The Global Outlook and Some Implications for the Israeli Economy

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Northwestern University
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שני עובדות מרכזיות

• שני עובדות ייצובו את המודנויות הכלכליות בשטח הקרוב

• עובדה 1:

הצמיחה של הכלכלת העולמית ושל שותפי המסחר המרכזים של ישראל נתמכה במגזרים שונים.

• עובדה 2:

שערי הריבית הריאליים נמוכים יותר מאשר באריית הממשכות והמשיכו לחיות נמוכות בעידן העתיד.
מסקנות

• עובדה 1 (צמיחת נמוכה) גורמת לכר שיחיה קשה יوتر
lassen ihr die Wirtschaft des Landes – ישראליות
– ישראל אירציה הגדול יותר פינו העוברה על מנהלesseract על גמישה

• עובדה 2 (שעריר ריביתリアルיסו ומכים) גורמים לכר שמדיניית

– מדיניות פיסקליית产טרץ על יער בחתמיה

• שטחי העובדות يؤديים לרצוי על תשואה בחברית גבולה על

- השכקות ייזוויות תשאונות מחולות את הפוריים, בייחוד במקני

- 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.

<table>
<thead>
<tr>
<th>Country</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>2.7</td>
<td>1.9</td>
<td>0.0</td>
<td>-2.6</td>
</tr>
<tr>
<td>Euro area</td>
<td>3.1</td>
<td>2.9</td>
<td>0.4</td>
<td>-4.1</td>
</tr>
<tr>
<td>Russia</td>
<td>8.2</td>
<td>8.5</td>
<td>5.2</td>
<td>-7.8</td>
</tr>
<tr>
<td>China</td>
<td>12.7</td>
<td>14.2</td>
<td>9.6</td>
<td>9.2</td>
</tr>
<tr>
<td>India</td>
<td>9.7</td>
<td>9.9</td>
<td>6.2</td>
<td>6.8</td>
</tr>
<tr>
<td>Middle East</td>
<td>5.8</td>
<td>6.2</td>
<td>5.1</td>
<td>1.8</td>
</tr>
<tr>
<td>Israel</td>
<td>5.8</td>
<td>6.3</td>
<td>3.1</td>
<td>1.3</td>
</tr>
</tbody>
</table>

Source: World Economic Outlook, April, 2011, International Monetary Fund
Looking forward
A very slow and uneven global recovery

IMF Real GDP Growth Projections

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>World output</td>
<td>3.2</td>
<td>3.5</td>
</tr>
<tr>
<td>United States*</td>
<td>2.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Advanced Euro area</td>
<td>1.5</td>
<td>1.6</td>
</tr>
<tr>
<td>India</td>
<td>7.5</td>
<td>7.5</td>
</tr>
<tr>
<td>Japan</td>
<td>0.4</td>
<td>0.0</td>
</tr>
<tr>
<td>Russia</td>
<td>-1.8</td>
<td>0.8</td>
</tr>
<tr>
<td>China</td>
<td>6.5</td>
<td>6.2</td>
</tr>
<tr>
<td>Israel</td>
<td>2.8</td>
<td>3.0</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Country</th>
<th>1998-2007</th>
<th>2021</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>3.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Euro Area</td>
<td>2.4</td>
<td>1.5</td>
</tr>
<tr>
<td>India</td>
<td>7.1</td>
<td>7.5</td>
</tr>
<tr>
<td>Japan</td>
<td>1.0</td>
<td>0.7</td>
</tr>
<tr>
<td>Russia</td>
<td>5.8</td>
<td>1.5</td>
</tr>
<tr>
<td>China</td>
<td>9.9</td>
<td>6.0</td>
</tr>
<tr>
<td>Israel</td>
<td>3.9</td>
<td>2.9</td>
</tr>
</tbody>
</table>

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 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

<table>
<thead>
<tr>
<th>Country</th>
<th>% of Total Exports (Volume)</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States (USA)</td>
<td>28% ($18.1B)</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>8% ($5.3B)</td>
</tr>
<tr>
<td>United Kingdom (UK)</td>
<td>6% ($3.9B)</td>
</tr>
<tr>
<td>China</td>
<td>5% ($3.2B)</td>
</tr>
<tr>
<td>Belgium</td>
<td>3% ($2.4B)</td>
</tr>
<tr>
<td>India</td>
<td>3% ($2.2B)</td>
</tr>
<tr>
<td>Netherlands</td>
<td>3% ($2.1B)</td>
</tr>
<tr>
<td>Vietnam</td>
<td>2% ($1.7B)</td>
</tr>
<tr>
<td>Turkey</td>
<td>2% ($1.7B)</td>
</tr>
<tr>
<td>Switzerland</td>
<td>2% ($1.4B)</td>
</tr>
<tr>
<td>Germany</td>
<td>2% ($1.4B)</td>
</tr>
<tr>
<td>Malaysia</td>
<td>2% ($1.4B)</td>
</tr>
<tr>
<td>Italy</td>
<td>1% ($0.8B)</td>
</tr>
<tr>
<td>Spain</td>
<td>1% ($0.7B)</td>
</tr>
<tr>
<td>Japan</td>
<td>1% ($0.7B)</td>
</tr>
<tr>
<td>Brazil</td>
<td>1% ($0.7B)</td>
</tr>
<tr>
<td>Russia</td>
<td>1% ($0.6B)</td>
</tr>
</tbody>
</table>
Exports are a powerful but declining engine of growth
Israel Exports and Weighted Trade Partners GDP
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

corr = 0.76
Zero Long–Term Rate: Swaps
10 year rates are extremely low

<table>
<thead>
<tr>
<th>10 Year Interest Rates and Expected Inflation Rates</th>
<th>USA*</th>
<th>Japan</th>
<th>Germany</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominal Swap Rate</td>
<td>1.26</td>
<td>0.10</td>
<td>0.26</td>
</tr>
<tr>
<td>- Inflation Swap</td>
<td>1.45</td>
<td>0.21</td>
<td>1.08</td>
</tr>
<tr>
<td>Real Swap Rate</td>
<td>-0.19</td>
<td>-0.11</td>
<td>-0.82</td>
</tr>
</tbody>
</table>

- 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

Nominal Interest Rate (%) vs. Year

Graph showing the nominal interest rate trend for the Bank of Israel from 2000 to 2016.
The market expects very low short term nominal interest rates

OIS Swap Forward Curve

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?
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?

D. Public investment, 2008-14

% of GDP
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.