GLOBAL ECONOMY AND IMPLICATIONS FOR ISRAEL

Aaron Institute for Economic Policy Annual Conference
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Outline

World economic outlook (WEO)

Policy priorities for Israel

Broader trends in global economy
Market sentiment has improved since mid-2016

Change in bond yields since August 2016 (percentage points)

Equity price changes since August 2016 (percent)

Source: IMF staff calculations.
Along with business and consumer confidence

**Manufacturing PMI**
*(three-month moving average; deviations from 50)*

**Consumer Confidence**
*(index; 2010 = 100)*

Sources: Haver Analytics; and IMF staff estimates.
As global activity has begun picking up steam

World Trade and Industrial Production
(three-month moving average; annualized percent change, unless noted otherwise)

Sources: Haver Analytics; and IMF staff estimates.
Trade growth reflects improved investment

Advanced Economies
(percent; 2016)

Emerging Market and Developing Economies
(percent; 2016)

Source: IMF staff calculations.
Forces shaping the outlook

Advanced economies

- Cyclical rebound & monetary stimulus
- Post-crisis repair varies
- Expansionary U.S. fiscal policy

Emerging market and developing economies

- Rebalancing in China
- Adjustment to lower commodity prices
- Geopolitical and political factors

Ongoing forces...

- Demographic headwinds
- Weak productivity growth

...overlaid on...

- Demographic trends
World growth rises to 3.8% by 2022, from 3.1% in 2016, led by Emerging and Developing Economies

World GDP Growth

<table>
<thead>
<tr>
<th>Year</th>
<th>World GDP Growth (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995-2004</td>
<td>4</td>
</tr>
<tr>
<td>2005-2015</td>
<td>6</td>
</tr>
<tr>
<td>2016</td>
<td>3</td>
</tr>
<tr>
<td>2022</td>
<td>5</td>
</tr>
</tbody>
</table>

Advanced Economies
Cyclical recovery in near term, subdued growth in medium term, at 1.7% in 2022.

Emerging Market and Developing Economies
Stressed economies bottoming out, commodity importers generally projected to maintain high growth, overall growth of 5% by 2022.

Source: IMF staff calculations.
Core inflation little changed even as headline inflation up recently

Euro Area inflation reaches 2% gradually, led by Germany

Advanced Economies
(three-month moving average; annualized percent change)

<table>
<thead>
<tr>
<th>Year</th>
<th>Headline CPI</th>
<th>Core CPI</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>3.0</td>
<td>1.5</td>
</tr>
<tr>
<td>2013</td>
<td>2.5</td>
<td>1.0</td>
</tr>
<tr>
<td>2014</td>
<td>3.0</td>
<td>2.5</td>
</tr>
<tr>
<td>2015</td>
<td>2.0</td>
<td>1.5</td>
</tr>
<tr>
<td>2016</td>
<td>1.5</td>
<td>1.0</td>
</tr>
</tbody>
</table>

Source: IMF staff calculations.

Euro Area Headline CPI Inflation

- Euro area
- Germany
- Italy

But global growth risks skewed to downside

- **Protectionism.** Inward-looking policies could hurt demand and productivity.
- **U.S. macroeconomic policy mix.** Faster-than expected U.S. interest hikes and dollar appreciation could temper U.S. growth and stress vulnerable economies.
- **Financial threats to EMs.** Some EM countries are exposed to sudden shifts in investor confidence. In China, continued reliance on credit and slow restructuring mean that the risk of an eventual disruptive adjustment is growing.
- **Sharp rollback of financial regulation.** Higher risk of costly financial crises.
- **Weak demand and balance sheets.** In parts of Europe, adverse feedback among low demand, low inflation, weak balance sheets, and anemic productivity growth.
- **Non-economic shocks.** Geopolitical tensions, political discord, extreme weather events, and terrorism and security concerns.
Impact of U.S. Fiscal Stimulus on Other Economies: Depends on Supply-Side Effects and thus Interest Rate Reaction

Illustrative fiscal stimulus of 1% of GDP in 2018, and 2% of GDP in 2019-2021

Advanced Economies Real GDP
(percent deviation from case with no change in U.S. fiscal policy)

Emerging Markets Real GDP
(percent deviation from case with no change in U.S. fiscal policy)

Source: IMF staff calculations.
Implications of Global Outlook for Israel?

- **Export growth stronger:** about 4% in 2017-19, from almost flat in 2014-16

- **Real GDP growth solid:** about 3% in 2017-19
  - Employment growth about 2.5%, so unemployment remains below 5%
  - But productivity growth low, about 0.5%

- **Inflation rises:** low unemployment aids wage growth, higher global inflation

- **Interest rates rise in time:** yet low global interest rates may limit increase

- **Housing prices:** recent stability welcome, but potential for renewed upward pressures if interest rates remain low and supply gains are not lasting
Some Broader Trends in the Global Economy

• Slowing international trade
  
  *World Economic Outlook*, Oct. 2016, Chapter 2

• Declining productivity growth
  
  “Gone with the Headwinds: Global Productivity Growth”, *IMF Staff Discussion Note*, SDN/17/04, April 2017

• Low interest rates
  

• Falling labor share of income
  
  *World Economic Outlook*, April 2017, Chapter 3
Productivity Growth Has Slowed Around the World

Total Factor Productivity Growth, 2000–22
(PPP GDP-weighted; dashed lines indicate period average)

Partly a crisis legacy, as investment hit by:
• weak corporate balance sheets and tight credit
• weak aggregate demand
• uncertainty about economic policy

But structural headwinds continue to slow productivity:
• ICT boom waning
• aging workforce, slower human capital gains
• global trade integration slowing, e.g., China
• benefits of earlier EMDC reforms fading

Source: IMF staff estimates.
Israel’s Labor Productivity Growth has also Slowed Primarily in Manufacturing

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>1.3</td>
<td>0.5</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>4.0</td>
<td>0.4</td>
</tr>
<tr>
<td>Other</td>
<td>0.8</td>
<td>0.7</td>
</tr>
</tbody>
</table>

Sources: Central Bureau of Statistics; and IMF staff calculations.
Labor’s share of income has fallen in many countries including Israel.

While the downward trend in the labor share of income is fairly broad based across countries and industries, there is tremendous diversity in its evolution.
Decline in Israel’s labor share broadly in parallel with AE

But Israel’s labor share decline continued post crisis?

Labor Share of Income (Percent)

Ratio of Israeli Labor Share to Advanced Economy Labor Share (Index, 1995=100)

(May reflect terms of trade gains over 20% since 2008, rather than real wages rising slower than labor productivity.)

Sources: World Economic Outlook, April 2017; and Fund staff calculations.
Technology key driver of declining labor shares in AEs, and Global Value Chain participation in EMs. “Hollowing out” of medium-skilled labor.

Aggregate Results: Contributions to Aggregate Labor Share Changes, 1993–2014
(Deviation from regression constant)


- Technology
- Financial integration
- Unexplained
- GVC participation
- Policy/institutions
- Actual change

High skill
Middle skill
Low skill
Middle-skill AEs
Implications of broader trends for Israel

• Global productivity growth may remain below prior trends
  → Reduce Israel’s productivity shortfalls to the major advanced economies to help sustain solid growth

• Technology appears to be reducing labor shares which constrains real wage growth
  → Improve the skills of Israel’s labor force to limit these pressures on living standards

Sources: OECD; and IMF staff calculation.
Note: 1/ 2014 data is used due to data availability.
Policies for strong and inclusive growth in Israel

Education and infrastructure investment
- Reform education to reduce achievement gaps
- Training to boost skills of those already in work
- Upgrade public transport infrastructure

Product market reforms to boost productivity
- Lower barriers to external competition
- Reduce regulatory burden, e.g., “one-stop-shop”
- Reform state enterprises

Broaden labor participation
- Expand active labor market policies (ALMP)
- Enhance environment for job creation by SMEs
- Raise the EITC—welcome recent MoF proposal

Sources: CBS; and IMF staff calculations.
Macroeconomic policies for global growth recovery subject to downside risks

Supportive environment for structural reforms while protecting fiscal buffers:

- **Monetary policy:** remain accommodative pending a durable rise in inflation
- **Fiscal policy:** ensure Israel has substantial fiscal space to help cushion shocks
  - Achieve central government deficit of around 2% of GDP over the cycle, which will keep public debt around 60% of GDP
  - Generate spending savings and revenue gains to enable enhanced investment in education and infrastructure, plus expanded ALMP and EITC.
- **Housing:** reforms to generate lasting supply gains to meet rising population needs
- **Macroprudential policy:** appropriately tight, Bank of Israel to monitor closely
- **Financial sector:** safeguard stability during reforms to promote efficiency
Thank you!

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### Growth projections: Advanced economies

(Percent change from a year earlier)

<table>
<thead>
<tr>
<th></th>
<th>World</th>
<th>Advanced Economies</th>
<th>U.S.</th>
<th>U.K.</th>
<th>Japan</th>
<th>Euro Area</th>
<th>Germany</th>
<th>Canada</th>
<th>Other Advanced Asia</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>2016</strong></td>
<td>3.1</td>
<td>1.7</td>
<td>1.6</td>
<td>1.8</td>
<td>1.0</td>
<td>1.7</td>
<td>1.8</td>
<td>1.4</td>
<td>2.3</td>
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<tr>
<td><strong>2017</strong></td>
<td>3.5</td>
<td>2.0</td>
<td>2.3</td>
<td>2.0</td>
<td>1.2</td>
<td>1.7</td>
<td>1.6</td>
<td>1.9</td>
<td>2.5</td>
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<tr>
<td>Revision from Oct. 2016</td>
<td>0.1</td>
<td>0.2</td>
<td>0.1</td>
<td><strong>0.9</strong></td>
<td>0.6</td>
<td>0.2</td>
<td>0.2</td>
<td>0.0</td>
<td>0.0</td>
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<tr>
<td><strong>2018</strong></td>
<td>3.6</td>
<td>2.0</td>
<td>2.5</td>
<td>1.5</td>
<td>0.6</td>
<td>1.6</td>
<td>1.5</td>
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## Growth projections: Emerging markets and LIDCs

*(percent change from a year earlier)*

<table>
<thead>
<tr>
<th>Year</th>
<th>World</th>
<th>Emerging Market and Developing Economies</th>
<th>China</th>
<th>India</th>
<th>Brazil</th>
<th>Russia</th>
<th>Commodity Exporting Economies</th>
<th>Low Income Developing Countries</th>
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</thead>
<tbody>
<tr>
<td>2016</td>
<td>3.1</td>
<td>4.1</td>
<td>6.7</td>
<td>6.8</td>
<td>−3.6</td>
<td>−0.2</td>
<td>1.0</td>
<td>3.6</td>
</tr>
<tr>
<td>2017</td>
<td>3.5</td>
<td>4.5</td>
<td>6.6</td>
<td>7.2</td>
<td>0.2</td>
<td>1.4</td>
<td>2.3</td>
<td>4.7</td>
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<tr>
<td></td>
<td></td>
<td>Revision from Oct. 2016</td>
<td>0.1</td>
<td>−0.1</td>
<td>0.4</td>
<td>−0.4</td>
<td>−0.3</td>
<td>0.3</td>
</tr>
<tr>
<td>2018</td>
<td>3.6</td>
<td>4.8</td>
<td>6.2</td>
<td>7.7</td>
<td>1.7</td>
<td>1.4</td>
<td>2.9</td>
<td>5.3</td>
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<tr>
<td></td>
<td></td>
<td>Revision from Oct. 2016</td>
<td>0.0</td>
<td>0.0</td>
<td>0.2</td>
<td>0.0</td>
<td>0.2</td>
<td>0.2</td>
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Sources: IMF, *World Economic Outlook* October 2016 Update; and IMF, *World Economic Outlook* April 2017