

Stanley Fischer: Overview and challenges facing the Israeli economy

Speech by Professor Stanley Fischer, Governor of the Bank of Israel, at the Seventh Annual Herzliya Conference, Herzliya, 23 January 2007.

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As you surely know, the Israeli economy is in very good shape. According to initial estimates by the Central Bureau of Statistics, GDP grew in 2006 by 5 percent, which seems all the more impressive as it was a year with hostilities in the north. Furthermore, we saw rises in investment, exports, employment, and productivity, while unemployment continued to fall, reaching 8.3 percent, compared to a record high of 10.7 percent in 2003. The lowest unemployment rate the economy achieved since 1990 was 6.6 percent. That was in 1996, when the labor market was at the start of structural change with the entry of foreign workers, and it is therefore reasonable to assume that the natural rate of unemployment – that commensurate with full employment – is now at a higher level. At the same time, financial stability and price stability have been maintained. This background allowed for cumulative interest rate cuts in recent months such that now, for the first time, there is a significant negative interest rate gap of 0.75 percentage points, between the Bank of Israel and the US Fed rates.

These achievements are beginning to give us encouraging signs regarding certain improvements in two problematic areas that the economy faces:

- **The public sector debt burden.** This, one of the biggest problems in the Israeli economy, fell to about 88 percent of GDP compared to 97 percent at the end of 2005. This is a remarkable achievement, but it is important that we continue along this path to bring the ratio down to 60 percent of GDP – the ceiling set by the Maastricht treaty – and after that, to bring the ratio down even further.
- **Poverty,** a major topic of public debate in Israel. The Bank of Israel monitors not only relative poverty – a measure principally of social gaps – but also a measure of absolute poverty. This is a measure of the individual's ability to purchase a basket of essential goods. We have therefore been closely following developments of a measure of the poverty line, calculated in real terms since our base year (which we've taken as 1997 for calculation purposes). From our analyses, we see that in 2005 there was some drop in absolute poverty after it had risen in the years 2001 to 2004. Those years where the absolute poverty index rose could be attributed to the period of recession in economic activity, and in 2004, individuals were suffering from the effects of cutbacks in welfare payments which continued gradually even after the recession. The drop in poverty in 2005 could be attributed to the growth that began in 2003. By the way, though poverty was seen to rise in 2005 – according to the relative measurement – it rose more moderately than in previous years.

Only in a few months time, when the Incomes Survey for 2006 is published, will we be able to see what happened with poverty – both in relative and absolute terms – in the past year and we all hope that we'll find that economic growth continues to positively affect all levels of society.

We all have a tendency to praise ourselves for our achievements and blame external forces when things go wrong. But the truth is that some of the achievements in the Israeli economy in 2006 stemmed from the favorable condition of the world economy; almost everywhere, and in particular the emerging market economies, registered rapid growth and low inflation in 2006.

But even after taking into account the external factors, we may still attribute an important part of our economic achievements to our own actions. I'll start with macroeconomic policy. And I refer to the government's budget policy – and this year the government managed to steer the state budget for 2007 through the Knesset very shortly after the end of 2006 – and to the Bank of Israel's interest rate policy. And it is impossible not to note the most important role: that of the business sector, which for years has grown at a faster pace than the economy in general.

Looking forward, we estimate that the economy will grow this year by 4.6 percent and that inflation will reach the target range of 1-3 percent. In terms of inflation-over-the-past-12-months, this is expected only by the fourth quarter of the year. In any case, the Bank of Israel's policy is to adjust the interest rate gradually as and when needed, to avoid unnecessary shocks to the economy and the financial markets.

I would like to add a few words about the many affairs that are termed – rightly or not – as corruption scandals. Obviously we'd prefer that such affairs didn't happen, but it is important to stress that the moment they do arise, they are dealt with promptly and seriously. This is a very important bright side, and it is not a trivial point. It shows that the judicial and legal infrastructures are not prepared to put up with such unacceptable behavior. We should also remember, that in most of the cases, we are referring only to a suspicion and it is not clear what the final outcome will be. In the past, we have seen many cases of suspicion that in the end came to nothing.

And what is the most important challenge facing the Israeli economy today? It is the challenge to maintain this growth drive and to translate it into what we term "sustainable growth." And what is the most important topic on this agenda? First, macroeconomic policy, i.e. budget policy and interest rate policy, which I noted earlier and the importance of which, I hope, the general public understands. And secondly, further to policy, is the need to continue with reforms.

Here I would like to expand on reforms in the Israeli economy.

The panel before me spoke about one of the most important reforms in recent years, the reform of the capital market. There were other important reforms, such as the reforms of the ports, and personal income tax.

In this context, I would like to present an initial list that we at the Bank propose to put forward. And more so, the Bank's Research Department is working to draft proposals for these reforms. Specifically our list includes:

1. **In the labor and welfare fields:** Here we return to a subject we have proposed, and which we are working on together with the Prime Minister's Office and the Ministry of Finance: that of negative income tax ("earned income tax credit"). Other topics in hand are the increase in incentives to go to work, *inter alia*, through helping improve work support services, foremost of which is childcare, and strengthening the Wisconsin Plan along such lines that are currently being discussed. That is tightening the link between incentives for participating companies and absorbing the individuals into the labor force in general, and ensuring quality placements for the workers in particular, as well as adjusting the program to the needs of the various population groups.
2. **In education:** It is important that a reform of the higher education system, along with the primary and secondary systems, is examined. Concerning higher education, the whole issue of funding must be dealt with. Fortunately, a new committee has been set up headed by former Minister of Finance, Beiga Shochat, to seriously tackle the field of higher education, and the Bank of Israel is involved in two sub-committees on this matter. As for primary and secondary schooling, one must find ways to increase the effectiveness of the system, to direct sufficient resources to it and to ensure equal opportunities for children from all strata of society in order to encourage and nurture excellence. Education is a very important issue that will aid economic growth in the long term as well as reduce social gaps. In Israel, as elsewhere, the yield on education has increased a great deal in recent years.
3. **Banking competition:** The Bachar committee achieved its mission of increasing competition in the credit field, but now we face the challenge of boosting competition in the retail field. Here, the Supervisor of Banks is the major player, and together with the management of the Bank of Israel and me, is examining ways to strengthen competition in the banking system including making it easier to transfer accounts from one bank to another, and more besides. There is the field of bank charges, and in this context the Bank of Israel has already prepared a bill that would grant the Supervisor of Banks the authority to regulate fees in areas that have no competition. This bill will be submitted in the next few days.
4. **In infrastructure:** In this context I refer to the fields of transportation – roads, rail, public transport – and the field of electricity – and here it is important to carry out the planned reforms.
5. **Real estate:** Here our emphasis is mainly on developing a more efficient real estate market, on land ownership (the Israel Lands Administration) and on easing the bureaucratic processes such as planning, licensing and registration. Reform in this field is clearly not a simple matter but it is important to begin freeing the real estate market in Israel from its many current restrictions.

6. **Defense spending:** This is very much on the agenda of the day, and I am happy to see that a committee headed by former director general of the Ministry of Finance, David Brodet, is dealing with this subject, and the Bank of Israel is involved. Clearly every country has the responsibility of defending its citizens, but it is difficult to know exactly what resources are required. It is easy to err in either underestimating or overestimating the funds needed. So it is important to establish from time to time a select group of professionals, such as the current committee, to check this matter thoroughly, and it is important too to follow through on any resulting recommendations.
7. **Health:** This subject often pops up on the agenda and, among other things, it is important to examine the pricing of various health services. I would like to add here that overall the health system in Israel is very good by any measure in international comparison.
8. Another matter of concern, particularly when coming to approve the state budget, is that of examining a new approach to the budget process. This includes a multi-year approach to fixing budget aggregates, the involvement and responsibility of the different government ministries in the budget process, decentralizing budget responsibility through quality management of local governments, and increasing transparency of the budget process.

Most of these matters are in different stages of treatment by the government, and the Bank of Israel not only supports their progress but also assists as best it can.

As I said earlier, this is only a very formative list, part of it already being dealt with and others only partly so, if at all. What is important is to start straight away on creating the necessary infrastructure that will propel the economy forward for many years. In other words, we must do everything possible to ensure this drive toward sustainable growth. This is vital not just for the future of the economy, but also for the future of the State of Israel.