

## Stanley Fischer: Challenges facing the Israeli economy

Remarks by Professor Stanley Fischer, Governor of the Bank of Israel, upon taking leave of the Knesset Finance Committee, Jerusalem, 4 June 2013.

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I would like to thank the members of the Committee for their wishes. It was an honor for me to serve as Governor of the Bank of Israel. It was not readily apparent that they would offer the position to someone who was not a citizen of Israel. But in the end, that is what happened, and my wife and I are very happy for the extraordinary opportunity that we had. Many people on the professional team at the Bank of Israel helped me during this period, contributing much to the work at the Bank during my term of office. We must not forget that I arrived in 2005, when the economy was in the midst of a period of impressive growth, and one of the reasons for the fact that we made it through the global crisis was that the economy entered the crisis in good condition: the government budget was balanced in 2007, the current account was in surplus, the banks were strong—everything required for a country to successfully get through the crisis was in place in Israel before the crisis.

I would also like to thank the former Chairman of the Finance Committee, MK Rabbi Moshe Gafni, who contributed much to the system's stability, and to the legislation of the new Bank of Israel Law, which was also helped along by former Knesset Speaker MK Reuven Rivlin. I recognize the fact that you cannot work alone—it is necessary for there to be people who agree to work with you, and in this context, I also note the Opposition Leader who is here, who was then in the coalition and who assisted with the passage of the law.

If I compare the situation of the economy today to what it was in 2005, the debt-to-GDP ratio is much lower, although the government deficit is higher. We moved to a situation where the current account is balanced compared to the surplus we were in before the crisis. The unemployment rate today is very low in an historic perspective, and the employment rate is higher. The incidence of poverty remains more or less at the same level as it was. The exchange rate is more appreciated today, which to a large extent is a result of the strength of the economy—people want to live in a strong economy with a weak exchange rate, but this is a situation that generally does not happen. The foreign exchange reserves are obviously much higher than what they were when I took the position, as a result of foreign currency purchases that we have been making since 2008. The average growth rate between 2005 and 2012 was 4.3 percent, and average per capita growth during those years was 2.5 percent. The average inflation rate then as today is within the target range, such that we can say that we did not, and do not today, have an inflation problem.

The last decade started with a deep recession and negative growth, and in the middle of the decade, we moved to rapid growth of 6 percent for a number of years, an exceptionally high rate for countries at the level of development of Israel. Following the financial crisis, we continued to grow at a higher rate than other developed countries, and if we continue maintaining responsible policy, we can, I hope, continue this way. The unemployment rate is very low compared internationally, since while unemployment in Israel is in decline, it has risen in many countries. Long-term inflation expectations are close to the midpoint of the target range. This means that the public believes that the economy can continue growing without inflationary outbursts, and it can plan its economic life without concern of spikes in prices. This is a very important achievement—thirty years ago, we never would have believed we would attain it.

The government deficit grew in 2012 by 4.2 percent, and in order to reinstate control over the budget, the government recently decided on important measures to reduce the deficit in the coming years. These measures are also very important due to the fact that the interest burden that the government is paying is very high in international comparison, as a result of the risk premium that the financial markets include for the Israeli economy. A diplomatic

process, if the markets attribute any importance to it, would reduce these costs in the final analysis, although it would take time, since the interest paid today is on debt that was issued in the past, and a reduction in the interest rate would affect new debt.

### **There are many challenges facing the Israeli economy.**

The first challenge to which will relate is handling the problem of poverty. The data unsurprisingly show that the incidence of poverty is higher among large families, and lower as the percentage of wage earners increases. Furthermore, the incidence of poverty among Arabs and ultra-Orthodox Jews is very high. In this context, it is important to implement a policy that will increase the labor force participation rate of these two sectors, and we are witness to important initiatives in the area of academic education, mainly among the ultra-Orthodox sector.

The Israeli education system's achievements in the international PISA tests are below average. We have recently had better achievements in TIMS tests, and I hope that they will also be reflected in the other tests. We must improve the achievements of the education system in order to achieve higher economic success.

The World Bank conducts a survey of the ease of doing business in all countries each year. In 2013, we were in 38th place, a very unsatisfactory placing. We have fallen significantly in this ranking during the past decade, not because our situation has deteriorated, but because the bureaucratic burden in other countries has lessened. The bureaucracy affects not only the ease of doing business, but also the cost of living. For instance, we see its effect on the ability to adjust the supply of housing and on housing prices.

The Concentration Committee made two important recommendations on the matter of breaking apart pyramids and separating financial and real holdings. In this context, I note that if we require the immediate complete separation of financial and real holdings, there would be no people who would be able to be controlling owners of banks, since they would not be able to obtain the required capital through their activities in the real industries. It is possible that in another few decades, we will reach the conclusion that controlling owners are not necessary for banks. But in the meantime, I suggest not to conduct such large experiments on the financial system. I usually don't make comparisons to Greece, but this time I will do so: For hundreds of years, we have seen the ramifications that an unstable financial system has on the market. We have a strong banking system, which was of tremendous assistance in our ability to withstand the crisis. We must not endanger its stability, so I suggest not to limit cross-holdings of financial and real entities for now beyond what the Concentration Committee recommended when it set a benchmark of NIS 6 billion for holdings of a real company by someone who holds controlling interest in a financial entity. I understand the logic behind the other suggestions, but I think that we must first of all examine the ramifications of lowering the number of entities that can hold controlling interest before we continue advancing in this field.

Labor productivity in the Israeli economy is 20 percent lower than the OECD average. While we are a wealthy economy, it is a mistake to compare ourselves to the US and Scandinavia all the time, where labor productivity is very high. It is important that we deal with all the challenges in education, the bureaucracy, infrastructure and more, in order to deal with the problem of low productivity.

The Supervisor of Banks headed a team that presented important conclusions regarding reinforcing banking competitiveness. Each time I would meet a senior banker from abroad, I would try to convince him to start banking operations in Israel. I didn't succeed, and since 2008, I have stopped trying since the crisis led banks to stop expanding their operations overseas. However, at the team's recommendation, there are many steps whose implementation can help reinforce competitiveness in the banking system.

Defense expenditures increase from year to year, although their share of GDP continues to decline and has now reached its level from the beginning of the 1960s. Still, defense expenditures are the largest component in the state budget. It is clear to all of us that we live in unsafe and uncertain surroundings. It is the government's duty to protect its citizens, and there is therefore no alternative to large budgets for the defense establishment. This also has positive ramifications, such as the defense establishment's contribution to the development of the high-tech industry. We do not have the luxury to think that we are Sweden and to plan our expenses without needing to allocate about 5 percent of GDP to defense. We must continue to provide ourselves with defense, but the allocation of more money to defense is not the only solution. We must also try to find other solutions, and try to achieve a peace agreement with our neighbors, including with the Palestinians. The phrase, "there is no partner for peace" is a self-fulfilling phrase. You need two for an agreement, and if we don't want to look for a partner, we will remain in the current situation. We must look for the partners for peace. Until we reach agreements, it will cost us more since we will need to reinforce our readiness. However, in the long term, we will benefit from it, and it will have positive ramifications in various areas. We must, therefore, find a way to act more proactively in order to stop the conflict that has continued here for far too long.