

Stanley Fischer: Recent developments in the Israeli economy – interview with Richard Quest

Interview with Professor Stanley Fischer, Governor of the Bank of Israel, and Mr Richard Quest, at the Globes Israel Business Conference, Tel Aviv, 10 December 2012.

* * *

Q: On the Israeli economy – we know there is a slowdown, we know it won't necessarily be as bad as some people have forecast. But you are optimistic.

A: The economy is doing well in most respects, and we're predicting growth for next year of about 3 percent, which until the European economies started declining we thought we might do better than that, we're not sure about that now. The things that are going well, the inflation rate is in the middle of the target range, the exchange rate is at a reasonable level, the balance of payments is in pretty good shape.

Q: What's not going well?

A: Well, the next government is going to have a very large budgetary problem. The Treasury announced last week that the deficit this year will be 4.2 percent of GDP. We're at full employment now, and that's a large deficit to have in this situation. And it's known that they have to cut about NIS 15 billion out of planned expenditure, and they possibly will also have to raise taxes a bit more than they have so far...that's a huge budgetary problem. One of the reasons for the Prime Minister choosing to go to elections was that he couldn't get a budget through the coalition – well, its going to have to be done with a new coalition.

Q: As far as the growth rate of the Israeli economy – growth rate of 3 percent – are you satisfied with that level of growth, bearing in mind that it seems to be non-inflationary and therefore gives you room for further monetary activity? What will you do in the future?

A: Well, the markets think that the interest rate is going to decline once more in the next twelve months. Clearly there is room if necessary to cut interest rates, we hope we won't get there. We keep a watchful eye on the price of homes, whenever that starts showing signs of going up we have to consider what further cuts in the interest rate will do, or find other macroprudential measures.

Q: Is the weakness in the Israeli economy that you are seeing primarily because of external reasons, or is there something going on within Israel?

A: A large part of the weakness undoubtedly comes from the global economy and from the fact that exports are not growing as rapidly as they have in previous years. Within the economy, investment demand grew very, very rapidly in 2011 and in some part of 2012. That has slowed down significantly – that presumably means that people looking ahead are less impressed by 3 percent growth than by 5 percent growth which is what we had until 2011, for some time. So I think that's a potential source of difficulty, and for the rest, I think there is a great deal of uncertainty – geopolitical uncertainty, and there is also governmental uncertainty, about what the next government will do-

Q: Let's talk about that. What are you most worried about what the next government might or might not do?

A: Well, that's a major worry – its not going to be easy to deal with this budgetary problem, in light of the fact they were not able to pass a budget a few months ago. The major challenge is whether the next government will be able to do what was done in 2003, which was to put

the economy on a very successful course of growth, based on the plan which got the budget into shape and which started liberalizing the economy. That seems to be the major challenge. What's the concern? That instead of that, because of the political situation or whatever, there will be a budget which just scrapes by. That means that next year, in 2014, we'll find ourselves again scrambling to get close to a budget target that is not as ambitious as it should be.

The deficit for this year, which is supposed to be 2 percent, will be around 4.2 percent. One guesses that next year they'll be aiming at 3 percent; when they said that 3 percent was the target for this year, we were arguing for something a little bit less. It's difficult to be ambitious at the beginning; it's much more difficult to be ambitious later, down the road, when you've already not done it once or twice. So that's really a major concern.

The second issue is one which is much more difficult to deal with, which is the issue of the business climate, as seen both from outside and from within. The World Bank issues a report each year called "Doing Business" which ranks countries in terms of how easy it is, or how difficult it is, to do business. In the last two years, we declined from being number 32 on that list, which is not great, to being 38 on the list, which is much less great. That reflects a general feeling that the business climate has deteriorated. It relates to bureaucracy, it relates to places where we stand out as having problems, in the construction process, in a variety of other bureaucratic processes, of registering property, in all of those things we are not doing well. We went far behind on paying taxes...these are things we have to deal with, if we want to get the economy growing again.

Q: You are basically saying, the budget is not in great shape and could get worse, the economic situation is slowing down and could get worse, and the business climate which is the engine of growth is not performing as it should and could get worse. Is that what you're saying?

A: Well, it's always good to have someone translate what I'm saying into English and I greatly appreciate that. But I can say all those things, but I can also say we're growing at 3 percent, we don't have a balance of payments problem, we don't have an inflation problem, and we're growing faster than almost any economy in the West.

Q: If the next government misses its budgetary forecast, and the deficit continues to be above target, that means you, or your successor, will have to take action to rebalance, to maintain the equilibrium.

A: Well it depends on the reasons for missing the budgetary targets. If the reason for missing the budgetary target is that the economy has slowed down, and tax revenues have gone down, and the government has stood by its expenditure plans, it's not obvious that they should try to reduce the deficit at that point. If the deficit has risen because spending has gone up, or something like that, then you're looking at a different situation. So we have to wait and see. One of the many things that the governments of Israel have fought in the last 6–7 years is to have moved from having one of the highest debt ratios in the Western world to having one of the lowest. Now we moved from 100 percent to 75 percent debt to GDP ratio. The others moved from below 75 to 100. So we have more room to run an expansionary fiscal policy if we absolutely have to do it, in a situation of unemployment and low growth. We don't need to do that now.

Q: Where do you stand in terms of tax rising or spending cuts to help balance the budget – or does it not make much difference to you and the central bank?

A: Most research shows that changing expenditures – cutting spending – is more effective than raising taxes as a way of dealing with the budget deficit. But we've cut taxes a lot in the

past years, and the Bank of Israel has argued that the cuts were a little too fast, and they have in fact been rescinded to some extent.

You can't do these things independent of asking what you are spending on. If we have to increase our defense budget, if we have to increase our education budget, then we'll have to finance these things.

Q: Do you believe there should be an increase on social spending, on education?

A: Increasing the efficiency of spending in these areas would be very useful. We have a very big educational problem in this economy, and at some point we are going to have to deal with it. We have been dealing with it, we probably need to do more.

Q: Whichever government takes office, there won't be much time and there won't be much wiggle room to get this right...If you don't get a budget deficit under control, it can get out of control very fast.

A: If you don't get it under control in the first year, that is 2013, which will be about half a year, or a little over half a year, it will be much harder to do in the future. Putting off these problems very rarely works.

Q: When you go to those meetings, at the IMF and other international forums, and you meet your European colleagues, you're enormously respected, you're very well known, your views count – do you ever not want to just say to the European ministers, get your act together – you're causing mayhem and mischief?

A: What are the Europeans trying to do? They're trying to build a federation at a time of enormous difficulty – enormous economic difficulties and political difficulties. So they're taking more than a year or two to do it. That's very frustrating. On the other hand, if they get it done, they will have created a different Europe for the long term, and that's what we need them to do.

Q: You know as well as I do that they built that house badly to start with, and they knew they were building it badly-

A: Richard, I must say that I don't put a lot of weight on what people tell me they knew, when something happened some time ago and they forgot to mention it to me – everyone now knows that they had to get to fiscal union right away. Well, I didn't hear that in 1994, I didn't hear it in 1997. I think that we're all much wiser after the fact. So I'm a little less tough on these guys who didn't see things. Just as when an economic crisis shows up there are always at least 5 people who saw it coming, and then you say, why didn't I pay attention to them; and there are another 50 who saw something else coming and you say thank goodness I didn't pay attention to them. So I have to blame myself. I didn't see it – I don't think many people saw it.

Q: What do you tell those people in the US who say – lets go over the “fiscal cliff”, because it is the only way that long term structural change will take place – when we see the pain?

A: The short term argument is that all the tax reductions of the past decade, and those of this crisis, will expire on December 31 of this year. That means tax rates will have gone up, and then Obama will be in a position, when he wants to cut tax rates, and Republicans want to cut tax rates, and it's argued that he will then be in a better position to reach an agreement...I don't have a lot of faith in this “we'll cause a lot of pain to the politicians so they'll do the right thing”. We've heard that story all the time, I haven't seen anything happen yet. I think we better rely on them trying to reach a deal right now.

Q: Central bankers are often in the headlines these days. Has there been a time during recent crises when you – the major central bankers in the world – met and said, we’re doing this, we just don’t know if this is going to work?

A: First, “we” does not include “me” – we are not yet members of the G7, the G10, or of the G20...there were meetings where we said something like, “this is what we have to do, we are not certain how it will work out, but this is the very best thing we can do”.

Q: What happens to politicians when they get their hands on a budget?

A: There’s a natural tendency to want to spend more money, because everybody asks you to spend more money, and the pressure is always people coming along and wanting money for this and for that. That’s why in some countries you need to have a very powerful Treasury, as we have in Israel. There is this spending tendency, governments prefer to run deficits. It’s very interesting that in two cases that culture changed dramatically – Canada in the 1990s and Australia in the 1980s – were chronic-deficit countries. In Australia now it’s bad for the government to run a deficit, and in Canada they worry about the deficits much more. Why? Because they cut the deficits and they grew much faster in both cases, they saw the results of running a decent economic policy. Can you rely on that? Not really, it depends on each country.

Q: What do you see as your responsibility when house prices, or property prices, get out of kilter?

A: We have to do what we can to prevent that happening. The main problem for a central bank is that it operates on the financing side, which is to say on the demand side of the housing market. We can raise the interest rate, impose regulations on the banks, which we’ve done, that will moderate the impact of low interest rates on demand for housing. But...reducing the price of housing on the demand side does not cause more houses to be built, it causes less houses to be built. The real place that you can get action that will solve the housing problem is on the supply side...if you increase the supply of land in this country more rapidly, you will be able to get housing prices down. If you can speed up the pace at which it’s possible to get planning permission, which is the place we’re worst in the Doing Business study – If we can deal with those prices, we’ll get the supply of houses to go up, which will increase production and reduce prices. We have to do what we can because we operate on the demand side, but we don’t have the control over supply that would enable Israel to solve its housing problems. One of the reasons we’ve been growing reasonably is that housing activity has been very strong.

Q: You are term-limited to 2015. If I could sign a law giving you a third term – would you want it? Would you take it?

A: I believe very strongly in term limits. I have hardly seen anybody get better after ten years on a job. I believe very strongly in this ten year term limit for governors. I thought that I should stop teaching when I stopped being sick to my stomach when I went in and lectured. I lost my fear of the students, I really don’t want to lose my fear of these people and the journalists among them, by being on the job too long. It is still extremely challenging, and it’s a great privilege to have that job.

Q: Will you stay in Israel after your term is up?

A: I very much want to stay strongly connected with Israel, we have family in the States and we’ll have to decide what we do. But I’m not going to disappear from the local scene, that’s for sure.

Q: I'm choosing my words carefully here...Do you have a desire to play a public role in Israel after you have been Governor of the Bank of Israel?

A: There are a few jobs that I would prefer over this one and I don't think any of them are available, or likely to be available.

Q: What brought you to Israel?

A: My wife and I, and my family, have been involved with Israel since we were young. We visited pretty regularly...spent Sabbaticals here, we knew Israel reasonably well. In 1983–85 I had the privilege of working with George Shultz when the United States and the Israeli government cooperated to stabilize the Israeli economy. We'd always been close to Israel, somebody gave me the opportunity to try to contribute something to Israel, and I said well, I'd always wanted to do that, and I'll never get another opportunity like this. The current Prime Minister was very influential and persuasive, he was the finance minister at the time. We are extremely happy we did it; it's been a wonderful experience.

Q: Is it fair to say that after 2015 we will not have heard the last from you?

A: I hope my voice will still be heard.