

Stanley Fischer: Major trends in the global economic crisis and its impact on Israel

Highlights of remarks by Professor Stanley Fischer, Governor of the Bank of Israel, at the panel “Major trends in the global economic crisis and its impact on Israel”, Herzliya Conference, Herzliya, 14 March 2013.

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I have been asked to talk about the relationship between what is happening in the global economy and its impact on Israel. One has to do that, because we are a small economy, with a very small GDP, about 1.5 percent of that of the United States. We are a very open economy, we export about 40 percent of our product, the value added of exports equals about 25 percent of GDP – either way, we are very open to exports and imports, and we are even more open, possibly, to the global gap between our interest rates, which are heavily affected by what happens in the rest of the world. Our interest rates are higher relative to the United States, relative to Europe, and money comes here to take advantage of the high rates, and that created an appreciation of the shekel – that has big effects for us. We cannot allow the interest rate gaps to get too large...So this is the world in which we live.

On the real side what is happening in the global economy is that the US economy is emerging from the crisis. One of the key things which differentiates the United States’s economy from the European economies is that the US very rapidly dealt with the financial system. Treasury Secretary Geithner took a big risk by subjecting the American banks to stress tests. But you better know the truth about the state your financial system is in.

The US looks better now because the housing sector is recovering, it looks better because unemployment has started coming down in a serious way and it looks better because the banking sector is stronger, the automobile sector is recovering, and there is enormous change in the energy sector which is taking place extremely rapidly.

There is a slowdown in East Asia, in growth rates, both in India and in China. In China, let’s say their growth has slowed from 10 percent to 8 percent, but the economy that is growing at 8 percent a year is more than double its size of ten years ago, so the 8 percent growth in today’s Chinese economy adds far more to global demand than the 10 percent growth of the Chinese economy of 10 years ago.

It remains true that the center of the global economy is moving eastwards, to where it was 200 years ago, from which it was temporarily displaced by the Industrial Revolution and that’s a factor, one of many factors that we in Israel have to take account of, as we think about how the rest of the world affects us.

There was a European theory that you should get 1–2 countries out of the Eurozone, so that the other countries would realize it could happen to them, but they’ve given that up for a very good reason – if you start a process like that it could really get out of hand. But they made that decision that they wanted to save the euro. Mario Draghi made the decision; he said that the European Central Bank would do what it had to do to save the euro. Well what it has to do is clear – provide some way of providing support directly to governments. Find some way of keeping the finances of governments more or less whole. We should understand that Greece in the end defaulted on its debt in a negotiated way. Not every government has to be forgiven its debt, but it has to be guaranteed support in negotiations over its problems. In any case, Europe is in a recession; over the next year we’ll probably see slightly better growth than we were expecting to have in the second half of 2013.

On the capital markets side, interest rates have been low for a very long time. That situation will continue until we begin to see signs of growth or signs of inflation. In 1994 the Fed changed its monetary policy from being very expansionary, and it raised rates unexpectedly and caused a temporary slowdown in global growth, because people were simply caught

unawares. That should not happen now. The Fed has been telling everybody that it's got to be ready for a change like this. By the beginning of 2015 interest rates should possibly begin to rise.

I won't go into the argument on currency wars, or if there aren't currency wars. It is a simple fact, whatever the motivation, that interest rates are zero, it's a simple fact that it's harder for us to deal with an environment in which global interest rates, in countries which account for more than half of global GDP, are essentially zero, but that's not a fact that we're going to change by complaining.

So what do we do in the Israeli economy?

At the ceremony when I got this job, in the house of the president, in May 2005, I said that this is a strong economy, they said I didn't understand it. But this is a strong economy – it has been through more shocks, including military campaigns, the resignation of the person responsible for changing the economic strategy in 2003 – then-Finance Minister Netanyahu, in August 2005, the change of Prime Minister after the stroke of Prime Minister Sharon, Hamas winning the Palestinian elections, in July 2006 the Second Lebanon War – I can continue listing more events – but the Israeli economy faced all of them impressively and growth continued at a rapid pace. It also went through the global crisis very well.

Where does all this come from? It comes from good fundamentals. Part of that is the banking system that is strong; it's a very conservative banking system, and people mostly don't like that, they wish the banks would take more chances, until something happens, then they wish they hadn't taken chances. So in 2008 and 2009 our banks were heroes for having been conservative, by 2010 the heroism effect had worn off already, and the public was complaining – which is what the public does about banks around the whole world. But it is important that our banking system continues to lend, but continues to lend taking account of risks.

If I can say something I've said more than once before, we are accused very frequently of supporting stability of the banks over stability of the consumers. The short answer is, we take care of stability of the banks because we care about consumers. In the United States, and in other countries, we have recently been witness to a banking crisis. We had such things in Israel as well in the 1980s. I am certain Israeli citizens who remember the crisis of the 1980s would not want to find themselves in such a crisis again, and that they are happy about the fact that we have not been forced to deal with such a crisis since then. That should continue to be the situation.

The short run situation of the Israeli economy is very good except in one respect. I'll give you the very good part first. Unemployment is at a 30-year low, the balance of payments essentially is balanced, inflation is a little below 2 percent, which is the center of the target range, banks are still in good shape, poverty is actually declining – though no politician gets credit for that, and increasing participation in the labor force, a larger and larger share of the population has been going out to work, which is not to say there aren't problems in the Haredi and Arab sectors, just that more are beginning to go out to work. What is not good is the forecast for the budget.

If the government sticks to its budget constraints, which are the expenditure rule, the taxes it has in place, and the deficit target of 3 percent of GDP, it will have an expansionary budget, or approximately a neutral budget. Everyone is aware of the "budgetary axe", but that is relative to what they were promised, it is not relative to what has been passed. The promises add up to an increase of 10 percent. It will be difficult politically to cut them. However, if we don't get the budget straightened now, it will be very difficult to do so later, and we will find ourselves doing things that are inconvenient and inefficient. It is therefore very important to stick to the budget targets and not to postpone the problem to a later stage.

In the long term, we must deal with the problem of poverty and with the problem of labor force participation which is concentrated in the Arab and ultra-Orthodox sectors. We

obviously have challenges in the field of education and in dealing with bureaucracy. Obviously, there is the security situation, it is very important that we reach a peace agreement with our neighbors, and I hope that all sides will be prepared for this soon.

If you would have said a decade ago that the United States, and even Israel, would become energy exporters, people would have told you it was crazy. If you would have asked in 2003, is the next global crisis going to be a result of a massive financial collapse in the West, I would have said there was no chance. We have to be ready for unexpected events, and it is therefore very important to us to build up ample economic reserves. I am not just talking about foreign exchange reserves. I am also talking, for instance, about budgetary reserves. We need a budget which, if we do need to increase expenditure, does not get into immediate difficulties. We must avoid populism – when difficult decisions are put off to next year, they are generally put off the following year as well. The book “Start-Up Nation” describes, even if a little exaggeratedly, the extraordinary development of Israeli high-tech. The continuation of this development, which should be accompanied by the proper policy steps on the part of the government, will be able to lead to the success of the Israeli economy in the coming years as well.

I would like to relate to the parting gift that Aharon Fogel wanted to offer me (to change the Bank of Israel law so that the growth, employment and financial stability targets would have the same level of priority as price stability). I hope that this gift does not come into being. The members of the Monetary Committee take the Law into account, as well as the way it is worded and the order of priorities among the various goals of the Bank of Israel. If we change this rule, we will have more inflationary periods and more recessionary periods. There are enough things that need to be fixed in Israel, but regarding the Bank of Israel Law, I think that the saying “If it isn’t broken, don’t fix it,” is applicable.

People who preceded me spoke about the issue of government efficiency. According to international surveys, the Israeli government is not the most effective government when compared internationally. Let us look for instance at the housing market. We all want a situation where prices don’t increase but the supply of housing does. This can only happen on one side – on the supply side. It is through the supply side that it would be possible to increase the quantity while lowering prices. The government has understood this and has tried to cause this to happen. It has presented various plans, but the desired result has not come to pass. We need to think of ways to streamline government ministries. The problem in the civil service is the political incentives. The Ministry of Finance and the Ministry of Defense are apparently efficient ministries, but there are many ministries that are not. Public service workers are high-level workers. We do not have the British tradition of “Yes, Minister”. The turnover among Directors General is frequent because the political system is not stable. The current Minister of Finance has had the longest term of office since that of Pinchas Sapir, and this is the exception.

The fiscal rule was formulated in order to reduce the public debt burden. The law states that it is possible to increase the growth rate in government expenditure as long as there is a decrease in the debt-to-GDP ratio. When we reach 60 percent, government expenditure will begin to grow in line with the growth in GDP according to the current formulation of the rule. However, I believe that we must strive for a lower debt than what is set out in the Maastricht rules. We are in the midst of a very complex situation, and like I said before, we must build up reserves in various areas, and among other things, we must make sure that we can raise money in the markets if it becomes necessary. When the global crisis broke out, the Australian government was able to allow itself to spend immense sums because its debt burden before the crisis was very low. If we enter a recession, the debt-to-GDP ratio will jump, and we will find ourselves in a situation where the government cannot finance the deficit at a reasonable rate of interest, like the situation in 2003. We must be in a situation where we can deal with various problems, even if we don’t know whether those problems will actually take place.

If we must increase defense expenditures because it is vital to the future of the country, as some people claim, we will need to pay for it, through an increase in taxes. I don't understand those who say, for instance, that "we have needs in education, so we must increase the deficit." If we have such needs, then we must finance them, mainly through taxes. I don't think that the defense budget can continue increasing at the rate it has for the past few years. Which brings me back to what I said about the importance of a peace agreement. When people say that there is no partner for a peace agreement, that is always true: you need two to tango, and it is very important to start this tango.

Regarding monetary policy, the interest rate is a tool that affects the entire economy. We cannot use the interest rate in order to solve the housing problem. We must obviously take the problems in housing into account. But if there are problems in a certain area, and the central bank's tools are not sufficient to handle these problems, someone else has to deal with it. In such a case, we are talking about increasing supply, which is currently in the realm of responsibility of the Israel Lands Administration and planning authorities.

We have tried various foreign exchange regimes over the years. My experience shows that, regardless of the exchange rate regime we are in, there will always be times when we will want to have other regimes and systems. However, experience shows that it is always correct to allow the exchange rate to change based on market forces. Everyone is impressed by the success of the Swiss in strengthening the exchange rate and preventing it from falling below 1.2 Swiss francs to the euro. From the day that decision was made, they purchased foreign currency totaling about 50 percent of their GDP. We also purchased a lot of foreign currency, but we aren't near those levels. The difference between us and them is that their interest rate is 0 percent, so holding foreign currency does not involve any financial cost on their part, as long as they aren't forced to retreat from the exchange rate they set. Up to this point, they are enjoying a "free lunch" – until the day comes when they will need to pay. I believe that our monetary policy was, at the bottom line, successful.

The alternative presented in this conference regarding the deficit, of 3.5 percent of GDP, is ambitious. It will be necessary to raise taxes, and I share the sense that we need to be cautious in this context. The median worker in Israel does not pay taxes. When taxes are raised, they want to raise them only for the rich. But there aren't as many rich people in Israel as people think. Taxing those around the median will lead to the collection of a lot of tax since there are many people around the median. From a political standpoint, it is easier to increase taxes on the rich than on the middle and lower levels.