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A MACRO PERSPECTIVE OF THE ECONOMY AND SOCIETY IN ISRAEL

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A Macro Perspective of the Economy and Society in Israel

Eran Yashiv*

Abstract

This chapter surveys macroeconomic developments in Israel during 2011 and discusses the difference between cyclical/temporary problems and structural problems. It also takes an in-depth look at possible solutions to the economy's structural problems. The social protest movement of the summer of 2011 and the Trajtenberg Committee Report placed these problems – which are expected to remain dominant in the foreseeable future – high on the public agenda. The data for 2011 indicate rapid GDP growth, a decline in unemployment to very low levels, and a significant increase in investment; they also point to a reasonable level of inflation. Forecasts for 2012 point to a major slowdown in the wake of global developments. The chapter discusses a possible fiscal policy for distinguishing between temporary and structural problems, and suggests (in accordance with the "Proposal by the Heads of the Taub Center – A New Public Agenda for Israel," Eran Yashiv (ed.) 2011) a number of policy solutions designed to address the structural problems.

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At the beginning of 2012, Israel, like most of the world's countries, faced a considerable degree of uncertainty. The European debt crisis, the economic slowdown and the conflict over fiscal policy in the United States, China's economic "landing," the fragility of the global banking and financial systems – all of these things occasioned a significant degree of uncertainty and negatively impacted on the Israeli economy.

Israel is not mired in the kind of crisis that has afflicted the southern European countries; most current Israeli indicators paint a positive macroeconomic picture. However, Israel is facing fundamental structural problems, some of which penetrated the public consciousness during the social protest activity of summer 2011, and were addressed by the Trajtenberg Committee Report published in September 2011. This chapter takes up all of these issues.

Section 1 deals with current developments in 2011. Section 2 discusses the differences between cyclical/temporary problems and structural problems, as well as the ramifications of these problems for fiscal policy. The concluding section offers recommendations for addressing the structural problems.

1. Current Developments in Israel's Economy

The Israeli economy is highly open to international trade of goods, services and financial capital. In a kind of replay of the events of the global financial crisis of 2008-2009, Israel once again at the end of 2011 faced negative effects of the world economic situation. The main current developments are surveyed below.

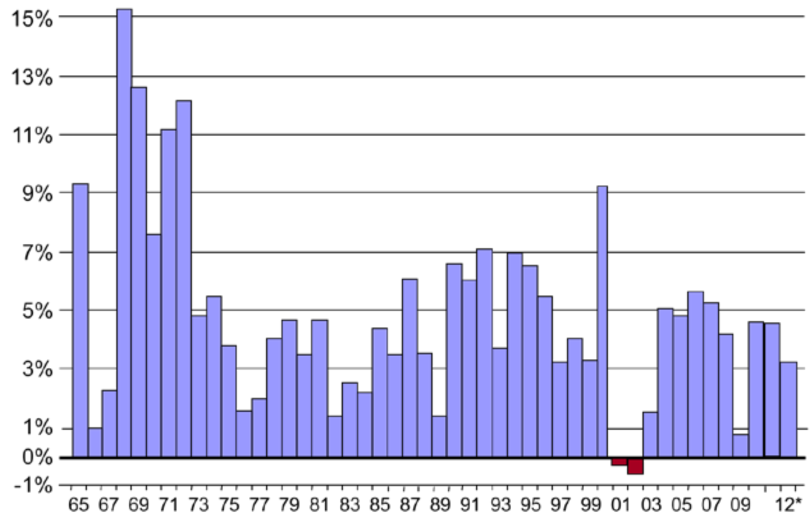
Real Economic Activity

As Figures 1 and 2 show, GDP and business sector GDP grew by 4.8 percent and 5.1 percent respectively; the per capita GDP increased by 2.9 percent. A rise in GDP usage this year was reflected in a significant increase in investment, its proportion of GDP rose from 16 percent in 2010 to 18 percent in 2011. The unemployment rate continued to trend downward, reaching 5 percent by the end of 2011; the overall 2011 average was 5.7 percent. This growth is not expected to continue. The forecast for 2012 calls for growth of slightly less than 3 percent (in the 2.7-2.8 percent range), accompanied by a rise in unemployment to 6.6 percent; the last quarter of 2011 already witnessed a decline in tax revenue and a slowdown in exports.

Figure 1

Annual rate of GDP growth

percent changes in real GDP, 1965-2012



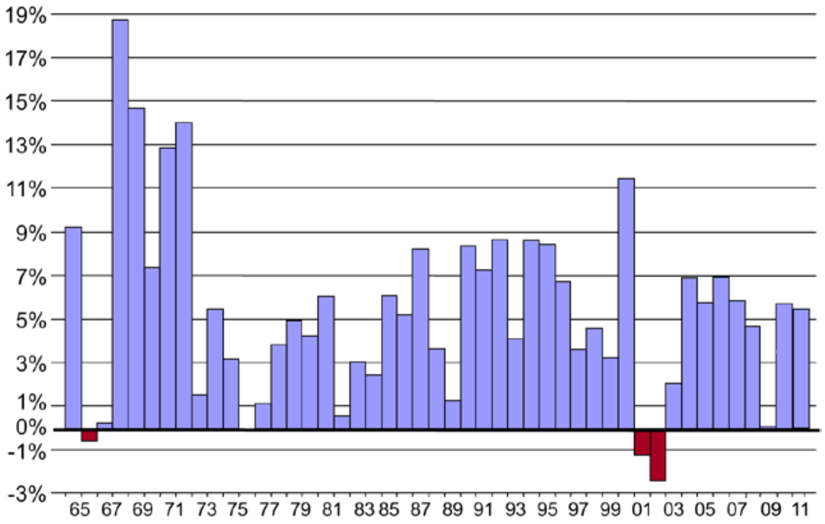
* Bank of Israel estimate for 2012.

Source: Taub Center for Social Policy Studies in Israel.
Data: Central Bureau of Statistics, Bank of Israel calculations.

Figure 2

Annual rates of growth in business sector GDP

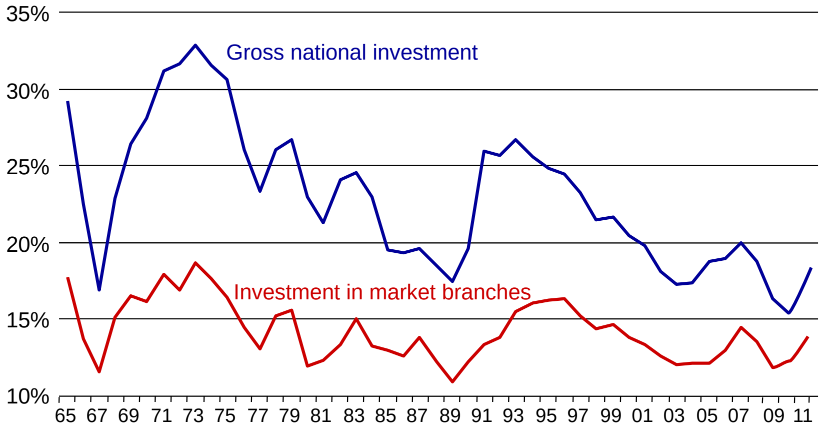
percent changes in real business sector GDP, 1965-2011



Source: Taub Center for Social Policy Studies in Israel.
Data: Central Bureau of Statistics, Bank of Israel calculations.

Gross domestic investment, reflecting capital purchases (equipment, machinery, buildings, etc.) and construction, is shown in Figure 3. Investment has declined over the years, from 33 percent of GDP in the early 1970s to less than 20 percent; however, the past year's data indicate a rise in terms of percentage of GDP. Investment in market sectors – a variable that excludes construction – is behaving similarly to investment in the aggregate.

Figure 3
Investment
as percent of GDP, 1965-2011



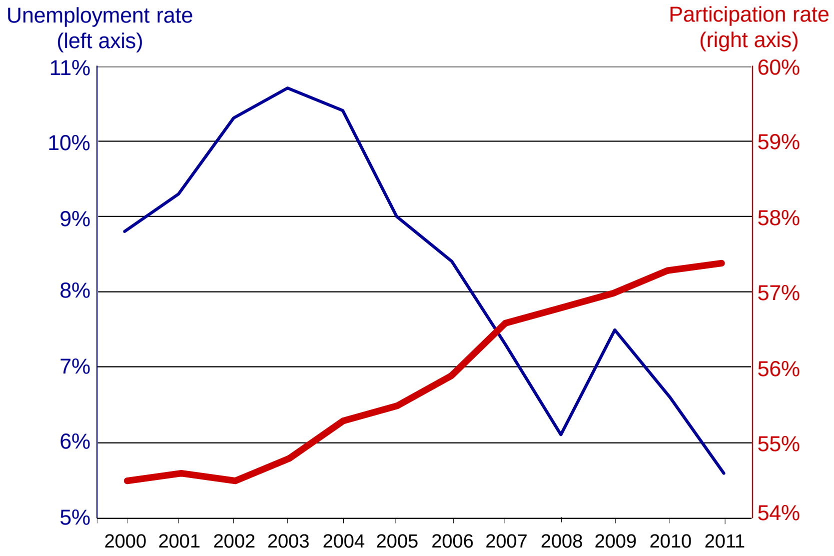
Source: Taub Center for Social Policy Studies in Israel.
Data: Central Bureau of Statistics.

As Figure 4 shows, the high rate of growth was reflected in a decline in unemployment from 6.2 percent at the beginning of the year to 5.4 percent during the last quarter of 2011; the average for the year (2011) was 5.7 percent. This is very low in terms of international comparisons; in the wake of the global crisis many European countries, as well as the US, still have unemployment rates of 8-9 percent or more. Israel has also enjoyed another rise in labor market participation rates, and the average real wage per job rose by 2.5 percent during 2011.

Figure 4

Unemployment rate and labor force participation

2000-2011

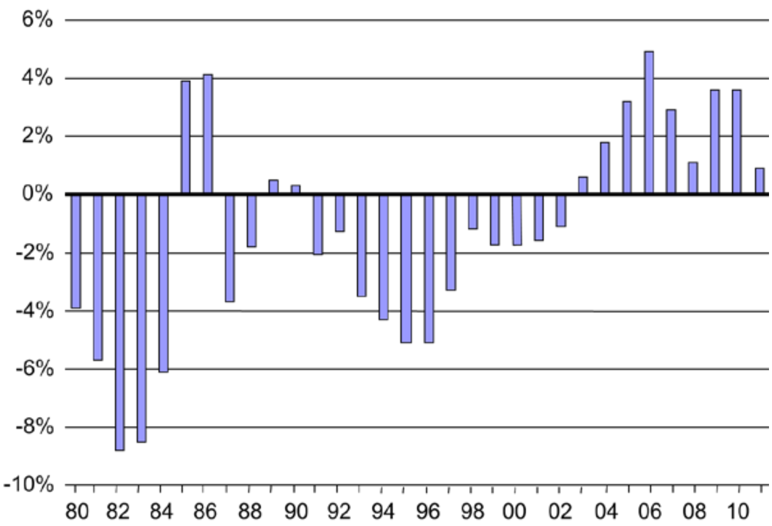


Source: Taub Center for Social Policy Studies in Israel.
Data: Central Bureau of Statistics, Bank of Israel calculations.

Foreign Trade

Figure 5 presents Israel's current account, which represents the total value of exports minus the total value of imports, plus foreign transfers to Israel (e.g., US foreign aid). The account total represents the scope of Israel's foreign trade. Deficits and surpluses in the account presented here represent Israel's total debts and assets relative to foreign economies. The current account has been improving since 2003. This improvement is reflected in a large surplus that reached a level of nearly 5 percent of GDP in 2006. This positive trend is continuing, although the surplus declined to 0.8 percent of GDP in 2011.

Figure 5
Balance of payments, current account
as percent of GDP, 1980-2011

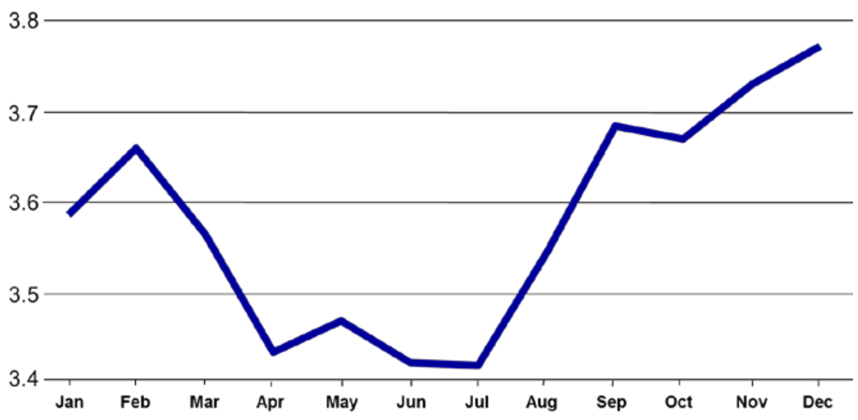


Source: Taub Center for Social Policy Studies in Israel.
Data: Central Bureau of Statistics, Bank of Israel calculations.

Figure 6, which presents the NIS/dollar exchange rate, shows a year split into two halves: the revaluation of the shekel continued until July 2011, due mainly to an interest rate differential favorable to Israel, which incentivized the movement of capital to Israel. From that point on the trend reversed itself: the shekel depreciated from 3.36 shekels to the dollar to 3.76 shekels to the dollar, and capital movement changed direction. This was the result of foreign investment realization in Israel that accompanied the foreign market crises as well as rising concerns over the situation in the Middle East. During this period Israel's default risk premium as reflected in the credit default swaps (CDS) market also rose.

Figure 6

Dollar-Shekel exchange rate, 2011



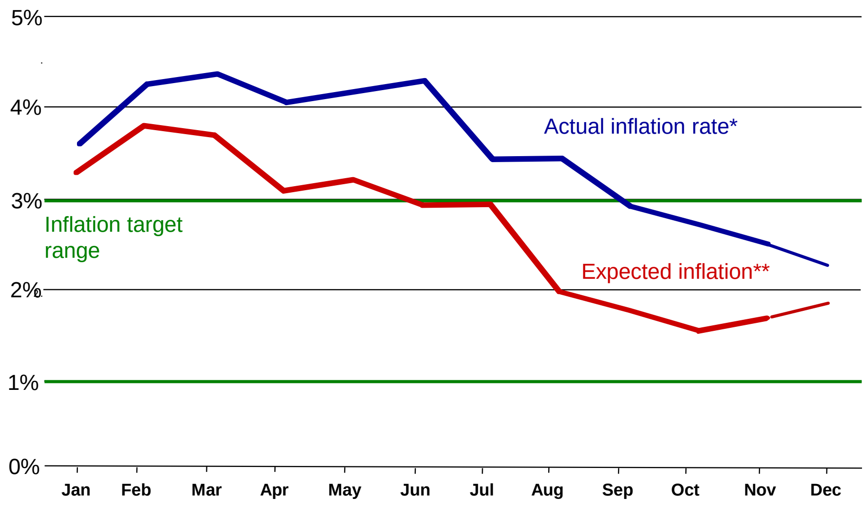
Source: Taub Center for Social Policy Studies in Israel.
Data: Bank of Israel.

Inflation, Interest Rates, and Financial Markets

Israel's inflation rate (Figure 7), which early in 2011 exceeded the target range of 1-3 percent per year reaching an overall annual rate of 4 percent, returned to the target range during the third quarter of 2011. Expectations of inflation derived from the capital market declined even more rapidly than did the inflation rate itself.

Figure 7

Inflation rate, 2011



* Inflation rate in the last 12 months (monthly averages).

** Expected inflation for the next 12 months (monthly averages).

Source: Taub Center for Social Policy Studies in Israel.
Data: Bank of Israel.

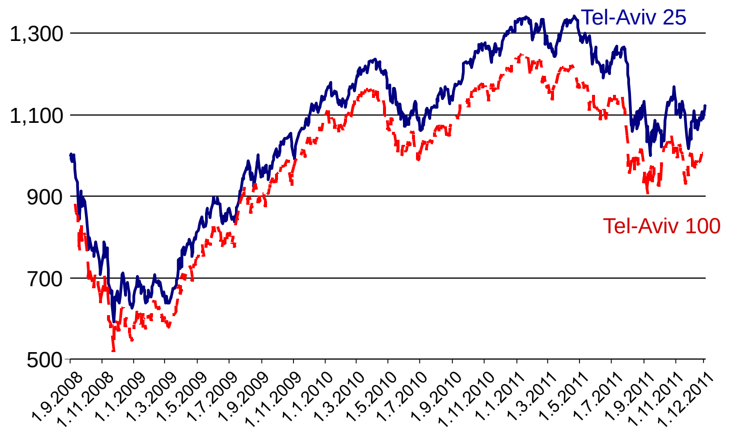
Over time, interest rates declined in a manner consistent with declines in the inflation rate and in inflation forecasts. This occurred in the context of a rise in the Bank of Israel interest rate from 2 percent in early 2011 to 3.25 percent in the third quarter – a restraining measure that caused a drop in inflation. As economic activity slowed, the upward trend came to a halt in October 2011, and the interest rate reductions carried out by the Bank of Israel's new Monetary Policy Committee brought the rate to 2.75 percent by late 2011. The CLA (current linked accounts) interest rate and the 5-year *SHAHAR* (NIS government bond) yield were consistent with the Bank of Israel's interest rate policy.

As the world market crises intensified, major stock market declines occurred; the TA-25 Index dropped by 18 percent over the course of 2011, as may be seen in Figure 8. Foreign influences were thus more dominant that year than were domestic developments (high growth and low interest rates).

Figure 8

Tel-Aviv stock exchange indices

September 2008 – November 2010



Source: Taub Center for Social Policy Studies in Israel.
Data: Tel-Aviv Stock Exchange.

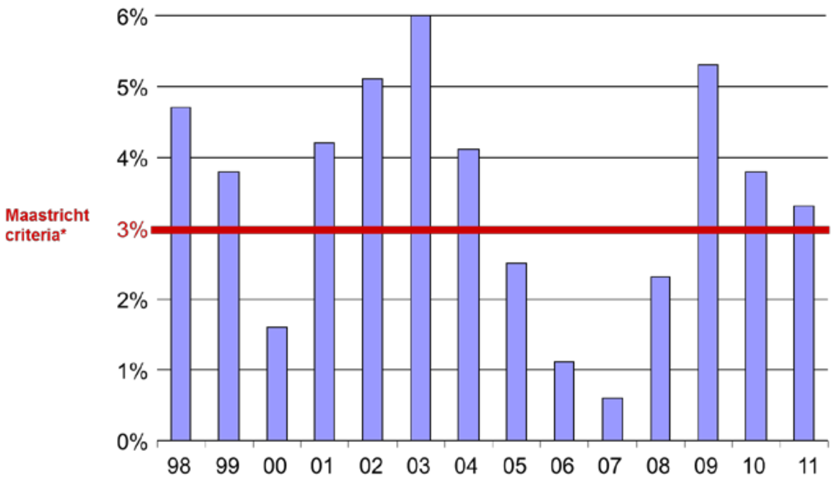
Fiscal Policy

Figure 9 shows the development of the government deficit. In 2011 tax revenues declined by NIS 2.2 billion, compared with the budget forecast of NIS 214 billion.

Figure 9

General government deficit

as percent of GDP, 1998-2011



* Using the European Union's Maastricht criteria from 1991, the debt is not to exceed 3 percent of the GDP. This agreement became accepted worldwide as a reasonable debt ceiling.

Source: Taub Center for Social Policy Studies in Israel.
Data: Central Bureau of Statistics, Bank of Israel calculations.

The Trajtenberg Committee recommendations of September 2011 entail budgetary changes that have been under discussion since the recommendations were published. It appears that the recommendations will be partially implemented in 2012, with no change to the budget framework. In consideration of the slowdown forecast for 2012, the main fiscal policy question for 2012 is whether it will be necessary to raise taxes in order to keep the deficit below the generally accepted 3 percent of GDP ceiling. Overall, 2011 was a year in which fiscal topics rose to the top of the public agenda (for further discussion, see *Proposal by the Heads of the Taub Center – A New Public Agenda for Israel* – Eran Yashiv (ed.) 2011).

To complete the current macroeconomic picture, one may say that, on the positive side, GDP growth was robust, as were the labor market and investment. Inflation, which tended at first to exceed the outer target of 3 percent, declined to within target parameters later on. Housing start figures were relatively high, and the house price index declined somewhat. On the negative side, one can point to a slowdown in economic activity toward the year's end, the emergence of a current account deficit, and a budget deficit increase due to a drop in tax revenues in the wake of the slowdown.

2. *Cyclical and Structural Aspects of Fiscal Policy*

The financial-economic crisis that began in 2008 continues to reverberate worldwide. Among other things it has produced a new environment for the management of government policy. Within the monetary sphere new issues are being taken up, such as interest rate policy at the zero lower bound,[1] quantitative easing,[2] macro-prudential policy,[3] etc. Fiscal policy,

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1 Zero interest rate policy: a concept describing the inability to set a negative nominal interest rate, such that the central bank is unable to reduce interest rates when they have reached zero.

2 Quantitative Easing (QE): When the central bank can no longer reduce interest rates, it can increase the size of its balance sheet by purchasing assets such as bonds. In such a situation the money supply increases with no corresponding drop in interest rates.

3 Macro-prudential policy: While prior to the crisis financial regulation around the world focused on maintaining the stability of each financial institution

for its part, is returning to traditional, Keynesian-style issues of fiscal activism,[4] while concurrently incorporating new concepts and techniques.

One major issue in the fiscal policy sphere is that of distinguishing between temporary or cyclical changes and structural changes, both in terms of assessing developments in the economy and in terms of the fiscal policy response. Temporary changes or problems may be cyclical or they may be caused by other short-term disturbances. Structural problems are long-term and often related to the structure of the markets, to the institutional environment (regulation, laws and their enforcement, labor unions, etc.) or to demographic processes.

An example of a temporary change in Israel is the tax cut of 2011 following a slowdown in world markets. An example of a structural change in the economy is the emergence of security issues necessitating a permanent change in the defense budget. Differentiating between structural and temporary changes is advantageous in several ways. Firstly, it facilitates the implementation of counter-cyclical policy during a recession (i.e., expanding the budget during a recession in order to stimulate the economy) while taking into consideration the development of the debt-GDP ratio. Secondly, this differentiation makes it possible to determine how structural fiscal changes (e.g., legislation, which affects state spending and revenues) affect the structural budget balance. And thirdly, this differentiation makes it possible to verify that long-term

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separately, macro-prudential policy focuses on the relationships between all components of the financial system, including the ramifications of inter-institutional relationships on the financial system's stability and on economic activity as a whole. The topic of macro-prudential policy is currently under development, and consideration is being given to a wide range of tools for managing such a policy, including controls on credit, restrictions on centralization, variable capital requirements linked to the business cycle, etc. (*Bank of Israel Report*, 2010).

4 Fiscal activism: Fiscal policy oriented toward market intervention, usually in order to encourage economic activity, GDP growth and employment during times of downturn.

policy is sustainable and compatible with planning as formulated by the decision making echelon.

One accepted means of implementing this distinction is that of the cyclically-adjusted budget balance – the budget balance that would be obtained were the economy on its long-term growth trajectory. The cyclically-adjusted budget balance adjusts for cyclical aspects of economic activity (i.e., the economy's deviations from its long-term growth trajectory due to temporary recessions or booms).

For example, during the current recessionary period, government tax revenues declined due to a drop in economic activity, while government spending increased due to a rise in the number of those eligible for benefits of various kinds. This combination led to an increase in the actual budget deficit. Assuming that the recession is temporary, one must look at the "structural" fiscal picture that would be obtained if there were no recession. This picture is delineated in terms of the cyclically-adjusted budget deficit, which neutralizes temporary recessionary effects on the actual budget deficit. Thus, the cyclically-adjusted budget deficit in this example is more useful than the actual budget deficit, that is, it provides a more accurate fiscal picture that reflects the true long-term state of the economy – rather than the state of the economy at the specific point in time where it is being affected by the recession.[5]

It should be remembered that fiscal policy is subject to numerous constraints: it is bound by fiscal rules such as restrictions on spending, on the deficit, and on the debt-to-GDP ratio; policy is sometimes limited in its ability to implement counter-cyclical measures due to these rules; fiscal policy reacts relatively slowly (this also depends on the length of the budget period and on the legislative arrangements); Israeli policy in

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5 Formally, a budget balance (deficit or surplus) is defined as:

$CAB = B - C = B - \varepsilon(Y - Y^*)$ where CAB is the cyclically-adjusted budget balance, B is the budget balance and C is the cyclical component; these values are calculated as percentage of GDP. The final component is a function of the GDP gap $Y - Y^*$, representing the actual GDP's deviation from the potential GDP; ε expresses the budget balance's elasticity vis-à-vis the GDP gap.

particular has trouble changing priorities and suffers from inertia; policy is also subject to critique on the part of the markets and the public. Basing policy on a cyclically-adjusted budget balance is one way of contending with these constraints.

The data point to the existence of a significant gap between a cyclically-adjusted budget balance and the actual budget balance. Table 1 presents the actual overall deficit, the same deficit cyclically adjusted by two different methods, and the cyclically-adjusted overall deficit for the OECD countries during the period 2002-2010. The adjustment for temporary influences on the deficit turns out to be significant.

Table 1. **Actual deficit and cyclically-adjusted deficit in Israel and the OECD countries, 2002-2010**

as percent of GDP

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Actual total deficit	5.0	5.8	4.0	2.4	1.0	0.2	2.0	5.0	3.4
Cyclically-adjusted total deficit	2.9	3.3	2.2	1.3	1.3	1.1	2.8	4.1	3.1
Cyclically-adjusted total deficit with international classification	4.0	4.4	3.1	2.3	2.4	1.9	3.9	5.1	4.0
Average cyclically-adjusted deficit in OECD countries*	1.5	2.1	1.7	1.3	0.7	0.7	2.5	4.5	4.6

***** Without Chile, Estonia and Slovenia.

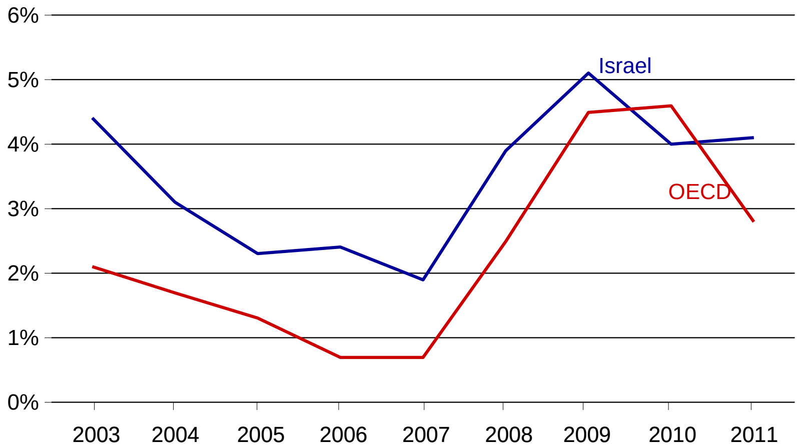
Source: Bank of Israel, 2010.

Figure 10 presents the cyclically-adjusted deficit data for Israel and the OECD countries during the period 2000-2010, based on a comparable international definition.[6] As one can see, Israel experienced a continual decline in its structural deficit, from 4 percent in 2000 to 2 percent in 2007; starting in 2004, Israel's structural deficit approached the OECD average. Beginning in 2008, when the present economic crisis erupted, structural deficits increased both in Israel and in the OECD countries, although in 2010 Israel's structural deficit was lower than that of the OECD countries. The meaning of this increase in the structural deficit in Israel and the OECD countries since 2008 is that the recent economic crisis led to a structural worsening of the fiscal picture, beyond the temporary disturbances occasioned by declines in state revenue and increased spending due to the crisis.

Figure 10

Cyclically-adjusted deficit in Israel and OECD countries

as percent of GDP, 2003-2011



Source: Taub Center for Social Policy Studies in Israel.

Data: Bank of Israel.

[6] The overall deficit was adjusted in this section to conform to the accepted international definition by adding linkage differentials to the local-currency debt (CPI-linked and non-linked), assuming 2 percent annual inflation.

The policy approach taken by Israel's Ministry of Finance in recent years bears similarities to the type of policy described above. During both 2008-2009 and 2011 the actual debt was greater than anticipated, due to cyclical or temporary factors. However, the Ministry of Finance did not change its budget policy – in de facto recognition of the cyclically-adjusted budget deficit's greater relevance for policymaking. Although the Ministry of Finance and the Bank of Israel both perform calculations similar to those described here, this approach has not been officially adopted; indeed, there is broad opposition to its official adoption.

In the wake of the summer 2011 protests and the calls for change in the socioeconomic sphere, the heads of the Taub Center issued a document (*Proposal by the Heads of the Taub Center – A New Public Agenda for Israel* – Eran Yashiv (ed.) 2011) containing proposals for change in Israel's national priorities. Despite the great differences in background, areas of expertise and overall outlook that exist within the Center leadership, there was a broad consensus regarding the main problems – government expenditure, housing, the labor market, education and higher education, health, infrastructure, welfare, market concentration – faced by Israeli society and the Israeli economy, as well as the national priorities to be adopted so that these problems may be systematically addressed.

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