

Stanley Fischer: Israel's economy

Summary of the address by Professor Stanley Fischer, Governor of the Bank of Israel, at the Israel Business Conference, Tel Aviv, 13 December 2010.

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Israel's economy is doing well, but there are still many long-term goals that need to be dealt with. Each one of them needs to be approached differently, and requires hard work and difficult decisions. I will outline what I consider to be the major challenges confronting us in the next decade.

First, we must ask ourselves about the strategy that will lead us towards long-term growth. It is clear that Israel's economy, like every open economy, must continue to be based on exports as the engine of growth and to be open to competition from other economies.

The results of international tests showing a persistent decline in the relative achievements of Israeli students indicate that we must continue to promote the education system and to solve the problems it faces in all segments and across the entire age structure.

The problem of education is directly connected with the problem of poverty, which in Israel is concentrated in two sectors in the population – the ultra-orthodox, and the Arab sector. Only 30 percent of ultra-orthodox men participate in the work force, with the inevitable result that a large part of that population is below the poverty line. In the Arab sector the main problem is the low level of employment of women, as well as discrimination, and the need to improve the education system. If we do not deal with these problems we will be unable to maintain our standard of living – that of the advanced economies.

Israel also suffers from a lack of infrastructures, and related to that, from bureaucracy, slow decision making, and a low level of public-sector efficiency. Our geopolitical situation is clearly another factor; if that problem would be solved, the standard of living in the whole region, and in Israel too, would improve significantly.

The problems I have enumerated till now are long-term ones. I will turn now to some short-term macroeconomic issues that come within the scope of the responsibility of the central bank. The main goal of the Bank of Israel, under the Bank of Israel Law passed by the Knesset this year, is the preservation of price stability, i.e., to keep inflation down to between 1 percent and 3 percent a year. In addition, the Bank's objectives are to work towards the achievement of the other goals of the government's economic policy, in particular growth, employment and the narrowing of social gaps, and to maintain the stability of the financial system and its proper functioning.

Recently inflation has been within the target range, and will probably remain within it until the end of this year. Inflation expectations for next year, however, are relatively high. As the expectations are around the upper limit of the target inflation range, this does not present a serious problem at this stage, but it is our task to ensure that inflation should not exceed the upper limit of the target. To achieve that requires a slightly tighter monetary policy.

Let us turn now to the second goal, employment. The rate of unemployment, which increased during the crisis and declined during the recovery almost to its pre-crisis level, has recently risen slightly. This, in effect, is good news, as the unemployment rate has increased because of an increase in the rate of participation in the labor force, and not because of a drop in the number of employed persons. If the rate of participation had not risen, the rate of unemployment would today be about 5.5 percent.

Our function is also to promote economic growth, and we therefore also keep an eye on developments in the exchange rate. The latest figures show that exports remained steady while imports declined, so that we expect the current account surplus to increase despite the relatively strong shekel exchange rate. Nonetheless, we must continue to support exports,

and we will therefore continue to intervene in the foreign currency market, and like every other country, we must be prepared for every possible economic scenario.

With regard to financial stability, we are currently mainly concerned over developments in the housing market. The Ministry of Finance reports that prices of new houses have fallen, while the Central Bureau of Statistics (CBS) reports that overall housing prices continue to increase. Until the trends in the real estate market become clearer, the Bank of Israel must ensure that no bubble in housing prices develops that would harm financial stability. The best solution is to boost the supply of houses and thus lower their prices, and together with the Ministry of Finance we are examining ways of doing that. Meanwhile, as I said, we must ensure that financial stability is maintained.

Another issue I would like to address is that of the medium term. The question is asked whether the recent discoveries of natural gas will have a major impact on Israel's economy. It is too soon to answer. We have to continue encouraging the various investors to keep searching for gas, and must await results. The immediate issue here is that of royalties, reviewed by the Sheshinski Committee. I support the Committee's approach, the aim of which is to find a way of dividing the gas profits between the entrepreneurs who search for and find the gas and Israel's citizens. In this context I refer you to what I said when the Committee's recommendations were published and I stand behind the views I expressed then.

The gas discoveries raise a related issue, known as the Dutch disease. I have stated in the past that in my opinion the right way to deal with the problem is the Norwegian model, in which the royalties and the relevant government's tax revenues are invested in a sovereign fund. The fund invests its income abroad, and the government's income from this investment is more stable over time, and the fund moderates the short-term effect of the gas income on the exchange rate, an effect that could prove disastrous for the tradable goods industries, as happened in the Netherlands and other countries.

I would now like to introduce the next speaker. Dr Jihad Al-Wazir, Governor and Chairman of the Board of the Palestine Monetary Authority (PMA), was born in 1963. Dr Al-Wazir obtained his Ph.D. in Business Administration from Loughborough University in the United Kingdom, and in the past served as Deputy Minister of Finance and Acting Minister of Finance in the Palestinian Authority. Relations between the Bank of Israel and the PMA under Dr Al-Wazir's leadership are marked by effective and productive cooperation, and I hope that they will continue to be so.