

Karnit Flug: Israel's challenge to fulfil its economic growth potential

Main points of remarks by Dr Karnit Flug, Incoming Governor of the Bank of Israel, at The Prime Minister's Conference "Partnership and growth", Tel Aviv, 29 October 2013.

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When I decided, several weeks ago, to accept the invitation to participate in this Conference, I did not know that it would be my first lecture following my appointment as Governor of the Bank of Israel. Nonetheless, I am very happy that the hand of fate has led to my speaking here today, two days after the government's decision to appoint me as Governor, and economic advisor to the government, because I believe that this Conference deals with one of the most important issues on the socioeconomic agenda in the State of Israel. The topic of the Conference – the Arab sector's partnership in the economy and in growth – is a major issue in terms of the Israeli economy's ability to fulfill its growth potential in the next few years and to reduce the scope of poverty and the gaps in Israeli society, which are among the highest in the OECD, and about which much has already been written and said.

The successful integration of the Arab public into the labor market in particular, and into the economy in general, is a very important, even essential, component of the Israeli economy's ability to continue to grow, and to support a higher standard of living for all Israelis. This Conference, which deals with various aspects of the impediments to the successful integration of the Arab population in the labor market, is therefore particularly important.

I will begin with a few words about the recent state of the economy: from the macroeconomic standpoint of growth rates, the economy is in good shape, particularly compared to other developed countries. In the past decade, the economy has enjoyed significantly higher growth rates than most other advanced economies, and the global financial crisis, which was reflected in a deep and sometimes prolonged recession in many economies, was weathered by the Israeli economy with relatively minor damage. Unemployment, which jumped in many economies during the crisis and remains very high in most of them, increased relatively moderately in Israel, and resumed its decline immediately following the crisis, so that we are currently at historically low unemployment levels.

The labor force participation rate, and in turn the employment rate, are increasing on a consistent basis, among other things as a result of the continuing entry to the labor market of Arabs, ultra-Orthodox Jews and women. Inflation – the main policy variable with which the Bank of Israel is entrusted – has been within the target range for a long time, which provides monetary policy the required degrees of freedom to support growth and employment in the short term, thus moderating the effects of the global slowdown which is still a restraining force on activity here as well.

From a long-term view, the Israeli economy suffers from a low rate of increase in productivity (product per hour of work). The average Israeli worker produces lower output per given work hour than his peers in most OECD countries. Not only is the increase in productivity not closing the gap with the other developed countries, the gap is growing. For instance, the ratio between product per work hour in Israel and that in the US has been declining over the years. In the Bank of Israel Annual Report for 2012, the Research Department analyzed the phenomenon and noted a number of reasons for the low productivity. One major reason is a low rate of investment, which leads to lower stock of capital for production available to the Israeli worker than what is available to a worker in other OECD countries. A further issue is bureaucratic impediments, or in broader terms, the business environment, which impede accelerated development of the business sector.

Returning to employment: Despite the significant improvement that has taken place in recent years, and which has led to the fact that our employment rates are no longer low when compared internationally, there are still two groups that stand out for their particularly low

rates: Ultra-Orthodox Jewish men and Arab women, each with their own characteristics and specific reasons. In these two sectors, even those who are integrated into the labor market generally earn a relatively low salary, which indicates relatively low productivity. This is mainly the result of a level of education and training that does not earn a high return in the labor market. The incidence of discrimination must also not be ignored, and we know that the Arab public has difficulty integrating into certain industries, even if the appropriate training is provided. One such example is the high tech industry where, for various reasons, few Arabs successfully integrate. Since this industry has one of the highest levels of productivity and salary in the economy, that fact has far-reaching effects on the ability to fulfill economic potential with given talent such that it will be reflected in an appropriate standard of living.

In the long term, demographics are expected to have far-reaching ramifications on employment, output and the standard of living. While those sectors with low levels of employment are expected to grow as a share of the population, the working age population is expected to decline as a share of the total population. If there are no changes in employment patterns, these demographic trends will reduce the annual growth rate by about 1.3 percent, every year. This is a strategic threat for the Israeli economy and for Israeli society – one that we must not ignore. Even if labor force participation increases, it is vital that we create the conditions required for workers to be absorbed in industries typified by a high level of human capital as well. Otherwise, employment growth will be able to make only a limited contribution to GDP growth, a reduction in poverty and an increase in the standard of living.

The government has recognized the importance of integrating these population groups into the labor force and, in 2010, it adopted detailed employment targets to which the economy is supposed to converge in 2020. The target rates set for the Arab population in 2020 – 41 percent employment for women and 78 percent for men – are ambitious but possible. At the same time, the rate of progress toward the goals thus far is not sufficient, and much more effort is required in order to meet them on time. The government made many important decisions that delineate a policy intended to help in achieving these goals. It is very important to continue implementing this policy, which is supposed to give the appropriate weight to the relevant issues in future budget priorities. Among others, these include raising the level of education and skills relevant to the labor market, expanded early childhood care solutions, improved transit accessibility between places of residence and employment centers, methods for removing cultural obstacles to participation in the labor force, encouraging small businesses in the Arab sector in various ways, encouraging the integration of workers from the Arab sector who have the appropriate talents in industries typified by low rates from this population group, and combating discrimination.

The Arab population in Israel contains immense untapped potential from the standpoint of the Israeli economy's growth capability. Beyond the economic potential, the issue also contains highly significant social potential. The correct policy, and its correct implementation, will bear fruit both from the standpoint of the Arab sector, increasing its integration in Israeli society and improving its economic situation, and from the standpoint of the general population and the economy as a whole. Our ability to continue existing as a society that is both multi-faceted and socially cohesive depends, among other things, on how employment develops in Arab society in the next few years. If we know how to maximize the potential for increased growth and how to reduce the gaps, we will all – Jews and Arabs – be able to enjoy the fruits of this process. If we can't manage to do this, then in my estimation, we will pay a heavy economic and social price in the years to come.

Later in the conference, there will be an in-depth discussion of the details, solutions and plans on the agenda. I wish us all an interesting and productive conference.