MISSION CONCLUDING STATEMENT

Israel: Staff Concluding Statement of the 2023 Article IV Mission

May 10, 2023

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV (/external/pubs/ft/aa/aa04.htm) of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Jerusalem, Israel:

Following a remarkable recovery from the pandemic anchored in strong fundamentals, the outlook is for growth to slow broadly in line with potential, as inflation falls to the targeted range *by the end of 2024. However, the risk balance is tilted to the downside, reflecting, among other things, external risks and the continued uncertainty around the proposed judicial reform.*

Key Policy Recommendations:

- Fiscal policy should safeguard fiscal buffers while raising growth-enhancing spending. The fiscal stance seems adequate to preserve buffers, but additional fiscal space is needed for boosting potential growth and reducing inequality. There is scope to raise income tax revenues.
- Monetary policy. With a tight labor market, positive output gap, and headline inflation above the target range, the policy stance should remain tight. The Bank of Israel (BOI) should continue to closely monitor underlying price pressures and stand ready to further hike the policy rate if inflation surprises on the upside or inflation expectations rise past the target band while underlying pressures remain strong, risking de-anchoring.
- Macrofinancial policies. The recent retightening of macro-prudential tools is welcome, as these have helped to contain unwarranted risk taking. Further calibration of macroprudential tools should be driven by sector specific developments. Policies should strive to continue to bolster housing supply.
- Structural policies. To enhance potential growth, authorities must prioritize education reform and infrastructure investment. Improving the skills of minorities will foster an inclusive economy. Improving local transportation infrastructure is key to reducing congestion, improving job accessibility, and alleviating cost of living pressures.
- Judicial reform. Permanently lowering the uncertainty around judicial reform requires a politically sustainable solution that is clearly communicated and well understood both domestically and abroad.

Outlook and Risks

Israel's economic performance in 2022 was remarkable. Growth reached 6.5 percent, pushed by a vibrant high-technology sector, with unemployment at a record low. Public debt-to-GDP fell rapidly to pre-covid levels, international reserves are ample, the external position is strong, and the banking sector has adequate capital and liquidity buffers.

Economic activity is expected to decelerate and thereafter converge towards its potential. Staff projects economic growth to slow to about 2.5 percent in 2023, as households' purchasing power moderates and firms rein in investment; government expenditure stays broadly constant as a fraction of GDP, reflecting prudent fiscal management; and the external position continues to be strong. Despite some easing, the labor market is expected to remain tight, with the unemployment rate increasing slightly, while labor force participation rises. The growth rate is anticipated to converge towards its potential rate, with the output gap closing in the medium term. Against this backdrop, inflation is forecast to fall to the target range by end 2024.

Risks to growth are tilted to the downside and risks to inflation to the upside. Spillovers from a weaker global outlook remain a downside risk to growth. Economic activity and inflation could both be negatively affected by a renewed surge in global energy prices, new supply chain disruptions, or an increase in geopolitical tensions. Heightened global financial volatility due to stress in foreign banking sectors could negatively impact the pricing and availability of financing. Rising geopolitical tension or a falling interest rate differential versus major central banks, could exert further depreciation pressure on the shekel.

Continued uncertainty around the judicial reform presents a notable downside risk to growth. Absent the emergence of a durable and politically sustainable solution, continued uncertainty could significantly increase the price of risk in the economy, tightening financial conditions and hindering investment and consumption, with potential repercussions for growth, also in the longer term.

Macroeconomic Policies

A lasting reduction of the uncertainty associated with the ongoing discussion of judicial reform is important to anchor the baseline. Permanently lowering the uncertainty around judicial reform requires a politically sustainable solution that is clearly communicated and well understood both domestically and abroad. Also, as in any country, maintaining strength of the rule of law would be important for economic success.

Staff assesses the fiscal stance to be appropriate, as a stronger-than-anticipated fiscal consolidation in 2022 allowed rebuilding fiscal buffers faster than envisaged, and the medium-term consolidation path is based on expenditure restraint, preserving buffers. The expected 2023 general government deficit—at about 1 percent of GDP—is anchored in expenditure projected to be among the lowest in recent times, and driven by a drop in windfall revenue from last year. Over the medium term, revenue in terms of GDP is expected to continue falling over time until it converges to its pre-pandemic level. As fiscal spending in terms of GDP is expected to remain low and broadly stable, fiscal deficits are estimated to converge to below 3 percent of GDP by 2028, while debt ratios are projected to continue falling and remain about 60 percent of GDP.

But additional fiscal space would be needed for growth-enhancing spending and to support the authorities' climate goals. Staff analysis suggests that additional investment in infrastructure and education could boost GDP growth and reduce inequality. Further resources would be needed to support the authorities' climate agenda, including for accelerating investment in transport infrastructure, funding R&D in green technologies and for adaptation strategies. Hence, Israel should proactively strengthen revenue measures to finance growth-enhancing spending while maintaining robust buffers.

To reinforce the conduct of fiscal policy, additional measures should be considered. A review of the fiscal framework should assess whether fiscal rules are binding, flexible, and transparent. To support the budgetary planning of growth-enhancing expenditure, including infrastructure projects and education, a framework to define priorities across competing needs could be developed. In this context, the "projections procedure" that provides MoF staff independence in the estimation of macroeconomic and financial projections is helpful. A mechanism to ringfence allowances for infrastructure and education projects could also be considered, while keeping fiscal envelops that protect fiscal buffers. This could improve transparency of available funding in the medium term, and support budgetary planning and implementation. The establishment of an independent fiscal council should be considered, to serve in an advisory role. It could propose criteria for projects to be included under the allowance for growth-enhancing measures and assess their enforcement. The council could also evaluate the fiscal stance, assess budgetary forecasts, and monitor the fiscal rule; and it could advise the government on the reprioritization of spending, including growth enhancing measures or further reduction of debt. Safeguards to guarantee minimum qualifications and avoid council members' conflicts of interest should be considered.

The central bank has appropriately moved the monetary policy stance above neutral; it should maintain this stance while underlying price pressures remain strong. Headline inflation, at 5.0 percent year-on-year in March 2023, remains above target, driven by broad-based price rises. This reflects underlying pressures which are still strong. While near-term inflation expectations have, since end-2022, moved back into the inflation target range, the output gap is arguably still positive, and the labor market remains tight. Recent shekel weakness adds further to inflationary pressures. It would be prudent to hold the policy interest rate elevated and restrictive, ensuring the monetary policy stance stays tight until there are clearer signs that aggregate demand is cooling, taking into account the transmission lag from the policy rate to inflation. The BOI's well-established independence in setting interest rates to maintain price stability is an important element in this effort. Market forces should be allowed to continue to set the price of the shekel.

Housing price and mortgage credit growth remained buoyant in the first half 2022 but have started to ease. The overall house price level increased by 17 percent for the year, supported by robust growth in mortgage lending. However, amid rising lending rates, driven by the higher policy rate, housing prices have started to stabilize. Mortgage credit growth, issuance of new mortgages, and total housing transactions started to gradually decline during 2022, while the stock of new dwellings for sale is rising. In parallel, building starts increased significantly in 2022.

To contain financial risks, staff welcomes the authorities' prudent macroprudential stance and efforts to raise the supply of housing. The recent retightening of macro-prudential tools is helpful to contain unwarranted risk taking. Further calibration of macroprudential tools should be based on sector specific developments. Continued increases in the supply of housing will ease real estate prices and affordability pressures. Staff welcomes recent measures to boost supply. These measures should be aligned with population growth over time, be supported by complementary infrastructure investment in areas where building is needed, and come with the removal of fiscal disincentives to residential construction at local authority level.

Staff assesses the banking sector to be broadly robust but pockets of vulnerability require close monitoring. Banks are well capitalized and liquid, while overall household and corporate leverage levels are comparatively low. However, concentration in the real estate sector is high. Bank loans for residential and commercial real-estate combined reached over 50 percent of total loans in

2022. While buffers are robust and asset quality is strong, a sudden and large correction of real estate prices, or a shock to household or corporate incomes or balance sheets, could jeopardize their ability to repay and negatively impact the system.

Further improvements in risk measurement and management should be considered. Staff welcomes the implementation of liquidity alerts to monitor liquidity risks. The BoI's retightening of capital requirements and minimum leverage ratios during the post-pandemic rebound and the recent strengthening of credit risk management—including a requirement to allocate additional capital against highly leveraged land financing—are also welcome. Making use of existing credit bureau information, staff recommend improving supervisory models for the measurement of risk at the individual exposure level to ensure that risk absorbing capacity in the system is appropriately adjusted to changes in risk across the financial cycle. A legal framework to clearly delineate activities of banking and non-banking institutions, including payment services, needs to be developed and adhere to international standards, taking into account consumer protection and financial stability aspects.

Staff cautions against interference in the setting of market interest rates. Recent initiatives to impose minimum payments on retail deposits and caps on mortgage rates would distort risk-taking and pricing mechanisms of banks, as well as the transmission of monetary policy. Such measures may also arbitrarily interfere with established contracts and market principles.

Education reform and infrastructure investment would improve productivity, foster participation and prevent further widening of inequality. A historical record of high overall rates of economic growth, driven predominantly by the dynamic high-tech sector, masks an underlying dual economy with highly unequal economic performance. Skill and knowledge gaps affect employment opportunities, particularly for specific demographic groups. Policies should focus on providing marketable skills, improving infrastructure, and removing product market barriers.

- Addressing skill gaps. Education reform should focus on providing market relevant skills, particularly among populations with low participation rates, such as the Haredi and Arab communities, while making sure to keep gender opportunity equality in higher-education and in the work-place. Improving teacher quality at schools in disadvantaged communities is also relevant. A greater adaptation of the different education streams will be needed to help align student qualifications with increasingly digitalized-labor market needs. Active labor market policies should seek to expand vocational training and encourage employers' involvement in training programs.
- Improving infrastructure. Infrastructure improvements are particularly pressing in transportation to ease traffic congestion and improve job accessibility. Upgrading digital infrastructure to expand access to digital networks in poor communities will be key in supporting labor participation and reallocation.
- Furthering product market reforms.Staff welcomes improvements in product market regulation, including allowing the import of products that meet European Union standards, and the free trade agreement under negotiation with the UK. Staff supports authorities' proposals to reduce

regulation of parallel imports, removal of barriers to entry of service companies to Israel, the health insurance cost reduction reform and increased financial market competitiveness.

The authorities should further advance measures to meet their commitments to reduce greenhouse emissions. Staff welcomes planned measures to support the authorities' nationally determined contribution (NDC) commitments. Staff analysis indicates that the 2030 electricity sector target is feasible; however, without reductions in other sectors, the overall target appears difficult to reach. Staff therefore recommends enacting a climate law and defining a carbon pricing mechanism, taking into account energy security needs. These measures should be reinforced by fiscal incentives across different sectors to foster private sector investment in mitigation. It is also important to look for alternative approaches based on Israel's innovative technologies for which additional fiscal support for R&D would likely be needed. Further advancing a strategy to deal with climate adaptation is also recommended.

The IMF team would like to thank all interlocutors at the Bank of Israel, the Ministry of Finance, the National Economic Council, the Ministry of Energy and Infrastructure, the Ministry of Environmental Protection, the Ministry of Transportation and Road Safety, the Ministry of Health, the Ministry of Labor, the Israel Tax Authority, the Capital Markets, Insurance and Savings Authority, the Israel Securities Authority, the General Labor Union, think tanks, associations and other private sector representatives for their accommodative flexibility, warm hospitality, and for candid and high-quality discussions.

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