The Global Outlook
and Some Implications for the Israeli Economy

Martin Eichenbaum
Northwestern University
June 2016

שתי עובדות מרכזיות

- שתי עובדות יעצבו את המדיניות הכלכלית בעשור הקרוב

- עובדה 1:
  - הצמיחה של הכלכלה העולמית ושל שותפי המסחר המרכזיים של ישראל נמצאת בירידה ותמשיך להיות נמוכה באופן יחסי.

- עובדה 2:
  - שערי הריבית הריאלית נמצאים בירידה מתמשכת וימשיכו להיות נמוכים בעתיד הנראה לעין.

מסקנות

- עובדה 1 (צמיחה נמוכה) גורמת לכך שיהיה קשה יותר לסקטור הייצוא לתמוך בצמיחה של הכלכלה הישראלית
  - ישראל צריכה להגדיל את פריון העבודה על מנת לשמור על צמיחה גבוהה.
- עובדה 2 (שערי ריבית ריאליים נמוכים) גורמים לכך שמדיניות מוניטרית תהיה פחות אפקטיבית בהתמודדות עם משברים מחזוריים בכלכלה.
  - מדיניות פיסקאלית תצטרך לעזור בהתמודדות.
- שתי העובדות יחדיו רומזות על תשואה חברתית גבוהה על השקעות ציבוריות אשר מגדילות את הפריון, בייחוד בזמני משבר

Background: the Great Recession

- The financial crisis of 2008 led to the largest, most severe recession in the post-war era.

- The crisis began in the U.S. Following the collapse of a housing bubble and a run on a highly-leveraged shadow banking system.

- The crisis spread to Europe due to concerns about the sustainability of government debt and the trade deficits of Portugal, Italy, Spain and Greece.

- The recession was a global phenomenon.
  - Between 1998- 2007, world wide trade volume grew on average by 6.7% a year.
  - In 2008, growth was only 3.0% and in 2009 growth fell by 10.5%.

In 2009 world GDP fell for the first time in the post-war era.

Annual percent change in output

	2006	2007	2008	2009
World output	5.2	5.4	2.9	-0.5
United States	2.7	1.9	0.0	-2.6
Euro area	3.1	2.9	0.4	-4.1
Russia	8.2	8.5	5.2	-7.8
China	12.7	14.2	9.6	9.2
India	9.7	9.9	6.2	6.8
Middle East	5.8	6.2	5.1	1.8
Israel	5.8	6.3	3.1	1.3

Source: World Economic Outlook, April, 2011, International Monetary Fund

Looking forward

A very slow and uneven global recovery

IMF Real GDP Growth Projections

	2016	2017
World output	3.2	3.5
United States*	2.0	2.0
Advanced Euro area	1.5	1.6
India	7.5	7.5
Japan	0.4	0.0
Russia	-1.8	0.8
China	6.5	6.2
Israel	2.8	3.0

Source: World Economic Outlook update, April, 2016, International Monetary Fund.
* Board of Governors, FRB, June 2016.

Why has the recovery been so weak?
The `optimistic' view

- Consumers' entered crisis with high leverage which they're *slowly* winding down.

- Monetary policy isn't very effective at the zero lower bound.

- Fiscal policy hasn't been sufficiently expansionary.

- The Europeans have been slow to reform their banking, product and labor markets.

- Uncertainty about future government policy.

- Uncertainty about future demand, here and abroad has led to extremely low investment levels.

The pessimistic view: secular stagnation

- The major economies are experiencing a very persist decline in underlying growth rates.

- Supply side considerations
  - Declining population growth rates
  - Declining growth rate of productivity.

- Demand side considerations
  - Declining investment rates relative to high savings rates
  - Persistent shortfalls in aggregate demand (Summers)

A Secular Decline in Growth Rates?

IMF Real GDP Growth Projections, April 2016

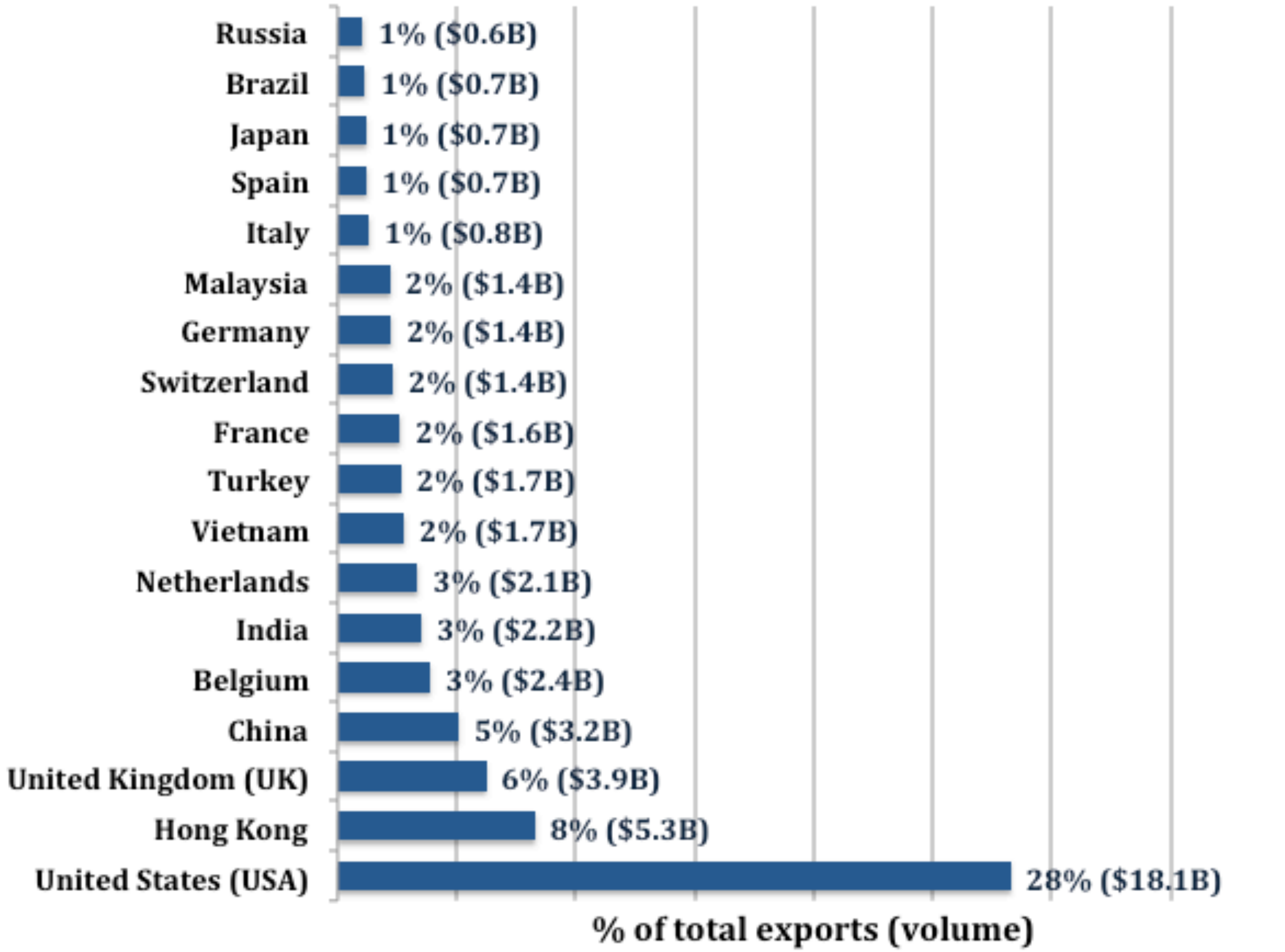
	1998-2007	2021
United States	3.0	2.0
Euro Area	2.4	1.5
India	7.1	7.5
Japan	1.0	0.7
Russia	5.8	1.5
China	9.9	6.0
Israel	3.9	2.9

Source: World Economic Outlook update, April, 2016, International Monetary Fund.

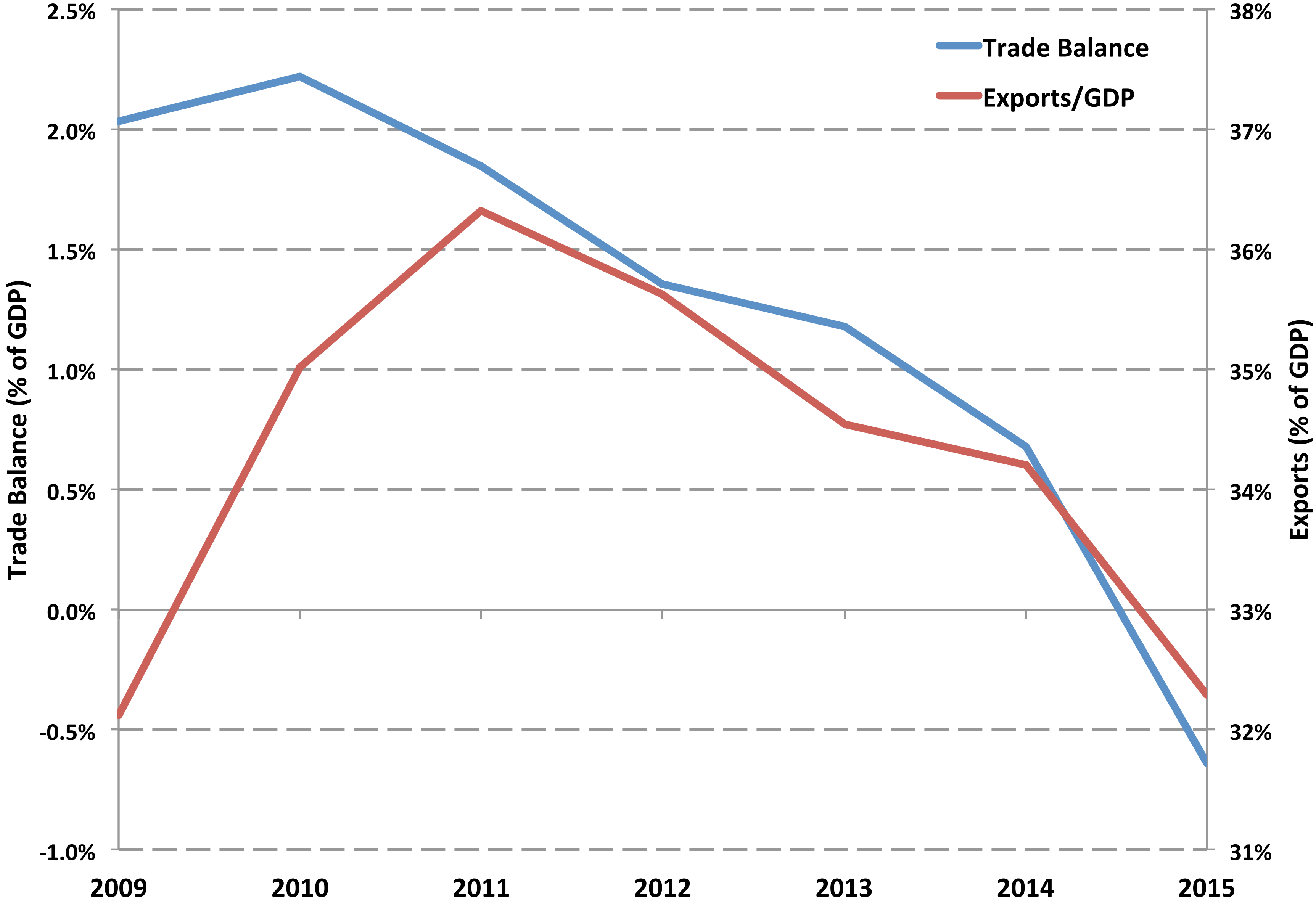
What does slowing world growth imply for Israel?

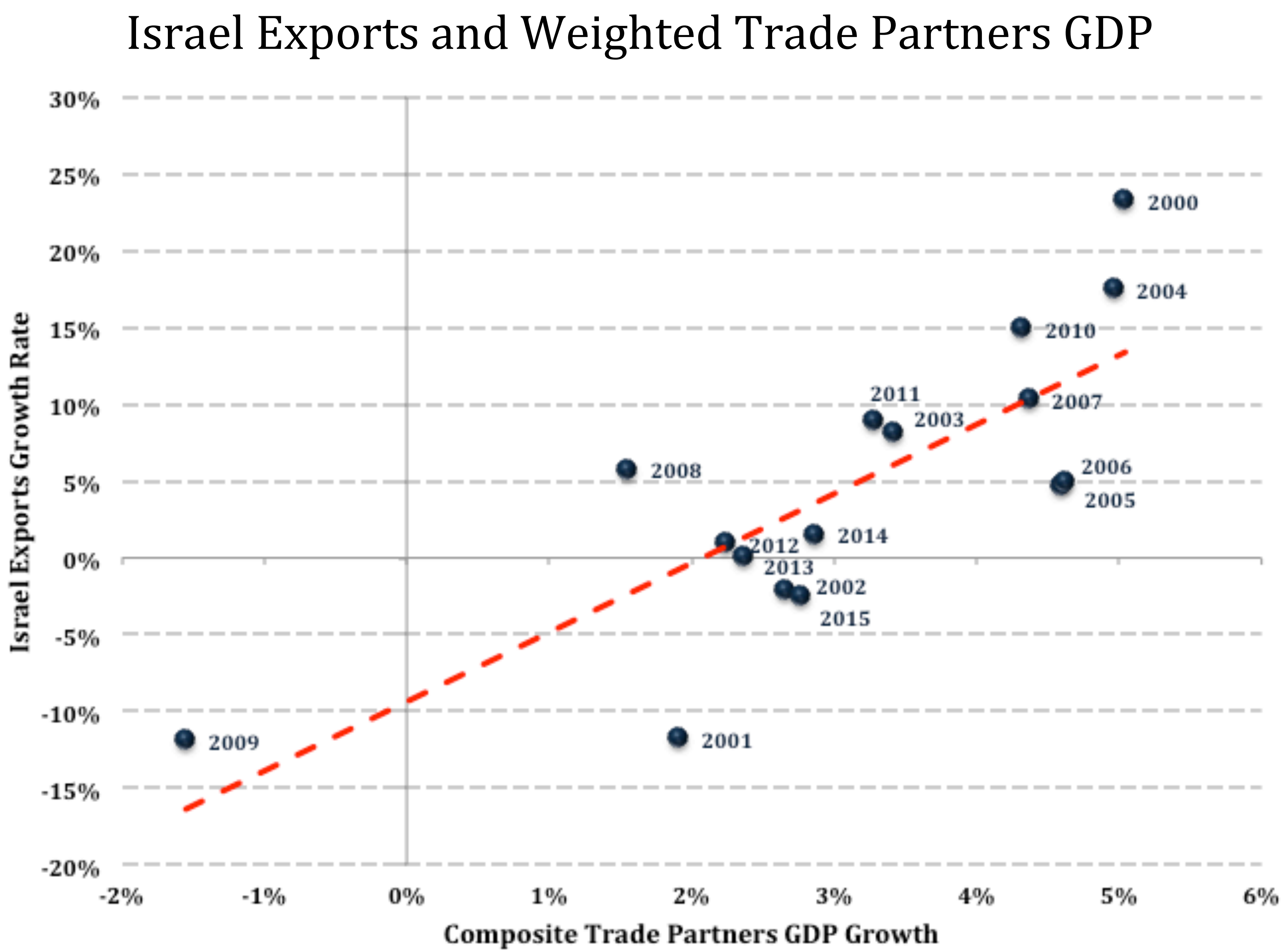
- Israel's exports are highly dependent on the growth rate of its major trading partners.
- Trade-weighted growth rate of Israel's partners is projected to be lower in the next 5 years than it was in the past.
- That decline decline will translate into lower growth of Israel's exports and ultimately to lower real GDP growth.
- Exchange interventions can only *temporarily* affect the real exchange rate. So they can't be the solution to the long term problem.

Israel Exports Trading Partners



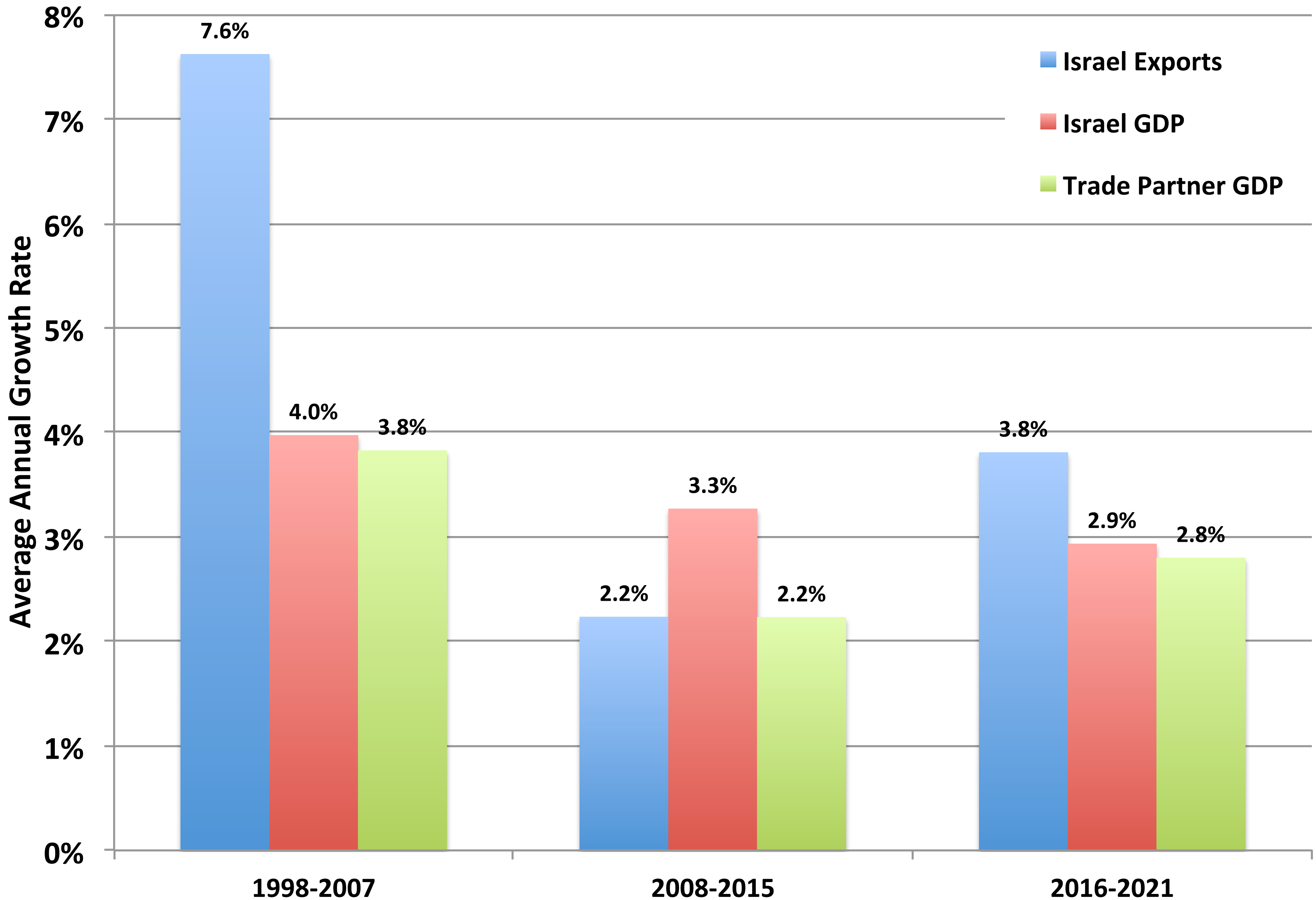
Exports are a powerful but declining engine of growth





Israel Exports and Weighted Trade Partners GDP
Israel Exports Growth Rate
Composite Trade Partners GDP Growth
30%
25%
20%
15%
10%
5%
0%
-5%
-10%
-15%
-20%
-2%
-1%
0%
1%
2%
3%
4%
5%
6%
2000
2004
2010
2011
2003
2007
2008
2006
2005
2014
2012
2013
2002
2015
2009
2001

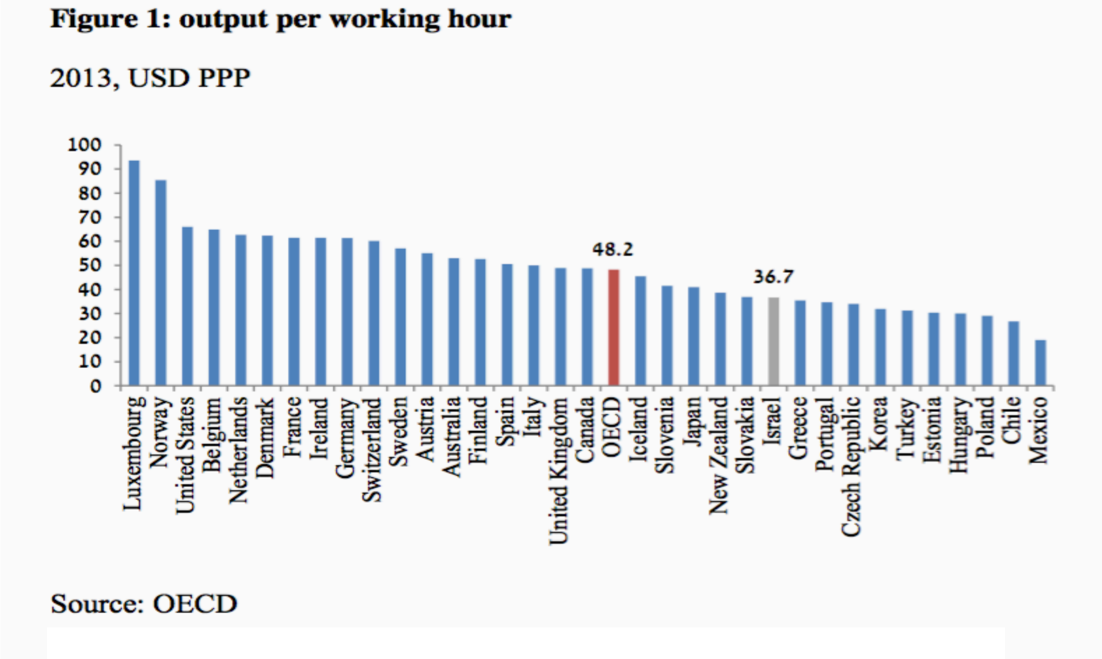
Looking forward: lower growth

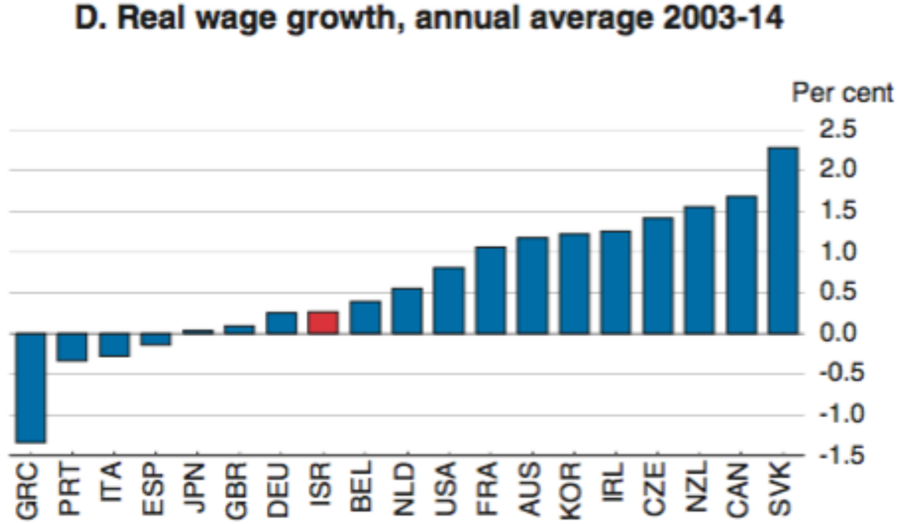


Fact 1: summary

- Growth rate of Israel's major trading partners is slowing down.
- That decline will result in slower growth of Israeli exports.
- Israel will have to boost productivity in the non-tradable and tradable sectors to compensate.
- Boosting productivity will require reforms and social investments.
- There's lots `low hanging fruit' (see OECD report).

Low productivity and wage growth relative to OECD





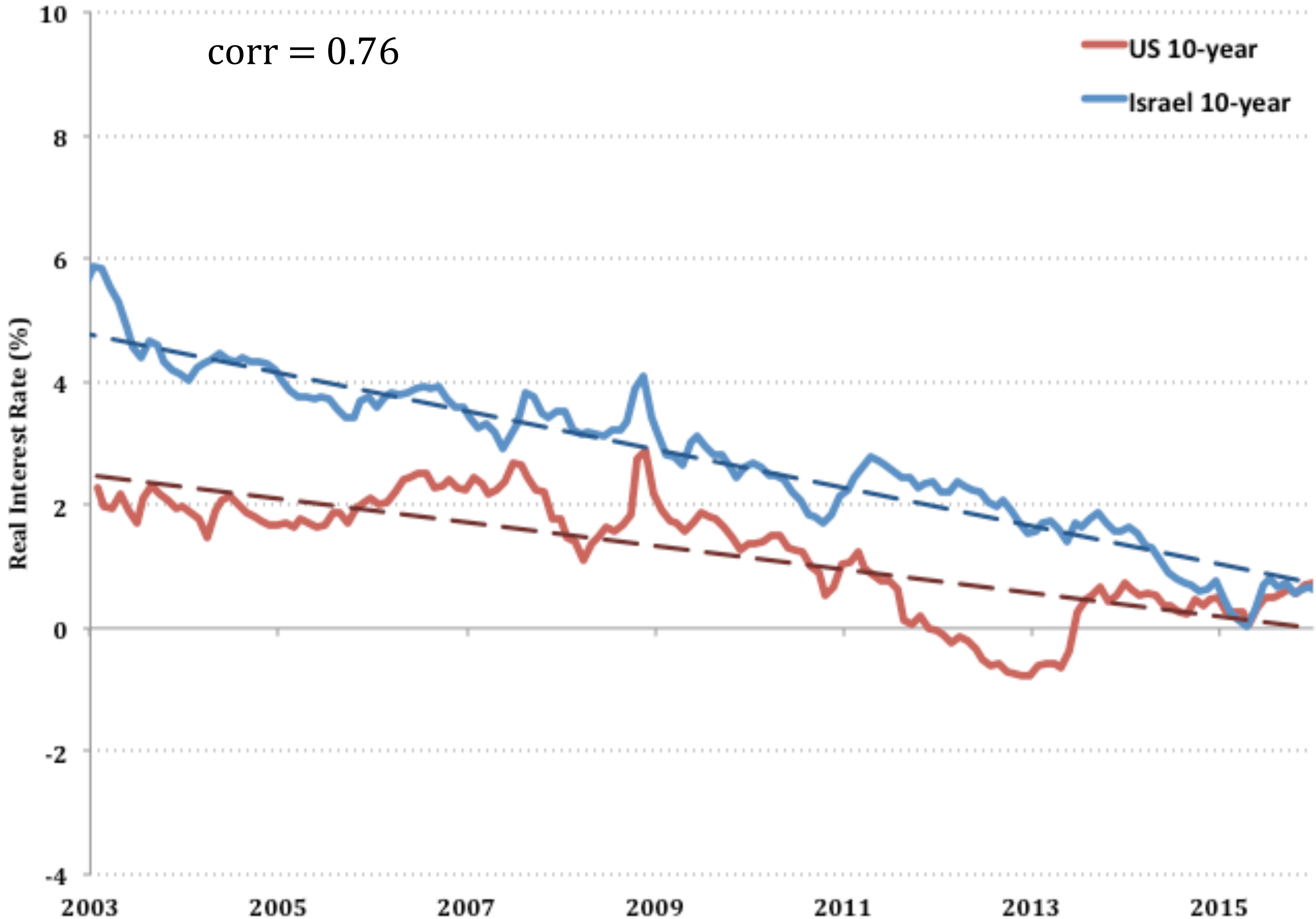
The returns to social investments

- To calculate the returns to fiscal investments, we need to compare benefits to costs.

- Israel is a small-open economy
  - The real interest is, with some lag and allowances for country specific risk premia, determined in world financial markets.

- Real interest rates are on a secular decline and are now at historical low.

US and Israeli Real Interest Rates



Zero Long –Term Rate: Swaps

10 year rates are extremely low

10 Year Interest Rates and Expected Inflation Rates			
	USA*	Japan	Germany
Nominal Swap Rate	1.26	0.10	0.26
- Inflation Swap	1.45	0.21	1.08
Real Swap Rate	-0.19	-0.11	-0.82

- Adjusted for 0.35 percentage point average difference between the CPI and The Federal Reserve's preferred PCE inflation rate

The returns to social investment

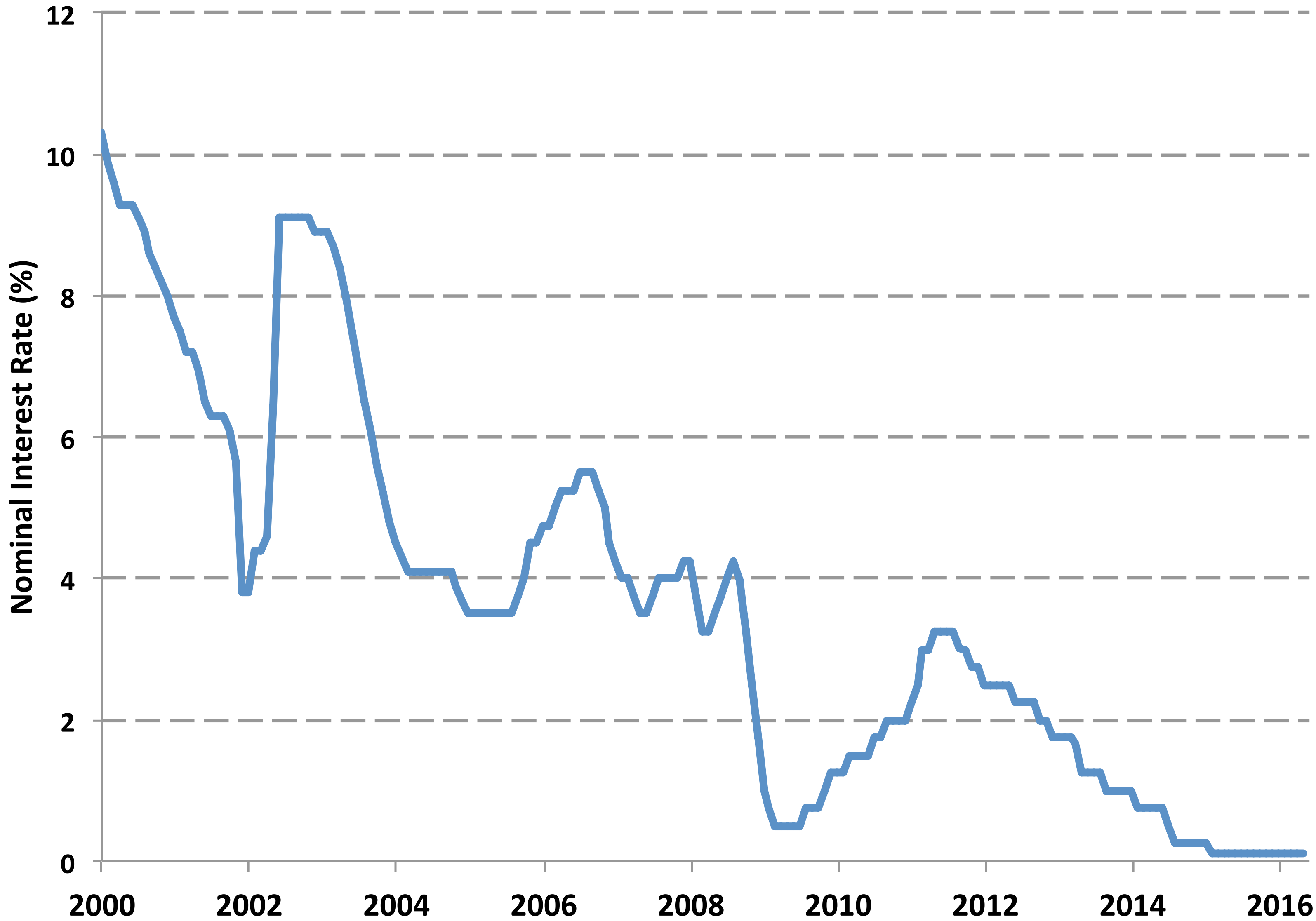
- Surely Israel can identify social investments that can pass a hurdle rate of under 1%.

- The returns to social investment / fiscal policy are even larger once we accept the ongoing relevance of the zero lower bound on nominal interest rates.

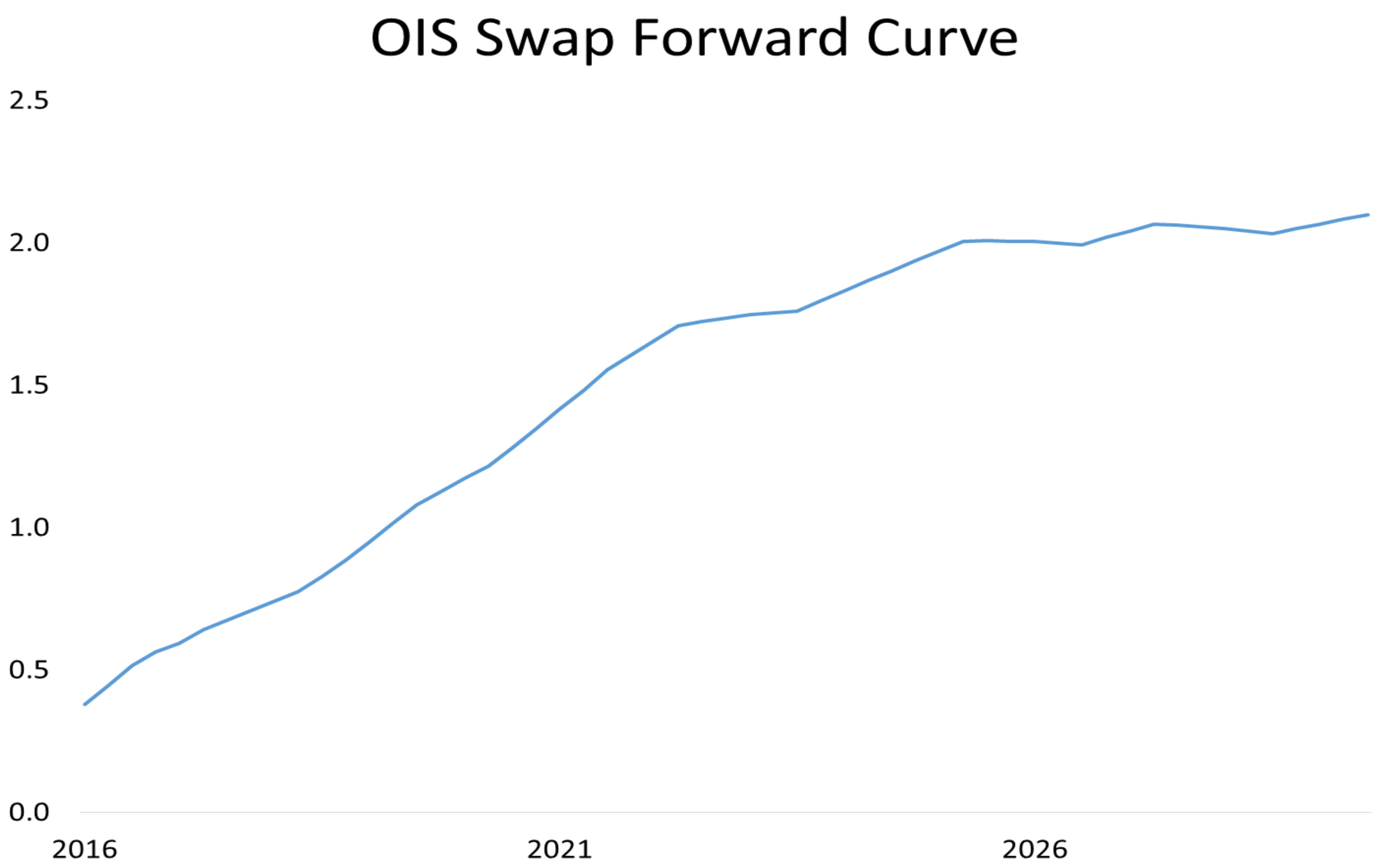
- Short-term nominal interest rates in Israel and abroad are close to zero. The market expects nominal rates to low for a very long time.

- As long as nominal rates are low, monetary policy has limited scope to help the economy respond to contractionary shocks.
  - It's hard to set policy rates much below zero (the ZLB problem).

The Bank of Israel Policy Rate



The market expects very low short term nominal interest rates



Sources: Bloomberg

Social Investment as Fiscal Policy

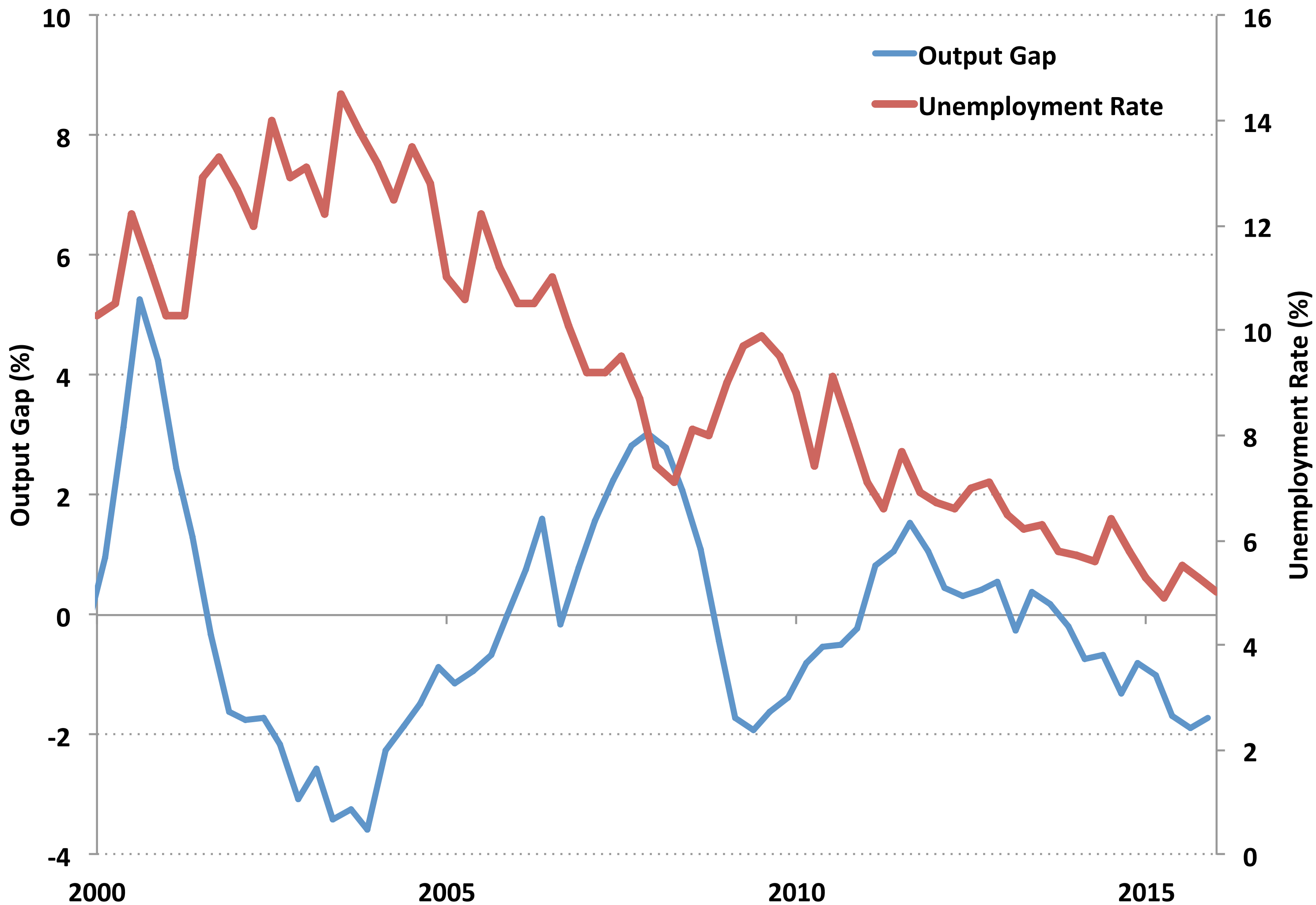
- Even for allowing for `exotic' options like negative interest rates and quantitative easing, the most powerful cyclical policy tool that we will have is fiscal policy.

- The impact of higher government spending on output – the `multiplier' – depends on various factors.

- Structural new-Keynesian models used by the IMF – ECB – the Fed – imply that
  - the multiplier is large when output cost associated with ZLB problem is large.
  - Highly correlated with the size of the output gap.

- Is the output gap big in Israel?

The output gap / unemployment rate in Israel



Mixed signals: depends on whether you look at output gap (production function based) or unemployment rate.

Social Investment as Fiscal Policy

- But we know – for a fact – that there will be contractionary shocks to the Israeli economy.

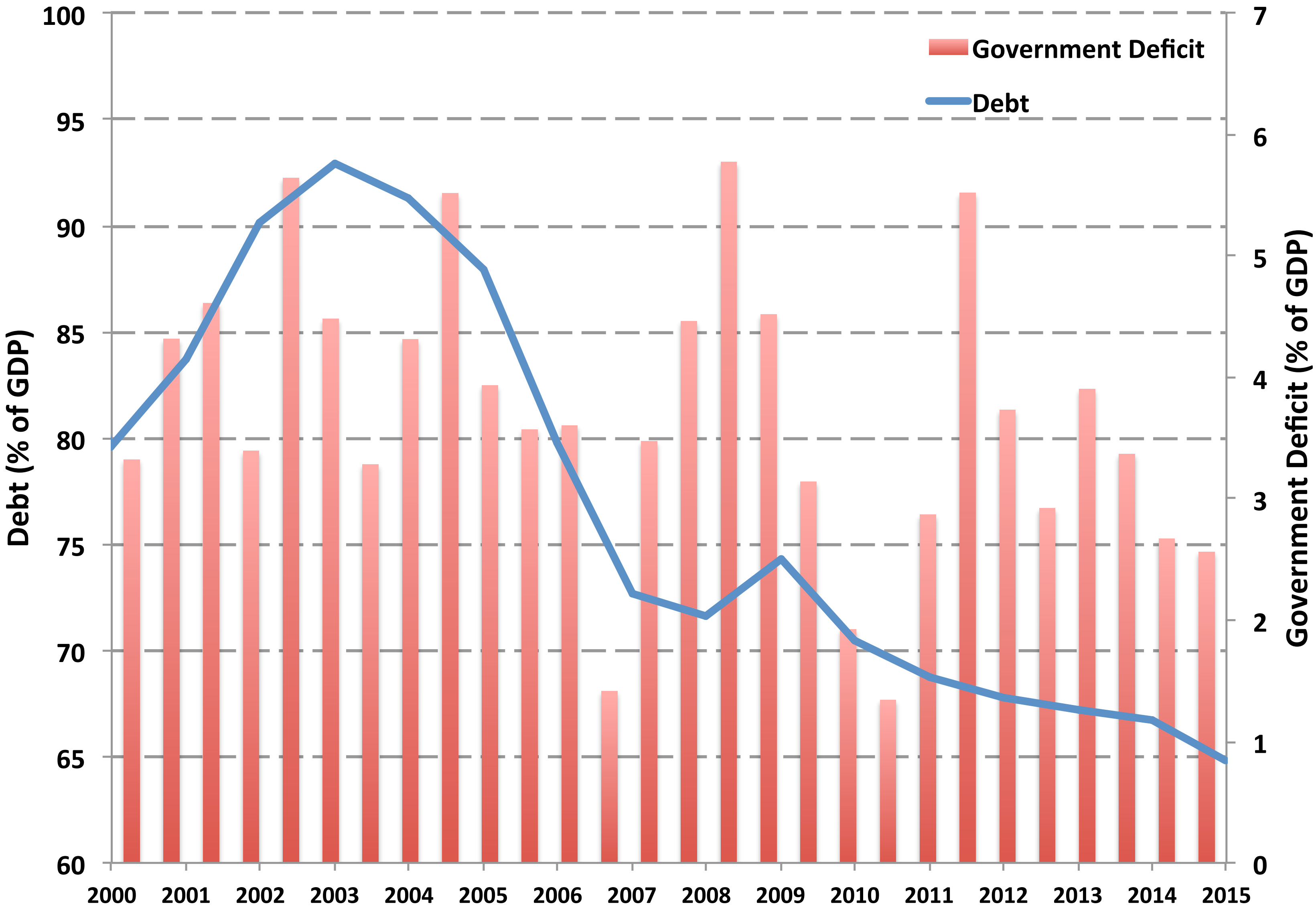
- In all likelihood they will occur before we return to a normal interest rate environment.

- At that point in time, the returns to social investment as fiscal policy will be extremely high.

Investment, not Entitlements

- Israel is justifiably proud of it's record on the deficit and the debt.
- I am not proposing that Israel increase spending on entitlements that might lead to a sustained increase in the debt-to-GDP ratio.
- The level of entitlements is a social decision that Israelis must decide
  - Of course, as an economist, I think that if you want more entitlements you should pay for them.

What about the deficit and the debt?



New battles require new strategies

- The growth is Israel's major trading partners will be lower than it was in the past. So the export sector will have a tougher time be the engine of growth for the Israeli economy.

- Nominal and real interest are likely to be low for a long time.

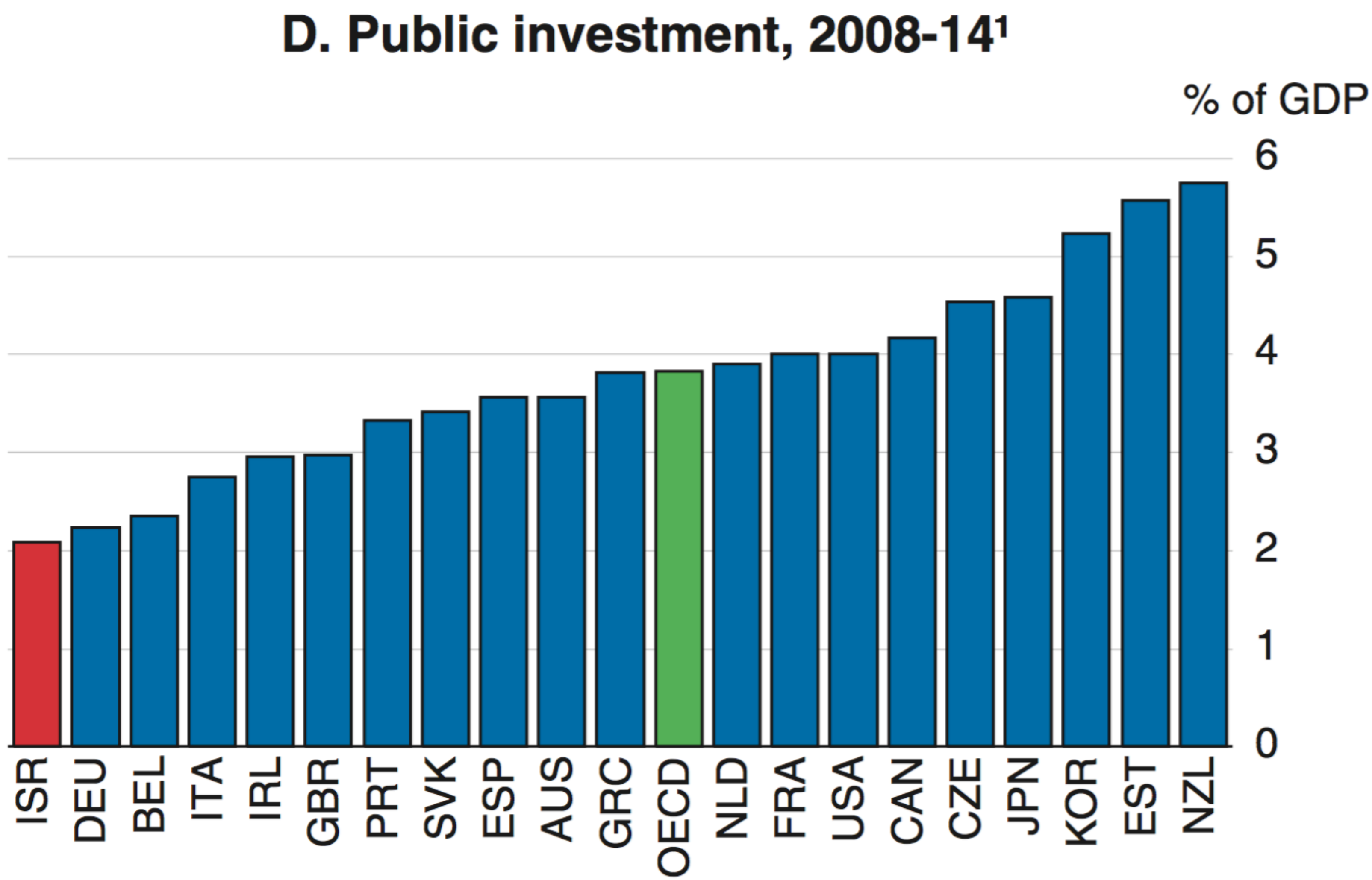
- Israel has low productivity rates.

- Monetary policy is likely to be relatively ineffective at combating adverse shocks to the economy.

- I conclude that returns to thoughtful social investments are high now and will be even higher in a future recession.

- The challenge: can Israel set up a system where the social investments are prioritized in thoughtful, non-partisan ways.

Public Investment as a percent of GDP
How does Israel compare to its OECD peers?



Role Models

- Fiscal will never be as non-partisan as monetary because the benefits tend to be concentrated across a smaller set of citizens.

- But that doesn’t mean Israel can’t move partly in that direction.

- Example:
  - Infrastructure Australia: an independent statutory body with a mandate to prioritize nationally significant infrastructure.