Karnit Flug: Macroeconomic policy and the performance of the Israeli economy

Remarks by Dr Karnit Flug, Governor of the Bank of Israel, to the conference of the Israel Economic Association, Tel Aviv, 18 May 2016.

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I would like today to speak about the performance of the Israeli economy and about macroeconomic policy – both the policy adopted and the policy that is desirable in the future. It is important to distinguish between policy operating in the short-term, which is intended to moderate the economic fluctuations referred to be economists as "the business cycles", and policy that operates in order to achieve long-term goals with the objective of leading to great achievements in the future. It is important to note that macroeconomic stability in the short term is a necessary condition for realizing long-term goals.

In order to ensure macroeconomic stability, policymakers use monetary policy and fiscal policy. Monetary policy focuses on maintaining price stability, and on supporting economic activity and employment when there are shocks moderating them. Fiscal policy balances the need to support growth in such conditions and the need to maintain a reasonable deficit, manage the public debt burden over time so as to minimize the burden of interest payments in the future, and provide the government with room to operate, referred to as "fiscal space" in times of crisis.

Economic policy that focuses on long-term goals – chiefly inclusive growth over time – operates through the various components of budgetary policy (size and composition of government expenditure, size and composition of taxes), and by ***promoting structural changes and reforms***, upon which I will focus later on.

The more effective the Bank of Israel's monetary policy is in creating macroeconomic stability in view of the business cycles, the more it provides the government's budgetary policy with the required room to operate in order to focus policy on dealing with the long-term challenges. The budget's focus on long-term challenges becomes even more important as the term of the budget becomes longer, such as with a two-year budget.

Economic policy is influenced by various factors, but due to the fact that we are a small and open economy, we are greatly affected by the global environment.

The global environment in which macroeconomic policy operates was moderate in 2015 as well, with weak global growth that included a further slowdown in the emerging markets, continued relatively low growth rates in the US and the eurozone, more moderate growth in world trade, and a sharp decline in energy and commodity prices both due to relatively moderate demand, and due to increased supply. Against this background, the major central banks continued, and some of them further enhanced, their very accommodative monetary policy.

From the standpoint of the Israeli economy, which is a net importer of commodities and energy, the changes in commodity prices were reflected in improved terms of trade, which led to a significant increase in the Current Account surplus. The increase in the Current Account contributed to appreciation pressure on the real exchange rate, which for its part weakened the competitive ability of the Israeli economy and contributed to the slowdown of growth in exports and of growth in general. With the decline of "surplus growth", or the growth gap between Israel and its main trading partners, the pressure for continued real appreciation weakened. Throughout this process, the composition of growth changed, with the contribution of surplus exports declining while the contribution of private consumption to economic activity increased.

These developments took place while inflation was very low, affected by global commodity and fuel prices and by government-initiated price decreases, and to a certain extent by the appreciation of the shekel.

Monetary policy has operated against this background. The Monetary Committee adopted a very accommodative monetary policy this year as well, leaving the interest rate at an historic low of 0.1 percent, and announced that in its assessment the interest rate will remain low for a considerable time. In addition, the Bank of Israel continued to purchase foreign exchange as part of two programs it is running – the program intended to offset the effects of natural gas production on the Current Account, and the program to moderate fluctuations that are not consistent with the basic economic forces. In view of the fact that the effective exchange rate is appreciated relative to equilibrium according to various estimates, it continues to pose difficulties for export growth and for the tradable sector. Exchange rate policy operated in the past and will continue to operate with determination in the future in order to assist growth in exports. The Monetary Committee's announcement of its assessment that monetary policy would remain accommodative for a considerable time, which means that the Committee's assessment is that it would not raise the interest rate immediately after the interest rate increase in the US, which is what actually happened when the interest rate in the US was raised in December, also serves as a counterforce to the forces for appreciation. The CPI figure for April and the disappointing growth figures for the first quarter that were published this week will of course be examined by the Monetary Committee. Since those discussions will take place at the beginning of next week, I won't go into this now.

In order to minimize the risks for mortgage borrowers and to support financial stability, the series of mortgage limitations imposed by the Banking Supervision Department also remains in place.

One of the main channels where the accommodative monetary policy has succeeded in influencing economic activity is in consumer credit. Credit increased, its price decreased, and the reduction of the interest rate led to significantly lower prices for consumer credit, and later to an increase of such credit, which in the end supported a more rapid increase in private consumption in recent years, and especially in 2015.

Private consumption, which accounts for 55 percent of GDP, was the dominant factor contributing to economic growth in 2015, and partly offset the weakness in activity resulting from the decline in exports and in investment. This was also reflected in the labor market, increased employment in the services industry, and increased wages. Despite the increase in wages which, alongside the decline in consumer prices, led to increased purchasing power for households, employers' cost of labor did not increase, and even declined slightly. This was mainly due to the increase in output prices, which was a result of the decline in energy prices and reduced financing costs – also a result of the low interest rate set by the Monetary Committee. This is a positive result for the economy from all standpoints.

Budgetary policy in 2015, which was mainly based on a transition budget, was reflected in a decline in the cyclically-adjusted deficit – the deficit adjusted for the effect of a deviation of growth from the long-term rate – to 2.7 percent of GDP. Policy thus minimized the fiscal impulse (the anti-cyclical effect). This is a reasonable policy given that the level of the cyclically-adjusted deficit is still relatively high, and that accommodative monetary policy supported economic activity. However, the fact that the government operated with a transition (1/12) budget for most of 2015 led to the fact that there was no discussion within the government or the Knesset regarding the targets of economic policy, and the budget therefore did not reflect the government's set of priorities and was not focused on achieving goals to increase growth over the long term, which I will talk about later.

The decline in the deficit, together with the relatively large increase in output prices and the erosion of CPI-indexed debt, supported the continued decline of public debt as a share of GDP – the opposite of the trend in most advanced economies and of the average level in those economies. The interest burden on the public debt remains high compared to the OECD average, but is in a downward trend that was accelerated in the past two years. The reduction of the interest burden, from about 4.5 percent of GDP in 2010 to about 2.5 percent of GDP today, frees up significant sources – about NIS 20 billion per year – for other uses. It is therefore important to maintain this trend.

The Bank of Israel's first assessments regarding 2017 indicate that the automatic pilot for expenditures, meaning the increase in expenditures required as a result of government commitments and expected demographic developments, is NIS 14 billion higher than the expenditure ceiling – similar to the Ministry of Finance's estimate that was published this week. Should the government make the necessary adjustments to meet the expenditure ceiling, then according to initial forecasts of tax receipts, the government is expected to meet the deficit target of 2.5 percent of GDP. The government will need to choose between cutting expenditure, which will make it difficult to achieve the long-term goals I will detail later, and increasing tax revenue, whether through the cancellation of exemptions or through raising tax rates.

Success in dealing with the short-term challenges, and the fact that the economy is in a reasonable state relative to the global environment, make it possible to increase efforts to narrow the gaps in a series of issues between us and the other advanced economies, and to lay the economic groundwork for the future.

It is important for the government to formulate a set of priorities that will enable it to focus on dealing with the fundamental problems in the economy and Israeli society in the long term.

How?

Economic policy to achieve long-term goals – inclusive and sustainable growth – acts by providing public services at a proper level, supporting growth engines in the economy, using policy tools to narrow gaps, reforms to increase efficiency in the use of infrastructure and public services, and increased competition in industries where it is not sufficient.

What are the challenges facing policy makers in the long term?

A forward-looking view shows that there are processes, some global and some domestic, working as ***headwinds to growth***: According to an analysis by international organizations, the growth rate of global GDP is expected to be more moderate in the next few years than prior to the Global Financial Crisis, and the growth rate of world trade is expected to moderate even more due to the weakening link between global growth and the development of world trade.

In Israel, the combination of demographic trends (an increase in the proportion of population groups with relatively low employment rates and a slowdown in growth of the primary working age population) alongside the fact that the contribution of increased education, as reflected in the average number of years of schooling, has neared its limit, will act to slow the future growth rate. Active policy is therefore needed to offset these trends.

Against the background of these future trends, it is important to examine the labor productivity trends of recent years and the directions in which policy must act in order to deal with the challenges.

In terms of productivity – measured as output per work hour – we are not closing the gap with the other advanced economies, even during the period since the global crisis. This gap between output per worker in these industries in Israel and output per worker in the same industries in the other advanced economies, is focused mainly on industries that manufacture mainly for the domestic market, which are by their character domestic industries, and are therefore not exposed to competition from abroad. It is important to know that these are industries that produce most of the output, and also employ the vast majority of workers, in the economy. The discussion on productivity seems very theoretical. But to illustrate, if we would close the productivity gap vis-à-vis the OECD average, we would raise the standard of living by about one-third – about the increase that we would receive in per capita GDP.

In this context, let us for example take the construction industry, which employs about 7.5 percent of those employed in the business sector – clearly a domestic industry – and examine the output per worker in the industry over a long period. Productivity in the industry declined in the 1970s and 1980s, and remained at a standstill since the 1990s, in contrast with an increase in manufacturing productivity that accelerated following the program to expose the Israeli economy to foreign manufacturing imports in the 1990s (the Exposure Program), and the agriculture industry where there was a moderate increase in productivity throughout the period. The construction industry "benefits" from the availability of foreign workers with wages lower than domestic workers with the same characteristics, and therefore suffers from a significant technological lag. The recent government decision to allow foreign construction companies to enter residential construction projects, if it is implemented to a significant extent, may contribute to a turnaround in the productivity trend in the industry. Companies that will bring advanced technologies to Israel will require domestic contractors to streamline as well, and will also contribute in the long term to an increase in the wages of domestic workers in the industry.

Last year, I also spoke to this honorable forum about productivity, and I focused on a number of sources for the disappointing increase in output per work hour in most industries in the business sector in the past two decades. I focused on the low stock of capital per worker, on the low level of infrastructure, and on the low government investment in R&D. In addition, I related to a number of opportunities for improving public services through investment in physical and human infrastructure in them, as well as to reinforce the policy of narrowing gaps and integrate various population groups in the labor market.

We can go back and talk about these problems and challenges, which have certainly not been solved in one year, this year as well. But this time, I would like to expand the discussion on the structural issues that have an impact on productivity picture. These mostly do not involve a marked increase in budgets, but mainly involve streamlined processes and creating changes, some of which may negatively impact the profitability of certain groups in the economy. Therefore, it is relatively difficult to make them. The updated Doing Business report by the World Bank shows that Israel fell to 53rd place in the easiness (or difficulty) of doing business here, from 26th place in 2007. This is a result of worsening bureaucratic conditions in Israel, and of the reforms in cleansing regulation that were implemented in other economies. Among all OECD countries, Israel is in 31st place out of 34 countries – fourth worse after Turkey, Greece and Luxembourg, and beneath all the others. Our weakness is particularly prominent in the areas of opening, registering and licensing businesses, building permits, tax payment processes, and barriers to international trade. Barriers and restrictions on the trade of commodities and services were also noted in the OECD report on Israel as being particularly high. By the way, our strengths are reflected in the protection of small investors, and in the relative ease of closing businesses. (It's too bad this is not true of opening them.)

In order to illustrate the types of problems that make it difficult to do business in Israel, we can focus on the "tax payment index". An analysis of the sub-indices of this parameter shows that despite the fact that the tax rate on businesses operating in Israel is low by international comparison, the number of payments that businesses are required to pay is high, and the time required to complete procedures is also high when compared to other advanced economies. For this reason, the bureaucratic cost is high, and despite the advantage of low tax rates, Israel is ranked 103rd out of 189 countries on the index. There is a similar effect in the index that examines the ease of opening a new business. While the ***monetary*** cost imposed on the entrepreneur is low by international comparison, the number of required procedures and the time involved in them is high. We are therefore ranked 56th on this index. Another parameter where Israel's negative position is prominent is international trade, where Israel's low ranking is caused due to the long time and high cost imposed on importers and exporters in order to trade with their opposites abroad, compared to the leading OECD members. Israel is also negatively prominent in registering properties and building permits, which are characterized by many prolonged processes, which is widely divergent from the other advanced economies. Among other things, these reflect the problem of a lack of synchronization between the various regulatory authorities in the construction and infrastructure area (the planning authorities, the local authorities, and so forth). This is the place to note that Ministry of Finance is taking steps to shorten the length and increase the efficiency of procedures in this area. The medium rating in obtaining credit data is for the most part explained by the lack of a credit database, an issue that as we know was recently passed as legislation and the database is currently being established by the Bank of Israel.

In order to examine the potential of reforms to reduce surplus regulation and to increase competition in these areas, I rely on an analysis carried out by the International Monetary Fund Research Department and presented in the most recent World Economic Outlook, and in the excelled OECD report on the Israeli economy. Areas in which Israel has a lot of room for improvement by advancing reforms include: increasing competition in the goods and services markets, including by reducing trade barriers; active labor market policy; and continued reduction of surplus regulation, particularly in industry with a "network effect".

The IMF's assessment is that reforms, mainly through deregulation and investment in industries with a "network effect" – such as air transport networks, trains, roads, electricity and gas, and communications, can increase GDP by about 1 percent in about 4 years.

This is the place to note several areas in which reforms to increase competition were carried out in Israel, generating far-reaching cost-cutting results: air shipping and cellular communications.

The liberalization of air shipping (both of passengers and of cargo) by making air policy more flexible and signing an "open skies" agreement with the European Union (which replaced bilateral agreements with a number of countries) are reflected in a marked increase in the frequency of low-cost flights and the number of routes on which service is operated by 3 or more companies. These are reflected in a marked reduction of the cost of tourism and air shipping of goods.

The reform in cellular communications which, among other things, disconnected the service agreements from the equipment purchase agreements, reduced interconnectivity fees, cancelled the fine for leaving a plan, and made it possible for virtual operators to enter the market, reduced the cost of service by more than 50 percent, and markedly increased the volume of activity, thereby contributing to consumer well-being.

These two reforms illustrate the potential for growth and improvement of well-being from reforms that lower the barriers to competition. Investment in the volume of public transit, improved interconnectivity in public transit, and increasing competition in this area are already bearing fruit in improved and less expensive service (alongside the government-initiated price decline). However, alongside this improvement, tremendous further investment is necessary in order to come close to the accepted public transit standards in metropolitan areas around the world.

A more friendly regulatory atmosphere in the goods and services markets – and particularly the removal of barriers in the goods and services trade areas and reference to the competitive supply from abroad – can contribute between 0.5 and 0.75 percent to annual growth in Israel according to the OECD's assessment.

Beyond the advancement of reforms that will lower barriers to growth, as reflected in our low ranking in the Doing Business index, and increased competition in industries where it is insufficient (including in the financial sector), it is important to also act to improve the level of public services to the citizen, including in education and training, particularly technological training, in health, welfare, active labor market policy – with particular focus on the integration of population groups with low integration levels into the labor market, inter alia by giving them the skills for the labor market. We should also not minimize the importance of investing in infrastructure and in growth engines, as I have shown at many previous opportunities.

The concept that I call to adopt is that "the long range is already here", and the more we advance to adopt a strategic plan focused on the issues that I have raised, the better we will be able to deal with these challenges. The adoption of such a program is critical in view of the processes I have described in both the global and the Israeli economy, which require us to do all we can to realize the tremendous potential we have.