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Statement by Mr. Chodos, Mr. Herrera, Mr. Lischinsky, and Mr. Morales on Israel (Preliminary)
Executive Board Meeting
January 19, 2021

We thank staff for their informative report, and Mr. De Lannoy and Mr. Tsur for their helpful Buff statement.

We commend the Israeli authorities for their strong and effective response to the pandemic crisis. The Israeli economy entered the crisis from a position of economic and financial strength, which allowed the authorities to deploy significant and agile policy support to mitigate its impact. Fiscal measures have been flexibly scaled up to protect household income, provide liquidity support to businesses, and shore up investment. As the policy rate approached the zero-lower bound, the Bank of Israel (BoI) used an array of unconventional measures to curb market disorderly conditions, restore confidence, ease financial conditions, and sustain the credit flow to the real economy.

We agree with the Israeli authorities on the factors that may support a faster recovery in the next two years, as summarized by Mr. De Lannoy and Mr. Tsur in their statement. Staff's baseline scenario projects that production will contract by 4 percent in 2020 but will rebound to 4.1 percent in 2021, and 5.0 percent in 2022, thanks to the positive momentum observed in late 2020, continued support for monetary and fiscal policies, a limited rise in unemployment, a sound financial system, and the rollout of vaccines, while the authorities' point to an average growth above 6 percent in the next two years. In more normal times, these differences would raise an eyebrow, but in today's rapidly shifting environment, they are not surprising considering the high uncertainty about the virus, potential scarring effects in labor and capital markets, and increased political uncertainty. However, we encourage the authorities to take a cautious wait-and-see approach because there are still significant downside risks for the economic outlook.

The latest news has been a mixed bag but on balance is somewhat negative. The resurgence of infections has led the authorities to impose a third lockdown, which could put a (temporary) halt to the strong recovery that started in the fourth quarter of last year. Political uncertainty continues after the failure of the government coalition to approve the 2021 budget, the dissolution of parliament, and the fourth call for elections in less than two years. One consequence is that fiscal policy in 2021 could be somewhat tighter under the interim budget than what was penciled in the baseline scenario, and consumers could be more cautious as the electoral clouds dissipate. On the positive side, the vaccination campaign has progressed swiftly and to date about 20 percent of the population has received at least one shot. At this rate, Israel could achieve herd immunity during the second quarter of the year, boosting confidence and supporting the recovery.

Going forward, we encourage the fiscal authorities to implement a contingent and gradual plan to withdraw the extraordinary stimulus in place and restore fiscal buffers once the recovery is on a strong footing. We agree that the supportive fiscal stance should remain in place in the near term while downside risks remain high. However, as in many other countries, a medium-term adjustment will be needed to restore fiscal space and control the large expansion in public debt. Under the staff's baseline scenario, the government debt to GDP is projected to reach 86 percent by 2025 (compared to 60 percent in 2019) and gross financing needs are expected to double to 20 percent of GDP. According to the staff's projections, the stabilization of the public debt will not only require eliminating the extraordinary fiscal support deployed around the pandemic crisis but will also require a permanent fiscal adjustment of 2 to 2.5 percent of GDP once the recovery is well under way. We take note that the authorities' projections are also somewhat more optimistic than staff's projection. *Could staff indicate what the main differences are with the authorities' debt projections and the magnitude of the differences?*

We commend BoI for a sizable and swift response to the pandemic crisis. Monetary authorities have implemented a series of actions to curb disorderly market conditions, provide liquidity support to financial markets and institutions, and increase the availability of credit to the real economy in coordination with macroprudential policies and public loan guarantees. With policy rates near or at the zero-lower bound, BoI has launched unconventional measures to strengthen the transmission of monetary policy, including a comprehensive asset purchase program (APP) on government and corporate bonds, a medium-term funding facility for banks, repos, FX swaps, and FX intervention in the spot market. *Could staff elaborate on its views (and BoI's views) about what is the effective lower bound (ELB) for the policy rate in Israel?*

We agree with the staff's opinion that, in the future, it will be appropriate to maintain an accommodative monetary stance. With headline and core inflation in negative territory, demand still weak, and a negative output gap, BoI will need to continue using unconventional tools to maintain easy financial conditions in the market and provide liquidity support to financial institutions. However, we take note that actual purchases of government and corporate bonds in the secondary market have been well below the program ceilings, particularly in the corporate bond program, where used capacity is only 25 percent. *Could staff elaborate on the main reasons for the limited uptake of the asset purchase programs deployed by BoI? Also, could staff describe the governance of corporate bond purchases of BoI, and if the government has provided BoI with an equity cushion to protect it from potential losses on their corporate bond purchases?*

We encourage staff to continue working on the recommendations for FX policy in small, open economies with deep and liquid currency markets when the policy rate is near or at the ELB. In these unusual times, with negative inflation and low- for- long interest rates in advanced and emerging economies, BoI has intervened in the FX market to soften the ongoing appreciation of the currency and preserve the overall expansionary stance of monetary policy. We take note of the staff's suggestion that BoI should cease FX intervention as a tool for managing inflation expectations and limit its use of addressing disorderly market conditions. However, appreciation pressures on the exchange rate could increase in the coming months, considering that the rapid rollout of the vaccine in Israel could accelerate its recovery compared to the rest of the world economy. Although we share the general recommendation on maintaining exchange rate flexibility as the first line of defense in case of external shocks, this issue needs to be revisited in the context of small and open economies with deep and liquid foreign exchange markets and close or at the ELB for the policy rate. Research under the ongoing Integrated Policy Framework agenda can shed light on this issue. *Could staff* *elaborate on its views about how the constraints on monetary policy should influence the conduct of FX policy when the policy rate is already near or at the ELB?*

We agree with the staff's view that in a downturn scenario, the regulatory capital requirement should not be lowered further. Before the COVID-19 shock, Israel's banks enjoyed strong capital and liquidity position, while the authorities maintained tight macroprudential policies to address concerns around a real-estate boom. Throughout last year, the financial system weathered the negative shock well, with modest increases in non-performing loans and realized credit losses. The authorities have eased capital and liquidity buffers to increase banks' lending capacity. Stress tests show substantial capital in the banking system to face negative shocks going forward. However, we share the concern that emergency financial policies, such as government loan guarantees, payment deferrals for small bank loans and other support measures could temporarily mask the extent of the increase of credit risks in the corporate and household sectors. We agree that an increase in business insolvencies is still likely. We support the staff's recommendation that regulatory flexibility should be temporary and, as the recovery takes hold, banks should rebuild their capital and liquidity buffers gradually and address problem assets on their books.

Finally, we encourage the authorities to resume reforms to enhance the dynamism of the labor market, strengthen digitalization, improve the education system to address the large achievement disparities between different groups, and introduce governance reforms to support the expansion of public investment.

With these comments, we wish the authorities and people of Israel success in these difficult times.