INTERNATIONAL MONETARY FUND

ISRAEL: Staff Concluding Statement of the 2017 Article IV Mission

February 8, 2017

Israel is enjoying solid economic growth and low unemployment, making this an especially favorable time to undertake reforms to help sustain strong and inclusive growth. Monetary policy should continue to support the return of inflation to the target band. Major progress has been achieved in reducing public debt, a trend that should be maintained while raising potential growth through sound investments in education, health, and infrastructure. Establising deposit insurance and enhancing bank resolution tools would enable further steps to ease entry into the banking system. Recent housing initiatives may moderate prices in the near term, but deeper reforms are needed to durably enhance supply and affordability. Israel can achieve substantial productivity gains through well designed reforms, including steps to ensure that regulation achieves its public policy goals at lower cost. Progress on raising labor participation must continue. This will require greater efforts to close gaps in education and mobility, complemented by increased support for the working poor.

Recent developments and outlook

1. **Israel's economy is growing solidly and unemployment has declined, yet inflation remains low**. Early estimates are for 3.8 percent growth in 2016, although this partly reflects one-off factors especially a surge in vehicle purchases. Job creation is strong, at almost 3 percent in 2016, helping reduce the unemployment rate to only 4.4 percent by the fourth quarter, and supporting a rise in wage growth from low levels. CPI inflation was -0.2 percent in 2016, with core inflation (excluding the impact of energy costs, fruit and vegetable prices, and government measures) low yet positive at 0.4 percent.

2. **The economic outlook is positive in the near term but challenges will increase over time**. Domestic demand growth is projected to moderate but a firming in exports will help keep real GDP growth at around 3 percent in 2017. Growth is expected to remain around 3 percent in the medium term, but there are significant risks from regional tensions and from uncertain trading partner growth. Domestically, growth could be impeded if infrastructure or skill bottlenecks emerge, or if progress in closing the gaps in the labor participation and productivity of the Haredi (Ultra-Orthodox Jewish) or Israeli-Arab populations is insufficient.

Monetary policy

3. **Inflation is expected to increase gradually but there are uncertainties around the timing of this increase**. A further rise in wage growth, together with higher foreign inflation and commodity prices, makes an eventual increase in Israeli inflation likely. Yet lower import prices, in part due to the appreciation of the shekel in recent years, may continue to drag on inflation in the near term, and there is also uncertainty about when domestic wage growth will affect inflation. Moreover, margins appear to be narrowing, perhaps linked to competition from rising internet purchases, which may continue to weigh on inflation going forward.

4. **Monetary policy should remain accommodative pending a durable rise in inflation and inflation expectations**. The Bank of Israel (BOI) maintained an appropriately accommodative monetary policy in 2015-16 given spillovers from low foreign inflation and easy monetary policies in major advanced economies. This policy stance, together with the BOI's guidance that monetary policy will remain accomodative for a considerable time, has helped keep long-term inflation expectations near the center of the 1-3 percent target band. Nonetheless, there has been some decline in short- and medium-term expectations, which, together with the uncertainties around the pace of inflation increases, argues for avoiding a premature monetary tightening and waiting until inflation is heading back toward target on a durable basis before acting.

Housing and macroprudential policies

5. **Housing prices have risen to high levels as demand growth meets inadequate supply, with the heaviest impacts on low-income households**. Even after doubling in real terms since 2007, Israeli housing prices rose almost 8 percent on average in 2016. Housing completions have failed to keep pace with the formation of new households. Affordability is low, with the ratio of house prices to income rising to levels significantly exceeding those in many other countries. In the past decade, a growing share of households therefore needs to rent, and rising rents reduce the income left for other spending, especially for low-income households.

6. **Recent housing market reforms include useful measures, but some initiatives are costly and may not have lasting benefits**. Bringing the relevant authorities under the Ministry of Finance (MOF) is already expediting land planning. The Housing Cabinet has helped address financing issues and impediments to urban renewal, which should be expanded substantially to boost supply where it is needed most. Although recent tax measures may dampen price rises in the near term owing to investor sales, without a supply change the price trend is unlikely to be altered significantly. The Buyer's Price scheme helps households purchase a first house, yet it benefits relatively few households that win a lottery, and comes at significant off-budget fiscal cost.

7. **Reforms that enable a durable expansion of housing supply are needed to improve affordability over time and thereby also lower macrofinancial risks**. Municipalities face disincentives to releasing land for residential development, and to granting building permits in a timely manner, because residential property taxes are well below those on commercial real estate. Blanket agreements with municipalities are overcoming these frictions in the case of major residential projects, but correcting municipal incentives would ensure the supply of residential property becomes more responsive to demand on a lasting basis. Improved public transport provisions is important to help relieve housing shortages in major centers. Construction costs and the time to build should be reduced by streamlining extensive building regulations and further opening the residential construction market to foreign competition, which could also help ease shortage of skilled workers. Finally, municipalities could charge taxes on undeveloped privately held land to promote its use. Macroprudential measures have avoided high housing prices leading to excessive household debt and the BOI should continue to monitor developments closely.

Financial sector policies

8. **Maintaining strong supervision is critical for the continued health of Israel's financial system**. The robustness of Israel's banking system, which enabled it to come through the global financial crisis without public financial support, is underpinned by rigorous BOI supervision. While preserving these high standards, it is welcome that a more risk-focused supervisory approach is being adopted to lower compliance costs. The establishment of an independent Capital Markets, Insurance, and Savings Authority is a notable step forward. It is also important to put the Solvency II framework into operation for the insurance sector in order to ensure its resilience to shocks and thus its capacity to meet commitments to clients. To improve coordination among regulators, especially the sharing of information, the legislation for the Financial Stability Committee needs to be enacted.

9. **The Israeli authorities are taking a range of measures to promote the efficiency of the financial sector in delivering services to firms and households**. A banking ID card is available to improve information for customers. A credit register is in development, which will broaden access to credit and help lenders compete. Policies to enable electronic banking

have been established, access to the payment systems has been expanded, and scope for sharing IT infrastructure has been increased. Banks are also scaling back branch and staffing costs, aided by temporary relief in capital requirements. To promote competition, credit card companies will be separated from the two largest banks, while keeping them under BOI supervision given their importance for the payments system. Enacting the securitization legislation is important to faciliate the funding of these companies.

10. **Further strengthening the financial stability framework while reducing regulatory uncertainty is needed to fully realize the benefits of greater competition**. A more contestible banking market increases the need for deposit insurance with appropriate coverage limits, together with enhanced bank resolution tools, to protect stability and contain potential costs. Hence, both of these instruments should be established before lowering minimum capital requirements for bank entry. More broadly, in the wake of major decisions on financial sector reform, it is important to safeguard the operational independence of each financial regulator from political pressures, including to ensure that potential new entrants are not deterred by uncertainty about future regulatory arrangements.

Fiscal policy

11. **Israel extended its record of reducing public debt in 2016**. The central government deficit came in at 2.1 percent of GDP, well below the 2.9 percent target, as spending was kept within budget and revenues exceeded projections, partly owing to exceptionally high vehicle sales. General government debt declined by almost 2 percentage points to 62 percent of GDP thanks to the low deficit, strong nominal GDP growth, and significant non-debt financing.

12. **However, despite Israel's solid economic prospects, the two-year budget for 2017–18 allows higher deficits and gradually rising debt**. Central government deficit targets for both 2017 and 2018 were raised to 2.9 percent of GDP, from 2½ and 2¼ percent respectively. Some of the new spending measures contained in the budget are welcome, yet investment rises little In practice, the deficit is likely to be about 2¾ percent of GDP in 2017-18 given prudent revenue projecions and firm spending control. On existing commitments, deficits of about 3 percent of GDP can be expected in later years. The debt ratio is therefore projected to rise 1½ percentage points in the next five years, to a level that exceeds the advanced economy median.

13. **Fiscal policy should be doing more to support Israel's growth potential**. Reforms of education and vocational training, supported by additional resources, could narrow the wide gaps in educational outcomes, bolster the skills of those already in work, and help Arab women and Haredi men enter the work force. Prospects for rising road congestion threaten productivity. Timely implementation of current public transportation projects is needed, and higher than planned investment appears advisable. Healthcare services are achieving good

results, yet queues are much longer for public services, making recent steps to contain pressures on resources from private insurers appropriate, even at some budgetary cost.

14. **Funding these essential public investments in human and physical capital while protecting Israel's fiscal buffers will require a balanced approach**. Defense spending accounts for a substantial share of public expenditure (6 percent of GDP, 20 percent of central government spending), making it important during peacetime to adhere to the multi-year defense budget to contain this spending in a durable manner. Additional savings can be achieved by raising the efficiency of central government administration and by further improving public procurement. Revenues can be significantly enhanced by scaling back tax benefits (which total 5 percent of GDP), replacing blanket VAT exemptions with targetted transfers, and through planned steps to enhance revenue administration.

15. **Altogether, fiscal policy should aim to keep the deficit around 2 percent of GDP on average over the cycle**. A central government deficit on this scale (equivalent to 3 percent of GDP for general government on a *Government Finance Statistics* basis) would generate a gradual debt decline in normal times, rebuilding fiscal space after recessions result in higher deficits and debt through the automatic stabilizers. Nonetheless, if structural reforms with clear benefits for potential growth are adopted, a deficit that is somewhat higher could be appropriate temporarily if needed to accommodate upfront reform costs. Current macroeconomic conditions support making the modest adjustment needed to reach a 2 percent target in the coming years. Indeed, if the deficit is below target in 2017, the authorities should seek to lock in that over performance by not cutting taxes or raising spending without offsetting measures.

16. **Important improvements in the medium-term fiscal framework have been made, but political commitment is key to its effectiveness**. Enhanced commitment controls (the Numerator rule) improve prospects to contain spending trends. To embed this change, it will be critical for the government to observe this rule in the next few years. The recently adopted expenditure review procedure will ensure that streamlining programs for 2017-18 are implemented and help identify future budget savings. However, the medium-term budget framework remains susceptible to deviations from the fiscal rules. Including concrete measures in the budget document to close such deviations would enhance their credibility. The government should also set clear criteria for that limit changes in the spending and deficit ceilings to exceptional cases such as natural disasters.

Structural reforms

17. **Inclusiveness is central to sustaining strong growth in Israel.** Together Haredi and Israeli-Arabs make up 26 percent of the population, but 43 percent of primary school children, so they play an increasingly important role in shaping Israel's future. Great strides have been made in broadening employment, especially by Haredi women, yet much room

remains to benefit from higher labor participation by Haredi men and Israeli-Arab women. Low average wages for these groups reflect education and skills gaps, that, together with inefficiencies in sectors sheltered from international competition, leave Israel with much scope to lift labor productivity closer to the levels of leading advanced economies over time.

18. **Product market reforms are needed to increase competition, boost productivity, and reduce living costs.** Regulation should be reviewed and modernized to achieve public policy goals in a low-cost manner. Simple and timely administration of regulations, such as a "one-stop shop," is critical for the ease of doing business. State enterprise reforms would help reduce costs felt across the economy, with action in the electricity sector key to helping Israel make efficient use of its natural gas resources. Barriers to external competition should be lowered by expanding the coverage of quota increases and tariff cuts, especially on food, with targeted subsidies to support agriculture. Moreover, import procedures should be simplified, Israeli standards aligned with those in other advanced economies, and restrictions that hinder foreign competition in services eased.

19. **Reducing participation and productivity gaps calls for a range of efforts supported by increased resources:**

- **Skills.** Innovative programs to enhance the motivation and ability of Haredi men and Israeli-Arab women to gain employment are being introduced with promising results. Over time the resources allocated to these programs (currently only 0.2 percent of GDP) should be expanded. Close coordination with employers is especially important to ensure the effectiveness of this spending.

- **Jobs**. More jobs are needed in, or close to, Haredi and Israeli-Arab communities. Investments in connecting their towns to main roads need to be increased, alongside improvements in access to public transport. Other supports for local business development, including access to financing, are also needed.

20. **Strengthening progress toward goals for poverty reduction also requires additional support for the working poor**. The minimum wage has risen significantly in recent years, to reach about 51 percent of average wages, which is among the highest by international standards. The priority now, is to substantially increase the Earned Income Tax Credit (EITC), which currently averages just 7 percent of the minimum wage, at a total fiscal cost of only 0.1 percent of GDP. Eligibility for the EITC should be expanded, including by lowering the minimum earnings threshold. These steps would give families greater capacity to support the education and health of their children, while reinforcing incentives to work.

The mission team thanks the Israeli authorities and other counterparts for the excellent discussions and greatly appreciates their warm hospitality.