

Karnit Flug: The Israeli economy – a macroeconomic perspective

Main points of a lecture by Dr Karnit Flug, Governor of the Bank of Israel, at the Supreme Court, Jerusalem, 6 August 2015.

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The Israeli economy is an open economy that is greatly affected by developments abroad. This is reflected in the growth rates in the economy, which are very much in line with those abroad. The effect of activity abroad is mainly reflected through international trade, which affects demand for Israeli exports, both goods and services. Goods exports are in a virtual standstill, against the background of the virtual standstill in global trade, which declined slightly in 2013 and recovered slightly during 2014. In contrast, services exports have performed better than global trade.

The labor market is in good condition. The unemployment rate is very low and this, alongside the continuing trend in the labor force participation rate, with new participants finding employment, reflects an increasing trend in the employment rate. The development of real wages per employee post indicates a moderate increase in recent years, and acceleration in the past year.

Monetary policy

The Bank of Israel's policy acts to achieve the Bank of Israel's targets as set out in the law. The main target is achieving price stability, meaning meeting the inflation target, and subject to that, support for the other economic targets, chiefly growth and employment, and support for financial stability. In recent months, the inflation rate has been below the target, and in the past 12 months, prices have declined by 0.4 percent, mainly due to a decline in fuel and commodities prices. In contrast, one-year forward inflation expectations are at the lower bound of the target range – 1.0 percent. Since the beginning of the year, the shekel has appreciated, which has contributed to lower prices, following a number of months of depreciation in the last few months of 2014. The appreciation also makes it difficult for Israeli exporters to compete in the global market, and our estimation is that the shekel is appreciated relative to equilibrium levels. Against the background of these developments – which are also affected by developments in the global economy – the Bank of Israel lowered the interest rate to the historically low level of 0.1 percent, and purchased foreign exchange.

The budget and the fiscal aggregates

The government has recently been dealing with the finishing touches of the budget. The proposed budget for 2015 and 2016, which was approved by the government, includes deficit targets of 2.9 percent of GDP each year, which are higher than those that are appropriate for the economy in its current state, with a level of activity close to full potential, high employment rates, and low unemployment rates by historical perspective. The proposed deficit targets do not support the continued reduction of the debt to GDP ratio. An international comparison of the tax burden shows that the tax burden in Israel is lower than the OECD average, and the share of public expenditure in Israel is smaller than the OECD average. Since our defense expenditures are much higher than those of other advanced economies, and the interest expenditures on the debt are relatively high, the civilian expenditure (excluding defense and interest) obtained is very low. Israel is in next-to-last place in an international comparison of civilian expenditures. (Civilian expenditures include public services such as education, healthcare, welfare, and public security, as well as expenditures on growth engines such as investments in infrastructure that are meant, among other things, to encourage future growth.)

An issue that has an effect on both the longer-term fiscal area and on the cost of living, is the outline of agreements being formulated between the interministerial team dealing with the issue of natural gas development and the gas companies. The Bank of Israel's position is that under the circumstances created, the new outline provides a reasonable response to the needs of the economy, particularly for the purpose of speeding up the connection of an additional natural gas pipeline and the promotion of development of the Leviathan and Karish and Tanin reservoirs. By the nature of negotiations, the outline does not achieve the ideal result, but it does contain many advantages for the economy. As such, the Bank of Israel supports the main points of the outline and progress toward its implementation.

The outline arranges a variety of issues related to the natural gas economy that were subject to uncertainty, thereby enabling more stable regulation of the natural gas economy, which will make it easier to advance the financing and development of the reservoirs, and will in the end enable redundancy of supply and a market structure that is more competitive than is currently the case. The outline also supports the achievement of the government's target to enable the realization of export contracts with Egypt and Jordan for both economic and diplomatic considerations.

Before final approval of the outline, it is important that milestones be set for advancement in the development of the Leviathan reservoir and connecting it to the Israeli gas economy, and that decisions be made regarding the measures that will be taken should the pace of development not be according to agreements. In particular, it is important that if a delay in development prevents the creation of a more competitive structure than is currently the case in the natural gas market, alternative steps be defined that will advance the connection of the gas reservoirs to the Israeli economy in the most rapidly possible manner, alongside a mechanism that will protect Israeli consumers from monopolistic pricing.