Stanley Fischer: Global economic developments – implications for Israel's economy

Summary of an address by Professor Stanley Fischer, Governor of the Bank of Israel, at a press conference on the occasion of the departure of the Bank of Israel delegation to the annual meeting of the IMF and World Bank in Washington, Bank of Israel, Jerusalem, 18 September 2011.

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This meeting is being held on the occasion of the departure of the Bank of Israel delegation to the annual meeting of the IMF and the World Bank, which will discuss global economic developments. I will therefore start with a description of the situation in that area. The global economy is experiencing a slowdown, which was a surprise mainly in the US, for which the forecasts of growth have been reduced by more than 1.5 percentage points since March. The data for the first quarter were revised downwards, so that in total the US economy grew by less than one percent in the first half of the year. The President presented a program, amounting to some 3 percent of GDP, to support economic growth, but despite that program growth is still expected to be low. The Fed may announce a program of quantitative easing, this time based on especially long-term bonds. Such a program is expected to be controversial, but the Fed does not currently have at its disposal the standard tools for coping with the slowdown.

Europe is facing a serious problem of government debts, and insurance against the default of various countries has become significantly more costly – while Israel's CDS (credit default swap) spread is 188 basis points (b.p.) (1.88 percent), Greece's has risen above 5,000 b.p. (50 percent), and Spain's is about 400 b.p. The slowdown in Europe so far has been relatively moderate, but the problems are expected to affect growth mainly in 2012, when growth in the eurozone is expected to be only 1 percent. Initial estimates suggest a slowdown also in world trade, with trade in goods at a standstill since March. This standstill leads to a slowdown also in Israel's exports, which constitute one of the most important engines of growth for the economy.

The above developments are taking place against the background of a very interesting process in which the center of gravity of the global economy is moving towards Asia. The scenario we are currently witnessing – with the Europeans speaking with the Chinese and with other BRIC (Brazil, Russia, India, China) countries about the support those countries will make available to help stabilize the markets in Europe – was unimaginable a mere 15 years ago.

The global slowdown has implications for Israel's economy. Interest rates in the major economies are expected to remain low for several years, and this will affect Israel's monetary policy. The slowdown has a direct impact on the demand for Israel's exports. The situation in Europe is likely to have a negative effect on financial stability there, and hence on global financial stability too. This concern has already been reflected in the price of bank shares in Israel. Nevertheless, Israel's economy has reached this situation in a good condition: GDP has grown at good rates in the last several quarters, and unemployment is at its lowest level in about 30 years. The exchange rate of the shekel against the dollar has weakened in the last few months, and is expected to help exports. The trends in the current account are changing: after growing accustomed to a surplus in the last few years, we now expect the current account to be more or less balanced next year. Israel's economy can certainly exist in the environment of a balanced current account, but it is a new situation with which we must familiarize ourselves. The interest rate in Israel is higher than those in the large advanced economies, and there is space for an interest rate cut should the need arise.

Israel's economy received a well deserved recognition for its successful achievements in the last eight years, expressed by the recent improved credit rating. In the statement accompanying the revised rating, the rating agency stressed Israel's robust budget policy and wise monetary policy, as well as the determined supervision of the banking system. Nonetheless, the statement also emphasized the threats on the horizon, and we must continue to adhere to the correct policies that will justify the higher rating we have been afforded, and persist in supporting the economy's strength in the future.

The issues that led to the outbreak of the recent demonstrations and to the formation of the Trajtenberg Committee are serious ones, and reflect serious problems in Israel's economy. Many of the issues relate to the high cost of living. Professor Manuel Trajtenberg is an excellent economist, and he is experienced in formulating policy recommendations. His appointment as head of the Committee was an excellent decision, as was his choice of the other members of the Committee to work with him, including, of course, the Deputy Governor of the Bank of Israel, Dr. Karnit Flug. It is premature at this stage to refer to the Committee' recommendations, as it is due to meet several times more before it formulates its proposals and publicizes them. We do know, however, that the recommendations are expected to remain within the budget framework, and not deviate from it. In this context we must point out that for two years we have been stating in the Bank of Israel Annual Report that from 2013 the various fiscal rules are inconsistent with each other, as the planned tax reductions are not consistent with the planned path of an increase in expenditure and reduction in the deficit – growth of close to 5 percent will be needed to avoid exceeding the target deficit.

The Committee for Examining and Encouraging Competition is also currently active and is expected to publish its recommendations shortly. This too is a serious and professional committee, and Karnit Flug represents the Bank of Israel on it, together with the Supervisor of Banks, David Zaken. I expect that this committee will provide a good, although not simple, solution to the problem of concentration in the economy, and will demand a lot of work from policy makers in the implementation of its recommendations.

The geopolitical situation is definitely worrying, and the negative scenarios, should they occur, are liable to have negative consequences for Israel's economy. These scenarios do not depend on the Bank of Israel's policies, but yet we have to be prepared for the possible impact on the economy, and we hope that in the end, the negative scenarios will not unfold.

What should we do, then, in the future? We must maintain the fiscal framework. It is possible that there will be an increase in the deficit as a result of the automatic stabilizers in the case of a sharp drop in GDP growth, but it would not be correct to take the initiative to increase the deficit beyond the possible activity of automatic stabilizers. Monetary policy will have to take into account developments in inflation, growth, interest rates abroad, the exchange rate, and balance of payments. Next week we will have to make an interest rate decision against the background of all these factors, and it will not be an easy decision. Likewise, we must continue our determined policy of supervision of the banking system, through cooperation with the banks. In connection with this, concerns are growing about the credit repayment ability of several companies in the economy, and we must be aware of that.

Many are now asking if the current situation is worse than what happened in 2008. In some respects, there is a similarity-now, like the eve of the crisis of 2008, we are seeing negative scenarios in the global economy, but we don't know if they will develop to the same level of severity as in 2008. In any case, we are refreshing the policy tools and the scenarios which we faced in 2008, but we must take into account that the next crisis, if it happens, will not be identical to the previous one, and we will need to adjust the policy response where necessary.

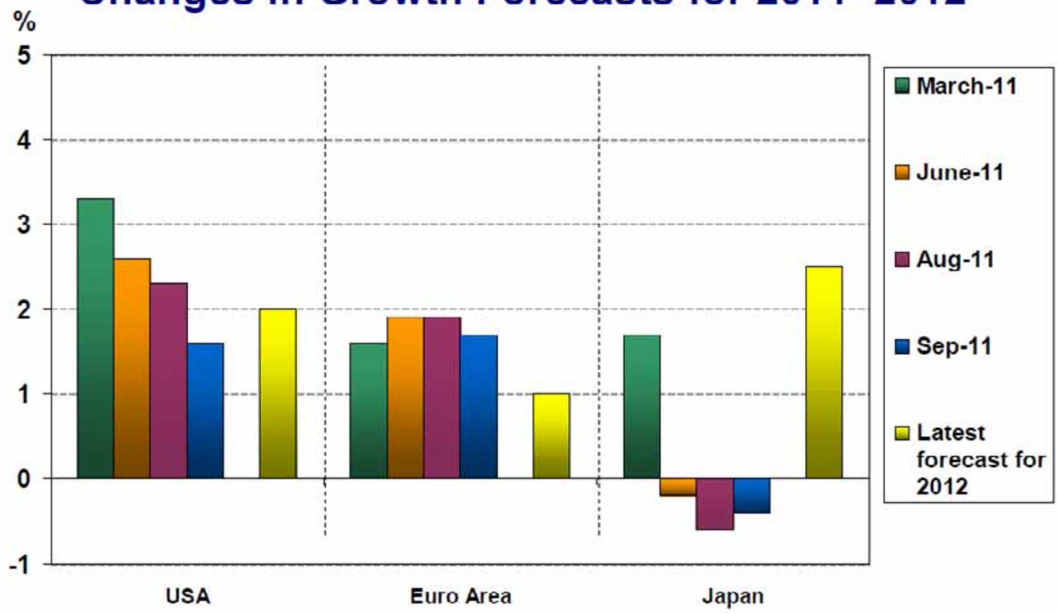
I would like to raise two points in conclusion:

The first point relates to the discussions regarding concentration. A lot is said about the people described as "tycoons". It should be remembered that the "tycoons" are acting within the existing legal framework, and they have done nothing criminal. Referring to them as people who have committed a crime is populistic – a populism which is easy in the short term, but dangerous in the long term.

The second point is that the economic reality in the near future will not be simple. With that, the Israeli economy is in a strong position, and we have the ability to deal with the reality which we face. It is important that we continue to take responsible policy steps as we prepare for this encounter.

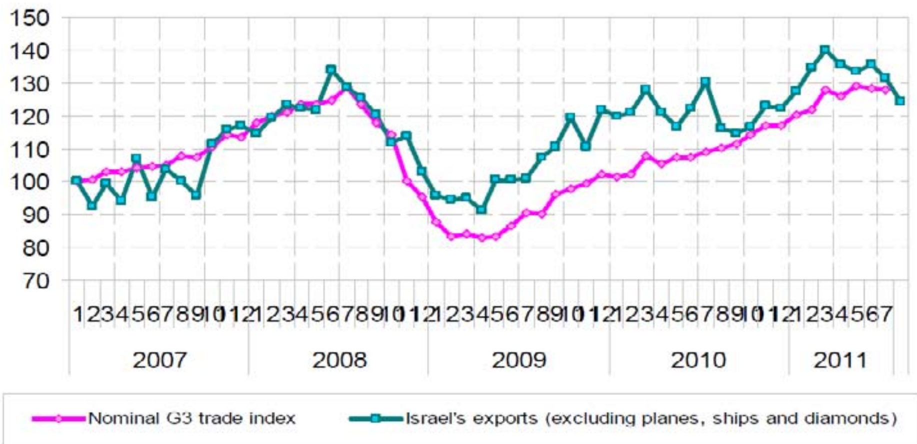
A happy and sweet new year!

Changes in Growth Forecasts for 2011–2012



SOURCE: The Economist.

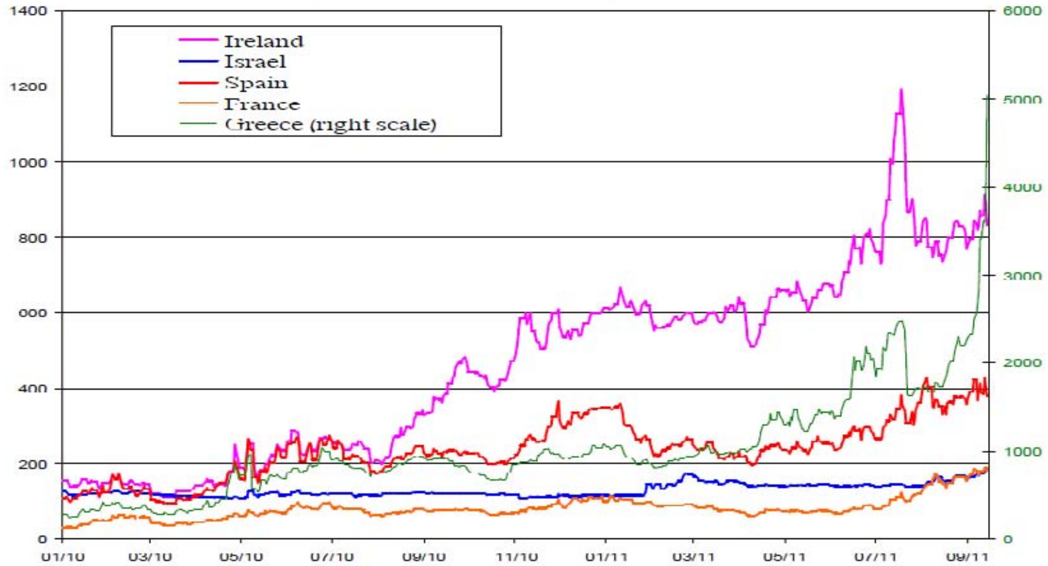
Israel's Exports and the G3 Trade Index,*
January 2007 = 100



*The G3 trade index is a weighted measure of the total foreign trade of the US, Germany and Japan. The index serves as an early indicator for global trade.

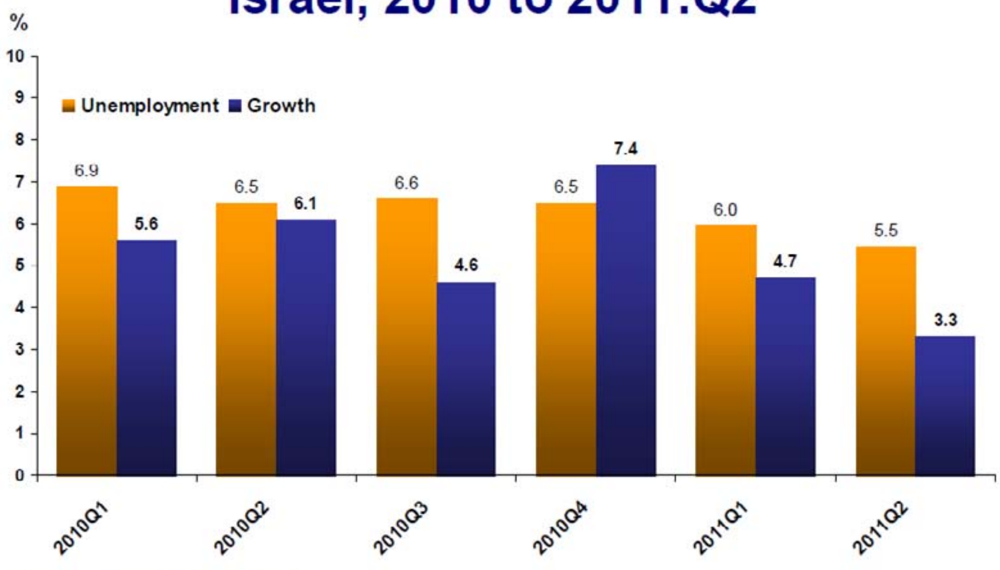
SOURCE: Bank of Israel.

CDS* Spreads in Selected Countries, January 2010 to September 2011

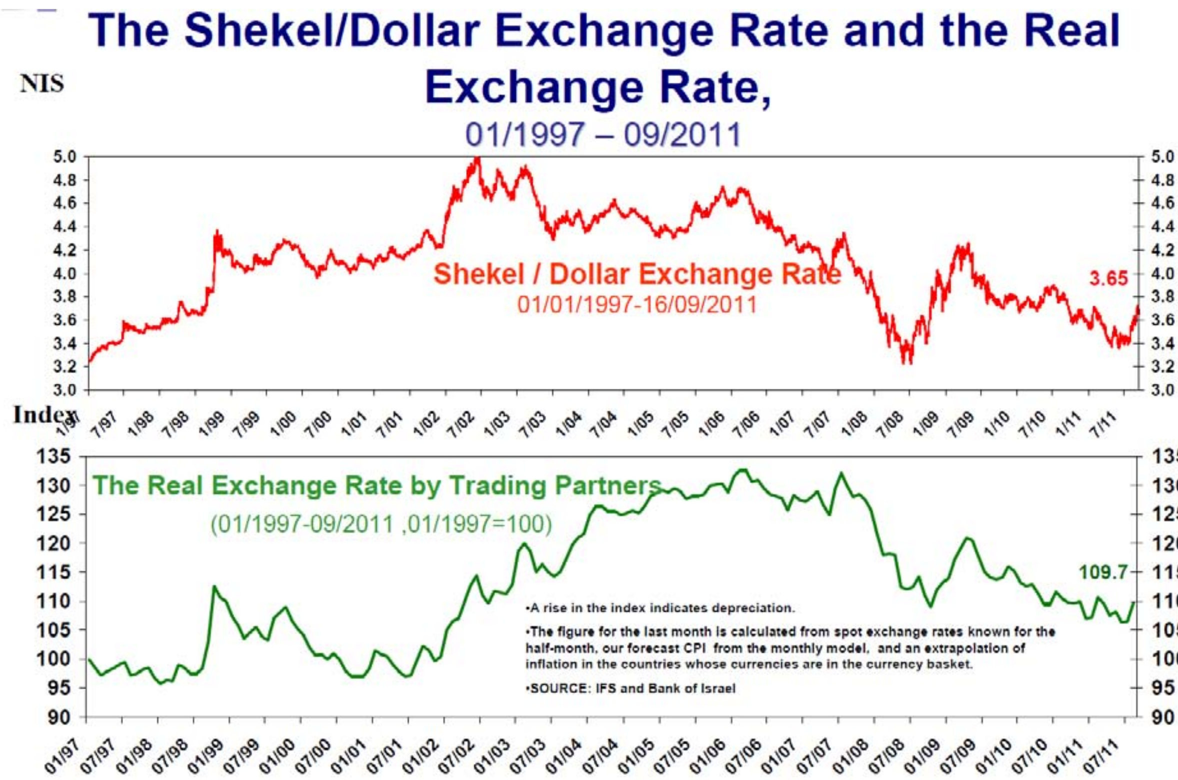


* Credit default swaps.
SOURCE: Bloomberg.

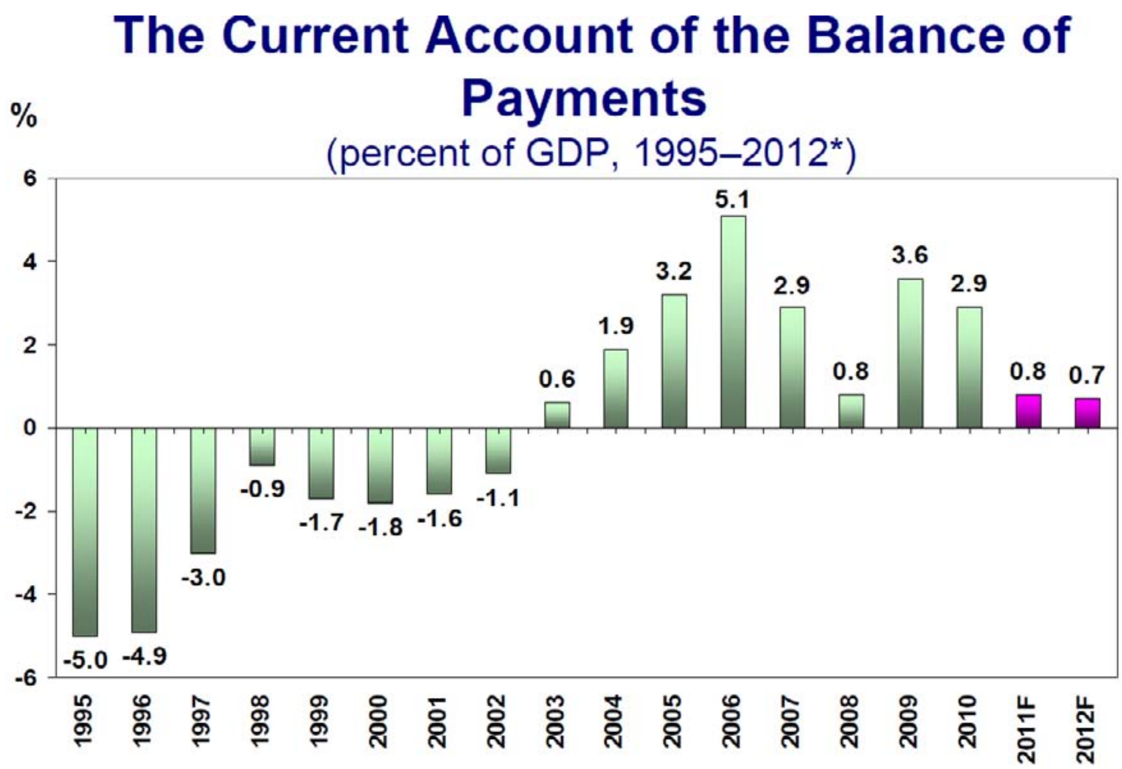
GDP Growth Rates and Unemployment in Israel, 2010 to 2011:Q2



Quarterly data, seasonally adjusted
Growth data: rates of change from previous quarter, in annual terms.
SOURCE: Bank of Israel.

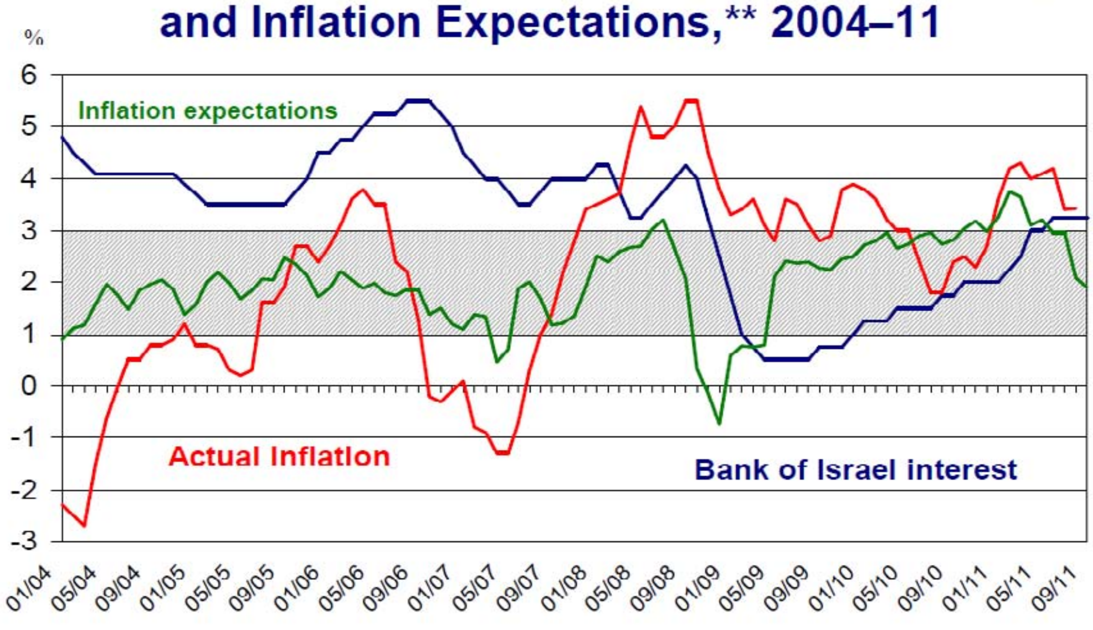


➢ The NIS/$ chart is on a daily basis, while the real exchange rate chart is on a monthly basis.



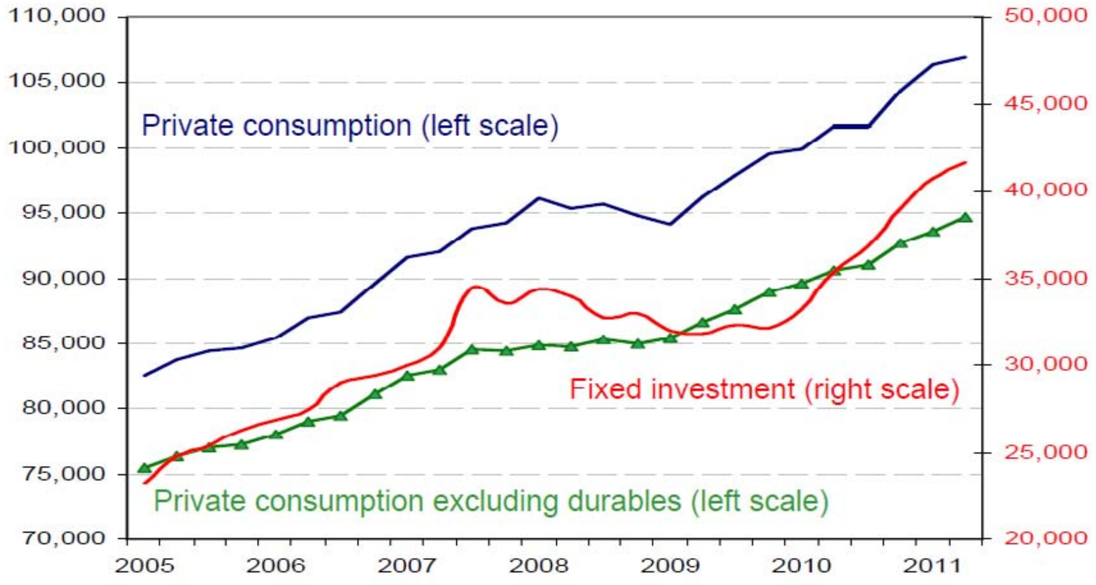
* Bank of Israel forecast for 2011 and 2012.

The Bank of Israel Interest Rate, Actual Inflation,* and Inflation Expectations,** 2004–11



* In the previous twelve months.
** Twelve months forward, calculated form the capital market.
SOURCE: Bank of Israel.

Consumption and Investment
(at constant prices, seasonally adjusted)



SOURCE: Bank of Israel.