.0	-0.4	0.2	2.0	1.1
Factor services	-2.8	-3.3	-3.6	-3.8	-5.1	-6.7	-6.6
Net transfers	5.7	6.1	6.0	6.1	6.3	6.6	6.6
Capital and financial account balance 3/	5.4	7.6	11.5	1.8	4.2	3.6	3.4
Capital account	1.9	1.9	2.1	1.6	1.7	1.2	1.8
Financial account	3.5	5.6	9.4	0.2	2.5	2.4	1.6
Direct investment	0.6	0.3	0.8	0.7	2.1	1.6	1.2
Portfolio investment	1.9	4.1	4.1	2.5	1.8	2.1	1.0
Other investment	1.1	1.2	4.5	-3.0	-1.3	-1.4	-0.6
Errors and omissions	0.8	1.3	1.6	1.5	-0.1	-1.6	0.0
Change in reserves 4/	-1.1	-3.4	-9.4	-1.9	-1.1	-0.5	0.3
Memorandum items (percentage of GDP):							
Current account balance	-5.9	-5.6	-3.7	-1.4	-3.0	-1.3	-3.3
Civilian trade balance	-7.0	-5.6	-3.4	-1.5	-2.4	-1.3	-2.7
Gross external debt	51.0	52.9	55.2	57.6	61.3	58.8	61.3
Net external debt 5/	21.9	20.1	15.2	11.3	9.9	6.7	6.6
Gross external debt (in US$ billions)	44.8	51.0	55.2	58.1	62.0	64.9	69.0
Net external debt (in US$ billions)	19.2	19.4	15.2	11.4	10.0	7.4	7.5
GDP (in US$ billions)	87.8	96.5	100.0	100.7	101.0	110.4	112.5

Sources: Central Bureau of Statistics, *Monthly Bulletin of Statistics;* and Fund staff estimates.

1/ Fund staff projection.
2/ Revised: tourism expenditures excludes outlays by Israeli citizens that reside overseas.
3/ Excludes reserve assets.
4/ Negative (positive) sign denotes increase (decrease) in reserves.
5/ Net external debt subtract out of gross external debt the foreign reserve asset holdings of the Bank of Israel, the commercial banks, and other monetary institutions.

Table 4. Israel: Indicators of External and Banking Sector Vulnerability, 1996-2001
(In percent of GDP, unless otherwise indicated)

	1996	1997	1998	1999	2000	Latest Data 2001	Date
Financial indicators							
Government debt	107.0	106.0	109.0	103.0	94.6	...	Dec. 2000
Broad money (percent change, 12-month basis)	24.0	25.3	22.1	21.9	19.8	17.2	Apr. 2001
Private sector credit (percent change, 12-month basis)	18.1	18.4	5.9	7.8	15.6	12.5	Apr. 2001
One-month T-bill yield (Makam; nominal)	15.5	13.4	11.3	11.4	8.8	6.5	Jun. 2001
One-month T-bill yield (Makam; deflated by 12-mth CPI, e.o.p.)	4.4	6.0	2.5	9.9	8.8	5.4	May 2001
External Indicators							
Exports of GFNS (percent change)	6.2	7.8	6.3	10.1	23.3	-0.9	Mar. 2001
Imports of GFNS (percent change)	8.0	3.2	1.8	14.6	11.4	8.7	Mar. 2001
Terms of trade (percent change, average) 1/	-2.6	-7.2	-3.3	-1.8	-5.3	...	Dec. 2000
Current account surplus	-6.1	-5.6	-3.7	-1.4	-3.0	-1.3	Dec. 2000
Capital and financial account balance	7.8	11.5	1.8	4.2	3.2	...	Dec. 2000
Of which: Inward portfolio investment (debt securities etc.)	4.3	4.1	2.5	1.8	1.9	...	Dec. 2000
Other investment (loans, trade credits, etc.)	1.2	4.5	-3.0	-1.3	-1.2	...	Dec. 2000
Inward foreign direct investment	0.4	0.8	0.7	2.1	1.4	...	Dec. 2000
Gross official reserves (in US$ billions; e.o.p.)	11.6	20.3	22.7	22.5	23.2	23.2	May 2001
Central Bank short-term foreign liabilities (in US$ billions)	0.1	0.1	0.1	0.0	0.0	...	Dec. 2000
Short-term foreign assets of the financial sector (in US$ billions)	13.3	11.2	13.4	14.5	16.5	...	Dec. 2000
Short-term foreign liabilities of the financial sector (in US$ billions)	15.5	17.5	19.2	21.2	22.7	...	Dec. 2000
Business sector exposure to depreciation (in US$ billions e.o.p.) 2/	10.3	14.3	13.3	11.3	6.1	...	Oct. 2000
Business sector exposure to depreciation (in percent of reserves)	88.7	70.3	58.7	50.2	26.3	...	Oct. 2000
Official reserves in months of imports GFNS	3.7	6.6	7.6	6.6	6.0	6.2	Mar. 2001
Ratio of foreign reserves to broad money	0.3	0.4	0.5	0.4	0.3	0.3	Apr. 2001
Ratio of foreign reserves to short-term debt	0.4	0.5	0.8	0.9	0.8	...	Mar. 2001
Total gross external debt/GDP (in percent)	52.9	55.2	57.6	61.3	64.2	...	Dec. 2000
Of which: Government debt/GDP (in percent)	26.3	26.2	27.3	27.2	25.2	...	Dec. 2000
Total gross external debt to exports GNFS (in percent)	173.9	177.9	180.6	169.8	143.6	...	Dec. 2000
External gross interest payments to exports GNFS (in percent)	10.8	11.6	11.4	11.3	9.1	...	Dec. 2000
External amortization payments to exports GNFS (in percent)	8.1	8.4	9.5	7.4	6.1	6.4	Mar. 2001
Ratio of short-term debt to total debt (in percent)	44.9	45.1	44.4	45.7	42.0	...	Dec. 2000
Country risk ratings (S & P/Moody's) 3/	A- / A3	A- / A3	A- / A3	A- / A3	A- / A2	A- / A2	
Spread of foreign bonds relative to U.S. bonds (in basis points)	30	40	100	50	120	110	Mar. 2001
Exchange rate (per US$, period average)	3.19	3.45	3.80	4.14	4.08	4.19	May 2001
REER appreciation (+) (period average)	5.9	7.0	-3.0	-3.8	8.0	-0.45	Mar. 2001
Change in Stock Market Index (in percent)	-1.6	36.1	0.6	64.4	0.3	-12.1	May 2001
Banking sector indicators (all in percent)							
Problem loans/total loans (largest five banks) 4/	14.6	12.6	12.1	10.9	...	...	Dec. 1999
Risk-weighted capital asset ratio (five largest banks, e.o.p.)	9.7	10.0	9.2	9.7	...	...	Dec. 1999
Share of foreign exchange credit in total credit to the public (e.o.p.)	27.0	32.1	35.3	35.9	34.1	...	Aug. 2000
Share of foreign deposits in total deposits of the public (e.o.p.)	29.0	28.9	31.5	31.0	30.7	...	Aug. 2000
Share of foreign currency liabilities in total liabilities (e.o.p.)	24.4	25.8	28.3	27.7	27.6	...	Aug. 2000

Sources: Bank of Israel; Central Bureau of Statistics; International Monetary Fund; Fund staff estimates and projections.

1/ According to WEO GEE trade deflators.

2/ Exposure of the business sector, measured by the difference between the capitalized flow of foreign currency receipts and payments (including all receipts and payments in or formally indexed to foreign currency at the time of measurement. Data for 2000 refer to end-July.

3/ Moody's upgrade in July 2000.

4/ Problem loans include nonperforming loans, rescheduled debts, and special mention loans.

Table 5. Israel: State Budget, 1995-2001 (in percent of GDP)

	1995	1996	1997	1998	1999	2000 Budget	2000 Estimate	2001 Budget Proposal 1/
Revenue	41.5	42.0	41.8	40.4	39.4	39.6	38.9	41.0
Domestic	38.6	36.9	37.4	35.8	35.5	35.3	36.0	38.3
Tax	31.9	31.1	31.7	30.5	30.6	30.3	32.7	32.8
Of which: On income and profits	17.3	16.5	17.2	16.7	16.7	16.4	18.9	18.4
On domestic goods and services	14.3	14.3	14.2	13.5	13.6	13.7	12.9	14.1
Nontax domestic	6.6	5.8	5.7	5.3	4.9	4.9	3.3	5.5
Of which: Loans from the National Insurance Institute	1.9	1.7	1.7	1.4	1.4	1.2	...	1.5
Foreign	2.9	5.1	4.4	4.6	3.9	4.3	2.9	2.7
Of which: Grants	1.9	4.2	3.3	3.3	2.6	2.7	...	2.4
Expenditure	45.6	45.8	44.5	42.7	41.9	42.0	38.9	42.8
Domestic	41.8	41.5	40.5	38.7	38.4	38.1	36.0	38.8
Current domestic	38.1	37.6	37.5	35.9	35.8	34.8	...	35.7
Of which: Wages	9.6	9.6	9.4	8.6	6.0	8.5	...	8.4
Interest	4.8	4.8	4.9	4.9	4.6	4.4	...	4.6
Subsidies and transfers	15.3	16.1	15.5	15.1	15.5	14.8	...	15.0
Repayment	8.8	10.4	9.7	10.0	9.1	9.2	...	10.9
Capital	3.7	3.9	3.0	2.8	2.6	3.3	...	3.2
Foreign	3.8	4.4	4.0	4.0	3.5	3.9	3.0	4.0
Of which: Interest	1.8	1.9	1.6	1.5	1.4	1.4	...	1.5
Budget balance	-4.1	-3.8	-2.7	-2.3	-2.5	-2.4	0.0	-1.8
Domestic	-3.2	-4.6	-3.1	-2.9	-2.9	-2.8	0.0	-0.5
Foreign	-0.9	0.7	0.4	0.6	0.4	0.4	0.0	-1.2
Financing	4.1	3.8	2.7	2.3	2.5	2.4	0.0	1.8
Domestic	2.7	2.7	3.2	2.7	2.6	2.0	0.1	1.8
Bank of Israel (net)	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	0.0
Nonbank (net)	2.4	2.6	0.2	1.0	1.8	1.2	-0.1	0.7
Sale of assets	0.7	0.1	2.5	1.3	0.5	0.8	0.6	0.6
Other (net)	-0.5	0.0	0.5	0.3	0.3	0.1	-0.2	0.4
Foreign (net)	1.5	1.1	-0.5	-0.4	-0.1	0.4	-0.1	0.0
Memorandum items:								
Defense expenditure	10.1	9.7	9.9	10.0	9.4	8.7	...	9.1
Primary balance	2.5	2.9	3.8	4.1	3.5	3.4	...	4.3

Sources: Data provided by the Israeli authorities; and Fund staff estimates.

1/ For 2001, excludes realized profits from the Bank of Israel. For 2000, the deficit on an equivalent basis was 0.6 percent of GDP.

Table 6. Israel: Medium-Term Scenario, 1997-2005

(In percent unless indicated otherwise)

	1997	1998	1999	2000	2001	2002	2003	2004	2005
GDP growth rate	3.3	2.4	2.3	6.0	1.8	4.5	5.4	5.2	4.7
Inflation (average)	9.0	5.4	5.2	1.1	1.0	2.5	2.5	2.5	2.5
Real effective interest rate 1/	4.2	6.0	6.6	8.2	6.5	4.5	5.3	5.0	5.0
Fiscal deficit/GDP									
Official definition	-2.7	-2.3	-2.5	0.0	-1.8	-1.5	-1.3	-1.3	-1.0
Conventional estimate 2/	-8.9	-6.2	-6.0	-0.7	-2.4	-3.0	-2.6	-2.6	-2.3
Public debt/GDP (end of period)	106.0	109.0	103.0	94.6	94.0	89.6	85.2	81.6	78.4
Gross investment/GDP	24.1	22.2	22.4	19.3	18.8	17.4	17.8	18.1	18.1
Public saving/GDP	-1.2	-1.1	-2.4	1.1	0.6	0.8	1.1	1.0	1.3
Private saving/GDP	19.4	19.5	19.6	14.8	15.0	14.7	15.6	16.2	16.1
Foreign saving/GDP	3.7	1.4	3.0	1.3	3.3	1.9	1.2	0.9	0.7
Foreign reserves in months of imports of goods and nonfactor services	6.6	7.6	6.6	6.0	5.7	5.3	4.9	4.5	4.2
Foreign debt as percent of GDP	55.2	57.6	61.3	58.8	61.3	58.2	55.0	52.3	50.0
Memorandum Items (growth rates):									
Aggregate domestic demand	2.0	1.1	4.7	2.5	4.4	4.7	5.8	5.4	5.0
Private consumption	4.8	3.5	3.4	5.8	5.7	5.2	5.5	5.5	5.4
Public consumption	2.0	2.7	2.9	1.2	1.9	3.0	3.0	3.0	3.0
Gross capital formation	-4.5	-7.4	10.7	-4.7	4.1	5.3	10.2	8.0	6.2
Exports of Goods and Services	7.8	6.3	10.1	23.3	-1.9	11.3	10.2	8.0	7.2
Imports of Goods and Services	3.2	1.8	14.6	11.4	2.3	9.9	9.7	7.7	7.2
Real GDP index (1994=100)	115.5	118.4	121.1	128.4	130.7	136.6	144.0	151.4	158.4
Potential output index (1994=100)	113.7	118.3	124.3	130.5	135.6	141.0	146.6	152.5	158.7
Output gap (in percent of potential output)	1.6	0.0	-2.5	-1.6	-3.6	-3.1	-1.8	-0.7	-0.2

Source: Fund staff estimates.

1/ Nominal effective discount rate of the Bank of Israel deflated by current CPI inflation.
2/ Official definition plus the inflation component of domestic interest payments.

Israel: Fund Relations
(As of June 26, 2001)

I. **Membership Status**: Israel became a member of the Fund on July 12, 1954, and accepted the obligations of Article VIII, Sections 2, 3, and 4 on September 21, 1993, and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions.

II. **General Resources Account**:	**SDR Millions**	**% Quota**
Quota	928.20	100.0
Fund holdings of currency	820.55	88.4
Reserve position in Fund	107.66	11.6
Operational budget transfers (net)	0.00	

III. **SDR Department**:	**SDR Millions**	**% Allocation**
Net cumulative allocation	106.36	100.0
Holdings	0.75	0.7
Designation Plan	0.00	

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund**: (In millions of SDRs; based on existing use of resources and present holdings of SDRs):

	Overdue	**Forthcoming**				
	05/31/01	**2001**	**2002**	**2003**	**2004**	**2005**
Charges/Interest	0.0	1.9	3.8	3.8	3.8	3.8
Total	0.0	1.9	3.8	3.8	3.8	3.8

VII. **Exchange Rate Arrangement**:

Since December 17, 1991, Israel has had a preannounced crawl against a currency basket, reflecting the composition of foreign trade, with a 5 percent band, widened to 7 percent in June 1995. In June 1997, the upper (more depreciated) band was raised by 16 percent with the slope unchanged at 6 percent per annum, while the slope of the lower (more appreciated) band was reduced to 2 percent per annum. As a result, since then the band has been widening at a predictable rate, and on July 1, 2001 the band will have a width equivalent to 52 percent of its lower limit, and no central rate.

VIII. **Article IV Consultation**:

The last Article IV consultation was concluded on March 23, 2000. Israel is on the standard 12-month consultation cycle.

IX. **Technical Assistance**:

For purposes of the Fund's operational activities, the West Bank and Gaza (WBG) continue to fall under Israeli jurisdiction in accordance with Article XXXI, Section 2(g) of the Articles of Agreement.

The IMF has provided technical assistance to the Palestinian Authority (PA) in the WBG, with a focus on assisting the PA in establishing economic and financial institutions, and in monitoring and reporting on fiscal developments and institution building. In particular, technical assistance has been provided in the areas of tax and customs administration, expenditure management, and pension reform (Fiscal Affairs Department); in the areas of bank supervision, foreign assets management, central bank operations and information technology (Monetary and Exchange Affairs Department); and in the areas of national accounts and monetary statistics (Statistics Department). The Middle Eastern Department has been assisting the PA with fiscal reporting to donors, in the context of the Ad-Hoc Liaison Committee (AHLC), and with budget formulation in the context of a medium-term macroeconomic framework. Palestinian officials have been participating in training courses offered by the IMF Institute both at headquarters and in the field.

X. **Resident Representative**:

Resident representative in the WBG since early 1996.

Israel: Statistical Appendix

Israel has subscribed to the Special Data Dissemination Standard. The periodicity, timeliness, coverage, and quality of Israel's economic data are generally adequate for surveillance. Nevertheless, the specific measure of the overall annual fiscal balance that is reported does not conform to the balance in most other countries because interest costs exclude the inflation component of such payments, and there is no within–year monthly report of expenditures broken down by composition. There is also a need for a measure of resource utilization, such as capacity utilization.

Israel: Core Statistical Indicators
(as of June 14, 2001)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates 1/	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP	External Debt
Date of Latest Observation	06/14/01	Mar. 2001	Apr. 2001	Mar. 2001	Mar. 2001	06/14/01	Apr. 2001	May 2001	2000Q3	May 2001	2001Q1	2000Q3
Date Received	06/14/01	05/24/01	05/2001	05/24/01	05/24/01	06/14/01	05/15/01	06/13/01	2/26/01	06/04/01	05/21/01	02/26/01
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly 2/	Quarterly	Quarterly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Quarterly
Source of Update	Reuters; BoI website	BoI; Reuters	BoI	BoI; Reuters	BoI; Reuters	BoI; Reuters	Central Bureau of Statistics; Reuters	Central Bureau of Statistics; Reuters	Central Bureau of Statistics; BoI; Reuters	MoF	Central Bureau of Statistics; Reuters	BoI/CBS
Mode of Reporting	Electronic Mail/ Publication	Electronic Mail/ Publication	Electronic Mail/ Publication	Electronic Mail/ Publication	Electronic Mail/ Publication	Electronic Mail/ Publication	Electronic Mail/ Publication	Electronic Mail/ Publication	Electronic Mail/ Publication	Electronic Mail/ Publication	Electronic Mail/ Publication	Electronic Mail/ Publication
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Annually

1/ Market rates are available daily through Reuters.
2/ On a cash basis.
Note: BoI = Bank of Israel; MoF = Ministry of Finance.

The Main Findings and Recommendations of the FSAP

The FSAP mission identified a range of issues that the authorities should address to improve the functioning, or enhance the stability, of the Israeli financial sector. The major ones, excerpted from Volume I of the FSAP report, are the following:

The need for a new Bank of Israel (BoI) Law

The conduct of monetary policy in Israel is highly transparent. However, gaps between the monetary policy de jure and monetary policy de facto leave room for improvement in transparency in several areas. The multiple functions of the BoI under the current BoI Law are vague and open to interpretation. In particular, the absence of specification by the law or government of whether the inflation target or exchange rate band has priority in the event of conflict means that the ultimate objective of monetary policy is not transparent and BoI independence is weakened. The need for government approval for some instruments may diminish the effectiveness of policy implementation by the BoI and weaken its accountability. The lack of clarity of the BoI Law regarding the conditions under which the governor can be removed from office by the government leaves room for indirect government interference in BoI policy. The current and recent governments and BoI governors have generally established clear goals for policy and the autonomy of the BoI to implement them. However, it is a weakness for central bank's independence and accountability to rest on personalities. A new central bank law could go a long way toward filling these gaps between monetary policy de jure and monetary policy de facto.

Deposit insurance

While there is no formal deposit insurance in Israel, the central bank law gives the governor of the BoI considerable authority and discretion to guarantee deposits and other claims on banks. In practice, in the last isolated bank failure (in 1985) all depositors were fully compensated by the BoI, and in the deepest financial crisis in Israeli economic history, the 1983 banking-share crisis, almost the whole system was taken over by the government, and depositors did not suffer losses as no bank was actually allowed to fail. The implicit guarantee is likely to reduce market discipline of bank soundness. To the extent that there is really any uncertainty (ambiguity) about deposit protection, it would not prevent deposit runs either. Hence, the authorities should consider introducing an explicit deposit insurance scheme.

An efficient failed bank resolution scheme

The provisions for bank exit are not adequate. In general, bankruptcy procedures work satisfactorily for liquidating the remaining shell of a closed bank. Before getting to that point, however, the supervisor needs the power to take over a failing bank, to protect its assets in the interest of its creditors, and to sell its valuable assets without disruption to its operations. It is highly likely that a number of small- or medium-sized banks will need to be merged or closed in the next few years. If the legal tools for managing the exit of these banks are not adequate, the authorities will almost certainly resort to a full creditor bailout as they have in the past. These would be an unwelcome burden on the budget and diminish market discipline of the behavior of banks. The current legal tools have worked satisfactorily, because all creditors have always been bailed out. If, because of the moral hazard involved, this practice is abandoned in the future (perhaps by adopting explicit deposit insurance), existing legal tools will not permit an efficient failed bank resolution. Given the expectation that some consolidation is needed and will occur in the banking sector in the future, correcting these legal shortcomings is important. This means that adopting a new modern banking law is necessary that incorporates provisions for the administrative takeover and resolution of insolvent banks or of banks that for whatever reason have their licenses revoked.

Payment system supervision

Payment systems are not adequately supervised and interbank payments are organized on the presumption that the BoI would cover the risk of any bank failing to settle. The BoI is considering the development of a Large Value Transfer System that would be able to eliminate the current risk to the BoI. The BoI should develop more systematic oversight of the payment system, though the weaknesses in these areas do not currently create unacceptable risks.

Coordination among supervisory agencies

All key financial sector activities (except payment systems) are satisfactorily supervised, though the structure of supervision might be improved by consolidating the supervision of all collective investment schemes in the Insurance Supervisory Agency (ISA) (thus moving supervision of nonretirement-related provident funds from the Ministry of Finance to the ISA). The most significant shortcoming and source of risk in the coordination of supervision arise from the inability of supervisors to share information on individual firms and financial conglomerates. In order to facilitate cooperation among regulators, a "Council of Financial Supervisors" comprising the BoI, ISA, and the Commissioner for Insurance should be established.

Pension reform

The pension system is in transition, and until new plans were introduced in 1995, had never been fully funded. The pre-1995 plans are currently showing a very large actuarial deficit: at least one major fund is illiquid and suffering from negative cash flows. The public sector pension system is unfunded and has accumulated substantial liabilities. While economic and demographic factors are not currently a problem, there is a concern that pension increases can be too easily be traded off for wage increases and lead to generational inequity and future fiscal strains. A well-planned program to move to a sustainable and funded second pillar pension arrangement, of which the 1995 reforms were first steps, will ensure that the long-term cost of the pension system becomes more transparent. In addition, the introduction of independent and professional boards of directors with clear governance and trustee responsibilities for the funds will ensure that investment policy and other board/managerial actions will be entirely focused on the best interests of the plan members. Such reform would also be likely to lead to fund management technology developments, such as asset/liability management, which would in turn support securities market development (by creating special demands) and reduce the role of the government in guaranteeing returns.

Capital control

The restriction limiting investments of insurance companies, provident funds, and pension funds in foreign currency and foreign assets to 5 percent of their assets is now the last remaining foreign exchange restriction. Removal of this restriction would provide for further enhancement of portfolio diversification and by completing capital account liberalization would send a positive signal to investors.

Public Information Notice (PIN) No. 01/
FOR IMMEDIATE RELEASE

International Monetary Fund
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IMF Concludes Article IV Consultation with Israel

On July 30, 2001, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Israel.[1]

Background

From mid-1999 until the third quarter of 2000, Israel experienced the best economic performance in many decades. Real GDP grew buoyantly, accelerating toward the third quarter of 2000, when the growth rate (seasonally adjusted) reached an annualized 9 percent. Despite rapid demand growth and the sharp increase in the price of imported oil, the inflation rate continued to decline, reaching zero by September 2000.

The rapid growth came to a sudden and decisive end in the fourth quarter of 2000, against the background of the outbreak of violence in late September and the global decline of the high-tech industry. Real GDP shrank by 9.8 percent (seasonally adjusted annual rate), and although the slide stopped in the first quarter of 2001, no monthly indicators are yet showing a sign of rebound.

However, notwithstanding the very serious deterioration in the economic and security environment, key financial market variables, such as exchange rate, the country risk premium, and market-based inflationary expectations, have remained broadly stable. They deteriorated marginally in late last year and early this year, but have largely returned to their original levels.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the [July, 30, 2001] Executive Board discussion based on the staff report.

Monetary policy remained tight in 2000. Nominal interest rates declined as the Bank of Israel cut its policy rate steadily, but due to the deceleration of inflation and the appreciation of the sheqel, monetary conditions continued to tighten. CPI inflation was zero percent at end-2000, substantially below the official target of 3–4 percent.

Buoyant economic activity during the first three quarters of 2000 contributed to a major improvement in the budget. The central government budget recorded a balance (i.e. zero deficits) in 2000, substantially bettering the targeted 2½ percent of GDP deficit. The 2001 budget aims at a deficit of 1¾ percent of GDP, but the deficit is likely to be larger due to a revenue shortfall resulting from the economic slowdown.

As concerns structural reforms over the past year, the tax reform package proposed in May 2000 has been stalled, no steps have been taken on the revision of the Bank of Israel Law, and bank privatization has been slow.

The nature of recent shocks makes short-term forecasting particularly difficult. The depth and length of the current downturn will depend on the evolution of the security situation, as well as the behavior of the NASDAQ and the global high-tech demand. The staff projects growth in 2001 at 1¾ percent, pulled down by weak exports and fixed capital investment, and CPI inflation at end-2001 to be at or below the lower bound of the target range (2½–3½ percent). Provided that the security situation and the global demand improve, growth next year could rise to 4-5 percent reflecting Israel's high potential.

Executive Board Assessment

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Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Israel: Selected Economic Indicators

(Percentage change, unless indicated otherwise)

	1996	1997	1998	1999	2000
National accounts (constant prices)					
Real GDP	5.0	3.3	2.4	2.3	6.0
Private consumption	6.0	4.8	3.5	3.4	5.8
Public consumption	5.2	2.0	2.7	2.9	1.2
Gross capital formation	6.5	-4.5	-7.4	10.7	-4.7
Exports of goods and services	6.2	7.8	6.3	10.1	23.3
Imports of goods and services	8.0	3.2	1.8	14.6	11.4
Labor market indicators					
Israeli civilian labor force	2.2	2.5	2.6	3.4	3.9
Overall employment	2.5	1.3	1.6	3.1	4.1
Unemployment rate (in percent)	6.7	7.7	8.6	8.9	8.8
Prices (end-period)					
Overall CPI	10.6	7.0	8.6	1.3	0.0
Underlying CPI (excluding housing, fruits and vegetables)	10.1	6.7	8.5	1.7	0.9
Money and credit (period average)					
Narrow money (M1)	14.9	14.3	12.1	3.3	11.0
Broad money (M3)	24.0	25.3	22.1	21.9	19.8
Net domestic credit	21.6	18.6	17.7	34.9	16.4
Interest rates (average, in percent)					
Discount rate	15.1	13.6	11.8	12.1	9.5
Nondirected credit in new sheqalim	20.7	18.7	16.2	16.5	12.9
Public finance (percent of GDP)					
Central government balance 1/	-3.8	-2.7	-2.3	-2.5	0.0
General government balance 1/	-5.6	-4.0	-3.6	-4.7	-2.2
Public debt	107.0	106.0	109.0	103.0	94.6
Balance of payments					
Trade balance (percent of GDP) 2/	-7.3	-5.1	-3.2	-4.4	-3.2
Current account (percent of GDP) 2/	-5.6	-3.7	-1.0	-1.9	-1.9
Foreign reserves (end-of-period, in US$ billions)	11.6	20.3	22.7	22.5	23.2
Exchange rate and terms of trade indices					
Nominal effective exchange rate (1990=100)	-2.7	0.2	-6.4	-7.7	9.1
Real effective exchange rate (1990=100)	5.9	7.0	-3.0	-3.8	8.0
Terms of trade (1990=100; index level)	103.6	107.3	111.5	117.9	119.1

Sources: Data provided by the Israeli authorities; and IMF, *International Financial Statistics*.
1/ Operational concept, excludes the inflation component of interest payments on domestic government debt.
2/ Staff preliminary estimates for 2000.