

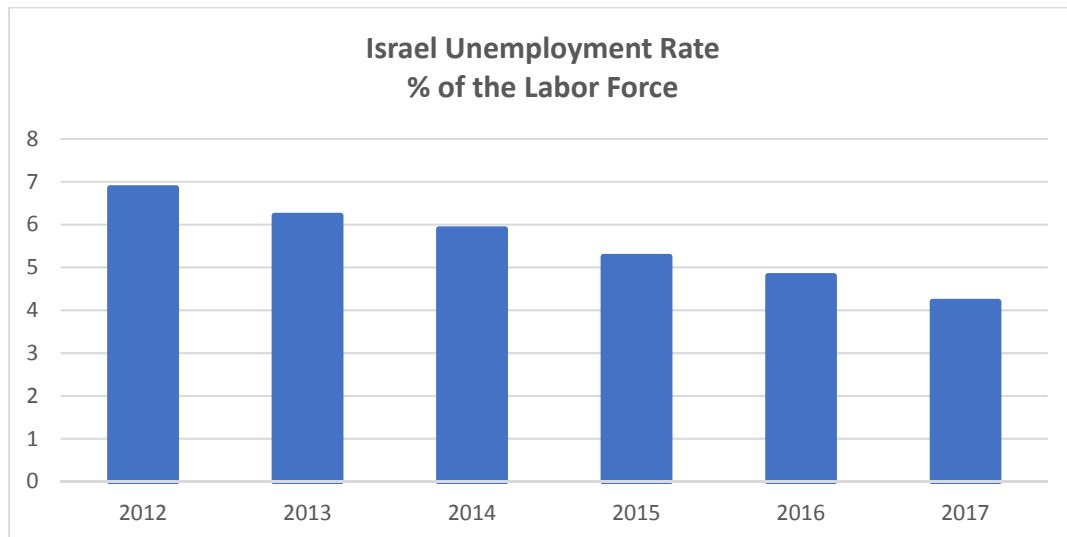
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Robust Economic Growth in Israel Should Continue

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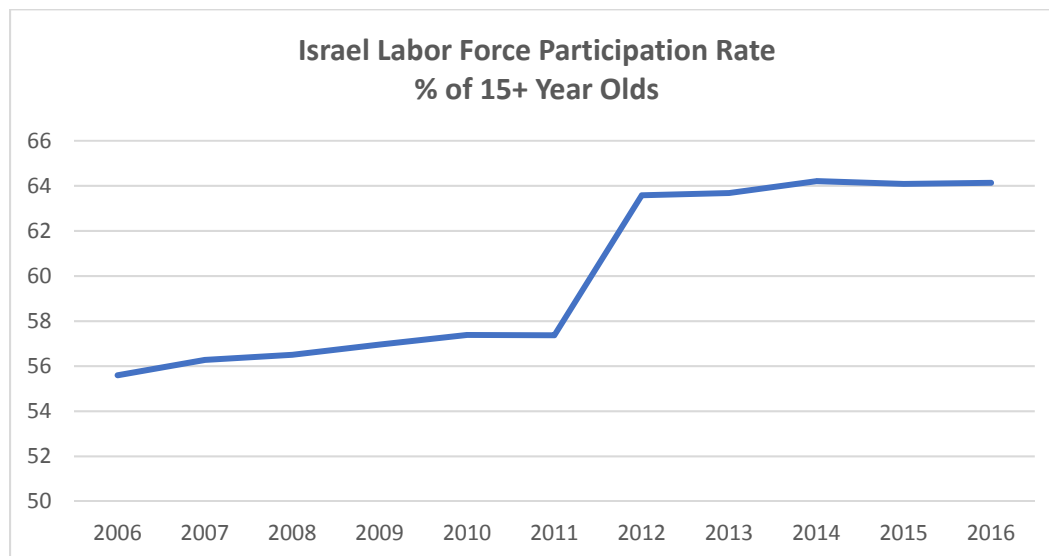
The Israeli economy displayed remarkable resilience over the past five years growing an average 3.3% annually, despite significant global headwinds. By contrast, many countries experienced currency chaos and recession. The Israeli unemployment rate fell from 6.8% in 2012 to 4.2% at present (see Chart 1). Now that Israel is at or near “full employment”, the debate is shifting toward concerns about overheating.



Source: www.worldbank.org

In the decade from 2006 through 2016, the job market was even stronger than indicated by the falling unemployment rate. At 1.8% per year, Israel’s annual population increase was the fastest in the

developed world. In addition, Israel's labor force participation rate jumped from 55.5% to 64.1% during this same period (see Chart 2). Hundreds of thousands of jobs were required just to accommodate this massive expansion of the labor force, let alone bring the economy to a full employment level.



Source: www.worldbank.org

One of Israel's persistent economic challenges is the tendency for the Ultra-Orthodox population and Arab women to shun paid employment. More recently, however, Ultra-Orthodox women entered the labor force in large numbers, and some religious men are starting to do the same. A rising percentage of younger Arab women are also seeking employment as their educational attainment levels rise. With a rapidly increasing population and higher labor force participation, an economy approaching full employment is quite an achievement.

While job growth was robust, wages were a different story. Given the significant expansion of the labor force, it is not surprising that real wage growth averaged a meager 0.6% over the past decade. However, as the economy neared full employment, wage growth accelerated. Over the past three years average wages increased by 2.3% per year.

The Global Economy Now a Tailwind

Global economic headwinds are shifting toward tailwinds as economies in Europe and the developing world return to growth. Exports should pick up despite upward pressure on the shekel. At some point the Bank of Israel will also need to raise interest rates to cool the hot real estate market. Although the risks of overheating are rising, we believe the Israeli economy still has room to grow.

With its rapid population growth and relatively young workforce, Israel needs to create thousands of jobs just to keep unemployment steady. Meanwhile, the long-term trend toward greater labor force participation from the Ultra-Orthodox and Arab communities should continue. Stagnant wages for much of the past decade means that worker pay can recover. One important implication is that the standard of living for the average Israeli family should improve faster in the coming years.

Israel Accelerating Infrastructure Investment

Another important development for the Israeli economy is accelerating infrastructure investment. Historically infrastructure investment lagged. Israel was hampered by large defense spending requirements and high debt. After years of belt tightening, Israel's fiscal house is in better shape and the government boosted spending. Transportation projects will be particularly important over the next several years.

Lagging transportation infrastructure contributed to population density and rapidly rising real estate prices in the Tel-Aviv metropolitan area. A new subway system currently under construction, as well as expanded high speed railroad links, should shorten commute times and allow increased residential development in less expensive areas. Easing infrastructure bottlenecks will go a long way toward offsetting the high cost of real estate.

Despite full employment Israel should be able to maintain reasonable economic growth over the next several years. The Bank of Israel will need to raise interest rates at some point to prevent overheating. As always the Israeli economy can be impacted by an unexpected global economic shock, terrorism or conflict with its neighbors. Barring a significant shock, the standard of living in Israel should rise at an accelerated pace, benefitting consumers and many of our portfolio companies.