Stanley Fischer: The Israeli economy

Acceptance speech by Professor Stanley Fischer, Governor of the Bank of Israel, for an Honorary Degree, Hebrew University, Jerusalem, 11 June 2006.

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It is a pleasure and an honor for me to speak today as the recipient of an Honorary Doctorate of Philosophy from the Hebrew University, and it is an even greater honor to have been asked to speak on behalf of my distinguished fellow honorees.

I would like to start by congratulating the students on whom doctoral degrees are being bestowed today. You have earned the congratulations and good wishes of all for the ability and dedication you have shown in completing your doctorates, and we wish you every success and happiness in your future careers.

By European and American standards, this is a young university. Its founding ceremony took place in 1925, at this spot, in the presence of Lord Balfour, Viscount Allenby, High Commissioner Herbert Samuel, Haim Nachman Bialik, Nahum Sokolov, Harav Kook, Harav Meir, and 10,000 others. That extraordinary turnout testifies to the importance the inhabitants of the Yishuv and of the Zionist movement attached to the founding of what they called the University of the Jewish people. The University already possesses a proud history, an essential part of the history of modern Israel, of the history of the Jewish people and their successful but ongoing struggle to establish a modern state in the ancient land of our forefathers.

Each of the honorary degree recipients here has been closely associated with the Hebrew University in the past, and for each of us this day brings back memories, of times, of colleagues, of friends. In my case among the personal memories are those of Don Patinkin, former President of the University, of Yoram Ben-Porath, also a former President of the University, and of Michael Bruno, former Governor of the Bank of Israel. And for many of us, this spot and this occasion will always be associated with the image of Yitzhak Rabin, receiving an Honorary Degree from the University immediately after the Six Day War.

For me, the Hebrew University has always been special. When I graduated from the London School of Economics it was at the Hebrew University that I most hoped to teach. Later I did teach here, but as a visitor on sabbaticals, not as a faculty member. This is the community in which Rhoda and I have formed some of our firmest and most lasting friendships. Each of my fellow honorees can talk of the friendships and the attachments they have formed among this community of scholars and in this city. And every one of us will attest to the joy and the pride we feel at being recognized by our colleagues of the Hebrew University of Jerusalem.

I have been asked to talk today about the Israeli economy. In brief, the economy is doing well. It grew by 5.2 percent last year, and the data for the most recent quarter show an acceleration of growth. Current forecasts are that the economy will grow by about 5 percent this year again. The budget deficit last year was below 2 percent, and it is likely to be below 1 percent this year. Our inflation rate is low. The exchange rate of the shekel is remarkably stable despite – or perhaps because of – the fact that the Bank of Israel has not intervened in the currency markets since 1997, and does not intend to do so except in truly exceptional situations. We have a current account surplus. The unemployment rate is declining, though unfortunately we have not yet seen a decline in the poverty rate.

We are about to enter the fourth year of growth that began in the middle of 2003, at the end of the deepest recession in the history of Israel. That recession started late in 2000 as a result of four adverse shocks to our economy: the collapse of the high-tech boom and the Nasdaq bubble that had enabled so many Israeli high-tech startups to flourish; the global recession that started in 2001; the tailing off of the immigration from the former Soviet Union to Israel; and the second intifada. It was worsened by an inconsistent set of policy responses to the recession.

By 2003 the global recession was ending, and in 2004 growth was higher than it had been in twenty years. The high tech sector was recovering. The security situation in Israel improved markedly. And the Israeli government in 2003 committed itself to a fiscal framework designed to restore confidence in Israel's ability to finance itself, to reduce the share of government spending in the economy, and gradually to reduce the tax burden. The government also initiated a program of structural reforms, including privatizations that had been talked about for at least 20 years, and reforms of the benefits system designed to reduce disincentives to work.

Over the past three years the government has carried out the program to which it committed itself. This, together with a well-defined inflation-targeting approach to monetary policy, has contributed to strengthening the confidence of Israelis and of foreign investors in the Israeli economy. That confidence is manifest not only in the recovery of growth, but also in the relative stability of our financial markets and of the shekel, most evident during the last few weeks in which general concerns about emerging market countries have led to significant currency depreciations and sharp stock market declines in other countries.

This is an impressive performance. But we need to set it in perspective. It was only in 2005 that per capita income in Israel returned to its level in 2000. If we are to move beyond our current status, where our income level is about that of the poorer European countries, below Spain, above Portugal, close to that of Greece, we need to keep growing, and rapidly. Per capita income in Israel is about $18,500. If the economy grows at 5 percent for the next decade, we will reach a per capita income level above $25,500. That would make a real difference to our standard of living and our ability to contend with the range of issues facing us, including poverty, and the security situation.

What would it take to keep the economy growing at a rapid rate for a prolonged period? First, a factor that is beyond our control: the global economy needs to keep growing. Second, a factor that is partly under our control: our security situation. Standing here, on the eastern side of Jerusalem, with a view behind us to the West Bank, we must be aware of our need to find a way to live with our Palestinian neighbors.

Third, a set of factors that is entirely within our control: our own economic policies. We need a general approach to economic policy that relies primarily on markets to allocate resources, while recognizing the essential role of the state, especially in the provision of public goods. At the same time, we need to accept the fact that no small economy can flourish except by integrating into the global economy, as Israel has so successfully done over the past fifty years. Indeed, the opening of the capital account in the last fifteen years, the end of foreign exchange controls, has had a profound and positive effect on the entire economy.

In macroeconomic policy, we need to maintain the fiscal discipline that has served us so well for the past three years. We still have a government debt to GDP ratio that is too high and that makes us vulnerable to any serious loss of confidence in the Israeli economy, by Israelis and by foreigners. To reduce the debt to GDP ratio we need to keep budget deficits small, and we need to keep growing. Government spending as a share of GDP in Israel is still very high by international standards, and needs to be reduced. Tax rates should continue to decline, as already planned. It is possible to do all that while leaving room in the budget to increase social and other essential government spending.

We can help alleviate poverty in the short run by restoring some of the cuts in welfare spending, particularly for the elderly and for the disabled, which were undertaken to get us out of economic crisis three years ago. But in doing so, we need to maintain and strengthen incentives to work for those able to do so.

In the long run, the best way to improve the welfare of the poor is through growth. And in the long run, growth comes primarily through technical progress, through improvements in knowledge and the ability to apply that knowledge to production. That is obvious in Israel, where the high-tech sector has played such a prominent role in our growth.

Here is where higher education and the universities come in. The creation of the Hebrew University is in many ways a miracle. It was no small matter to establish a university that meets international standards in a community as small as that of the Yishuv in Palestine, as far as it then was from the centers of academic life. Idealism, Zionism, and – sadly – the destruction of the Jewish communities in Europe, helped strengthen the University in the pre- and post-World War II periods.

It is also no small matter to have established a system of higher education as good as that in Israel. But the university system is under serious strain. At one time almost all Israelis who went abroad for Ph.D's returned. Now most do not. That is partly a matter of relative salaries, it is also a matter of the unavailability of positions. If the universities are to remain strong, indeed to become stronger, and to help keep Israel at the scientific frontier, they need more money.

That money does not have to come from the government. Some of it can come from the licensing and sale of intellectual property, an approach in which the Hebrew University has been very successful.

But that will not be enough. To strengthen the universities, it will sooner or later be necessary to charge more to the students receiving university education. That can be done without compromising the right to a higher education of any qualifying student, for instance through some variant of the Australian plan which provides loans to students, which they repay as they enter the labor force and begin to earn.

In the past Israeli students have strongly objected to any significant rise in tuition. That is understandable. But significantly higher tuition payments are needed to enable the universities to attract the faculty they need and to continue to contribute to advancing Israel's technological progress and prowess.

In concluding, I must apologize for making so utilitarian an argument for strengthening the universities. For a good university is far more than a source of technological progress; it is a repository and source of knowledge, of culture, of values, of civilization. That too is why a society – why Israel – needs to cherish and support its universities and its system of higher education.

Thank you.