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Press Release:

Remarks by the Governor
at the Eli Hurwitz Conference on the Economy and Society 2023

I will begin my remarks with a few words about the state of the economy, the real economy, inflation, and monetary policy. I will follow with reference to the state budget that the Knesset recently approved, and conclude with a few words about the markets’ response to the proposed changes in the judicial system.

If I had to characterize the state of the economy in one word, I would say “complex.”

The level of economic activity is high:

* GDP has surpassed its trend in the past year and a half and has shown no serious decline.
* If we look at the average for the past two quarters in order to net out the effect of motor vehicle purchases in the previous quarter, which originated in tax considerations, we find a 3.7 percent growth rate, very close to the long-term trend.
* In this respect, we are slightly better off than we expected at the beginning of the year, mainly due to the investment component and services exports.
* The labor market is tight. Participation and employment rates are very high and surpass their 2019 average. The unemployment rate is very low.

In contrast, there are certain indicators of slowing of activity:

* For example, the job vacancy rate, although higher than in 2019, has been leveling off in recent months.
* In addition, private consumption as a share of GDP has fallen according to the most recent data, possibly attesting to the onset of the effect of the monetary restraint on the economy.

There are additional indicators of slowing. Activity in the real estate market—manifested in purchases of dwellings and mortgage volume—is declining, outstanding bank credit to small businesses has contracted, and the pace of capital raising by high tech companies has fallen off considerably relative to recent years. **Summarizing this part of my remarks, I find that economic activity is strong but the most recent data show that some slowing has occurred.**

Now, a few words about inflation and monetary policy:

Inflation in Israel is in the 25th percentile among OECD countries. However, the inflation rate is high at 5 percent. The latest CPI dealt the capital market, the forecasters, and ourselves as well an upward surprise at 0.8 percent, after a 0.4–0.5 percent increase had been expected. The deviation from the forecasts originates mainly in the component of travel abroad. On the bottom line, inflation appears to be sticky.

The effectiveness of monetary policy in various countries is a topic of much discussion.

It is important to me to explain two important points. First, just as a person who diets sometimes finds the last five kilograms the hardest to shed, it is easier to lower inflation from 9–10 percent to 5 percent than from 5 percent to 2 percent.

In addition, it is important to look at the mix of inflation. The rapid decline in inflation in the US traces mainly to steep decreases in the goods, energy, and food components. Israel saw almost no inflation in these respects from the very outset, for reasons including long-term natural gas contracts. Inflation in services, or the core, in contrast, is proving stickier in both Israel and the US.

To demonstrate this, imagine a graph that shows, on its X-axis, the number of months that have passed since inflation surpassed the central bank’s target, and on its Y-axis the distance between the central-bank interest rate and the inflation rate. This yields a “tightness index” of sorts, one that shows how determined and rapid a central bank’s response to inflation is. By this measure, the response of monetary policy in Israel has been relatively swift. We began to raise interest rates at an early stage relative to the upturn in inflation and actually preceded the upturn in the course of 2021 by cutting back on the bond purchases that we had been making during the pandemic. Along the way, our “tightness index” was very favorable, and it is important for us to sustain this level of tightness due to our deep-seated commitment to price stability.

Looking forward, one may observe the inflation forecasts in the coming year as expressed by financial institutions in Israel after the interest rate announcement. In the coming month, we expect to see a CPI that is not low and we foresee inflation remaining in the vicinity of 5 percent. In the course of the year, however, inflation is expected to subside and to converge toward the target range during the first quarter of the coming year—thanks to our tight monetary policy. Below I elaborate on the question of the exchange rate and its effect on inflation. Here I note that in the most recent interest rate decision, the Monetary Committee noted that interest rates are in a restrictive environment, the sort that corresponds to the slowing of inflation in the course of the coming year. This obtains as long as no major changes in activity and the inflation environment occur. Since then, we have seen further depreciation in the vicinity of 2–3 percent. Insofar as this trend continues, an even tighter monetary policy may be needed.

I conclude this part of my remarks with three insights about inflation and monetary policy, relating to:

1. the value of maintaining price stability.
2. the adverse impact that inflation inflicts on weak population groups;
3. the relationship among inflation, interest rate hikes, and higher mortgage-loan payments.

There are, I think, two kinds of people in Israel: those who need an explanation about why maintaining price stability is such an important target, and those who lived here in the 1980s.

Generally speaking, price stability is an essential condition for economic stability. I have spoken about this many times. Price stability is a basic condition for economic growth and protection of households’ and businesses’ purchasing power. A stable price environment abets certainty and, by so doing, promotes investment and job creation and allows businesses and households to make intelligent decisions and plan their future.

Beyond this, it is important to realize that high inflation is injurious to weak population groups above all:

* Weak population groups spend a larger share of their total income on private consumption and, therefore, are more exposed to price increases. Thus, the higher one’s income is, the less one spends on private consumption relative to income.
* In addition, weak population groups spend relatively more on products that are not easily substitutable or done without. It is easier to forgo another flight abroad than a loaf of bread.

Now I wish to explain an important point about the relationship between rate increases and higher mortgage-loan payments.

As I noted, raising the interest rate is a painful but essential tool in stamping out inflation. The costs of mortgage repayment is an inevitable part of this pain—a pain that we examine and fit into the process each time. This is a correct thing to say, but would like to relate to another aspect: the tradeoff between the long term and the short term. I’ll explain this point with the following simulation: the development of monthly payments on a twenty-five-year NIS 1 million mortgage with a mix of 40 percent prime, 30 percent fixed and unindexed, and 30 percent fixed and CPI-indexed, taken in January 2022, at the average rates recorded then on each track. One line in the simulation shows what the monthly payment would be if the market conditions that were built into the forecasts—the yield curves as they had existed at the time the loan was taken—had actually come about. Another line shows what would happen in a reality similar to ours: inflation rises to 5 percent, the interest rate climbs gradually to 4.75 percent and remains at that level for about a year, inflation then slows gradually to an annual pace of 3 percent for two years and then drops to 2 percent, and the Bank of Israel rate falls gradually to the vicinity of 2.5 percent. I stress that by saying this I am not expressing an expectation or an estimate of how long the Bank of Israel rate will remain in its present environment; I am merely offering a simulation that illustrates the general idea. This said, the monthly payment goes up by about NIS 1,000, as many Israelis are feeling today, and then edges back toward the original payback path.

Now, what would happen in a scenario where the Bank of Israel does not respond and the inflation rate rises to 10 percent and stays there? In this case, the monthly payment hardly increases at first, mainly due to the structure of the payback table of the mortgage loan. Later, however, it rises exponentially and, in this simulation, considerably.

I must note that I am speaking of the nominal monthly payment of course; the simulation does not take wage adjustments into account. However, it is important to bear in mind that the combination of long-term 10 percent inflation and no interest rate increase is unsustainable. History shows that when inflation reaches such high levels without monetary tightening it tends to continue rising quickly. Were that to happen, the adverse impact would be much greater.

The message of this simulation, despite its qualifications and the straw-man nature of the last-mentioned scenario, is that amid the lively discourse about the pain that comes along with increases in mortgage payback rates, it is important to realize that the negative impact to mortgage borrowers would be much greater and more painful if inflation is not restrained.

Having touched upon a topic related to the banking system, I now turn to the vigourous public debate about the banks that is taking place as I speak. The banking system plays a central role in the transmission of monetary policy and, by so doing, is a highly important link in shaping the macroeconomic environment. The recent upturn in the inflation and interest rate environment is definitely making the banking system highly profitable. This phenomenon is unsurprising: the connection between rate increases and widening margins is well-known and documented in the economic literature. In Israel, it is augmented by the indexation of outstanding credit to the inflation rate. In this context, I consider it important to say what I have said several times: I expect the banking system to roll over the rate increase to the public by not only making credit more expensive but also paying higher interest on deposits.

The transmission of the Bank of Israel rate to the deposit rate has definitely improved somewhat and is conspicuously favorable in comparison with other countries.

As of today, the public has NIS 1.4 trillion in local-currency bank deposits, of which more than NIS 500 billion is sitting in current accounts. Depositors rarely receive interest on these balances but the banks generate interest income from them. In this matter, I have told the banks plainly: you must behave decently and apply long-term strategic thinking. Accordingly, you must inform customers that they can put their money in interest-bearing deposits so that they may benefit from the advantages that come with a high interest environment.

If the banking system fails to do this on its own, the Bank of Israel will not hesitate to wield its regulatory tools and require the banks to approach their customers at their initiative and offer them more attractive savings programs than demand accounts.

Current accounts are only one component of a bank’s relationship with its customers, in which the customer’s wellbeing and that of the bank must be kept in balance. Recent measures by some banks to offer customers creative ways to cope with the effect of the interest increase on their monthly payments are an apt example of the banks’ ability to help customers and reach out to those in need of assistance.

The banking system has to continue taking steps of this kind, expand them to additional fields, and treat consumers of financial services with due sensitivity at this time of rapid price and interest increases.

Now I wish to say a few words about the state budget that the Knesset approved last week.

First, as I have said several times in the past, the budget framework is not overly expansionary and, in this context, it is a responsible budget framework, as are the wage agreements that were concluded several months ago. Both of them correspond with the targets of the monetary policy and the convergence of inflation back to the target. In this context, I think the Bank of Israel made a considerable contribution, together with the resolve of the Minister of Finance, to preserving the budget framework despite the many pressures that were applied. Looking at the mix of the budget, however, I believe that it lacks crucial growth drivers for the economy and in certain places actually makes a negative contribution to that cause.

I refer mainly to the two most important axes for the acceleration of growth in Israel: physical capital and human capital.

In regard to physical capital, I start by saying that, overall, in the current budget the Ministry of Finance has exhausted its budgeting of infrastructure investment relative to the existing planning inventory. It is no secret that physical capital in Israel is small by international standards. The gap is considerable, particularly in view of Israel’s brisk demographic growth. One of the main determinants of the gap in physical capital is underinvestment in national infrastructure such as public transport, roads, the metro project, and so on. Everybody knows the price of this: Israel stands out unfavorably in the international indices of traffic congestion. As I have pointed out on many occasions, however, the underinvestment—that is, the shortfall of budget resources that are needed to bring the infrastructure inventories to faster fruition—is largely due to the lack of a long-term planning inventory and budget certainty in reference to it. One way of creating such certainty, which I recommended at this conference and elsewhere in the past, is by establishing an extrabudgetary fund for transport infrastructure, to which a sum from the budget would be transferred each year in order to fund investments once they mature. This is the optimal way to create planning and budgetary certainty. Planning and budgetary certainty irrespective of business cycles would prevent the occasional situations in which there is a budget but no programs or programs and no budget. It is important to emphasize that these transfers should be part of the state budget and should be included in calculating the deficit. To make sure that the fund is used for its purpose—investing more in needed infrastructure and preventing leaking of the contents of the fund to current expenditure—a fiscal council should be established to review the investment policy and make sure that the projects financed by the fund are high in quality and conducive to growth, as the IMF recommends. I know that some of you have already heard me and others at the Bank talking about this more than once. But just as eight consecutive years have passed since the Bank of Israel began to persuade the government to introduce a negative income tax—a measure that is widely praised today—so in regard to setting up an infrastructure-investment fund, we will simply continue to repeat ourselves.

The second topic is human capital: The Bank of Israel has been claiming for years that one of Israel’s strategic economic challenges is rooted in raising labor productivity, foremost by enhancing human capital. Examples of this abound: in each of the Bank of Israel annual reports in the past decade, the productivity report that the Bank published in 2019, and the strategic documents presented to the two most recent governments.

To improve the quality of human capital, the quality of the education system has to be improved so that it will impart the skills that the steadily and rapidly changing labor market really needs. On this point, there is room for improvement in all parts of the population. An important challenge in the field of human capital centers on two population groups: Ultra-Orthodox men and Arab women. Both have low employment rates and skill sets that need major improvement. In demographic terms, the share of the ultra-Orthodox population in the total population is expected to grow considerably.

Back in 2019, I gave a speech that was called “Ultra-Orthodox Society as Part of Israel’s Economy of Tomorrow.” The analysis I offered shows that, according to a basic growth model combined with demographic forecasts, if the employment rate of ultra-Orthodox men remains roughly where it is today, per-capita GDP in 2065 will be some NIS 13,000 below a scenario in which their employment rate converges to that of the rest of the economy. In such a situation, to maintain a level of tax receipts similar to that of 2018, direct taxes will have to be raised by 16 percent by 2065. This figure returned to the headlines recently in the discourse surrounding the approval of the budget. These, of course, are only magnitudes that demonstrate the importance of the matter.

It is important for me to emphasize that beyond the economic efficiency argument that I noted, there is a normative element: We must, as a society, ensure equal opportunity for all parts of the population at the basic levels of skills that the labor market needs—particularly mathematics and English—so that every youngster, from whatever sector in Israel, will be able to choose to go to work and earn a handsome wage.

The fiscal council that I mentioned above should also be able to review an entire project from an integrated and long-term perspective, and should make it possible to present potentially controversal matters for public debate in real time—that is, at the early stage of forming the government and formulating the budget. This should happen before the budget is approved by the various committees, at a stage when it can still be amended and not at the eleventh hour.

Unfortunately, as far as human capital and willingness to participate in the labor market are concerned, the current budget has nothing really new to offer and raises concern that it will even do the opposite.

Now I wish to say a few words about the markets’ response to the domestic events surrounding the proposed changes in the judicial system.

In the past few years, the NASDAQ index and the level of capital-raising by the high-tech sector marched in tandem. In recent months, this link appears to have weakened somewhat: despite the increase in the NASDAQ index in recent months, capital issues remain small.

It is true that high-tech issues have declined worldwide. However, Israel’s share in such issues has fallen steeply in recent months, meaning that capital raising has slipped more steeply in Israel than in the rest of the world. In particular, the ratio of capital issues in Israel relative to those in the United States has fallen considerably and has returned to pre-2019 levels.

In addition, according to a recent estimate by the Innovation Authority, 50–80 percent of high-tech firms established in March 2023 chose to incorporate by means of a foreign company. Insofar as this trend persists, it may have an adverse effect on the economy in the long term.

I will not dwell on this too much, but since the beginning of the year the domestic capital market has underperformed the rest of the world and its CDS spread—the price of the risk premium of government bonds—has widened.

Another connection that has slackened in the past few months is that between foreign equity indices and the NIS exchange rate. The foreign-currency market, the most liquid market of all, is an important indicator of sentiment about the Israeli economy.

I offer an analysis of a linear regression model of the log NIS/USD exchange rate over the log NASDAQ index in daily readings for a relatively short period, in which macroeconomic variables have less of an effect. In 2018–2022, extreme events aside, the actual NIS/USD exchange rate and the exchange rate estimated from the regression model behaved similarly. That is to say, the US equity market “explained” the exchange rate rather well. Since late 2022, the two variables have moved separated, meaning that the ability of the US equity market to explain the exchange rate has lost much potency. Thus, the “predicted” exchange rate, derived from the regression, stands at NIS 3.3 to the dollar whereas the actual rate is around NIS 3.7. Simply put, one may call this “excess depreciation”—the kind not derived from the estimated connection between the exchange rate and the US equity market that existed until late 2022. These results are robust to different periods and additional variables. To be conservative and study the entire recent period and not only the end data, one may quantify the excess depreciation at around 10 percent.

Excess depreciation has a perceptible effect on the economy. A model estimated by the Bank of Israel shows that the transmission from the exchange rate to inflation is some 20 percent over six months. Put simply, for each percent of depreciation, the annual index is expected to rise by about one-fifth of a percent. Even if the estimates that I presented just now are not totally accurate—the model in question, like any economic model, is imperfect—there is no doubt that the depreciation we have experienced has had a major effect on inflation. By combining these two arguments—excess depreciation and transmission from the exchange rate to inflation—one may infer, using conservative coefficients, that we have excess inflation of at least 1 percent.

One cannot refute this argument by stating, “But the dollar is appreciating all over the world”; Given that most currencies have actually gained against the dollar in the past half-year, the depreciation of the NIS stands out.

To evaluate the impact of the domestic factors on the exchange rate with greater acuity, we turn to the daily change in the exchange rate and parse it into global and domestic determinants. This deconstruction is carried out as follows: we take the exchange rates of the twelve most traded currencies against the dollar, which account for 98 percent of total trading against the dollar; calculate a weighted average of the changes in the currencies against the dollar, and obtain the global effect. The difference between the representative rates and the global effect yields the change that originates in the domestic effect. Upward changes represent depreciation.

It may be seen that much of the recent movements trace to domestic factors and some of them may be linked to specific events.

**In sum, the Israeli economy is dynamic and resilient, as it has been throughout the crises of recent years. At the moment, it features solid activity with some slowing in the end data and inflation that remains sticky.**

**There is no doubt the Israeli economy has experienced a major domestic shock in the past few months. This is unsurprising: any economy likes certainty and stability. In recent months, pursuant to the proposed changes in the judicial system and their related events, Israel’s economic certainty, as perceived by the markets, has declined.**

**The moment economic certainty is challenged, the certainty of doing business is challenged as well.**

**This is not to say that the world will stop trading with Israel overnight; neither does it mean that the Israeli economy will not see major investments—and it is important for me to laud every such investment, such as Nvidia’s choice of Israel as the site of its supercomputer.**

**It does mean, however, that further uncertainty will come at a sizable economic price. Therefore, decision-makers should restore stability and certainty to the Israeli economy. As I have said in the past: insofar as legislative changes are carried out, they must maintain the strength and independence of the institutions, and this, in discourse among all stakeholders and with broad consensus.**

**Thank you.**