

## **Stanley Fischer: Challenges confronting the Bank of Israel and the economy**

Address by Professor Stanley Fischer, Governor of the Bank of Israel, at the President's residence on the occasion of his appointment for a second term as Governor of the Bank of Israel, Jerusalem, 2 May 2010.

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Mr. President, Mr. Prime Minister, Madam President of the Supreme Court, the Minister of Finance, members of the Government, members of the Knesset, Honorable Ambassadors, former Governors of the Bank of Israel, leaders of Israel's banking and business sectors, members of the management and staff of the Bank of Israel – my colleagues and friends, representatives of the media, members of our family, friends and honored guests:

I would like to thank the Prime Minister, the Minister of Finance, and the government for nominating me for a second term as Governor of the Bank of Israel, and thank the President for agreeing to the nomination, and for his warm words. I am grateful to the government and especially the Prime Minister for the trust they have placed in me.

It continues to be an honor and a privilege for me to lead the Bank of Israel, and to represent our country at home and abroad.

I would like to express thanks to many others who have played an essential role in the operation of the Bank of Israel over the past five years: to the dedicated and highly professional management and staff of the Bank of Israel, without whom the Israeli economy would not have come through the global economic crisis as well as it has, and whose capacities and outstanding professionalism are recognized world wide; to the many citizens of Israel who have expressed their support in different and often touching ways; to friends and family who have made living in Israel a pleasure for Rhoda and me; and above all to Rhoda, who has shared in the ups and downs of each day's events in the Bank of Israel and in the country, and whose love and support have sustained me in this period, as in the previous forty years.

Five years and one day ago, standing in this same place, as a new immigrant, I said that the history of Israel's economy is fundamentally a success story. After the ceremony several friends politely told me that I didn't understand the real situation. In some respects they were right. But not about the strength of our economy. Between the middle of 2003 and the middle of 2008, we grew at an annual rate of over 5 percent. Then we were struck by the worst global crisis in 80 years, and as everyone knows, we came through it relatively well. The most recent data confirm the strength of the recovery taking place in our economy.

This success is based on two factors: a sound economic policy framework; and a vibrant and innovative private sector. The economic framework combines the basic approach of integration into the world economy – in light of the fact that a small open economy like ours has no chance of succeeding on its own – with an understanding of the need to maintain a sound macroeconomic framework, through fiscal discipline and a monetary policy dedicated primarily to maintaining price stability and thus the purchasing power of the shekel. With regard to fiscal discipline, I want to pay tribute to the Minister of Finance and to his predecessors, as well as to the professional staff of the Treasury, who can be relied on to fight for sound budgets, and whose efforts have been essential to the successful development of the economy.

The private sector has been the engine of growth of the economy for the last quarter century, and the success of Israeli innovation and enterprise is the envy of many countries. The private sector does not need much from the government in order to succeed – primarily it needs a clear and predictable market-oriented economic framework in which to operate, and

a set of incentives that encourages the entrepreneurs and the professionals who are essential to our success to work and invest in Israel.

There has been a great deal of attention in recent weeks to the very high incomes that are earned in parts of the private sector. Some incomes in some sectors, including the banking industry, do seem to be too high, but we need to be very careful in dealing with the problem, for we can all too easily exaggerate and cause severe damage to the Israeli economy. The Supervisor of Banks has sent instructions to the banks on salaries, and is closely monitoring their implementation and the need for additional measures to deal with the pay of senior management. With regard to other public companies, we must find a way of strengthening the supervision of managers' salaries by Boards of Directors.

Our economic success is the basis for our possible acceptance later this year into the OECD, the organization of the most advanced economic countries. These achievements are essential not only to the economic wellbeing of Israelis, but also to the existence of the state of Israel, the Jewish state, our hope of two thousand years. Over the longer term, we need to be economically successful no less than we need to be able to defend ourselves militarily. These two factors – the economic and the military – are intertwined, and their interconnections are very complex, too complex to begin to discuss today.

To describe our success to date is not to say that all is well in the economy and the society. For much is not well, and we face many challenges. I start with the challenges confronting the Bank of Israel, the first of which is the implementation of the new Bank of Israel law, passed recently by the Knesset. The law is designed to protect the independence of the Bank of Israel, within a framework that will revolutionize decision-making processes in the Bank, and further increase our transparency and accountability to the Knesset, the government, and the public. In the last five years we have gone a long way in increasing transparency, including by publishing the minutes of the meetings in which interest rate decisions are made. In addition, the law clearly defines the policy goals and the responsibilities of the Bank, and clarifies working relationships between the Ministry of Finance and the Bank of Israel in areas where we overlap.

The new law sharply constrains the power of the Governor of the Bank. Today, and for the last fifty six years, the Governor alone has made both the policy and the managerial decisions in the Bank. Under the new law, monetary policy decisions will be made by the Monetary Policy Committee, which has six members, three of them external to the Bank, with the Governor as chairman and with a double vote in cases of a tie. Major administrative decisions will need the approval of the Board of Directors, which has seven members, five of them external, with one of the external members being appointed as Chairman.

Why did we propose these new arrangements? Because experience and research have shown that on average committees make better decisions than a single individual. For that to happen, the members of both committees have to be chosen for their professional capabilities, and not on a political basis. The appointments process specified in the new law for choosing the members of the two bodies is designed to prevent political factors from influencing the choice of their members. Further, I neither expect nor want either internal or external members to vote as a bloc – insiders versus outsiders. Rather each member should exercise her or his independent professional judgment on the issues at hand.

The most important non-policy task confronting the Bank of Israel in the next few years is to make the new system of governance of the Bank work effectively for the good of the economy and the citizens of Israel. That will not be easy, but we know that what we do now will establish the decision-making processes of the Bank until the next law of the Bank of Israel is passed, somewhere around 2066. So we had better get it right.

Implementing the new law requires the Bank of Israel to achieve, as far as possible, the goals of monetary policy as set out in the law: first, to maintain price stability; second, to support the other goals of government economic policy – particularly growth, employment

and the narrowing of social gaps, so long as this does not conflict with price stability over the course of time; and third, to support the stability of the financial system.

In implementing the new law, we will have to draw the lessons of the global crisis, the Great Recession. Among the most important lessons are those being drawn about the structure and regulation of the financial system. The Supervisor of Banks is carefully following the regulatory reforms in the area of corporate governance and risk management suggested by the newly established Financial Stability Board and the Basel Committee, and where relevant, is adapting them and requiring their implementation in the Israeli banking system. In addition, we are studying the new topic of macroprudential surveillance, and considering its implementation.

We will also have to take another look at the overall system of financial sector supervision in Israel. Our financial system emerged from the crisis in relatively good shape, but the crisis nevertheless revealed several weaknesses that need to be corrected.

The second set of challenges I want to discuss are those confronting the economy and society outside the direct policy responsibility of the Bank of Israel, those that relate to the role of the Governor as the economic adviser to the government. Many of these issues are analyzed in the Bank of Israel's Annual Report for 2009, which was published recently.

Broadly speaking, the two wider economic challenges that confront us are to maintain and even accelerate the growth rate of the economy, and to reduce poverty and social gaps. These two goals are closely related, for the most important way of reducing absolute poverty is through sustained economic growth, even though in the short term there may be a trade-off between growth and the reduction of social gaps.

The government has already announced ambitious plans for infrastructure – especially transportation – projects to be undertaken starting in the near future. These and other projects in the water, electricity, and ports areas are essential for growth to be sustained in the long term.

The educational system and our educational achievements are critical to the achievement of sustained growth, and trends in this area are extremely worrying. We do not have one educational system, we have many. There is no core curriculum that ensures that every student learns the basic skills that are needed to compete in the ever-changing global economy. Our results in the OECD's PISA (Programme for International Student Assessment) tests are woeful, and we are falling in the international rankings.

We cannot build the nation and our future if we do not educate our people – all our people – to equip them to live in the modern world. At some point, the sooner the better, we have to confront the separate educational systems and their political context, and stop and reverse the deterioration of our educational standards.

We are all concerned about the growing social gaps in our society. Naturally we think of the gaps between the very top salaries and those at the bottom of the salary scale. Those trends too are worrying, and they are not easy to deal with, though improving the educational system will surely contribute to creating a more just society. But in thinking about social gaps, we need to recognize that the biggest gaps are between different groups in our society – among the Arab sector and the haredi sector in which poverty is concentrated – and the remainder of our society. So we need also to focus our attention on increasing the educational achievements and the labor force participation of those groups – and this is an even more difficult, but no less essential, task.

The notable successes of the Israeli economy and Israeli science, signified by the Nobel Prizes awarded to Israeli scientists this decade, are based on the educational system of Israel of thirty to forty years ago. We need to restore the quality of both the school system and the system of higher education if we are to maintain the qualitative edge on the basis of which the Israeli economy has thrived and on which Israel's future depends.

In this context we have recently seen the first signs of positive reform in the educational system, and we hope this will continue and yield the desired results.

Improving the educational system will require both reforms and financing. The government has recently passed a new fiscal rule to determine the growth rate of government spending, accompanied by a declining path for the budget deficit and the government debt to GDP ratio. The government has also announced its intention of continuing to cut marginal tax rates, with the goal of encouraging growth. Provided the economy can return to growth at about 5 percent – which looks somewhat ambitious at present – both the deficit and the tax rate cutting targets can be met. But if growth is slower, the government will have to decide whether to cut the growth rate of government spending, or rather forgo some of the planned tax rate decreases, or to do some of both. This will be a difficult decision. In making it the government will have to weigh the benefits of maintaining government programs in a variety of areas, including education, against the benefits of cutting taxes.

In international comparisons, Israel is typically somewhere around 25–30 in the country rankings as a place in which to do business. We seem to be unusual in the variance of the rankings of the individual components of the indices: we do well on the ease of financing and the openness of the economy; we do not well on the complexities of the tax system; and we do very badly on bureaucracy. I fear also that in years to come we will do much worse on the corruption index. If we are to sustain growth, we need to reduce bureaucracy and fight the corruption that so often accompanies it. These too are not easy tasks, but they are essential for the wellbeing of Israeli society.

Israel's economic record is all the more remarkable for having been achieved despite our not being at peace with all our neighbors. Even in the last five years, we have twice fought limited wars against neighbors. This economy, with its dynamism and creativity, could grow much faster if we were to achieve peace with our neighbors – and there are of course much better reasons than economic growth to hope and work for peace with our neighbors.

This is an ambitious agenda. If we were to achieve it, we could within one or two decades find ourselves living in one of the most advanced economies in the world.

Is it possible? Yes, entirely. If you wish it, it is no legend – but it will take extremely hard work and determination to turn the wish into reality.

Thank you.