Executive Board Minutes 21/7-2

January 19, 2021–4:10 p.m.

Israel—2020 Article IV Consultation

Documents: SM/20/181, and Cor. 1, and Sup. 1

Staff: Petrova, EUR; Sommer, SPR

Length: 1 hour

ISSUED: September 14, 2022
APPROVAL: September 21, 2022

CEDA OGADA
Secretary

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[1] Minutes are the official record of a formal Board meeting in which the Board may adopt decisions and reach understandings related to the business of the Fund. Staff background documents issued before the meeting are the principal basis for the meeting. Preliminary "gray" or "buff" statements by Executive Directors and staff's responses to Directors' technical questions are circulated prior to the meeting. Adopted decisions and/or summings up—the Chair's "sense of the meeting" or policy conclusions/recommendations—are issued after the meeting. The minutes include all these elements, as well as the discussion record (a verbatim transcript of the discussion lightly edited for clarity). Minutes are made public consistent with the IMF's Transparency Policy and Open Archives Policy.

THE ACTING CHAIR'S SUMMING UP

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for the appropriately rapid and large monetary and fiscal support in response to the COVID-19 pandemic, which has helped soften its impact on the country. They also welcomed the authorities' efforts for early wide-spread vaccination, which could lead to a faster recovery. Going forward, as uncertainties remain high, Directors saw merit in continued supportive policies, as well as measures to strengthen social protection and reforms to enhance the resilience of the economy.

Directors concurred that fiscal policy should remain supportive and gradually become more targeted. Prompt adoption of the 2021 budget would help prioritize spending, position the economy for growth, and reduce economic uncertainty associated with the pandemic. Directors considered that, if further downside risks materialize, fiscal support should be maintained beyond mid-2021. They also noted that once the recovery is on firm ground, fiscal efforts will be needed to restore pre-crisis buffers and rebuild fiscal space.

Directors commended the Bank of Israel's swift response to the crisis and concurred that monetary policy should remain accommodative. They agreed that, going forward, as inflation trends toward the target band, FX intervention should cease as a tool for managing inflation expectations and its use be limited to addressing disorderly market conditions.

Directors noted that Israel's financial system is well prepared to face the impact of the pandemic. Banks' capital remains strong, with substantial capacity to face large shocks. Nonetheless, Directors stressed that unless downside risks materialize, the minimum regulatory capital should not be lowered further, and structural buffers should eventually be restored. They also noted that efficient handling of a potential increase in nonperforming loans would help limit debt overhang and spur capital reallocation.

Directors emphasized that structural reforms should aim to tackle pre-COVID legacies, including low productivity and high inequality. Better funded labor activation policies, digitalization, and education reforms would help strengthen marketable skills of low-skilled workers, who were especially affected by the pandemic. Directors also encouraged completing governance reforms, particularly in procurement and AML/CFT.

It is proposed that the next Article IV consultation with Israel take place on the standard 12-month cycle.

EXECUTIVE BOARD ATTENDANCE[2]

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
	W. Nakunyada (AE)
	F. Sylla (AF)
	L. Herrera (AG)
	A. Grant (AP)
	F. Fuentes (BR)
	M. Law (CC), Temporary
	A. Guerra (CE)
L. Levonian (CO)	
D. Palotai (EC)	
A. Buisse (FF)	
R. von Kleist (GR)	
S. Bhalla (IN)	
	M. Massourakis (IT)
	K. Chikada (JA)
	K. Osei-Yeboah (MD), Temporary
	F. Al-Kohlany (MI), Temporary
	A. De Lannoy (NE)
M. Poso (NO)	
A. Mozhin (RU)	
M. Mouminah (SA)	
A. Mahasandana (ST)	
P. Trabinski (SZ)	
	D. Ronicle (UK)
	R. Farber (US), Temporary

C. McDonald, Acting Secretary
S. Maxwell, Summing Up Officer
V. Sola, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
Communications Department: W. Amr. European Department: E. Flores Curiel, P. Gerson, I. Petrova, S. Toh, J. Zhou. Finance Department: T. Krueger**.** Legal Department: C. Blair. Monetary and Capital Markets Department: U. Das. Strategy, Policy, and Review

[2] For countries in each constituency, please see the Constituency Codes in the annex.

Department: N. Sheridan, M. Sommer. Executive Director: A. Andrianarivelo (AF), S. Chodos (AG), C.Huh (AP), M. Mahmoud (MI), P. Moreno (CE). Alternate Executive Director: B. Alhomaly (SA), H. Azal (EC), C. Just (EC), F. Mochtar (ST), R. N'Sonde (AF), F. O'Brolchain (CO), L. Palei (RU), P. Rozan (FF), C. White (AP). Senior Advisors to Executive Directors: H. Andrianometiana (AF), R. Goyal (IN), M. Ismail (AE), L. Johnson (AP), B. Lischinsky (AG), S. Potapov (RU), F. Spadafora (IT), T. Shay (NE), M. Zhunusbekova (SZ). Advisors to Executive Directors: A. Abdullahi (AE), P. Al-Riffai (MI), A. Arevalo Arroyo (CE), S. Belhaj (MD), E. Boukpessi (AF), K. Dacharux (ST), D. Fadhel (MI), Y. Kikucji (JA), G. Meizer (EC), M. Merhi (MI), A. Olhaye (AF), B. Piasecki (SZ), B. Rankin (CO), I. Skrivere (NO), C. Westphal (US), R. Gindrat (SZ), D. Coelho (BR), R. Masood (UK), C. Roman (FF).

DISCUSSION RECORD[3]

The Acting Chair (Mr. Furusawa):

The 2020 Article IV consultation with Israel takes place after a long pause—the last Article IV consultation with Israel was in 2018--and in the context of unprecedented circumstances.

As Directors noted in their gray statements, robust growth and prudent pre-crisis policies allowed Israel to accumulate large buffers and provided the authorities with policy space to mount a prompt and effective response to the crisis. Israel has, thus, shown remarkable resilience during the pandemic. Nonetheless, the outlook remains challenging, not least due to the ongoing third lockdown of the economy and the new parliamentary elections. The authorities' swift vaccination campaign is an important source of optimism.

Mr. De Lannoy:

I would like to start by thanking--on behalf of the authorities, Mr. Tsur, and myself--the team, led by Ms. Petrova, for the very constructive and interesting discussions during the mission. I will limit my intervention to three topics.

First, on COVID-19 and the vaccination campaign. Israel is currently under the third national lockdown due to the currently high mortality rate and a high positivity rate of almost 10 percent. At this stage, the coronavirus seems to be in the driver's seat, but the exceptional success of the Israeli campaign to vaccinate its population is expected to take back control soon. Israel has already inoculated 23 percent of the population with the first dose of the vaccine, and the second dose is being rolled out as we speak. The government estimates that by mid-March, more than half of the population will be vaccinated.

What is the secret behind the success? It cannot be that Israel's small size is the main explanation. If this were the case, other small countries would be able to show similar successes. Future studies will probably discuss this question comprehensively; but until then, it is believed that Israel's public health system, that relies for many decades on four big health organizations that provide publicly financed services, even in less populated areas, plays a crucial role in Israel's capacity to rise to the challenge of such a complicated

[3] Edited for clarity.

logistical operation. Both Israel and the pharma companies have acknowledged this logistic capacity, and it has encouraged them to provide Israel with a relatively high number of vaccines early on.

Second, on monetary policy and the exchange rate, the long-lasting appreciation of the shekel since 2005 was driven by fundamental forces, and businesses had no choice but to adjust to it. While in 2005, exports of goods accounted for 70 percent of total exports, by 2019, it had declined to 50 percent, with manufacturing losing its share in the business sector, from 24 percent to 17 percent, for the benefit of more competitive service activities.

Unemployment decreased during this successful transformation, from 7 percent to 4 percent, but this time is different. The recent sharp appreciation of the shekel, particularly from the beginning of the year, is taking place at a time when unemployment is high, inflation is negative. At least some of the appreciation might turn out to be temporary, against the background of the unprecedented crisis and extraordinary expansionary monetary policies in large, advanced economies.

The Bank of Israel decided not to jeopardize the achievement of preserving the relative resilience of the economy in the first half of the pandemic, as the Managing Director calls it, and the potential benefits from the promising vaccination campaign.

The Bank of Israel's announcement last week, that it will purchase US$30 billion in 2021 to deal with the recent sharp appreciation, is an exceptional step in extraordinary times and is based on the assessment that it would be one shock too many for the Israeli economy to bear at this time. This policy is consistent with the Bank of Israel's price stability and financial stability objectives.

The case of Israel during these challenging times illustrates how important it is for the ongoing Integrated Policy Framework (IPF) agenda to study foreign exchange (FX) policies in small open advanced economies, especially when the policy rate is near or at the effective lower bound, as noted by Mr. Chodos in his gray statement.

Finally, on fiscal policy and structural reforms, while there are some discrepancies with the staff regarding the predicted pace of the recovery and the trajectory of public debt, the authorities could not agree more with the staff and Directors in their gray statements on the principles for the way forward. The authorities agree on the need to preserve the supportive policy in the short term, also considering that the broad unemployment rate has remained at double-digit levels. At the same time, they fully agree that fiscal consolidation will be needed as soon as the recovery gains momentum. In particular, the Bank of Israel and the ministry of finance are emphasizing the importance of addressing the structural budget that already existed before the pandemic. This is necessary also to allow for higher levels of investment in infrastructure and to enhance the equality of the labor force in a context where the employment rate is one of the highest of Organisation for Economic Co-operation and Development (OECD) countries.

The staff representative from the European Department (Ms. Petrova):

Let me address two issues that were not addressed in our written responses to Executive Directors, the importance of the recent vaccination efforts for our projections and the perceived difference between the staff and the authorities' projections.

We commend the authorities for their decisive steps to combat the pandemic. As of this date, 28 percent of the Israeli population has received their first inoculation. The vaccine rollout has been much faster than anticipated at the time the mission took place and at the time we submitted the staff report to the Board. If the pace and effectiveness of these efforts are sustained, the growth prospects would improve very significantly, and we indicated this as an important upside risk to our baseline projections.

At the same time, the surge in COVID cases has led to a third lockdown and, together with the news of the parliamentary dissolution, have amplified downside risks for the near term.

New daily cases are at a record high, continue to increase, and place Israel among countries with the highest number of reported cases per 100,000 people. Therefore, in this race between the vaccine and new cases, it is too early to declare a victory over the pandemic. We consider that it would be premature to raise the 2021 growth projections, as we think that containment measures and social distancing are still likely to drag growth in the first half of 2021.

Regarding the issue about the differences in projections, as the buff statement noted, the authorities prepared and published an optimistic and a pessimistic growth scenario, rather than a point estimate. This underscores the challenges of preparing a baseline forecast scenario in the current unprecedented circumstances, where positive and negative news emerge with equal intensity.

Nonetheless, our baseline scenario is well within the authorities' range of projections. Our baseline projections for 2021 and 2022 are closer to the Bank of Israel's pessimistic scenario and to the ministry of finance's optimistic scenario. Therefore, we are of the view that the perceived projection differences are mainly a reflection of the great uncertainty that the economy still faces and, to some extent, timing in the preparation of the projections, as the Bank of Israel only recently considered that the optimistic scenario is more likely to materialize.

Mr. Sylla:

We appreciate the staff's responses to the questions raised by Directors, including those in our gray statement. We wish to highlight a few following points.

First, we commend the Israeli authorities for their strong and effective policy response to the COVID-19 pandemic crisis. We also wish to commend them for the ongoing successful vaccination campaign. With the current vaccination rate, Israel may soon achieve herd immunity, which could significantly boost confidence and the recovery prospects. Still, we need to be cautious, as rightly highlighted by Ms. Petrova.

Mr. Chairman, as noted by many Directors in their gray statements and this afternoon, the high uncertainty around the pandemic and global economic developments call for the pursuit of supportive fiscal policies and an accommodative monetary stance. In particular, well-targeted fiscal measures are needed to strengthen support to the most vulnerable segments of the population, including the minority groups. As the crisis abates, a growth-friendly fiscal adjustment will be needed to rebuild fiscal buffers and put the public debt on a downward path.

Second, like Ms. Levonian, Mr. Palotai, Mr. Massourakis, and other colleagues, we share the staff's view that the COVID-19 pandemic should be an opportunity to address the pre-COVID vulnerabilities that have hindered productivity and raised inequality and poverty. In this regard, we wish to underscore the importance of a steadfast implementation of the structural policy agenda, with a focus on addressing labor market vulnerabilities to help reduce the potential long-term scarring and foster economic resilience.

Mr. Fuentes:

We commend the Israeli authorities for their response to the pandemic shock, effectively implementing a supportive fiscal package, and timely fostering and easing of monetary and financial conditions. In particular, we want to commend the remarkable rollout of the vaccination campaign, reaching over 23 percent of the population in record time, as mentioned by Mr. De Lannoy. This impressive achievement places Israel on solid ground to combat the adverse effects of the pandemic and provide a decisive boost to recovery prospects.

We issued a gray statement, stating our views on Israel's performance and prospects, so I will focus my intervention on two issues for emphasis.

First, the Israeli economy has exhibited the initial signs of a recovery in the recent months, but the authorities should be mindful of the timing and pace of removing policy support. Fiscal expansion remains crucial to firm up economic reactivation, considering the downside risk scenarios and the political uncertainty. As suggested by the staff, the implementation of the stimulus package could benefit from a more targeted scope, particularly in the labor market, and its scale should still be contingent on the state of the economy and the progress in controlling the spread of the virus. To this end, we welcome the recent amendment approved by the parliament to expand the 2021 budget to match population growth and preserve COVID-19-related spending. However, the official approval of a supportive 2021 budget remains critical to help prioritize and reallocate spending to support the recovery and make contingencies for downside risks to avoid jeopardizing fiscal sustainability.

Second, Israel's economic resilience will benefit from a steadfast commitment to advance the structural reform agenda to avoid long-term scarring. The staff analysis of scarring scenarios presented in Annex II of the staff report highlights the potential impact of the pandemic on medium-term growth capacity.

Over the past decade, growth in Israel has been largely supported by an increase in employment rates, while productivity growth has remained low. However, during the crisis, unemployment and furlough rates, especially of low productivity workers, appear disproportionately larger than the output contraction. Even the achievement of often optimistic employment goals in a fairly flexible labor market, potential output could be negatively affected by low participation rates and limited workers' reallocation. Therefore, addressing vulnerabilities in the labor market should take priority, along with the authorities' objectives of improving the education system and boosting infrastructure investment, given the significant output gap and ample underutilized resources.

Mr. Nakunyada:

We observe that the outbreak of the COVID-19 pandemic interrupted decades of robust growth performance, which benefited from prudent macroeconomic management. Nevertheless, the demonstrated economic resilience and pandemic response measures moderated the economic downturn. Going forward, we encourage that the rapid vaccine rollout sets the stage for a strong rebound.

We broadly share the staff's assessment and would like to emphasize a few points.

First, continued fiscal support, while preserving fiscal space, remains essential to moderate the prolonged effects of the COVID crisis. That said, priority should be accorded to the better targeting of fiscal support and strengthening social safety nets. Once the recovery takes hold, fiscal consolidation will be critical to place debt on a downward path and help create fiscal space. While we note the ad hoc budget expansions for 2021, we view a comprehensive and official budgetary process as important to enhance transparency and medium-term planning.

Second, we view the monetary accommodation and liquidity support provided by the Bank of Israel as appropriate in the context of well-anchored inflation expectations and the negative output gap. We, however, urge the authorities to maintain exchange rate flexibility to absorb external shocks. Further, we emphasize the need to monitor the rising non-performing loans and to expedite the operationalization of the insolvency framework.

Finally, like other Directors, we concur that the current crisis presents a unique opportunity to implement longstanding structural policies aimed to mitigate long-term scarring and strengthen economic resilience.

Mr. Herrera:

We agree with the thrust of the staff report. We commend the authorities for their strong and effective response to the pandemic crisis. We published a gray statement, so I will limit my remarks to three issues.

First, we agree with the view of the authorities in the buff statement, that the recovery could go faster than what is expected by the staff. So far, the rollout of the vaccination campaign has been impressive; and at this rate, Israel could achieve herd immunity during the second quarter of the year, boosting confidence and domestic demand.

Second, even if there are grounds for optimism, we encourage the authorities to take a cautious wait-and-see approach and to maintain a supportive policy stance until growth is on a strong footing. Down the road, once the recovery takes hold, the authorities should implement the necessary fiscal adjustments to stabilize public debt in the medium term. In the same vein, we endorse the staff's recommendation that, as the recovery takes hold, banks should rebuild their capital and liquidity buffers.

Third, we take notice of the staff's suggestion that the Bank of Israel should cease FX intervention as a tool for monitoring inflation expectations and limit its use for addressing disorderly market conditions. At the same time, last Thursday, as Mr. De Lannoy pointed, Bank of Israel stepped up its intervention in the FX markets to buy $30 billion of foreign currency in 2021, up from $21 billion last year. Although we agree with the staff recommendation of maintaining exchange rate flexibility as the first line of defense in case of external shocks, we wonder if this advice should be reviewed in the context of small open economies with deep financial markets, like Israel, and other emerging markets, which are today against the effective lower bound for the policy rate. In these economies, as the interest rate approaches the effective lower bound, the currency bears more and more of the burden of adjustments. Also, near the effective lower bound, the relationship between currency appreciation and inflation expectations can become mutually reinforcing and trigger a deflationary spiral.

The unconventional response would be to increase the scale of asset purchase programs on domestic assets. However, these policies can also have unintended consequences for fiscal policy or financial stability in the context of small economies. I do not know what the right answer to this dilemma is, but I certainly hope that the research under the ongoing Integrated Policy Framework agenda will shed light on this issue.

Mr. Law:

We have issued a gray statement, so I will be brief and offer the following for emphasis.

First, Israel's swift vaccination campaign is commendable. This will provide a strong boost to consumer confidence and allow economic activity to resume. However, to reach herd immunity, it will be important to ensure the population in the West Bank and Gaza has equal access to the vaccines as well. We hope the Israeli authorities will work with the Palestinian Authority in this regard.

Second, fiscal policy should remain supportive and gradually become more targeted, and there needs to be a continuation of the policy under the new coalition government. Debt sustainability should remain an overarching objective for the country. We encourage the authorities to focus the fiscal policy on providing support for the health sector, bolstering social protection and active labor market policies, and undertaking job-creating public investment projects.

Third, we welcome the authorities' efforts in undertaking macrostructural reforms, including increasing their digitalization capacity. We believe that these efforts will lay a solid foundation for a strong economic recovery in the next few years.

Mr. Buissé:

We have issued a gray statement, so I will limit myself to four targeted points for emphasis.

First, I want to underline that the authorities' swift and decisive actions helped to mitigate the economic fallout and protect livelihoods and businesses. It will be important that fiscal policy remains supportive in 2021, notwithstanding the political uncertainty and the need to rely on an ancillary budget. The authorities do have policy space, and fiscal consolidation should be undertaken only once the recovery is on firm ground. I agree with the staff assessment, that it will have to be primarily based on revenue measures and especially tax reform.

Second, with its early widespread vaccination campaign, Israel appears to be a test case on the impact of the vaccine on confidence and activity. I read carefully the staff's written answers on the factors behind the fast vaccine rollout, and I thank the staff for the oral answers on the impact of the vaccination on the macroeconomic outlook. I still think we will all follow very closely how things develop, to be sure to identify the most efficient factors that can be replicated everywhere else.

Third, low inflation deserves close monitoring, even though 5- and 10-year inflation expectations remain anchored within the inflation target band. I note that the price level declined in May and has remained suppressed since and that near-term inflation expectations are below target.

Fourth, and last, I share the view that structural policies are needed to strengthen the resilience of the economy and address the inequalities between low-skilled and high-skilled workers. Working on addressing the duality of the Israeli economy could be a focus of a future Article IV review, and so could the deeper work on competition, in a context where past OECD work had evidenced relatively high concentration levels in certain sectors. Having said that, I duly take note of the staff's answers, evidencing some progress on competition, notably, the reform of the energy sector and the financial system.

Ms. Mahasandana:

We have issued a gray statement with Mr. Chikada and Ms. Grant, commending the Israeli authorities for their swift policy response that helped contain the adverse effects of the pandemic. We also welcome the recent successful rollout of the vaccine and its positive impact to the economic outlook. For today, I have two points to highlight.

First, amidst the high degree of uncertainty, the continued policy support from the Israeli authorities will be important to help mitigate the economy from the risk of a future negative impact of the pandemic. We concur with the staff's recommendation that fiscal measures should gradually become more targeted. Accommodative monetary policy, including the adoption of unconventional tools, have been effective in ensuring sufficient market liquidity, averting the tight financial conditions experienced in March and, thus, should be maintained into the recovery.

With exchange rate flexibility as a first line of defense and the policy rates practically at the zero bound, the authorities face a challenging policy trade-off and need to intervene in the FX market to mitigate the adverse effect of the excessive currency appreciation, as well as the inflation, especially given the inflation expectations edging below target. We, therefore, agree with Mr. De Lannoy that Israel's experience on these policy challenges underscores the importance of the IPF work and would urge the staff to use the lessons learned from Israel for the benefit of the IPF work and the policy advice to the other members, especially the small open economies.

Second, advancing the reform agenda should continue to be a top priority. Structural reforms and public investment should be accelerated to support and rebuild a recovery that is resilient and inclusive. We are of the view that the policy to boost productivity could benefit from greater digital penetration, especially among the low-skilled workers, which would also help the information and communication technology (ICT) sector that is still going strong.

When the recovery takes a firm footing, fiscal consolidation will also be needed to ensure medium-term fiscal sustainability. As advised by staff, this should be carried out in conjunction with a tax reform to create room for the necessary infrastructure and active labor market policy spending.

Mr. Guerra:

We issued a gray statement, wherein we have provided extensive comments, so I will limit my comments to three points.

First, we commend the authorities for their resolute actions to contain the effects of the pandemic. It is worth noting the swiftness and effectiveness of their vaccination campaign. We believe the international community could extract useful lessons from the Israel authorities' vaccination strategy. This should be something that that we believe the IMF will be--it would be good for the IMF to, let's say, compare these different strategies.

Second, we welcome the swift and effective response by the Bank of Israel. We agree that monetary accommodation through unconventional monetary policy and liquidity measures remains appropriate. While inflation is now in negative territory, we take positive note that inflation expectations remain well anchored in the inflation target band.

Exchange rate flexibility should be the first line--and should remain the first line of defense against external shocks, and we should limit the use of FX intervention to address disorderly market conditions. We also look forward to a discussion of this policy in our discussions on the IPF.

As inflation returns to target, we encourage the Bank of Israel to ease FX intervention as a tool to manage inflation expectations.

Finally, a steadfast implementation of the structural policy agenda, with a focus on addressing labor market vulnerabilities, will help reduce the potential long-term scarring and foster economic resilience. Particularly, it would be beneficial to implement labor market policies that contribute to aid the most affected sectors and groups, as my colleagues have already stressed.

Mr. Bhalla:

Three characteristics of the management of the Israeli economy stand out.

First, we observe a very steady GDP growth rate for the decade 2014 to 2024, of about 3.5 percent a year, with a minor COVID dip in 2020. This suggests that the Israeli authorities exercised a very fast, credible, and successful response to the crisis.

Second, a very fast vaccination drive, likely one of the fastest in the world in terms of the coverage of the population. On both these macro management issues; the authorities need to be commended and from which other countries can learn.

The third characteristic of the Israeli economy is that it has had the highest number of lockdowns, three, and that these lockdowns have not had any or much effect on the infection rate. Indeed, the infection rate has accelerated post-every lockdown that they have had. What might account for this divergence in performance?

Mr. von Kleist:

We are in broad agreement with the staff's findings and appraisal and with the comments of many previous speakers. Let me, therefore, underscore the following points.

We commend, like others, the Israeli authorities for their decisive response to the crisis, both on the fiscal and monetary side, as well as especially on the swift rollout of the vaccination campaign, which has been exemplary.

Israel's effective policy response was supported by a strong financial position at the beginning of the crisis, as underscored by the buff statement.

We also take positive note of the banking sector's resilience, even under severe stress scenarios.

Looking ahead, let me echo the call of many other Directors, including Ms. Levonian, Mr. Shortino, Mr. Buissé, and Mr. Pösö, that efforts should be stepped up to address the labor market and education disparities that increase inequality and hold back productivity growth.

Mr. Farber:

In the report, we found the staff's summary of the progress on previous Article IV recommendations particularly useful. Like others, we also commend Israel for leading the world in vaccinating its population on a per capita basis, which will hopefully facilitate a rapid economic recovery. As mentioned by the Managing Director in a recent interview, there is a difference between having the vaccine and distributing the vaccine. In that regard, Israel's execution is to be commended.

Not explicitly stated, but certainly heavily implied, is that the rapid vaccine campaign that has occurred in less than a year. Our staff reports would look entirely different, had it been under other circumstances, where to create a vaccination, it takes about five years. And that really speaks to the importance of investments in education, science, and healthcare.

In the staff report, they speak to the persistence of the negative output gap, which is estimated at 5.2 percent of potential GDP and is not projected to close until 2025. In light of the current vaccination program information, it would be useful and interesting to observe if that gap actually narrows quicker than projected and how that would compare to vaccination rates in other countries as a lesson-learned activity.

As the staff recommended, and several Directors agreed, we agree that continuing fiscal support is appropriate. We would also appreciate an update on the potential timing for the comprehensive 2021 budget.

Finally, we appreciated the staff's response about the difficulty of measuring the impact of the recession on minority groups, but we also note that the staff did not consider some of the stimulus measures to be well targeted and would appreciate more information on how targeting could have been better.

We are also concerned about the central bank's significant reserve accumulation, which seems designed to limit the shekel's appreciation. We note the staff's assessment that the shekel is now stronger than reflected by fundamentals. We echo the staff's recommendation, that the central bank avoid using FX intervention to manage inflation and to only use intervention to address disorderly market conditions.

Mr. Mozhin:

We have issued a comprehensive gray statement, and for that reason, I would only want to offer a few comments for emphasis.

First, as described in the staff report, Israel entered the COVID-19 crisis on a very solid footing, with strong fundamentals and substantial buffers to contain the social and economic damage from the shocks associated with the pandemic. The small share of heavily affected sectors in gross value added and, in parallel, the large ICT sector have made Israel's real output contraction milder than that in many other countries.

Second, we are encouraged with the pace of progress in the vaccination program, with more than 20 percent of the population already vaccinated in less than a month, since the beginning of the national program. This is clearly an upside risk to the outlook. According to the Bank of Israel, economic growth can reach 6.3 percent in 2021 under the scenario of fast vaccination. We would invite the staff to elaborate on how a faster recovery can impact the staff's recommendations on fiscal policy, both over the short term and medium term.

I received a message that almost 30 percent of the population is now vaccinated, so the 20 percent number is already outdated.

Third, we note the staff assessment that Israel's external position is moderately stronger than warranted by fundamentals and desirable policies. We believe that the outcome of the current account models is subject to unprecedented uncertainty, in particular, around the impact of the pandemic. Israel's country-specific factors, such as its high savings rate, mandatory pension contributions, as well as gas exports, can play an important role, while not being reflected in the current account norm.

Finally, in the case of Israel, as a small highly open economy with inflation already negative and markedly below the inflation target band, strong exchange rate appreciation can further depress inflation and inflation expectations. In this context, we would tend to agree with the authorities' decision to announce the forex intervention program of up to US$30 billion in 2021 to mitigate the impact of the shekel appreciation. In that respect, we join Mr. Herrera and Mr. Guerra, to the extent I understood them correctly.

Mr. Palotai:

While Israel is one of the most technologically advanced economies, its economy has been heavily affected by the pandemic and the first two nationwide lockdowns. Although Israel entered the third lockdown with growing resilience, also supported by the fastest vaccination campaign in the world, the uncertainties surrounding the recovery and the upcoming election remain elevated.

We issued a gray statement, so I will limit my comments.

We have some concerns that the broad unemployment rate will remain in the double digits in early 2021. Considering that the low-skilled groups face greater challenges, we strongly encourage the authorities to pay due attention to reintegrating workers and mitigating the hysteresis effects through well-targeted measures.

We do commend the Bank of Israel for undertaking wide-ranging measures, which have provided liquidity to the markets and sustained the flow of credit to households and businesses. We know that the shekel's recent appreciation has posed a challenge to the country.

We agree with Mr. Guerra, that exchange rate developments should primarily be determined by market forces and would appreciate if the staff could further update us on the impacts of the duly announced large-scale FX intervention program.

We stress the importance of a stable government and the adaptation of the annual budget, as well as the strengthening of the medium-term planning of structural reforms. To mitigate possible risks to debt sustainability, policymakers need to be ready to make appropriate adjustments to fiscal policy to address labor market vulnerabilities, scale up public investment, boost economic resilience, and restore pre-crisis buffers for the continuation of structural reforms.

Finally, allow me to commend the authorities for the successful vaccine rollout. We shall do our best to learn from the practices and experience of Israel. We also commend Israel for their historic peace accords.

The staff representative from the European Department (Ms. Petrova):

I saw two sets of questions. One set related to the outlook, the output gap, and our recommendations on the fiscal stance. The second set of questions related to the foreign exchange intervention and an update on the recent announcement about the foreign exchange intervention.

First, to start with the questions related to the output gap. Indeed, if the vaccination campaign continues at a very fast pace, it is conceivable that the output gap will close at a faster pace than is projected in our medium-term projections. However, I do want to be cautious about immediately making changes in our projections because, as we know, the authorities have introduced a third lockdown. And in conjunction with this third lockdown, which has been extended until the end of the month, they have extended a few of the measures; for example, the deferral on mortgage loan payments to the end of March. This suggests that some of the visibility, when it comes to how the businesses and households are reacting to the lockdown, is not immediately transparent.

In conjunction with the rapid pace of vaccination, we may also be seeing some more scarring. For that reason, it is not immediately obvious that the output gap will close that much faster. At this point, we need to be patient with revising our projections, given the high uncertainty that still exists. We need to be patient and see how these two developments continue to evolve. If it turns out that the third lockdown does not have a significant impact on activity, we will revise our projections accordingly.

What does that mean for our fiscal advice? As I noted previously, we see the lockdown as still having an impact during the first half of 2021. For that reason, we do not think that there is a need for a faster withdrawal of fiscal support. As many Directors have noted, given the circumstances, the fiscal policies need to remain supportive. Under the current circumstance, that still remains our baseline advice.

Regarding the foreign exchange interventions, I would first like to note that our recommendation, for discontinuing the foreign exchange interventions as a way of managing inflation expectations, needs to be data-driven. We recognize that the appreciation pressures have an impact on inflation. And for that reason, in our staff report, we have indicated that foreign exchange intervention should cease to be a tool for managing inflation expectations, once inflation is headed toward the inflation band. We do not think that this has happened yet.

Furthermore, when it comes to the foreign exchange intervention that was announced by the authorities a few days ago, I would like to note that it is too early to assess the long-term impact of this announcement. We see that there has been already an impact on appreciation. The pressures on the shekel have eased. However, we do not know whether there is going to be a sustained impact of this announcement. Furthermore, since this announcement was frank in the context of supporting the economy and the transition of the traditional sectors--I would like to emphasize here the point that we made in our written responses, that we find structural reforms that ease the transition of resources to the high growing sectors as a better tool to facilitate this transitioning to high-growth sectors and address the weaknesses in the traditional sectors.

Mr. De Lannoy:

In response to Mr. Law’s point on the vaccination of non-Israeli citizens in the West Bank and Gaza, I would like to point out that all Israeli citizens will have access to vaccines. For non-Israeli citizens in the West Bank and Gaza, the responsibility for healthcare and, therefore, also for vaccines and vaccination campaigns, is the responsibility of the Palestinian Authority, since the Oslo Accords.

Israel does not stop vaccines--even vaccines not currently approved for use in Israel--from reaching the Palestinian Authority. Israel has, so far, not received a formal request from the Palestinian Authority, for example, for the vaccination of Israeli citizens in the West Bank and Gaza.

Let me close the discussion with expressing, again, my authorities’ appreciation of Ms. Petrova and her team for the very constructive dialogue and valuable policy advice. I would also like to thank Directors for their support, as well as for their constructive comments and suggestions today. We will certainly convey these messages to the Israeli authorities.

The Acting Chair (Mr. Furusawa):

As Directors have pointed out, Israel’s economy met the pandemic from a position of strength. Nonetheless, and despite the optimism raised by Israel’s impressive vaccination efforts, COVID-19 continues to create a very challenging policy environment. Directors rightly call on the authorities to continue to support the economy through fiscal measures and an accommodative monetary policy. Yet, there are also pre-crisis legacies that need to be addressed, low productivity and a high level of inequality that need to be addressed.

The Acting Chair (Mr. Furusawa) noted that Israel is an Article VIII member, and no decision is proposed.

The Acting Chair (Mr. Furusawa) adjourned the discussion.

ANNEX

- Staff's Statement
- Gray Statements
- Staff Responses to Executive Directors' Technical Questions
- Constituency Codes

Statement by the Staff Representative on Israel
Executive Board Meeting
January 19, 2021

This statement provides information that has become available since the staff report was issued to the Executive Board on December 22, 2020. The thrust of the staff appraisal remains unchanged.

1. **Parliament was dissolved on December 23 after the coalition government failed to agree on a budget for 2020, triggering parliamentary elections in March**. PM Netanyahu is the head of the interim caretaker government. Political fragmentation has risen, posing risks of a stalemate in establishing a governing coalition. Nonetheless, the general course of economic policies is unlikely to change.

2. **With potentially significant delays in the adoption of the 2021 budget, parliament approved government spending to mitigate the fiscal contraction that would otherwise occur**. This includes NIS 72 billion (about 5 percent of GDP) in pandemic-related spending in line with the authorities' 2021 plans. Legal amendments also allow an increase in the 2021 government spending allocation—which is based on the 2019 budget—in line with population growth rather than with inflation. The approved general government expenditures are about ½ percent of GDP lower than previously projected, which could result in a slightly tighter fiscal stance than implied by the baseline in the event that a 2021 budget is not adopted.

3. **Political uncertainty and the race between the spread of the COVID-19 virus and vaccine distribution have widened the risks to the economic outlook**. The sharp rise in new COVID-19 cases in December and early-January necessitated imposing a third nation-wide lockdown, which together with political instability ahead of the elections could exacerbate precautionary behavior and drag growth. On the upside, since end-December, Israel has rolled out a swift vaccination campaign, administering more than 1.8 million doses to around 20 percent of the population as of January 10, 2021. Should vaccination pace and effectiveness be sustained, Israel may reach herd immunity in 2021Q2, significantly boosting confidence and recovery prospects. Medium-term risks have also widened, with rapid vaccine distribution limiting economic scarring, while political uncertainty puts reform progress in jeopardy.

BUFF/ED/21/8

January 12, 2021

Statement by Mr. De Lannoy and Mr. Tsur on Israel
Executive Board Meeting
January 19, 2021

On behalf of the Israeli authorities, we thank the mission team for an excellent report and the candid, constructive, and friendly dialogue. We appreciate the efforts made by the team to conduct a complete and effective mission under the challenging circumstances of COVID-19 and the virtual environment that it has created. The authorities agree with the vast majority of the analysis and recommendations in the report. We would like to offer the following updates and comments:

Recent Developments

The COVID-19 crisis has emerged following continued growth, low debt to GDP ratio, and an improvement in inequality indicators in Israel. The health crisis led to an economic crisis of unprecedented intensity, but at the same time, the economic developments over the course of the year repeatedly illustrated the resilience of the Israeli economy. In the two times that the restrictions on supply were lifted following lockdowns, economic activity has risen quickly and sharply. Some businesses succeeded in aligning the features of their activity with the new situation, with the high-tech service industry notably well placed, as reflected in the continued growth of services exports. Nevertheless, the severe adverse impact has been felt by employees in industries characterized by low productivity and wages.

Israel has experienced a fast recovery of its economic activity in November and December following the exit from the second lockdown. The broad unemployment rate (including employees on unpaid leave) reached about 23% during the second lockdown and declined to about 12.7% in the first half of December. Nevertheless, the authorities are concerned by the fact that unemployment has failed to reduce below that level and are ready to mitigate this challenge with its supportive policy.

While morbidity reemerged and the government has decided on a third lockdown, the vaccine campaign in Israel is a source of growing optimism. The campaign began earlier than expected, and to date, the vaccination pace in Israel is the highest in international perspective: already at the beginning of January 2021, 20% of the population have been vaccinated.

On the political front, the Israeli parliament dissolved without approving a budget for 2021 and the country is heading to its fourth election campaign in the past two years. Nevertheless, the parliament approved an amendment to the law that expands the budget for 2021 to match population growth and to preserve the current support for health and social needs that emerge from the COVID-

19 crisis. The government has also approved a program to target 2 billion Shekels to businesses that experienced a sharp reduction in their income. The authorities believe that given these additions, the current planned funding is adequate to mitigate the baseline scenario.

Outlook and Risks

We broadly agree with staff about the outlook and the risks but at the same time, we believe that growth will be faster than staff projects, based on the fast recoveries from previous lockdowns and the remarkable vaccine campaign. The Bank of Israel (BOI) has published optimistic and pessimistic scenarios but assesses that given the rapid pace of inoculations, the optimistic scenario is significantly more likely to materialize. This scenario assumes a process of rapid inoculation of the population that lasts until May 2021, and no government restrictions with a significant positive impact on economic activity beyond May 2021. GDP is expected to expand in this case by 6.3% percent in 2021 and by 5.8% in 2022. While staff assumes, similar to the BOI, that restrictions will fade during 2021 as vaccine coverage expands and therapies improve, their growth outlook is more pessimistic with 4.1% in 2021 and 5% in 2022, resembling the BOI pessimistic scenario, which assumes a more prolonged inoculation process lasting until June 2022, and GDP growth of 3.5% in 2021 and 6% in 2022.

Fiscal Policy

The health crisis led to a determined response from the government. We appreciate staff's view that the volume of fiscal support has been adequate. This support has been possible thanks to the prolonged reduction of public debt, up to 60% of GDP prior to the crisis. The political situation undoubtedly created challenges but despite that, the government provided extensive assistance to the unemployed, to businesses that were adversely impacted, and to the health system's response. Furthermore, the Ministry of Finance (MOF) has been publishing a monthly report on the government's programs, to allow important planning and policy analysis.

The lack of an orderly government budget for 2021 and the need to rely on an interim budget, weigh on the government's ability to operate. Nevertheless, the MOF succeeded during 2020 to support the economy efficiently. The approvals of ad-hoc budget expansions for 2021 indicate that this support will also be available in 2021.

Staff's baseline projection for debt is more pessimistic compared to the authorities' projections. The Israeli authorities believe that the fast recoveries from previous lockdowns, the promising vaccination campaign, and the long-lasting fiscal responsibility imply a better prospect. Nevertheless, the structural deficit that has been burdening fiscal stance already before the pandemic is a source of concern that should be addressed. As for the way to achieve fiscal consolidation, and referring to staff's notes on tax policy, the Israeli authorities note that the top PIT rates in Israel are relatively high, and they emphasize the government's objective of returning and preserving IP as a tool to enhance recovery.

Monetary Policy and Inflation

To face the COVID-19 initial shock to the financial markets, the BOI acted rapidly by supplying liquidity to the economy in shekels and foreign currency. As staff well noted, this policy was successful and mitigated the pressures on exchange rates, bond yields, and corporate spreads. Following this timely emergency support, the BOI ensured that the credit market is well supporting the needs of all borrower types in the economy—households, businesses, and the government. The BOI has eased the Monetary policy using various tools, including several programs to ensure that credit continued to flow towards small businesses as well.

Inflation in Israel was low even before the crisis, and the sharp decline in demand led to an additional decline in inflation. The BOI assesses that within several months, the year-over-year inflation rate will return to positive and that it will continue to increase gradually towards the lower bound of the target range. Throughout the crisis, the expectations for medium- and long-term inflation have remained anchored within the inflation range target.

After remaining relatively stable since April, the shekel began to strengthen at the beginning of October. This trend accelerated in November and December, resulting in 6.5% and 3.3% appreciation of the shekel against the dollar and an aggregate of trade-currencies respectively. While the appreciation is partly generated by spillovers from the extraordinarily accommodative monetary policy in other advanced economies, it is difficult to determine the extent to which it reflects fundamental developments. The IMF's REER-index and REER-level models point to an overvaluation of 10%-20%, but the implied CA gap suggests an undervaluation of 5.7%. As staff well notes, the results of the CA models are subject to unprecedented uncertainty around the impact of the pandemic. We agree with staff about the role that factors that are not reflected in the CA norm might play, and we would like to emphasize here Israel's high savings rate, including its high level of transfers and grant inflows, mandatory pension contributions, and gas exports. Given this uncertainty, the BOI has decided that at these unusual times of negative inflation and an unprecedented crisis, it should act to soften the ongoing appreciation, as consistent with the overall expansionary monetary policy.

The Financial Sector

The BOI took, within the framework of the Banking Supervision Department's authority, a broad range of steps to ensure the banks' continued ability to extend credit to the economy. Staff rightly reports that the BOI also eased macroprudential and supervisory requirements, and several specific important steps. It should be also noted that on December 2020, the BOI announced that on January 17th, 2021, the restriction on the part of mortgage loans indexed to the policy rate interest rate will be two-third of the loan instead of one-third, to reduce the mortgage burden on households.

As staff reports, the BOI's sensitivity tests show that Israeli banks would stay stable even under the most severe scenarios. It should also be noted that the stability of the entire financial system has been closely monitored, by the Financial Stability Committee headed by the BOI and established in November 2018, and by the Capital Markets, Insurance and Savings Authority (CMISA) among others.

Macro-Structural Policies

We appreciate the in-depth analysis by staff on policies needed to mitigate long-term scarring and improve the resilience of the economy. We share staff's views and believe that this crisis should not be wasted. While the crisis has been causing human and economic suffering, it has already resulted in some promising developments: the urgent need to assist employees has created useful databases to deploy ALMPs that promote reskilling and upskilling during the recovery; and maintaining vital economic and social activities during the crisis led to increasing digitalization capacity, including in the wholesale sector and the educational system.

The government has been taking several steps in recent years to increase productivity in the long run. For instance, it increased the expenditure on education and improved affirmative action; and markedly shifted infrastructure investment from roads to mass transportation. In August 2019, the BOI published a vast report with various recommendations to deploy more policies to enhance productivity growth. A cautious consolidation policy will hopefully create the budgetary space that is needed to finance some of these policies in the next years.

GRAY/21/164

January 14, 2021

Statement by Mr. Massourakis and Mr. Spadafora on Israel
(Preliminary)
Executive Board Meeting
January 19, 2021

We thank staff for an informative set of reports and Mr. De Lannoy and Mr. Tsur for their candid Buff statement. We broadly agree with the thrust of the staff's appraisal and policy recommendations. We would like to offer a few additional comments for emphasis.

- **The Israeli economy is coping with the unprecedented impact of the COVID-19 pandemic, which resulted in a historic GDP contraction despite an appropriate policy response, relatively low vulnerabilities before the crisis and large fiscal and financial buffers**. Amid persistently high uncertainty – including from recent political instability – the outlook remains challenging and downside risks prevail. On a positive note, vaccinations seem to be off to a swift start.
- In view of a gradual and rather partial recovery, **we agree with staff that it is essential the 2021 budget preserve an fiscal stimulus** and be adjusted – while becoming more targeted – if downside risks materialize; for its part, fiscal consolidation should start only once the recovery is firmly established. In staff's view, with an output gap that is expected to close as early as 2025, the unemployment rate is projected to remain slightly higher than the pre-COVID level because of scarring effects. We thus support the staff's call on the authorities to put a premium on improving labor activation policies, strengthening the social safety net and fostering job-rich investment; fostering digitalization promises to be the avenue of choice to boost productivity.
- **The prompt and comprehensive response by the Bank of Israel has been critical to reverse market instability, restore confidence and sustain an adequate supply of credit to the economy**. Several reasons – such as low near-term inflation expectations, negative output gap projections and uncertainties on renewed lockdowns – justify the staff's recommendation that monetary accommodation through unconventional measures and liquidity support should be maintained. *In the face of the ongoing discussion on the availability of banks' capital buffers during the crisis, we would like to ask staff for an assessment of the extent of actual usage of capital buffers by Israeli banks, also considering the initial tightening of macroprudential standards at the beginning of the pandemic.*

- **We share the staff's call on the authorities to see the current crisis also as an opportunity to tackle pre-COVID legacies that have stalled productivity and raised inequality and poverty. Structural policies should also aim to mitigate long-term scarring and strengthen the resilience of the economy**. It is notably unfortunate – but hardly surprising – that the impact of the pandemic on unemployment and furlough rates of low-productivity workers appears to be disproportionately larger than the output contraction. Addressing vulnerabilities in the labor market should thus take priority, notably by stepping up active labor market policies that can also be instrumental in limiting hysteresis effects.

GRAY/21/167

January 14, 2021

Statement by Mr. Bevilaqua, Mr. Fuentes, and Mr. Coelho on Israel
(Preliminary)
Executive Board Meeting
January 19, 2021

We thank staff for the comprehensive report and Mr. De Lannoy and Mr. Tsur for their helpful statement. The COVID-19 pandemic has taken a significant toll on the Israeli economy producing a historic recession driven by nation-wide lockdowns. In response, authorities acted swiftly and timely to implement containment measures, provide policy support and roll out a remarkable vaccination campaign. With almost 20% of the population inoculated, authorities have already provided a decisive boost to economic recovery efforts.

Despite the severe shock, the Israeli economy has exhibited great resilience. The pandemic caused an unprecedented contraction in economic activity in 2020, but the combination of sound macroeconomic policies and strong fundamentals have placed the economy on solid ground to combat the adverse effects of the health crisis and kick-start recovery sooner than anticipated. As highlighted in the report, the pre-COVID scenario was characterized by sustained growth, low unemployment and large pre-crisis buffers. These conditions allowed authorities to implement large and rapid policy responses to mitigate the adverse effects of the pandemic. As a result, real output has contracted less than in other advanced economies and authorities are expecting a faster-than-projected recovery in 2021 and 2022.

Fiscal policy should remain accommodative to buttress recovery. We commend authorities for effectively implementing a supportive fiscal package. The government has adequately managed the trade-off between protecting the economy and preserving fiscal space to meet potential challenges from an extended crisis. The decision to maintain some exceptional support measures until mid-2021 and the recent parliamentary amendment to preserve the support to COVID-related health and social needs are welcome developments. Nonetheless, the 2021 budget could still produce a tighter fiscal stance amid the current political environment. In assessing the fiscal response, we take note of authorities’ discrepancies with staff regarding the trajectory of the public debt. *Could staff elaborate on the sources of these differences considering the projected pace of recovery and the new data available?*

The monetary easing fostered by the Bank of Israel (BOI) remains appropriate. Monetary authorities have responded decisively to the crisis by providing liquidity and ensuring an orderly functioning of financial markets. As inflation remains subdued and below the target band, we believe maintaining a supportive monetary policy stance is warranted under the current circumstances, especially by providing targeted temporary liquidity in response to the new lockdowns. We also take note that financial institutions maintain adequate levels of capitalization to withstand the ongoing shock. That said, we agree that minimum regulatory capital levels should not be lowered further, and macroprudential and supervisory requirements should be restored as the crisis abates to avoid exposing the system to the materialization of downside risks scenarios.

Going forward, a gradual shift in policy scope is warranted to facilitate workers and capital reallocation. While the pandemic had a profound impact on the labor market, we see merit in exploring the implementation of more targeted policies, such as training and job-search assistance to help workers transition to new jobs. Furthermore, structural policies such as expanding digitalization, strengthening social protection, and boosting investment in education could increase labor productivity and elevate potential output.

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GRAY/21/168

January 14, 2021

Statement by Mr. Pösö and Ms. Skrivere on Israel
(Preliminary)
Executive Board Meeting
January 19, 2021

We thank staff for the comprehensive report and Mr. De Lannoy and Mr. Tsur for their insightful Buff statement. We broadly share staff's assessment and offer the following remarks on the outlook and risks, crisis policy response, and the structural reform agenda for emphasis.

While the economy is projected to rebound, the outlook remains uncertain, and some risks have already materialized. We note from the Buff statement that the authorities see staff's views on the growth outlook as too pessimistic. *We would appreciate staff's views on the reasons behind the differing views on the outlook.* We note that the downside risk of political uncertainty has materialized, as the Parliament was dissolved after a failure to reach an agreement on the budget in December 2020. While we are somewhat reassured by staff's assessment that the general course of economic policies is unlikely to change, the political uncertainty in the lead up to the elections in spring means that the progress on more fundamental reforms will likely be slow. At the same time, we positively note the impressive pace of the vaccination campaign, with 20 percent of the population having already received the vaccine. *We would be interested to hear about the reasons behind the successful vaccination campaign.*

The Israeli authorities have implemented appropriate monetary and fiscal policies in response to the unprecedented impacts of the crisis. We commend the authorities for their swift, appropriately bold, and effective monetary policy response, and we agree with staff that monetary accommodation and liquidity support should be maintained. Israel's financial system appears to be in a strong position to weather the crisis. Nevertheless, potential risks should be closely monitored as support measures are eventually withdrawn which could lead to an increase in insolvencies. As public debt had been gradually reduced in the period ahead of the crisis, it created some room to provide fiscal support. Nevertheless, we share staff's advice that fiscal support should become more targeted, and fiscal consolidation will be needed once immediate crisis pressures abate to put the public debt on a downward path. We found the stylized chart on the impact of different fiscal stimulus measures on growth and inequality particularly interesting. Additionally, Text Table 1 on fiscal actions, and Text Table 2 on monetary and financial actions lay out a helpful roadmap to guide the authorities' actions through the three stages of lockdown, reopening, and recovery. This clearly illustrates the value added that staff can provide with country-specific policy advice, and we welcome that bilateral surveillance is gradually resuming and the membership can benefit from Fund's advice.

As the immediate crisis pressures abate, the authorities should reinvigorate their structural reform efforts to raise productivity and tackle inequality and poverty. We agree with staff that labor market policies should be a priority, with special attention paid to more vulnerable groups, including women, Arab workers, and the low-skilled and low-educated. We welcome that the authorities intend to use new databases to deploy active labor market policies and promote reskilling and upskilling, as noted in the Buff statement. We agree with staff on the need to improve the outcomes of the education system. The authorities should also explore avenues to broaden the public's access to and the use of the internet and increase the digitalization of government services. As public investment is likely to be boosted with a strong positive impact on growth, further strengthening of the government procurement system is warranted.

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GRAY/21/170

January 14, 2021

Statement by Mr. Mozhin, Mr. Palei, and Mr. Potapov on Israel
(Preliminary)
Executive Board Meeting
January 19, 2021

1. We thank staff for their comprehensive report and Mr. De Lannoy and Mr. Tsur for their helpful Buff statement. After a decade of robust growth, the COVID-19 pandemic has severely impacted the Israeli economy. Similar to the developments in many other economies, output is expected to have contracted by around 4 percent in 2020, with rising fiscal deficit, unemployment, and poverty. Political fragmentation creates additional risks to the outlook. On the positive side, Israel is leading the world in terms of the speed of vaccinations, with more than 20 percent of the population already vaccinated in less than a month since the beginning of the implementation of the national plan. According to the Bank of Israel (BOI), economic growth can reach 6.3 percent in 2021 under the scenario of fast vaccination. The buffers accumulated over the recent years and the large high-tech sector helped the authorities contain the social and economic damage from the shocks. With uncertainty over the virus still high and global demand weak, macroeconomic policy should remain supportive and adapt to changing circumstances. Structural reforms should aim to mitigate long-term scarring and address long-standing challenges in the economy.

2. Fiscal policy expansion has been appropriate to soften the impact of the pandemic. The stimulus packages of about 10 percent of GDP in 2020 were rightly focused on supporting the health sector, unemployed and furloughed workers, households, and businesses. The sharp increases in the fiscal deficit and public debt were appropriate under the circumstances. We agree with staff that adoption of the 2021 budget will reduce economic uncertainty and provide additional support for social protection, active labor market policies, and public investment projects.

3. As a result of the pandemic response, public debt and gross financing needs have increased sharply, as in many other economies. According to staff, fiscal consolidation of about 2–2.5 percent of GDP will be needed to place debt on a solid downward path. We agree with staff that reviewing tax benefits and improving public procurement procedures

would be the preferable priority areas. *Could staff elaborate on possible additional fiscal adjustment measures that can be implemented, once the recovery is firmly entrenched?*

4. Monetary policy accommodation remains broadly appropriate given deflationary pressures and a negative output gap. The BOI has effectively deployed its tools to soften the effects of the pandemic on the Israeli economy through policy rate cuts and low interest rate loans to banks. Moreover, the level of international reserves at above 40 percent of GDP is high, exceeding the IMF benchmark reserve adequacy metrics and providing additional cushion to address possible additional negative shocks and geopolitical risks. We take positive note that substantial capital and liquidity buffers in the banking system, supported by regulatory and liquidity measures, should enable banks to mitigate the ongoing macroeconomic shock.

5. As the recovery progresses, it will be important to shift policy support to more targeted measures that foster necessary business adjustments and facilitate post-pandemic reallocation of resources. Structural reforms will be crucial for mitigating the risks of permanent damage to the economy from the pandemic. While the ICT sector has demonstrated resilience and has expanded strongly in recent years, overall labor productivity is low. We support staff's recommendations to consider enhancing active labor market policies, accelerating infrastructure investment, improving the education system, and advancing digitalization. Further efforts are also needed to strengthen governance, including the AML/CFT framework and public investment management.

With these remarks, we wish the Israeli authorities success.

GRAY/21/172

January 14, 2021

Statement by Mr. Zhang and Mr. Law on Israel
(Preliminary)
Executive Board Meeting
January 19, 2021

We thank staff for the informative reports and Mr. De Lannoy and Mr. Tsur for their helpful Buff statement. The Israeli economy entered the COVID-19 pandemic from a position of strength. Nonetheless, the economic impact of the COVID-19 pandemic is unprecedented, leading to a historic economic contraction in 2020. We broadly agree with staff's appraisal and would like to offer the following for emphasis.

We commend the swift vaccination campaign rolled out by the Israeli authorities. The vaccination pace in Israel is the highest in international perspective, with around 20 percent of the population already being vaccinated, and every Israeli is expected to be vaccinated by the end of March. This would provide a strong boost to consumer confidence and allow economic activity to resume. However, it is important to remember that the virus knows no borders. Israel cannot reach herd immunity if the Palestinians in the West Bank and Gaza are not vaccinated as well. In this vein, we call on the Israeli authorities to work with the Palestinian authorities in combating this pandemic under the spirit of, as well as their commitment in, the Oslo Accords.

Fiscal policy should remain supportive and gradually become more targeted, and there needs to be continuation of the policy under the new coalition government. We take note that given the potentially significant delays in the adoption of the 2021 budget, the parliament has approved the government spending to mitigate the fiscal contraction that would otherwise occur. We encourage the authorities to focus the fiscal policy on providing support for the health sector, bolstering social protection and active labor market policies, and undertaking job-creating public investment projects.

We find the accommodative monetary policy stance appropriate, given near-term deflation pressure and a persistent negative output gap. We take note that the Bank of Israel (BOI) assesses that within several months, the inflation rate will return to positive and will gradually increase towards the lower bound of the target band of 1 percent. The BOI’s response to the crisis has been fast and effective, helping to arrest market overreaction, restore confidence, and sustain credit flow. Liquidity support to financial markets and institutions should continue to be maintained. We also encourage the authorities to expedite its progress toward setting up a deposit insurance and to reduce moral hazard in the banking system.

We shared the authorities’ views that this crisis should not be wasted to undertake macro-structural reforms. We commend the authorities’ efforts in deploying active labor market policies to promote reskilling and upskilling during the recovery and to increase their digitalization capacity in delivering vital economic and social activities. We believe that these efforts will lay a solid foundation for a strong economic recovery in the next few years.

With these remarks, we wish the authorities every success in their policy endeavors.

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GRAY/21/174

January 14, 2021

Statement by Mr. Palotai, Mr. Just, and Mr. Meizer on Israel
(Preliminary)
Executive Board Meeting
January 19, 2021

We thank staff for the high-quality report, and Mr. De Lannoy and Mr. Tsur for their informative Buff statement. While the Israeli economy has shown resilience in the face of the pandemic, the dissolution of parliament in December 2020, the growing political fragmentation as well as the third wave of the pandemic significantly weigh on the outlook. Therefore, both fiscal and monetary policies should remain accommodative until the recovery is well entrenched. Boosting productivity through investment in physical and human capital is also critical to raise potential growth. We broadly share staff`s appraisal and policy recommendations, and would like to offer the following remarks for emphasis.

We welcome the authorities‘ large fiscal stimulus to soften the impacts of the pandemic as well as their efforts for a swift and general COVID-19 vaccine rollout. The fiscal expansion was largely appropriate in 2020, while the dynamic information and communication sector could remain a key building block of resilience. The authorities should be vigilant about the long-term hysteresis effects on employment, and place greater focus on labor activation policies, considering the high unemployment and furlough rate, especially of low-skilled workers. Without such policies Israel may face a further increase in inequality and larger structural unemployment over the long term. *We note that the broad unemployment rate was not included in the staff report, while this rate has remained at double-digit levels. Staff`s comment are welcome.* The authorities should also stand ready to deploy additional support measures if required, primarily targeting viable companies and supporting households. We are concerned about Israel's political uncertainty and the lack of an orderly government budget. *Can staff elaborate to what extent the ad-hoc budget expansions for this year limit crisis management as well as the financing of long-term structural plans. Given the difference in views between the authorities and staff on the GDP and debt forecast, we would also appreciate if staff could further elaborate on whether the latest developments have brought the forecasts closer together, and if not, what are the* *reasons behind it? We also wonder if a rapid vaccine rollout can offset other uncertainties?* We positively note that Israel`s export and current account remained resilient.

We welcome the Bank of Israel`s (BoI) swift and effective responses to the pandemic, which not only stabilized financial markets and restored confidence, but also helped prevent a credit crunch. We commend the BoI for decisively expanding their policy tools and its balance sheet with the objective to maintain and support financial stability. A continuation of loose monetary conditions appears warranted not only by the low-inflation environment and negative output gap projections but also the sharp appreciation of the shekel. *Could staff provide more details on whether the fundamentals are going to remain supportive of a strong shekel and how to assess the impacts of the central bank's latest interventions and announcement on the exchange rate? Given that the macroprudential and supervisory requirements were also eased, could staff also provide more details on the length of these measures and how the authorities plan to rebuild these buffers?* Furthermore, we take positive note of the BoI's broad range of steps to sustain the flow of credit to households and businesses. We also welcome the results of the BoI`s sensitivity tests according to which Israeli banks would stay stable even under medium severity scenarios. Nevertheless, the likely increase in insolvencies and rising asset quality problems need to be monitored, even if credit losses have been limited to date.

Further progress on structural reforms is necessary to address labor market segmentation, increase productivity, tackle inequality and poverty as well as to strengthen the resilience of the economy. While we welcome that investment support measures have been part of the fiscal stimulus package in response to the COVID-19 crisis, we would see merit in scaling up these programs. We encourage the authorities to accelerate the implementation of their reform agenda to avoid a partial recovery. At the same time, preserving some fiscal space to face the uncertain path to recovery is critical, while fiscal consolidation should resume in a growth friendly way, along with well-targeted measures. We concur with staff that a tax reform could help rebuild pre-crisis buffers, while also addressing structural weaknesses. As staff flagged, the current crisis is also an opportunity to tackle pre-COVID legacies in Israel. *Although the authorities agreed on the need for structural reforms, it would also be helpful to know how the authorities would prioritize and sequence these measures, also considering the available fiscal space. Staff`s comments are welcome.*

GRAY/21/175
Revised: 1/15/21

January 14, 2021

Statement by Mr. Sylla, Mrs. Boukpessi, and Mr. Olhaye on Israel
(Preliminary)
Executive Board Meeting
January 19, 2021

We thank staff for an insightful set of papers and Messrs. De Lannoy and Tsur for their informative Buff statement.

Albeit prior to the Covid-19 pandemic, the Israeli economy was displaying robust macroeconomic performance the pandemic has triggered an unprecedented economic crisis. The economy is projected to contract sharply in 2020, pushing debt to GDP and gross financing needs higher, thus significantly increasing vulnerabilities among which poverty and inequality as in other advanced economies. We commend the authorities for their rapid and robust response to the economic, social, and health consequences of the pandemic. Moreover, the active Covid-19 vaccination campaign with some two million people - out of nine million population – inoculated since December 19 should also be commended. While the economy has started to show signs of recovery, continued fiscal and monetary support would be needed in the short-term as the outlook remains highly uncertain with risks dominated by the Covid-19 pandemic and vaccine dynamics, regional geopolitical developments and domestic political instability and uncertainty. In addition, stepping up efforts and pressing ahead with the implementation of macro-structural policies will be critical to help limit the scarring effects from the crisis, make the recovery more sustainable and strengthen economy's resilience to shocks.

We broadly share the thrust of staff's appraisal and would like to make the following comments.

In the near-term, fiscal policy should continue to be geared towards supporting the economy while consolidation measures should be taken once the crisis abates and the recovery becomes more entrenched. A swift adoption of the 2021 budget is needed as it would help mitigate economic uncertainty associated with the pandemic, prioritize spending and advance important growth-enhancing reforms, among which the comprehensive tax and benefit reform. That said, we welcome the approval by the parliament of an interim budget last December. Should the path of the economic recovery be slower than anticipated and further downside risks materialize, fiscal support would be needed beyond mid-2021. We agree with the focus on continued support for health outlays, strengthened social safety nets programs, public investment projects conducive to employment creation and active labor market policies. *Given the quite low labor force participation and skills among the minority groups, we would be interested in staff's elaboration on how inclusive the support to the population have been during this challenging time and particularly for minority segments*. Once the recovery takes hold, both revenue and expenditures based fiscal consolidation will be needed to place debt on a downward path and rebuild pre-crisis buffers.

The Bank of Israel (BOI)'s should maintain its accommodative policy stance to support the recovery and ensure that inflationary expectations are anchored within the inflation target band. We commend the central bank for swiftly easing its policy stance at the onset of the crisis to provide adequate liquidity to the economy and introducing measures to keep credit flowing for businesses and households. These have been instrumental in alleviating the pandemic-related pressures on exchange rates, bond yields, and corporate spreads. Going forward, with the policy rate near the zero bound, we agree with staff that greater focus should continue to be put on unconventional measures, notably asset purchases programs to keep market financing costs and term premia contained, especially for corporate bond spreads. However, as inflation moves toward the 1-3 percent target band, exchange rate flexibility should continue to be the first line of defense to external shocks, with FX intervention limited to addressing disorderly market conditions. Considering the uncertainty around the pandemic, we note staff's indication in para 34 of the report, that "liquidity support extended (…) could be more targeted and (…) supported by adequate corporate data analysis. In addition, staff indicates that improved data collection and methodologies would be crucial in assessing households and firms vulnerabilities. *Could staff share its views on the role of the FSC in this context and the authorities' reactions to these recommendations?*

We welcome the continued resilience of the financial system despite the Covid-19 shock. The banks' conservative approach on loan provisioning has been appropriate. Notwithstanding, we tend to agree with the authorities that financial accommodation should continue in 2021, but , we would like to encourage them to continue to monitor closely the financial system, particularly the risks that may arise from an increase in NPLs and insolvencies and to continue help tackle debt overhang, support businesses and debt restructuring.

Pursuing structural reforms is key to increase productivity growth, support the recovery while enhancing resilience to shocks. We agree with the priority areas highlighted in the report, notably the need to implement active labor policies to address vulnerabilities in the labor market from both pre-Covid-19 and Covid-19 pandemic. In addition, like staff, we are of the view that Israel should take advantage of the ICT sector's high value added to expand digital penetration among low-skilled people and within the country's economic and social activities. These actions will be critical to further increase productivity and minimize the medium and long-term scarring effects of the pandemic on the Israeli economy. In this context, we would like to praise staff for the Annex II of the report on Scarring Scenarios which we found very interesting. Finally, albeit the AML/CFT framework has shown to be highly effective, further progress in strengthening governance and the AML/CFT regime is needed, notably in the context of scaling up in public investment.

With these remarks, we wish the authorities success in their endeavors.

GRAY/21/177

January 14, 2021

Statement by Mr. Trabinski and Mr. Gindrat on Israel
(Preliminary)
Executive Board Meeting
January 19, 2021

We thank Mr. De Lannoy and Mr. Tsur for their informative Buff statement. The pandemic has produced an unprecedented economic contraction in Israel. The authorities' response has been swift, with a remarkable vaccination campaign ongoing.

We concur that the fiscal stance should remain accommodative until a firm recovery is underway, but the debt dynamics should be kept in check. While providing an adequate response to the crisis is clearly the priority, we would also like to recall the persistent structural deficits prior to the pandemic. As staff, we are of the view that dealing with the structural weaknesses in the budget is vital to rebuild buffers amid the current debt dynamic. Given the existing debt vulnerabilities it would be important to address the high debt-to-GDP ratio, which does not decrease over the DSA horizon. Measures to enlarge the tax base appear sensible.

The monetary policy response is adequate. With inflation well into negative territory amid exchange rate appreciation pressures and extraordinarily expansionary monetary policies in other large advanced economies, we concur that monetary accommodation should continue until the policy objectives are achieved. We concur also with staff on the need to make support gradually more targeted going forward to avoid creating vulnerabilities and to facilitate a reallocation of economic resources.

Structural reforms are needed to address low productivity growth and increase labor force participation. Education and training should play a key role in this regard. Israel spends less on primary and secondary education per student, and its education outcomes in terms of PISA scores are lower, relative to the OECD average. At the same time, Israel is among the leading nations when measured by scientific publications per capita, while the high-tech industry contributes significantly to economic activity. This apparent contradiction points to large disparities in the education system. Even if additional resources could narrow the gaps in achievement across social groups, deeper reforms of the education sector may be warranted, including reforms that lead to a better match of skills for the economy.

With some preconditions in place, public investment in infrastructure could have a significant impact. We can concur with staff's advice in this regard. However, especially given the limited fiscal space available, reaping the benefits of new public investment presumes sound public investment management and public procurement framework. *Could staff elaborate on the public investment management framework in place and any advice in this regard, including PIMA?* Additionally, it should be ensured that existing infrastructure is efficiently used and that the SOEs are fit for the task. *Considering past bilateral surveillance advice on these matters, staff's comments would be welcome.*

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GRAY/21/178

January 14, 2021

Joint Statement by Ms. Mahasandana, Mr. Chikada, Ms. Grant, Ms. Johnson, Mr. Dacharux, and Ms. Kikuchi on Israel
(Preliminary)
Executive Board Meeting
January 19, 2021

We thank staff for the well-written report as well as Mr. De Lannoy and Mr. Tsur for their informative buff statement. Israel entered the pandemic-induced crisis with relatively strong fundamentals, thanks to a decade of favorable economic growth, relatively low household debt, a strong external position, and a healthy banking sector with comfortable capital buffers. The ICT sector, which constitutes a significant part of the economy, has been able to withstand the pandemic impacts relatively well and thus dampen long-term scarring effects. We also welcome the recent positive development in regional relations which could lead to increasing intraregional economic activities. We broadly support the staff report and offer the following additional comments.

We commend the authorities for their timely responses that have cushioned the economy from the adverse impacts of the pandemic. BOI's government bond and corporate bond purchase programs, together with adjustments of macroprudential measures have alleviated the initial liquidity shock in March and restored financial market confidence. The fiscal stimulus package was also forceful, with support amounting to 10 percent of GDP and a high execution rate. Nonetheless, unemployment has risen and both headline and core inflation have fallen below zero, although inflation expectations have remained anchored within the target range. Israel's external position remains strong, with a rebound in high-tech exports and accelerated capital inflows. *With the third national lockdown and political uncertainty from the dissolution of parliament, we welcome staff's comments on Israel's inequality and social discontent, especially given the high unemployment rate and furlough rates among low-skilled workers.*

Fiscal policy settings should remain accommodative to manage the impacts from the pandemic. Looking ahead, like other countries, the challenge for Israel will be how to transition from broad to targeted support and when to unwind fiscal support to create fiscal room to invest in much-needed structural reforms and limit scarring on the economy. In this regard we found staff analysis, especially Table 1 which spells out different phases of the pandemic and the appropriate fiscal support, extremely helpful. We also note with interest the divergence of views between staff and the authorities on the outlook and debt baseline. Going forward, once the recovery is on a firm path, fiscal consolidation is encouraged to ensure medium-term public debt sustainability.

Structural reforms will be needed to boost inclusive and productive growth for the Israeli economy. We note with concern that Israel's overall labor productivity was significantly lower than other small open advanced economies pre-crisis and this will only be further constrained by the pandemic. We therefore agree with staff that the pandemic provides an opportunity for the authorities to tackle long-standing structural challenges. The ICT sector is a bright light for productivity, but the authorities must work on ways to distribute the benefits more broadly. *Staff comments are welcome on potential reforms that could be adopted.* The pandemic has also led to concerning setbacks in educational results. We encourage the authorities to progress significant educational reforms that reduce disparities and provide investment in STEM skills that will ensure students are well prepared for an increasingly digital economy.

GRAY/21/183

January 14, 2021

Statement by Mr. Ronicle and Mr. Masood on Israel
(Preliminary)
Executive Board Meeting
January 19, 2021

We would like to thank staff for their insightful report and Mr. De Lannoy and Mr. Tsur for their instructive buff statement, particularly on recent developments. We commend the authorities for their fiscal response, enabled by robust buffers going into the crisis, and the Bank of Israel's measures to maintain credibility and credit flow. We note and welcome the recent developments on the vaccine roll-out which, coupled with historic peace accords, improve the outlook and might create space for structural reform efforts when the political situation stabilizes.

We agree with staff's assessment that the fiscal response has been appropriate and encourage the authorities to pass a new budget when the political situation allows. The stimulus of 10.25% of GDP across health, employment and infrastructure has helped to mitigate the impact of the crisis, although we note that unemployment has increased. At the point it is possible to pass a new budget, we anticipate there will be greater visibility on the impact of the vaccine roll-out on the economy, but encourage the authorities to ensure that fiscal withdrawal adequately supports the economy and countenances the impact of longer than expected disruptions. We agree with staff that fiscal consolidation should only start once the recovery is firmly established and should focus on medium-term debt vulnerabilities and generating inclusive growth, particularly tax reforms that balance incentivizing labor market participation and raising revenue.

We welcome the Bank of Israel's fast and effective response, including its willingness to adopt unconventional measures via asset purchase given limited space to reduce interest rates. Alongside this, measures to ease macroprudential and supervisory requirements – facilitated by banks substantial capacity to face large shocks, have succeeded in providing liquid, preserving credit flow and maintaining stability. Nevertheless, we wonder if monetary policy should be eased further: although inflation expectations remain within the target band, actual inflation has persistently undershot the target over the past six years and is currently negative and staff do not expect the output gap to be closed until 2025. The authorities are described as emphasizing unemployment over inflation, but it is not clear from the papers that there is a trade-off here – loosening policy should help close the output gap at a preferable pace, reduce unemployment and raise inflation to target. *Could staff elaborate further on why the authorities perceive there to be a trade-off between inflation and unemployment at the current juncture, and could staff explain why they are not advising a faster closing of the output gap and earlier return of inflation to target?*

While scarring is projected to be relatively limited due to the higher share of the ICT sector in Israel's value added, it remains imperative that structural reforms address vulnerabilities in the labor market. The impact of furloughing and job losses are unevenly distributed, concentrated in contact-intensive sectors. A consequence of this is that Arab workers, part-timer workers and those with low skills have been disproportionately impacted. Measures that assist reskilling, digitalization and address the educational losses resulting from lockdowns, will all be critical to ensure that there is not a long-term increase in structural unemployment.

GRAY/21/184

January 14, 2021

Statement by Mr. Guerra and Ms. Arevalo Arroyo on Israel
(Preliminary)
Executive Board Meeting
January 19, 2021

We thank staff for the comprehensive report and Mr. De Lannoy and Mr. Tsur for their helpful Buff statement. While entering the pandemic from a position of strength given robust growth and ample buffers, economic activity in Israel was severely affected by the COVID-19 shock. The authorities reacted swiftly to mitigate the effects of the pandemic by implementing a broad set of fiscal, monetary and financial measures. Notwithstanding a gradual recovery that is expected in the near-term, given the ongoing uncertainty, political developments, and structural challenges, the medium-term outlook requires further efforts to address these issues.

The authorities have taken resolute actions to contain the effects of the pandemic. We welcome the monetary and fiscal support to strengthen the health sector and aid households and businesses. We found the Roadmaps of Fiscal and Monetary Actions very useful to understand the authorities' plan as the pandemic evolves. As noted in the Buff statement, the vaccination campaign in Israel boosts confidence and recovery prospects, with the highest vaccination pace as compared to other peers—around 20 percent of the population already vaccinated.

While fiscal support has appropriately aided households and workers, it must remain supportive and should become more targeted. Given the high inequality in comparison to peers, bolstering social protection to aid the most affected should be pursued as the pandemic abates.

Being the recovery on track, we agree with staff that fiscal consolidation should be pursued to put debt on a sound downward path. The authorities should focus on restoring pre-crisis buffers and rebuilding fiscal space with the implementation of tax reforms. We take note of the difference in views between staff and the authorities regarding the baseline projections for debt and the pace of the recovery. *Staff comments are welcome.*

We welcome the swift and effective response by the Bank of Israel. We agree that monetary accommodation through UMP and liquidity measures remain appropriate. While inflation is now in the negative territory, we take positive note that inflation expectations remain well anchored in the inflation target band. We agree with staff that exchange rate flexibility should be the first line of defense against external shocks and to limit the use of FX intervention to address disorderly market conditions. *Staff comments are welcome on how FX intervention has contributed to manage inflation expectations in the case of Israel.* Liquidity support has been adequate but as risks remain to the downside, we agree with staff that modalities of prolonged support might need to be adjusted and targeted backed by data analysis.

A steadfast implementation of the structural policy agenda with focus on addressing labor market vulnerabilities will help reduce the potential long-term scarring and foster economic resilience. We agree with staff that strengthening digitalization, enhancing the education system and increasing investment are important measures. Particularly, it will be beneficial to implement labor market policies that contribute to aid the most affected sectors and groups. As most affected employees are low-skilled, reskilling and upskilling, in hand with vocational training programs could contribute to address the skill gap in these groups. We welcome improvement in the AML/CFT framework and encourage the authorities to continue working to close the gaps in the government procurement system to strengthen public investment management and reduce the potential misuse of public money.

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GRAY/21/186

January 14, 2021

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.

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GRAY/21/192

January 14, 2021

Statement by Mr. Buissé, Mr. Rozan, and Mr. Roman on Israel
(Preliminary)
Executive Board Meeting
January 19, 2021

I would like to thank staff for their insightful report and Mr De Lannoy and Mr Tsur for their instructive buff statement.

The Israeli economy entered the COVID-19 pandemic with a strong position, after several years of prudent macroeconomic policy making, strong growth and low unemployment. The authorities' swift and decisive actions helped mitigate the economic fallout and protect livelihoods and businesses. Accommodative policies should be maintained as long as growth is not firmly entrenched, given the fiscal space. Recovery measures should aim at further addressing the challenges the country has to face, in particular the duality of the economy and inequalities in certain segments of the population. We broadly share staff's assessment and wish to highlight the following points.

On the back of solid growth over the past decade, contraction of the economic activity was significant, though we note that real output contraction was somewhat milder than that of other advanced economies, reflecting the small share of heavily affected sectors in gross value added. While the rise in new COVID-19 cases in December and early-January necessitated imposing a third nation-wide lockdown, on the upside, we note that early widespread vaccine distribution could boost confidence in the near term, allow activity to resume faster, and prevent medium-term scarring. In this context, we wonder if the upside scenario has not become more central as a result of this strategy. *Staff comments would be welcome.*

We share staff's appraisal that the volume of fiscal support has been adequate thus far and should be extended for as long as is needed to protect livelihoods and limit economic and social scarring. Support for households (benefits for unemployed and furloughed workers and grants for the self-employed) and businesses (notably guaranteed loans for SMEs) helped soften the impact of the pandemic. It will be important that fiscal policy remain supportive in 2021, notwithstanding the political uncertainty and the need to rely on an interim budget. The authorities do have policy space, and fiscal consolidation should be undertaken only once the recovery is on firm ground. We agree with staff's assessment that it will have to be primarily based on revenues measures, and especially tax reform, to restore fiscal buffers while also ensuring more inclusive growth. We encourage the authorities to start planning for this, in particular through the reform of personal income tax rates; also, profit-based corporate tax incentives could be scaled back.

On the monetary side, both conventional and unconventional measures taken by the Central Bank were timely and appropriate. Easing of macroprudential and supervisory requirements also helped provide liquidity and limit volatility. Even though 5- and 10-year inflation expectations remain anchored within the 1–3 percent inflation target band, we note that the price level declined in May and has remained suppressed since then, and that near-term inflation expectations are below target, deserving close monitoring. On the currency side, we would welcome further analysis by staff on the level of the shekel, which has appreciated over the past few years, on the back of the very dynamic tech ecosystem, with negative side effects on more traditional sectors. *Staff elaboration on how policy makers could address the impact of the exchange rate on these sectors would be welcome.*

On the financial sector, we share staff's assessment that Banks' capital remains strong, with substantial capacity to face large and prolonged shocks and we concur with the recommendation that the level of minimum regulatory capital should not be lowered further (unless downside risks materialize), and structural buffers should eventually be restored.

We share staff's views that structural policies are needed to strengthen the resilience of the economy and address inequalities between low-skilled and high-skilled workers. Working on addressing the duality of the Israeli economy would be important and could be a focus of future article IV – in this regard, we welcome the indications in the buff statement of the authorities on the measures taken to increase productivity. Labor activation policies, improved digital penetration, and education reforms should be pursued. More investment in infrastructures would support the recovery and help create jobs, in a context where the stock of public capital is below that of peer countries and has long been due for an upgrade. Lastly, while the staff report only refer to competition from the standpoint of public procurement, we wonder if more analysis should not be pursued more generally. Past OECD work had evidenced deficiencies in the structure of the Israel economy in this regard, with relatively high concentration in certain sectors. *Staff comments would be welcome.*

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GRAY/21/195

January 14, 2021

Statement by Ms. Shortino, Mr. Farber, and Mr. Westphal on Israel (Preliminary)
Executive Board Meeting
January 19, 2021

We thank staff for this report and Mr. De Lannoy and Mr. Tsur for the informative buff statement. Israel entered the COVID-19 crisis on solid footing, and we commend the authorities for their strong monetary and fiscal responses. We found staff's inclusion of the authorities' progress on previous Article IV recommendations particularly useful. We also commend Israel for leading the world in vaccinating its population on a per capita basis, which will hopefully facilitate a rapid economic recovery.

As with most countries, the authorities should maintain a robust **fiscal** response until the recovery takes hold. We echo staff's recommendation that during the recovery period the authorities should focus on promoting job growth, strengthening the social safety net, and investing in infrastructure. Staff notes that poverty rates are higher for Israeli-Arab and Haredi groups and that Arab workers have likely suffered relatively more job losses. *Can staff provide more detail regarding policies to address this issue?* We also agree that the authorities should prioritize passing a comprehensive 2021 budget as soon as possible to reduce uncertainty. We appreciate the staff's detailed analysis in Annex III on when to withdraw fiscal support.

On **monetary** policy, we agree with staff that the central bank responded well to the COVID-19 shock by reducing the policy rate, providing additional liquidity support to financial markets, purchasing corporate bonds, and deferring repayments for retail loans. Taken together, these steps helped to mitigate rapid market movements and restore confidence. We are concerned, however, about the central bank's pace of reserve accumulation, which seems designed to limit the shekel's appreciation. We note staff's assessment that the shekel is now deemed stronger than reflected by fundamentals. We echo staff's recommendation that the central bank avoid using FX intervention to manage inflation, and to use intervention only to address disorderly market conditions.

We agree that the current crisis is an opportunity to address longstanding **slow productivity growth** and **rising inequality** by further investing in human capital. Israel should also take advantage of reduced borrowing costs to invest in its infrastructure to ease economic bottlenecks, particularly in transportation and digital infrastructure. Increasing Israel's investment rate and strengthening the safety net will also help to reduce Israel's current account surplus, which is a significant driver behind the appreciation of the shekel and the below-target inflation rate.

Israel's **financial sector** has proven remarkably resilient, particularly from a capital perspective. We echo staff's encouragement to develop contingency plans in case asset quality deteriorates materially, as seems likely to happen in many countries globally. Staff note that business insolvencies are also likely to surge, which will make it important to develop effective insolvency procedures, minimize barriers to corporate restructuring, and spur productivity-enhancing capital reallocation.

GRAY/21/197

January 15, 2021

Statement by Ms. Levonian and Mr. Rankin on Israel
(Preliminary)
Executive Board Meeting
January 19, 2021

We thank staff for their detailed report and Mr. De Lannoy and Mr. Tsur for their insightful Buff statement. We generally agree with staff's assessment and would like to offer the following remarks for emphasis.

While the economic impact of the COVID-19 pandemic is unprecedented, the Israeli economy entered the COVID-19 pandemic from a position of strength. Prior to the pandemic GDP growth was robust, unemployment low, debt at comfortable levels, banks enjoyed strong capital positions, and international reserves were abundant. While the pandemic inflicted a historic contraction on the Israeli economy, the authorities' response has been appropriate. In particular, we commend the authorities for their swift vaccination campaign, inoculating 20 percent of the country within three weeks. Should vaccination pace and effectiveness be sustained, Israel may soon reach herd immunity, significantly boosting confidence and recovery prospects. *What lessons should other countries take from Israel's vaccination campaign?*

Fiscal stimulus has helped soften the impact of the pandemic, but should become more targeted going forward. We concur with staff's assessment that the volume of fiscal support has been adequate in supporting critical needs while preserving some fiscal space to meet future shocks. Nevertheless, poorly targeted programs like "grants for every citizen" likely had a relatively low impact on growth and equality. Going forward, we echo staff advice that the authorities should place greater focus on strengthening the social safety net and job-rich public investment projects. Once the recovery is on firm ground, fiscal consolidation will be needed to place debt on a firmly downward path. We note that ongoing political uncertainty and lack of an orderly budget for 2021 puts a dynamic fiscal response in jeopardy.

Monetary policy should remain accommodative. Extending the current set of BOI policies remains broadly appropriate given low inflation expectations, negative output gap projections, and a renewed lockdown. Looking forward, we concur with staff that exchange rate flexibility should be the first line of defense against external shocks. We positively note that Israel's financial system remains resilient, with strong capital positions. Nevertheless, given longstanding risks, in the event of a significant deterioration in asset quality, the authorities should strike a balance between providing further accommodation and ensuring prudent buffers. We underscore staff's recommendation that preparations to handle a potential increase in business insolvencies would help limit scarring and could spur productivity-enhancing capital reallocation.

Structural policies need to strengthen the resilience of the economy. The current crisis is an opportunity to tackle pre-COVID legacies that have stalled productivity growth and raised inequality and poverty. We concur with staff that addressing vulnerabilities in the labor market should take priority. In this respect, we note with concern that female workers have been furloughed at a greater rate than males, as well as staff's finding that Arab workers have likely suffered a relatively larger number of job losses. In addition, longstanding needs for education reforms should be addressed. Closing the large disparities in education achievement between Arabic- and Hebrew-speaking students would help raise average test scores, currently among the lowest of advanced economies. Further emphasis should also be placed on subjects providing marketable skills (e.g., math, science, and technology). Tackling labor market and education inequalities would provide a foundation for robust and inclusive growth. We welcome the historic signing of the Abraham Accords between Israel and the United Arab Emirates, and Israel and Bahrain. These accords will contribute to enhancing stability, security, and prosperity across the region.

We wish the authorities every success in their efforts.

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GRAY/21/199

January 15, 2021

Statement by Mr. Bhalla and Mr. Goyal on Israel
(Preliminary)
Executive Board Meeting
January 19, 2021

1. We thank the staff for the report on Israel and Mr. De Lannoy and Mr. Tsur for a helpful Buff statement.

2. Given the importance and spread of COVID, and the fact that Israel has had the largest number of lockdowns (three), some more analysis as to how the lockdowns impacted spread of virus would be informative.

3. However, Israel's macro record appears to be outstanding. Real growth averaged 3.5 % prior to the pandemic. The COVID drop is expected to be only -4 %; and economic growth is expected to average 4.5 % over the next four years such that by 2024 Israel would have been where it would have been without COVID. In addition, Israel's investment rate has stayed relatively constant at around 21 % of GDP, and the inflation rate has stayed steady at under 1 %.

4. We note that inflation is undershooting the target range reflecting negative output gap and downward movement in prices of tradeable goods. We encourage authorities to continue with the accommodative monetary stance as it will be consistent with need to boost employment and economic activity and will help prices to move towards the target range. Though we agree with the Staff that forex intervention may not be used to achieve inflation objective, probably it is justified, if objective is to contain exchange rate movements triggered by large capital inflows due to excess global liquidity.

5. We encourage authorities to maintain policy stimulus and should avoid a premature withdrawal. While, inflation is undershooting the lower bound of target range, the public debt level is relatively moderate compared to its peers and is predominantly domestic. Nonetheless, once recovery gains adequate traction, authorities may consider fiscal consolidation measures to recreate fiscal space.

6. We wish authorities all the best in their future endeavors.

Israel

Responses to Technical Questions Posed by Executive Directors in Advance of EBM/21/7—January 19, 2021

Staff's responses to technical questions are below. Issues related to the reasons behind the difference of views between the staff and the authorities on the outlook and whether latest developments have brought the forecast closer will be addressed in staff's intervention at the Board meeting.[1]

Outlook / Risks

1. **We would appreciate staff's views on the reasons behind the differing views on the outlook.**

2. **We take note of the difference in views between staff and the authorities regarding the baseline projections for debt and the pace of the recovery. Staff comments are welcome.**

3. **Given the difference in views between the authorities and staff on the GDP and debt forecast, we would also appreciate if staff could further elaborate on whether the latest developments have brought the forecasts closer together, and if not, what are the reasons behind it? We also wonder if a rapid vaccine rollout can offset other uncertainties?**

4. **While the rise in new COVID-19 cases in December and early-January necessitated imposing a third nation-wide lockdown, on the upside, we note that early widespread vaccine distribution could boost confidence in the near term, allow activity to resume faster, and prevent medium-term scarring. In this context, we wonder if the upside scenario has not become more central as a result of this strategy. Staff comments would be welcome.**

5. **What lessons should other countries take from Israel's vaccination campaign?**

- Staff will respond to questions 1-5 during the Board meeting.

6. **We would be interested to hear about the reasons behind the successful vaccination campaign.**

- While it is still too early to make a full assessment of the vaccination campaign, the following factors are likely playing a role in the fast vaccine rollout: (i) early acquisition agreements with several vaccine producers. The agreement with Pfizer includes a data sharing commitment that would allow better understanding of the vaccine impact at the distribution phase (ii) a universal public healthcare system connected to a nationwide digital network and other infrastructure that allows fast communication with patients and tracking of inoculations;

[1] EDs have requested that staff indicate those areas for which responses will be provided during staff's oral intervention at the Board. This avoids the need for EDs to repeat their questions during the discussion. In addition, staff may want to indicate which questions they intend to address orally.

(iii) full mobilization of the health system and underutilized public spaces to allow socially distanced distribution; (iv) no waste policy that allows low-priority groups to utilize expiring vaccines on a first-come-first serve basis.

7. **We note that the broad unemployment rate was not included in the staff report, while this rate has remained at double-digit levels. Staff`s comment are welcome.**

- Broad unemployment (including furloughed employees) is discussed in paragraph 13 and figure 5 of the staff report. The broad unemployment rate declined to 10.4 percent in mid-December and is likely to remain in double digits in early-2021 due to the third lockdown. Under the assumption of a successful vaccine rollout and containment of new COVID cases, the broad unemployment rate is projected to fall rapidly in 2021 and converge to the standard unemployment rate in the medium term.

8. **With the third national lockdown and political uncertainty from the dissolution of parliament, we welcome staff's comments on Israel's inequality and social discontent, especially given the high unemployment rate and furlough rates among low-skilled workers.**

- Alongside ensuring adequate support for the health system, the authorities' highest priority should be to support households and mitigate the impact of the pandemic on workers that have been affected the most by the pandemic. Better funded labor market policies and strengthening the social safety net would help prevent worsening of Israel's already high inequality.

Fiscal Policy

9. **Nonetheless, the 2021 budget could still produce a tighter fiscal stance amid the current political environment. In assessing the fiscal response, we take note of authorities' discrepancies with staff regarding the trajectory of the public debt. Could staff elaborate on the sources of these differences considering the projected pace of recovery and the new data available?**(Bevilaqua, Mr. Fuentes, and Mr. Coelho)
10. **Could staff indicate what the main differences are with the authorities' debt projections and the magnitude of the differences?**

- The main difference in the fiscal projections stems from the authorities' assumption of a future fiscal adjustment of about 2-2½ percent of GDP, for which measures are yet to be defined. We recognize that Israel has a strong track record of fiscal adjustment when debt increases above comfortable levels, but we have not incorporated the adjustment into our projections. We plan to do so once more specific information and legislative commitment are in place.

11. **Could staff elaborate on possible additional fiscal adjustment measures that can be implemented, once the recovery is firmly entrenched?**

- There is scope to expand the income tax base by reducing tax preferences, including those for training funds, and pension and rental income. The VAT base could also be expanded. The authorities consider that there is room to streamline spending, but civilian expenditure is low relative to that of peer countries.

12. Can staff elaborate to what extent the ad-hoc budget expansions for this year limit crisis management as well as the financing of long-term structural plans.

- The authorities were able to manage the crisis without a 2020 budget. However, a comprehensive budgetary process—which includes both Covid-related and other spending--would provide a more comprehensive and transparent view of the budgetary needs and spending priorities. It would also allow better medium-term planning of the fiscal costs of structural reforms. More generally, the fiscal expansion reduces fiscal space, requiring consolidation once the recovery is on a strong footing. This means that a larger consolidation effort would be needed to finance long-term investments and strengthen the social safety net.

13. Given the quite low labor force participation and skills among the minority groups, we would be interested in staff's elaboration on how inclusive the support to the population have been during this challenging time and particularly for minority segments.

14. Staff notes that poverty rates are higher for Israeli-Arab and Haredi groups and that Arab workers have likely suffered relatively more job losses. Can staff provide more detail regarding policies to address this issue?

- We do not have specific information on the extent to which minority groups have benefited from fiscal support measures. Nonetheless, about two-thirds of the authorities' fiscal package supports unemployed and furloughed workers, as well as small businesses. While it is true that minority groups have lower employment rates, it is also true that the impact was more severe on the low-skilled groups. Therefore, we would expect that minority groups significantly benefit from these programs. However, as mentioned in the report, not all support measures were well-targeted, and therefore, there is scope to strengthen the support to the most vulnerable.

15. Could staff elaborate on the public investment management framework in place and any advice in this regard, including PIMA? Additionally, it should be ensured that existing infrastructure is efficiently used and that the SOEs are fit for the task. Considering past bilateral surveillance advice on these matters, staff's comments would be welcome.

- A PIMA has not been conducted for Israel, and there is merit in assessing Israel's public investment management framework against benchmarks in light of Israel's large investment needs. Israel has made progress in improving procurement practices and, and as noted in the staff report, would benefit from further measures that mitigate procurement risks. Regarding existing infrastructure, while the pandemic has eased the pressure on roads, these pressures are likely to re-emerge, and congestion charges remain an option in the medium term. The authorities' focus on public transportation infrastructure is also welcome (e.g., Tel Aviv's subway construction).

Monetary and Exchange Rate Policy

16. Could staff provide more details on whether the fundamentals are going to remain supportive of a strong shekel and how to assess the impacts of the central bank's latest interventions and announcement on the exchange rate?

- With the caveat of large pandemic-related uncertainties ahead, staff views as plausible the continued stronger external position based on current projections of sustained current account surpluses, higher international reserves and strong international investment position. The pace of shekel appreciation accelerated markedly in Q4 2020 and in 2021 to date, and the January 14 announcement of a FX intervention program of up to US$30 billion in 2021 (compared to US$21 billion in 2020) was a signal to blunt further rapid appreciation, given its impact on inflation and the ongoing negative effects of the COVID-19 crisis on the real economy. While initial market reactions resulted in weakening of the shekel, it is too early to assess if the trajectory of appreciation can be durably affected by this announcement. As the staff report has noted, while foreign exchange purchases help mitigate the impact of shekel appreciation on the inflation, structural measures are critical to strengthen the resilience of the economy and facilitate recovery and the transitioning of resources from sectors affected by the pandemic to growing sectors.

17. Could staff elaborate further on why the authorities perceive there to be a trade-off between inflation and unemployment at the current juncture, and could staff explain why they are not advising a faster closing of the output gap and earlier return of inflation to target?

- The authorities do not perceive such a tradeoff but observed that the measurement of inflation and the output gap have become difficult and exceptionally uncertain due to the deep shock arising from the COVID-19 crisis. Thus, unemployment takes on a greater role for clarity of policy analysis at the current juncture. Please note that the authorities requested a correction in the paragraph summarizing their views to avoid the perception of such a trade-off. Furthermore, staff has advised that a somewhat slower pace of withdrawal of fiscal support may be needed to help close the output gap.

18. Staff comments are welcome on how FX intervention has contributed to manage inflation expectations in the case of Israel.

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?

- The policy rate near the ELB imposes constraints that may require the use of other types of policies, including unconventional policies and FX intervention, to play a greater role. This is being elaborated in the ongoing work on the Integrated Policy Framework. In the case of Israel as a small highly open economy, with inflation already negative and markedly below the inflation target band, strong exchange rate appreciation can further depress inflation and related expectations through tradable prices, unless softened through intervention. In this context, it is notable that medium and long-term inflation expectations have remained anchored within the inflation target band

19. Could staff elaborate on its views (and BoI's views) about what is the effective lower bound (ELB) for the policy rate in Israel?

- Given the potential distortions and risks of shifts in regime under negative nominal interest rates, the BoI has referred to zero lower bound as the effective lower bound for their policy rate (see https://din-online.info/pdf/bank31.pdf). Staff sees merit in this view, especially during the pandemic when BOI's more targeted approach to liquidity provision and ensuring access to finance has shown to be effective.

20. 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?

- Use of the main program for secondary market government security purchases has been relatively good. The program was only NIS 50 billion when launched in March. When utilization reached about NIS 34 billion by end-September, the BoI raised the ceiling by NIS 35 billion (for a total of NIS 85 billion) to preemptively signal space for further interventions, as needed, to protect market functioning and smooth bond market financing.

- The corporate bond purchase program was small and launched in mid-2020 to address residual wider spreads in corporate bond financing. But its use waned fairly quickly as underlying conditions for corporate financing substantially eased thereafter (including with IPOs rebounding). On governance aspects, corporate bond purchases are benchmarked for companies rated A- and higher, and preclude other risks (e.g., foreign exchange or equity-related). While there is no explicit government indemnification for this special program, the central bank law allows losses to be retained and netted out in special accounts, prior to any future annual distribution of profits to the government.

21. On the currency side, we would welcome further analysis by staff on the level of the shekel, which has appreciated over the past few years, on the back of the very dynamic tech ecosystem, with negative side effects on more traditional sectors. Staff elaboration on how policy makers could address the impact of the exchange rate on these sectors would be welcome.

- Structural measures that strengthen the resilience of the economy would not only minimize medium- and long-term scarring but also mitigate the impact of the shekel appreciation on traditional sectors. These reforms include much needed public investment spending and policies that facilitate easy transition to growing sectors (ALMPs, vocational training, boosting marketable skills of low-skilled workers and minority groups).

Financial Sector

22. In the face of the ongoing discussion on the availability of banks' capital buffers during the crisis, we would like to ask staff for an assessment of the extent of actual usage of capital buffers by Israeli banks, also considering the initial tightening of macroprudential standards at the beginning of the pandemic.

- Based on available information, notwithstanding the space provided by relaxations made at the beginning of the pandemic on both regulatory capital buffers and macroprudential requirements, it appears that use of banks' capital buffers has been modest thus far. For instance, Common Equity Tier-1 capital ratio for the five main banking groups combined declined only modestly from 11.2 percent at end 2019 to 10.9 percent at end Q2 2020, and this ratio for every one of the five banking groups remains at least 10 percent.

23. Given that the macroprudential and supervisory requirements were also eased, could staff also provide more details on the length of these measures and how the authorities plan to rebuild these buffers?

- In March 2020 at the time of the start of the main relaxations, including the reduction in the minimum CET-1 regulatory capital requirement, macroprudential and supervisory requirements were eased for an initial period of 6 months. This period was to be extended, as necessary, and have since remained in place. Among relaxations described in the staff report, the extension of the loan repayment deferral request window has most recently been extended to March 2021. The sunset of these measures remains to be determined given the renewed lockdowns of the Israeli economy. Concurrently, specific plans for capital rebuilding have yet to be presented by the authorities.

24. Considering the uncertainty around the pandemic, we note staff's indication in para 34 of the report, that "liquidity support extended (…) could be more targeted and (…) supported by adequate corporate data analysis. In addition, staff indicates that improved data collection and methodologies would be crucial in assessing households and firms vulnerabilities. Could staff share its views on the role of the FSC in this context and the authorities' reactions to these recommendations?

- The authorities recognized the need for further efforts to deepen data analysis with the aim of assessing such vulnerabilities. They pointed out that under the FSC umbrella, inter-agency exchange of data and close monitoring of developments that enabled timely policy responses have proceeded smoothly. Special studies using more granular corporate data, including as commissioned by the National Economic Council, are also being undertaken.

Structural Reforms

25. Although the authorities agreed on the need for structural reforms, it would also be helpful to know how the authorities would prioritize and sequence these measures, also considering the available fiscal space. Staff`s comments are welcome.

- As Mr. De Lannoy and Mr. Tsur's Buff points out, the authorities have focused their efforts on public transportation infrastructure. The negative impact of the pandemic on low-skilled employees has also made a clear case for ALMPs that promote upskilling and reskilling. Furthermore, digitalization has progressed rapidly in government services that are needed to maintain vital economic and social activities. Other reforms—e.g., education—are unlikely to gain traction until a new government is in place.

26. The ICT sector is a bright light for productivity, but the authorities must work on ways to distribute the benefits more broadly. Staff comments are welcome on potential reforms that could be adopted.

- The Arab and Ultra-Orthodox communities are the fastest growing population segments in Israel. The authorities thus need to pay close attention to the incentives for these groups to participate in the labor force. A sustainable solution—mentioned in the current and previous Article IV staff reports—is to improve the marketable skills of minority groups and better integrate them into the more productive sectors of the economy. Education reforms are key to addressing this challenge. Strengthening the social safety net will also help reduce Israel's high level of inequality.

27. Past OECD work had evidenced deficiencies in the structure of the Israel economy in this regard, with relatively high concentration in certain sectors. Staff comments would be welcome.

- High concentration, particularly on network sectors, is to be expected given the size of the economy. Nonetheless, the authorities have focused on fostering competition in some areas. In this regard, since the last Article IV consultation, the authorities have passed a reform of the electricity sector and have taken a series of measures to enhance competition in the financial sector, including splitting the card companies from the banks and approving a new banking license—the first in 40 years—for a digital bank.

Constituency Codes

OEDAE
Angola, Botswana, Burundi, Eritrea, Eswatini, Ethiopia, The Gambia, Kenya, Lesotho, Liberia, Malawi, Mozambique, Namibia, Nigeria, Sierra Leone, Somalia, South Africa, South Sudan, Sudan, Tanzania, Uganda, Zambia, and Zimbabwe

OEDAF
Benin, Burkina Faso, Cameroon, Central African Republic, Chad, Comoros, Democratic Republic of Congo, Republic of Congo, Côte d'Ivoire, Djibouti, Equatorial Guinea, Gabon, Guinea, Guinea Bissau, Madagascar, Mali, Mauritania, Mauritius, Niger, Rwanda, São Tomé & Príncipe, Senegal, Togo

OEDAG
Argentina, Bolivia, Chile, Paraguay, Peru, and Uruguay

OEDAP
Australia, Kiribati, Korea, Marshall Islands, Federated States of Micronesia, Mongolia, Nauru, New Zealand, Palau, Papua New Guinea, Samoa, Seychelles, Solomon Islands, Tuvalu, and Vanuatu

OEDBR
Brazil, Cabo Verde, Dominican Republic, Ecuador, Guyana, Haiti, Nicaragua, Panama, Suriname, Timor-Leste, and Trinidad and Tobago

OEDCC
China

OEDCE
Colombia, Costa Rica, El Salvador, Guatemala, Honduras, Mexico, and Spain

OEDCO
Antigua and Barbuda, The Bahamas, Barbados, Belize, Canada, Dominica, Grenada, Ireland, Jamaica, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines

OEDEC
Austria, Belarus, Czech Republic, Hungary, Kosovo, Slovak Republic, Slovenia, and Turkey

OEDFF
France

OEDGR
Germany

OEDIN
Bangladesh, Bhutan, India, and Sri Lanka

OEDIT
Albania, Greece, Italy, Malta, Portugal, and San Marino

OEDJA
Japan

OEDMD
Afghanistan, Algeria, Ghana, Islamic Republic of Iran, Libya, Morocco, Pakistan, and Tunisia

OEDMI
Bahrain, Egypt, Iraq, Jordan, Kuwait, Lebanon, Maldives, Oman, Qatar, United Arab Emirates, and Yemen

OEDNE
Andorra, Armenia, Belgium, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Georgia, Israel, Luxembourg, Moldova, Montenegro, Netherlands, Republic of North Macedonia, Romania, and Ukraine

OEDNO
Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway, and Sweden

OEDRU
Russian Federation and Syrian Arab Republic

OEDSA
Saudi Arabia

OEDST
Brunei Darussalam, Cambodia, Fiji, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Nepal, Philippines, Singapore, Thailand, Tonga, and Vietnam

OEDSZ
Azerbaijan, Kazakhstan, Kyrgyz Republic, Poland, Serbia, Switzerland, Tajikistan, Turkmenistan, and Uzbekistan

OEDUK
United Kingdom

OEDUS
United States