

Karnit Flug: The conduct of economic policy, and the various functions filled by the Bank of Israel and the government in conducting the policy

Remarks by Dr Karnit Flug, Governor of the Bank of Israel, at the press conference marking the publication of the Bank of Israel's 2015 Annual Report, Tel Aviv, 3 April 2016.

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Summary

The Governor of the Bank of Israel:

- Accommodative monetary policy helped the economy to deal with a moderate global environment. The reduction of the deficit as well as several other factors supported the continued decline in the share of public debt in GDP, the opposite of its trend in most advanced economies.
- The success in dealing with short term challenges, and the reasonable state of the economy relative to the global environment permits an enhanced effort to reduce the gap between Israel and other advanced economies in several areas and to prepare the economic infrastructure for the future.
- The trends in the global environment and the demographic trends in Israel are setting complex challenges for the future, and obligate us to act to change the trends in labor productivity, education, health, and infrastructure, so that Israel's economy can fully utilize its potential.
- It is therefore important that the government formulate a set of priorities which will allow it to focus on dealing with fundamental problems of Israel's economy and society in the long term.
- In order to deal with these, the government will have to improve the level of public services, to invest in infrastructures, and to support growth.

Today we are publishing the Bank of Israel's 2015 Annual Report. The report presents an analysis of economic activity in Israel in the past year, the economic policy that came to support it, and points of emphasis and recommendations to policy makers for future years. In my remarks today, I will focus on the conduct of economic policy, and the various functions filled by the Bank of Israel and the government in conducting the policy.

It is important to distinguish between policy that acts in the short term, and is intended to moderate economic fluctuations – which economists call “the business cycle” – and policy that is geared toward achieving long terms goals.

In the short term, policy makers use monetary policy and fiscal policy. Monetary policy is focused on maintaining price stability, and on supporting economic activity and employment when there are shocks that moderate them. Fiscal policy balances the need to support growth in such conditions with the need to maintain a reasonable deficit and manage the public debt burden over time to minimize the burden of interest payments in the future, and to provide the government room to act, termed the fiscal space, in times of crisis.

Economic policy focused on long term targets – chief among them achieving inclusive growth over time – acts through the budget policy on its various components (size and composition of government expenditure, size and composition of taxes), as well as by promoting structural changes and reforms.

The more effective monetary policy is in smoothing out the business cycles, the more it allows budgetary policy the space to act in order to focus policy on dealing with the long term challenges.

Economic policy is impacted by various factors, but as we are a small and open economy, we are affected very much by the global environment.

The global environment facing macroeconomic policy in the short term was moderate in 2015 as well – weak global growth which included an additional slowing in emerging markets and continued relatively low growth in the US and eurozone, very moderate growth in world trade, a sharp decline in energy and other commodity prices due both to relatively moderate demand and against the background of an increase in supply. Against the background of all these, major central banks continued, and some even enhanced, their very accommodative monetary policy.

In Israel, the main developments included of course the very low inflation rate, impacted by commodity and energy prices worldwide, and by price reductions initiated by the government; the moderate growth which was impacted by the weakness of exports against the background of moderate world trade, but also by specific domestic factors and the appreciation of the shekel, the relatively strong labor market, and the rapid increase in outstanding mortgages and housing prices.

Monetary policy operated against this background. The Monetary Committee adopted very accommodative monetary policy this year as well, including the reduction of the interest rate to a low of 0.1 percent in March 2015, alongside foreign exchange purchases within the framework of two programs – the program intended to offset the impact of natural gas production, and the program to moderate fluctuations that are not in line with economic fundamentals. In light of the fact that the effective exchange rate is appreciated relative to its equilibrium value according to various estimates, it continues to weigh on growth of exports and the tradable sector. Exchange rate policy acted in the past and will continue to act in the future in order to facilitate growth of exports.

In order to reduce the risks in the mortgage market and to support financial stability, the series of limitations in mortgages imposed in recent years by the Banking Supervision Department remained in place.

One of the main channels through which accommodative monetary policy succeeded in impacting on economic activity is credit to households. This credit increased, its cost declined, and the reduction of the interest rate thus led to a marked reduction in the price of consumer credit, and subsequently to the increase of such credit, which in the end supported the increase in private consumption by a relatively rapid rate in recent years, primarily in 2015. Private consumption, which makes up 55 percent of GDP, was the dominant factor in contributing to growth this year, and partly offset the weakness in activity that derived from the decline in exports and investments. This was also reflected in employment.

Budgetary policy in 2015, which was based primarily on the interim budget, reflected a decline in the cyclically adjusted deficit – that is, the budget net of the effects of the deviation of growth from the long term rate – to 2.7 percent of GDP. As such, the policy reduced the fiscal stimulus (that is, its countercyclical effect). This is a reasonable policy given that the level of the cyclically adjusted deficit is still relatively high, and that the accommodative monetary policy supported activity. The decline in the deficit, together with a relatively rapid increase in the GDP deflator, and the erosion of the CPI-indexed debt, supported the continuation of the decline in the share of public debt in GDP, the opposite of its trend in most advanced economies, and of their average level. The interest payment burden remains high relative to the OECD average, but is in a trend of decline, which has accelerated in the past two years. This decline derives not only from the decline in the debt ratio but also in the active policy of the Ministry of Finance Accountant General's division, which acted to roll over the debt at today's low rates, and also to reduce the roll over risk by extending the duration of the debt. The reduction of the debt repayment burden – from about 4.5 percent of GDP in 2010 to about 2.5 percent of GDP today frees up significant resources for other uses. The deficit ceiling that was set for the 2016 budget and the reduction of VAT and corporate taxes

in response to enhanced tax collection that derived to a great extent from the strength in real estate transactions, are liable to halt the continuation of these positive developments.

The success in dealing with the short term challenges, and the economy's reasonable situation relative to the global environment, permit an increased effort to act to reduce the gap, in a range of issues, between us and advanced economies, and to set the economic infrastructure for the future. It is important that the government formulate an order of priorities in a manner that will allow it to focus on dealing over the long term with fundamental problems of Israel's economy and society.

How? The economic policy for achieving the long term targets – inclusive and sustainable growth – acts through provision of public services at an adequate level, support of the economy's growth drivers, operation of policy instruments to reduce gaps, reforms to increase efficiency in the use of infrastructures and in public services, and increased competition in industries in which it is insufficient.

What are the long-term challenges facing policy makers?

A forward-looking view indicates that there are processes, some of them global and some domestic, serving as a headwind to growth – based on analysis by international institutions, the global growth rate is expected to be more moderate in coming years relative to the years prior to the global financial crisis, and the growth rate of world trade is expected to moderate even more, due to the weakening of the link between global growth and the development of world trade.

Here in Israel, the combination of demographic changes (an increase in the share of populations whose employment rates are relatively low, and a slowdown in the increase of the prime working age population) alongside the exhaustion of the contribution from an increase in education, as reflected in average number of years of schooling, will act to slow the growth rate in the future. Thus, active policy to offset these trends is required.

Against the background of these future trends, it is important to examine recent years' trends in labor productivity, quality of public services and income gaps, in order to outline the directions in which policy should act in order to deal with the challenges.

Labor productivity – measured as output per work hour: We are not closing the gap relative to advanced economies, and this is correct as well in the period since the global crisis. This gap, between output per worker in various industries in Israel and output per worker in those industries in advanced economies, is focused at industries producing primarily for the domestic market, and they are domestic in their characteristics, and therefore are not exposed to competition from abroad. It is important to note that these are industries that are producing the main component of GDP, and also employ a significant majority of workers in the economy. The discussion on productivity sounds very theoretical. However, for illustration, if we were to close the productivity gap vis-à-vis the OECD average, we would increase the standard of living by about a third, which is about the increase we would gain in per capita GDP.

In this regard, we can look at, for example, the construction industry, which employs about 7.5 percent of those employed in the business sector – a clear domestic industry – and let's examine the output per worker in this industry over a long period of time. Productivity in the industry declined in the 1970s and 1980s, and has remained at a virtual standstill since the 1990s, in contrast to an increase in productivity in manufacturing, which was accelerated since the exposure program in the 1990s, and the agriculture industry in which there was a moderate increase in productivity over the entire period. The construction industry, which "benefits" from the availability of foreign workers, whose salary is low relative to domestic workers with similar characteristics, suffers from a significant lag in technology. The government's recent decision, to allow foreign contracting firms to enter into residential construction projects, if implemented at a significant scope, is likely to contribute to a turnaround in the trend of productivity in the industry – companies that will bring advanced

technologies to Israel will force the local contractors to increase efficiency too, and in the long term will contribute to an increase in the wages of domestic workers in the industry.

The **level of public services** shows a mixed picture – in industries in which adequate investment was made in recent years, whether in physical infrastructure or in an appropriate work force, we benefit from the return on the investment, in the form of high quality of level of services. Yet at the same time, in industries in which appropriate investment was not or is not made, the service level is low or is expected to be negatively impacted. It is important to emphasize that the return on public investment, or the harm from a lack of such investment, are not seen immediately. We currently benefit from past investments, and begin to feel the impact in areas in which investment was not sufficient. I will illustrate with several examples from various industries:

The current level of health services is good by international comparison, as indicated by public satisfaction surveys (and as reflected as well in a relatively high life expectancy, low infant mortality, etc.). However, various indicators show that the physical and human infrastructures are very “strained” and there are already focal points of very extreme congestion. Thus, the number of hospital beds per 1,000 people is relatively low, urgent care occupancy is especially high, and the share of doctors below age 55 is nearly 50 percent – the highest among advanced economies. Without marked investments in the physical infrastructure and in training doctors and nurses, the service level will deteriorate rapidly, particularly in view of the expected aging of the population.

Regarding education level, the results of years of disregard are already seen – both in terms of Israeli students’ poor results on international standardized tests, and in the large gaps between students from families at various income levels. For example, in an index examining the share of students from low socioeconomic conditions who achieve high scores on these tests, we are nearly at the bottom of the list. This index reflects the fact that affirmative action is not succeeding in improving the chances of a student from a weak economic background reaching a high attainment level. Crowded classes and a small number of computers relative to the number of children (a computer for every ...fourth student) are only indicators that public expenditure per child is low, and the outcomes are in line with that. Thus it is important to note in the past two years there has been a notable increase in government expenditure on education services, including a marked increase in teachers’ wage, which will certainly be expressed over time as well in improvement in level of teachers.

A positive example of the result of investment is the area of public transport. In the availability of public transportation services, which deteriorated until a decade ago, a marked improvement has been seen over the past decade due to significant government investment and the opening of the industry to competition, and together with the reduction in prices of public transportation that was recently set in law, we expect an increase in the use of public transportation, which will contribute to the public welfare, and to an improvement in the quality of the environment.

In terms of **inequality in the economy**, the analysis presented in the report indicates that it is not a matter of fate, and that it can be reduced through increased use in policy tools that have been proven effective. It is worth noting the decline that occurred in gross income inequality (economic inequality), which today is not high in international comparison, against the background of a marked increase in labor force participation, which increased the share of families with two wage earners, and thus reduced the inequality in work hours per household. A decline in inequality in economic income occurred despite the inequality in wage per hour remaining high. This trend is supported by policy to reduce the negative incentives for employment that were incorporated in the past in the welfare system, and some increase in services supporting employment such as making the Compulsory Free Education Law effective from age 3 and expanding the subsidy of afternoon childcare and home-based prenursery facilities. As we have already shown in the report, there is a need to expand the scope of these services. In contrast, the inequality in net income, after

allowances and taxation, remains especially high, and derives from a combination of relatively low contribution of the system of allowances and the progressive tax system to reducing inequality. A main tool in dealing with this issue, which the government even expanded the use of recently, is the Earned Income Tax Credit.

A fair share of the results we have seen regarding the insufficient level of public services, the moderate increase in productivity reflected in moderate growth, and the high inequality in net income, are the consequences of **civilian expenditure that is too low**. After public expenditure that was very high in the beginning in the 2000s, there was a marked reduction in the share of public expenditure in GDP, and currently the gap in civilian expenditure between us and most advanced economies is large, and thus also the public expenditure. Government expenditure on clear growth drivers such as R&D is also low in international comparison. Broader government support can be the key to factories' ability, not just in the high tech sector, to upgrade technology that will help them succeed in a competitive world, or active labor market policy – relevant professional training, or making services that support employment, such as subsidizing childcare, more accessible – can help in successful integration into the labor market, and to increase the entry of working families who nonetheless remain poor. An increase in the Earned Income Tax Credit will contribute to increasing the earnings of low-income working families. Steps are being taken in these directions, and there is also a decision to greatly expand professional training beginning with this year. It is important to work assiduously in these directions.

So how can the government act to advance the economy's challenges in view of the challenges we are facing, in both the short term and the long term? How is it possible to improve the quality and efficiency of services to the citizen, to improve the level of human capital and the physical infrastructure, in order to support inclusive and sustainable growth?

As I illustrated in the beginning of these remarks, the accommodative monetary policy helps the economy to deal with the global business cycle, and thus allows the government to focus on policy challenges for the long term. In order to deal with these, the government must act to improve the level of public services, to invest in their increased capacity, and to support the economy's growth drivers.

If we will want to achieve these targets, it will also be necessary to increase efficiency and to markedly increase civilian expenditure, and thus, beyond the use of resources that open up from reducing the interest burden on government debt, and in order not roll over the burden of this increase on to future generations, there will be no alternative to increasing tax revenues, though canceling tax exemptions that are not justified economically, and/or to increasing tax rates.

Beyond the improvement in the level of services to citizens, and to investment in infrastructure and growth drivers, it is important as well to act to promote reforms that will reduce the barriers to growth as they are reflected in, for example, our poor showing in the Doing Business index, and to increase competition in industries where it is not sufficient, including the financial sector.

The long term is already here, and to the extent that we move early to adopt a strategic plan focused on the issues I have raised, we will be better able to deal with these challenges. Adopting such a plan is critical in view of the processes that I described, both in the global economy and in Israel, which obligates us to do all that is possible in order to maximize our tremendous potential.