

Karnit Flug: The challenges facing short- and long-term economic policy

Main point of remarks by Dr Karnit Flug, Governor of the Bank of Israel, at the Calcalist conference “The challenges facing short-and long-term economic policy”, Tel-Aviv, 30 December 2015.

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I would like to relate in these remarks to the challenges facing macroeconomic policy: monetary policy, under the auspices of the Bank of Israel, which is focused on smoothing the short-term effect of volatility in the economy (business cycles) on inflation and on growth and employment; and fiscal and structural policy, which is focused on achieving inclusive growth that will support an increase in the standard of living of the entire population over time.

Two days ago, the Bank of Israel Research Department published its macroeconomic forecast for the coming two years, from which we can assess the trends forecast *for the short term*. The growth forecast was revised downward, influenced by a further downward revision of global growth and global trade forecasts. The forecast projects continued moderate growth of 2.8 percent in 2016, and some acceleration in the following year. Exports are expected to grow in accordance with the global trade forecast, and private consumption is expected to moderate slightly, following a relatively sharp increase in 2015.

This is the main scenario of the forecast. However, it is important to remember that there is uncertainty surrounding the forecast – as there is with any forecast – as presented graphically in the fan chart (which presents the range of projections with a likelihood of 66 percent). Some of the uncertainty regarding growth in Israel is derived from similar uncertainty that exists in relation to the global environment that will exist during that period. It is important to remember that monetary policy affects inflation and growth with a lag. In other words, it is forward-looking, and therefore, by definition, it operates under uncertainty.

Another illustration of the uncertainty, as well as the dynamism, of the environment in which we are operating can be seen in the significant revisions of the forecasts made by the international organizations (in this case the IMF) in relation to global growth and – even more importantly for the Israeli economy – in relation to growth in global trade. During the past year, the forecast for global trade was revised downward by 2 percentage points for each of the years 2015 and 2016, which obviously has an impact on the forecast for Israeli exports, and therefore on the growth of the economy in general.

As we know, inflation has been very low for the past two years – far below the inflation target – and is expected to remain low during the coming year as well. Despite that, it is important to note that the inflation target regime continues to enjoy trust, as shown in the medium and longer-term inflation expectations. The low inflation is to a large extent the result of commodity and energy price declines and of price reductions initiated by the government. In the past year, these factors were responsible for a 1.7 percentage point decline in the CPI, such that the CPI excluding these factors increased by 0.8 percent. In this context, it is important to emphasize that monetary policy does not aim to offset such one-off factors, but rather is forward looking, and acts to gradually return inflation to within the target range. By the way, for the coming months, the government has already made decisions to reduce prices that together come to 0.4 percentage points of the CPI.

Another factor that has an impact on both activity and inflation is obviously the exchange rate. The (effective) appreciation of the shekel, which is impacted by the surplus in the current account and by the very accommodative policies of the major central banks, makes it difficult for exports to grow under conditions where demand for Israeli exports is in any case moderate, and acts to further moderate inflation. Our assessment is that at its current level, the shekel is over-appreciated relative to what is in line with the basic economic forces, and we are therefore continuing to operate in the foreign exchange market.

Against this background, the Bank of Israel has used a variety of policy tools: an accommodative interest rate policy, together with a declaration that the Monetary Committee's assessment is that policy is expected to remain accommodative for a considerable time, intervention in the foreign exchange market in order to prevent an even sharper appreciation, and a series of prudential measures to deal with the risks inherent in the housing market.

Another factor taken into account in the Bank of Israel's policy is the housing market. Home prices that have been increasing since 2007, and with them mortgage volumes, and which have also been affected by the low interest rate environment, are sources of concern to us from both the financial stability aspect of borrowers' ability to repay, and the social aspect of affordability – the economic ability of a household to provide itself with housing services. It is therefore important to continue dealing with the problem comprehensively through a continuing increase in the supply of homes in high-demand areas. In practice, the increase in supply reacted with a large lag to the increase in demand. Government measures in this matter, and a focus of efforts on shortening the planning process together with specific programs, will contribute to change.

The monetary policy tools support economic activity in a moderating global environment, and a return of inflation to within the target range. Accommodative monetary policy, which acts to moderate the cyclical effects of the global environment on the Israeli economy, can enable the government to focus its policy on the long-term challenges to achieving inclusive and sustainable growth.

The long-term challenge – inclusive and sustainable growth

I would now like to focus on two main challenges facing the government: increasing the growth in productivity, which will contribute to an increase in earning power and in growth; and narrowing gaps and reducing the dimensions of poverty.

Productivity in Israel is lower than in other advanced economies. While countries with low per capita GDP generally grow faster and reduce the gap relative to other countries, the growth in productivity in Israel is moderate and is not narrowing the gap vis-à-vis other countries. There are various causes of this, which the Bank of Israel has already discussed at a number of opportunities. The low productivity is particularly prominent in the industries that focus on the domestic market and that are not exposed to international competition – industries in which product per work hour is low by any standard.

Earlier I presented the short-term macroeconomic forecast. In preparing the long-term forecast, there is, obviously, greater uncertainty. The result of the simulation based on demographic trends is worrying. The expected trends of growth in the proportion of the population characterized by low labor force participation rates and low earning power, alongside the aging of the population and the dissipation of the contribution of the increase in education in the coming years, indicate that the “automatic pilot”, meaning the expected increase in GDP absent a change in policy, will reflect a marked slowdown in the projected rate of growth. If we add to that the widespread assessment that the growth of global trade will also be moderate in the coming years, then without a policy focused on increased productivity, the standard of living that the Israeli economy can provide to its citizens is expected to become more distant from that at the forefront of advanced economies.

Beyond the low productivity and its slow growth, the Israeli economy is also characterized by high levels of inequality and poverty. Inequality in economic income – income before taxes and transfer payments – is not exceptional by international standards. But the tax and transfer payments policy is less active than in other countries in reducing inequality. Therefore, inequality in disposable income – income after direct taxes (which are progressive) and transfer payments (benefits) – is high. Inequality is not predestined. In the same way, the dimensions of poverty in economic activity are not exceptional, but the government's policy to reduce poverty, which is relatively modest, is reflected in a particularly high poverty rate by international standards in terms of disposable income.

The trends I have outlined, or a low productivity growth rate, processes that are expected to further slow future growth, together with high levels of poverty and inequality in disposable income, bring into sharper relief the need to focus government policy on encouraging productivity and reducing inequality and poverty.

So what can we do?

We can continue, with greater vigor, ***implementing (with emphasis on the term implementing)*** policies to include population groups in employment (the program to reduce gaps with the Arab community that was supposed to have been discussed by the government included many positive components in this area); act to increase human capital – both in the framework of the education system and through professional and technical training – in order to increase productivity and earning power; act to remove impediments to growth, through investment in infrastructure, improving the business environment, increasing competition in industries where it is insufficient, promoting reforms in essential infrastructures, and supporting R&D, including in low technology industries. There is also room to upgrade the public services, and for adjustments in the tax system through benefits – for instance by increasing the earned income tax credit (negative income tax), and more.

If we act decisively to implement multi-year plans, most of which exist but are implemented sluggishly, we will be able to maximize the immense potential of the Israeli economy for the good of all its citizens.