

Karnit Flug: The state of the Israeli economy and challenges ahead

Main points of a speech by Dr Karnit Flug, Governor of the Bank of Israel, at the “Calcalist” Capital Markets Conference, Tel Aviv, 19 November 2013.

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I will begin by presenting the state of the Israeli economy and the challenges we face in the short term, and will then provide a brief discussion of the long-term challenges as well.

The Israeli market, as we know, is heavily influenced by the global environment. We are in an environment of global economic moderation, with a very moderate recovery in the advanced economies, and expectations are that this process will continue in the coming year. With that, the emerging economies are in a slowdown, and the expectation is that growth will continue to be relatively moderate for these countries. Global trade, whose influence on the Israeli economy is very large, is growing at a very moderate pace, and despite the fact that we expect its growth to accelerate in the coming year, it will still be relatively moderate. Inflation in the vast majority of advanced economies is low, and with this background, we are witnessing extremely low interest rates and very intensive monetary accommodation in the major markets.

Growth in the Israeli market is higher than in the other advanced economies over the past few years, including during the crisis, however it is closely correlated to them. The data published for the third quarter point to moderate growth of 2.2 percent. This is a disappointing figure, and the main factor pulling growth downwards is exports, while consumption is what is currently pulling forward. On the assumption that world economic growth recovers as expected, we expect continued growth of 3.4 percent in 2014, but it is important to mention that excluding the effects of natural gas production, lower growth is expected, and since natural gas production does not make a significant contribution in the short term to growth in employment, we expect growth in unemployment in the coming year.

An overall view of the labor market shows that it is strong, as reflected in continued growth in the employment rate, and continued decline in the unemployment rate to such low levels that we have not seen in many years. This is the aggregate picture, and it is certainly a good picture. At the same time, if we look a little closer, we see a picture that is somewhat less rosy: An assessment of the composition of the labor market shows that growth in the number of employed persons is concentrated in the public services, while employment in the business sector has been at a standstill for a long time.

Another shadow is the standstill in exports. Looking at a somewhat longer period, we see that exports have not grown for two years, and have recently even contracted. This is connected first of all to moderating global demand, and also to problems specific to large companies, but exports, as we know, are also affected by the exchange rate of the shekel, which has strengthened in the past year. I should note that the aggregate sensitivity of exports to the exchange rate is not high. The estimate of exports' sensitivity to the exchange rate is just 0.2. While the profitability of high technology companies is affected by the exchange rate, the sensitivity of low technology industries to the exchange rate is much higher. While the share of low technology and mixed-low technology manufacturing in exports is just 20 percent, these industries comprise about 60 percent of manufacturing employment. We take this fact into account as well when considering monetary policy decisions.

Monetary policy is faced with a number of challenges. As we know, the shekel strengthened in the past year. There are real forces strengthening the shekel, including mainly the fact that the Israeli market is growing faster than other economies. But the forces for appreciation are also derived from the global monetary environment. Obviously, the production of natural gas in and of itself is good news – it improves the energy situation in the economy and

contributes to the balance of payments. But it also obviously has an effect on the exchange rate.

As I noted, interest rates in the major economies are very low. The interest rate in Europe was recently lowered to just 0.25 percent, and the major central banks are continuing to pursue quantitative easing policies. This situation has led us to the low current interest rate of 1 percent. The low interest rate environments – both domestic and global – obviously have an effect on asset prices, including home prices. The lack of investment alternatives increases the demand for homes for investment purposes, while the housing market is also affected by the low level of supply. The government is making efforts to increase the supply of homes, but in the meantime, these efforts are not leading to a moderation of prices.

Monetary policy focuses on meeting the Bank of Israel's goals: maintaining price stability, supporting economic activity, and strengthening and maintaining financial stability. For this purpose the Bank of Israel uses a number of tools. The main tool is, of course, the interest rate tool, which has reached a very low level. The Bank of Israel has for the past few years been pursuing a policy of involvement in the foreign exchange market in cases of excessive volatility in the exchange rate that is not in line with the fundamental economic conditions. The Bank also purchases foreign exchange in order to offset appreciation pressures derived from market overshooting in reaction to the production of natural gas. It is important to note that our foreign exchange policy takes the long-term economic forces into account, and we are acting to give the business sector time to adjust to the trends derived from these forces. In order to deal with the risks derived from growth in the balance of housing credit, the Bank of Israel has for a number of years been placing various limitations on the mortgage market. These are prudential tools that reduce the risk both to the financial system and to borrowers.

A few words on the long term. Over time, we see very slow growth in the rate of productivity, and in parallel to growth, we were seeing growth in poverty and in inequality. ***The main challenge facing the Israeli economy over the long term is to succeed in creating inclusive growth.*** I would like to explain what I am referring to by this term. I am referring to continued, sustainable growth whose results will be divided more equally among all parts of the population, such that they will support a higher standard of living for all sectors, and a reduction of poverty and inequality in the distribution of income. Inclusive growth cannot be driven by a narrow growth engine. It must be broad based over a variety of industries, so that it can provide employment to all parts of the population over time. These include, for instance, small and medium businesses, tourism, and low technology industries – industries that can provide employment and income to workers at all skill levels. Such growth, in the center of the country and in the periphery, will ensure that the labor market is able to also absorb those who join it from the sectors with relatively low human capital or with employment levels that are still low.

The challenge in creating inclusive growth is immense. It is a goal that many countries are grappling with, and it is not easy to achieve. It is important that, in formulating its strategic plan for the coming years, the government focus its policy such that we progress in this direction. Inclusive growth will contribute to strengthening the cohesiveness among various population groups and within the groups themselves.