

Stabilisation, vulnerability and liquidity as a safety net: some thoughts evoked by the Israeli experience

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Introduction

This paper focuses on the Israeli experience during the prolonged transition period from an inflationary and controlled economy to a deregulated low-inflation one, with special emphasis on international liquidity as a safety net which can provide some protection against the risks inherent in the stabilisation process.

First, I will present some stylised facts about the Israeli economy during the last 15 years, since the successful implementation of an economic stabilisation plan. In the second section, I will describe and analyse the sources of financial vulnerability during this period. The third section discusses various kinds of volatility while the fourth will be dedicated to the concept of maintaining a “third line” of defence – a strong international liquidity position – in addition to and in support of prudent macroeconomic policies and a sound banking system. This section will survey ways in which the authorities can reduce financial vulnerability and describe how this was done in the Israeli context. The paper concludes with a summary of the main points.

Some stylised facts concerning the Israeli stabilisation process

The Israeli economy has undergone a profound transformation during the last 15 years. This came after a decade in which fiscal excesses, a weak central bank and an unsound banking system, together with

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negative external shocks, led to financial instability and high inflation. An inevitable crisis took place in 1983–84, when inflation accelerated to almost hyperinflationary levels.

Following the heterodox stabilisation programme implemented in 1985, the government deficit decreased from an unsustainably high level to a low one, and runaway inflation was restrained. The annual inflation rate stabilised at 18–20% and remained at that level until the beginning of the 1990s. Stabilisation was achieved by means of an exchange rate anchor, but since 1992 the monetary system has been characterised by gradually increasing flexibility of the exchange rate regime. Since 1992, monetary policy implementation has been guided by inflation targets, bringing about a gradual decrease in the inflation rate to 3–4% a year (which is also the target for 2000). In August 2000 the Israeli government for the first time adopted a price stability target (a 1–3% annual inflation rate) to be achieved by 2003. Specific inflation rates were set as follows: 2.5–3.5% for 2001 and 2–3% for 2002. The government's decision was in line with a broader strategy of accommodating Maastricht criteria by 2003.

Monetary stabilisation, coupled with the fall in the borrowing requirements of the government and the increasing flexibility of the exchange rate regime, enabled the Bank of Israel and the Ministry of Finance to gradually liberalise money, capital and foreign exchange markets. Today, the money and foreign exchange markets are completely liberalised and open to capital movements. Regrettably, capital markets still lag behind, especially with respect to the ability of pension funds, provident funds and insurance companies to invest abroad. Moreover, the pension system is very much in need of an overhaul.

The transition from very high inflation rates to a rate of 3–4% brought about significant changes in the assets and liabilities portfolio of the public. Since the stabilisation plan of 1985, the share of CPI-indexed assets and assets denominated in foreign currencies has contracted, in favour of non-linked assets denominated in domestic currency. This transformation accelerated during the mid-1990s when meeting inflation targets involved high real interest rates. Nevertheless, the many years of high inflation made the public very cautious, and therefore most of the increase in non-linked assets was in short-term assets. It seems that many years of stability are needed before investment in long-term fixed income assets becomes popular.

As has happened in many emerging markets during the mid-1990s, growth of net domestic non-linked assets was mainly fed by huge capital inflows. A significant part of these flows came in the form of foreign exchange credit to the public by domestic banks. The banks did not take direct currency risks since they used funds from abroad. Nevertheless, they took indirect currency risk through credit risk associated with the loans.

According to the Controller of Foreign Exchange (2000) estimates, the net foreign currency exposure of the business sector was just \$11.3 billion by end-1999. Such aggregation might, though, disguise the fact that some economic entities have surplus foreign-currency liabilities and others have surplus foreign-currency assets. An indication of the extent of the bias can be derived from a survey (Ibid, p 92) of 33 big Israeli corporations that are also major exporters. While their foreign liabilities amounted to \$14.5 billion (44% of the sector's liabilities), their assets amounted to \$3 billion (only 14% of the sector's assets). Their exposure, therefore, amounted to 90% of the exposure of the whole business sector in June 1999.

It should also be noted that until the end of 1994 the business sector, by and large, preferred being over-exposed to the Israeli shekel and under-exposed to foreign currency, since local interest rates were relatively low. But as local interest rates were raised, the business sector gradually shifted its position towards being exposed to foreign currency, and probably even excessively so. Since mid-1997 Israeli companies' exposure to foreign currency has been declining, and today the central bank does not regard the sector's exposure to be a cause for concern, since a large portion of the business sector has income in foreign currency. The decline of the business sector's exposure to foreign currency was due to an increasing awareness of the risks involved in being exposed to the foreign currency market. The Bank of Israel fostered this growing awareness through a substantial widening of the foreign exchange band in mid-1997 and its watertight policy of non-intervention in the foreign currency market.

At the beginning of 1998 the Supervisor of Banks examined the indirect foreign currency exposure of Israeli banks, called their attention to risky positions and instructed a number of them to take corrective actions. The Bank of Israel also held discussions concerning the need for specific capital requirements to cope with the aforementioned risks,

but no final decision was reached. The Supervisor of Banks monitors the exposure of Israeli Banks on a regular basis.

In sum, the rather stable monetary and financial system created during 15 years of stabilisation has sheltered Israel from the turmoil of recent years. Implementation of the principles of strict fiscal and monetary discipline, flexibility of the exchange rate regime, soundness of the financial system and adequate international liquidity, have all contributed to the stability of recent years. It seems then that it is possible to build lines of defence that can help protect the economy from strong external shocks.

Financial vulnerability is inherent to the stabilisation process

Financial vulnerability is inherent in a transition from an emerging economy to an advanced one, and this truism holds even if the transition is very successful. Exposing the deeper reasons for this imbedded vulnerability needs more research, but two of the usual suspects to be rounded up here are the learning process needed for adjusting to the new system, and aspects of moral hazard.

Some of the most fundamental reasons for these vulnerabilities can be attributed to the new rules of the game set by the government, and to the learning process which all participants, including the authorities themselves, need to undergo on how to operate in the new environment. Apart from policymakers, the sectors in need of adaptation include savers, corporations and, last but not least, the financial sector.

A second reason for those vulnerabilities might have to do with moral hazard. Agents, especially sophisticated ones, such as those often found in the financial system, might use the new and less regulated environment to take bigger risks, believing that if worst comes to worst, the government will step in and rescue them, rather than risk a systemic crisis.

It seems that the main potential for vulnerabilities comes from three different areas: macroeconomic policies, financial sector activities and corporate sector operations. Vulnerability could stem, for instance, from the following sources:

Macroeconomic sources of vulnerability

- *Exchange rate ambiguities and misunderstandings*: A fixed or managed exchange rate regime is usually crucial to bringing inflation down from very high levels. A managed exchange rate is very credible in the short run: it generally comes after a huge devaluation of the currency, leaving room for some real appreciation. Moreover, nobody believes that the government will give in during the first month or two of the programme. However, as time passes and inflation continues to erode the real exchange rate, the public starts having its doubts. And obviously households, corporations and banks commit errors of judgement during the transition period. Authorities sometimes contribute to the making of such errors since they make promises that they can not fulfil. A considerable degree of moral hazard can be created if the authorities do not convey the right messages to all the relevant parties.
- *“Remonetarisation”*: Once inflation comes down, the demand for domestic currency denominated assets grows substantially. But initially this growth (known as “remonetarisation”) is concentrated in short term assets, eg bank deposits, CDs, etc. This creates a large pool of liquidity, which is susceptible to any sign of weakness in the system.
- *More efficient markets*: Developed money markets make it much easier to mobilise domestic credit and make operating in credit and other financial markets much smoother. While this does in general contribute to a superior functioning of the economy it also entails some risks, primarily because it makes possible large and rapid changes in the composition of the public’s portfolio of assets and liabilities at times of increasing risk.
- *Capital import exuberance*: Achieving the standard of living of developed countries means that emerging economies have to grow faster. Growing faster necessitates mobilising savings, part of which would usually come from abroad. This means foreign financing of a deficit in the current account of the balance of payments, and it is very difficult to judge what constitutes a sustainable level of such a deficit. Therefore, occasional macroeconomic adjustment might be needed, accompanied by a contraction of the economy, financial distress and social pain.

- *Inflation complacency*: While bringing inflation down from very high rates to medium ones can be achieved almost overnight, bringing it down further to low levels is usually a long and painful process, requiring sustained tough monetary policy and high interest rates. Such monetary policy can not be popular and it usually creates pressures on the central bank to loosen its grip. A combination of such pressures and a temporary fall in inflation – due to seasonal, random or one-time effects – might make the monetary authorities loosen their stance. Such premature lowering of interest rates might bring about a relapse of higher inflation, and worse still: the loss of credibility that the central bank suffered might necessitate higher interest rates than would have been needed without the premature interest rate reduction.

Financial sector vulnerabilities

- *Exposure to exchange rate risk*: Growth of domestic monetary aggregates (“remonetarisation”) is usually fed by capital inflows, all the more so when the exchange rate is managed. Moreover, tight monetary policy, which means high local interest rates, can make foreign currency credit seem attractive for borrowers. Such credit increases the exposure of the private sector to exchange rate risks. Even if domestic banks cover their direct exchange rate exposure, they are not always aware of the substantial indirect exposure, stemming from the exposure of their clients to exchange rate fluctuations. Special attention should therefore be paid to the extent of foreign currency leverage of corporations, as it could be possible that the net foreign currency exposure of the private sector (firms, households and banks) is nil while gross exposure – namely the exposure of particular sectors – is perilous.
- *Hedging instruments and the concentration of risk*: Increasing the flexibility of the exchange rate regime encourages the development of hedging instruments. These instruments can allow market participants with opposite positions to reduce risk. Nevertheless, they can also move the risk from one market player to the other and sometimes they can cause an unhealthy concentration of risk, especially in the banking sector, which is the leading seller of these instruments. Writing options, for example, is especially risky if the market for

foreign exchange is narrow, as nascent markets usually are. In such markets, small shifts in the demand for, or supply of, foreign currency can cause significant changes in the price of the asset, making it difficult to manage the risk of the options writers and leaving them exposed.

Regarding the argument that in order to reduce national risk exposure counterparties need to be offshore, it needs to be emphasised that widening the distribution of risks is important per se for risk minimisation, even if its efficiency is hard to judge. However, it is not very probable that having foreign banks as the counterparties would enhance stability, as such institutions might be reluctant to remain exposed to the local currency when the economic environment becomes even marginally less stable.

- *Learning process*: Decreasing reserve requirements allows the financial sector to move from sovereign risk to corporate risk. New financial instruments – such as the hedging instruments mentioned above – which develop in freer markets create big opportunities for profits but also entail big risks. Moreover, rules of conduct and of information disclosure do not always keep pace with innovations, and it therefore takes time before prudent practices are fully established. The supervision mechanisms change slowly, so that risks are not properly managed and the banks might fail to accumulate capital reserves when times are good, in preparation for rainy days. For all these reasons and the others mentioned above, the banking sector becomes more vulnerable during the transition period.

Real sector vulnerabilities

- *Credit over-expansion*: The fall in the government borrowing requirement and the liberalisation of the money, capital and foreign exchange markets, made possible by increased stability, enable increased leverage of the corporate sector. Easier credit necessitates a greater degree of restraint in both giving credit and using it, but such prudent credit policies take time, and often crises and bankruptcies, to develop.
- *Exchange rate hazards*: A liberalised exchange rate regime could mean a more volatile exchange rate, at least in the short run. Financial markets can supply effective instruments for coping with exchange rate risks. However, the management of risks with such instruments

requires that the risks be well known, understood and internalised. In the meantime, corporations remain vulnerable to the risk involved in the new financial environment.

- *Structural changes*: Periods of transition and stabilisation involve widespread changes in the real economy, stemming from privatisation, increased competition, the reduction of protection of the domestic sector, and fundamental transformation of many economic enterprises. The turmoil inherent in this process can increase the vulnerability of the economy and place severe constraints on the authorities' policy options.

While fundamental vulnerabilities might concentrate in the aforementioned areas, the first signs of weakness of the economy often emerge in the foreign exchange market. The latter can therefore be regarded as the economy's early warning system. Moreover, it is important to note that the current international financial environment magnifies the exposure to foreign exchange risks. Volatility, volume and globalisation of world financial markets seem to be the channels through which an attack on the system might spread itself. Since these characteristics are here to stay, the question of how to be prepared to face their consequences must be addressed.

How can the authorities reduce the vulnerability of the financial system?

This section will start with some general thoughts about coping with financial vulnerability, emphasising the concept of maintaining "sufficient" foreign reserves. This subject has received some attention recently, but the ideas that have been discussed are difficult to implement and it is not clear to what extent they are effective in coping with the vulnerabilities of the system. However, as we will see, one lesson from the Israeli experience is that high net liquidity can help to lower the overall cost of borrowing abroad as well as maintaining financial stability.

Some general thoughts

Dealing with the new and more fragile financial environment means building multiple lines of defence, which support one another and

can weather an attack. Moreover, the existence of an adequate third line of defence – to be described in the following sections – can reduce the likelihood of attack, and reduce damage should an attack develop.

The first line of defence would include all the elements of prudent macropolicies; proper fiscal policy is the most obvious element, but adequate monetary policy, combined with as flexible an exchange rate regime as possible, is also crucial. A second line of defence consists of a sound financial system, and especially a sound banking system. An invisible hand alone cannot ensure soundness and confidence. Regulators and supervisors have to supply this public good. A critical third line of defence, which also plays the role of a safety net, is the proper management of the country's international debt and liquidity. This line of defence, to which increasing attention has been paid in the aftermath of the recent financial crises in emerging markets, will be the subject of the rest of this section.

There is now a consensus on the desirability of taking into account the size and duration of foreign exchange liabilities when setting the appropriate size of foreign exchange liquidity. Pablo Guidotti from Argentina has suggested that countries should manage their external assets and liabilities in such a way that they are always able to live without new foreign borrowing for up to one year. But what does “to live without new foreign borrowing for up to one year” actually mean? How is it possible to know the borrowing requirements for the next year? If Guidotti's rule means maintaining reserves that are at least sufficient for servicing the debt one year ahead, will this provide a sufficient cushion against shocks?

Alan Greenspan (1999) recently introduced another concept, “liquidity at risk”. This can be calculated by considering the “country's liquidity position under a range of possible outcomes for relevant financial variables (exchange rates, commodity prices, credit spreads, etc)” and the probabilities of these outcomes. A country can manage its “liquidity at risk” position by different combinations of reserves, debt and their maturity. “For example, an acceptable debt structure can have an average maturity in excess of a certain limit. In addition, countries could be expected to hold sufficient liquid reserves to ensure that they could avoid new borrowing for one year with a certain ex-ante probability, such as 95% of the time.”

Greenspan mentioned setting international standards for the level of “liquidity at risk”, which can be handled in different ways. Increasing the level of reserves through mobilising long-term debt can decrease the level of “liquidity at risk”. However, “a wide range of innovative financial instruments – contingent credit lines with collateral such as the one maintained by Argentina, options on commodity prices, opposite options on bonds, etc” can also be used to manage a country's “liquidity at risk”.

The rather new concept of sovereign countries establishing contingent credit lines with private banks is, of course, intriguing. At first sight it looks like a perfect solution for countries that need to strengthen their foreign position. It is straightforward, transparent and seems to reduce the risks to which a country is exposed when approaching a crisis. Moreover, this way can also reduce the odds of such a crisis taking place. However, on closer examination, lines of credit look just a little too perfect: can such lines be big enough to be of consequence when a real crisis hits? Will the international banking system refrain from defending itself by cutting parallel credit lines to a country when the contingent credit lines are used? Will such contingent arrangements not be too much of a temptation for governments not to pose the familiar moral hazard problem? Such reservations are by no means an indication that this idea is a bad one. It is, after all, an insurance arrangement, and it is believed that in general insurance does work. But only time and further experience will tell how effective and efficient contingent credit lines really are.

Following Guidotti's rule or setting some limit to “liquidity at risk” would not always provide sufficient cushioning against shocks. In the case of a breakdown of confidence in the government's policy, demand for foreign exchange might be much larger than the level of reserves determined according to such a rule. Demand might come from different directions: repaying or hedging short- or long-term debt, requirements for accumulating foreign assets and financing the current account, hedging FDI, etc. Once the currency is under attack and the central bank is selling foreign currency, it is unable to discriminate between different flows.

Nevertheless, Guidotti's rule and the highly interesting concept of “liquidity at risk” deserve careful consideration. Adopting these rules can provide a cushion by increasing the financial stability of the economy,

as it improves the structure of its net external debt, namely by enlarging the relative weight of its long-term debt. A stronger financial structure of assets and liabilities increases the credibility of the economy and enhances its access to international capital markets.

It is important to note that the rule introduced by Greenspan is stochastic. The required level of “liquidity at risk” could be provided by the level of reserves which ensures that the economy could avoid new borrowing for one year with a particular ex-ante probability, such as 95% of the time. It can be calculated by considering the country’s liquidity position under a range of possible outcomes for relevant financial variables and the probabilities of these outcomes. Implementing such a rule is much more complicated than Guidotti’s rule. But keeping in mind that the concept of “Value at Risk” is already quite well known, it might be possible to develop and to implement the approach of “liquidity at risk”, with the help of institutions that are familiar with calculating “Value at Risk”.

Let us assume that the authorities wish to improve their liquidity position. How could this be achieved? In the long run, policy will have to be aimed at improving the underlying performance of the economy, by reducing the current account deficit, encouraging balanced growth, especially in exports, promoting adequate domestic savings, and so on. In the shorter term, improving the liquidity position of the economy cannot be based on intervention, since it could necessitate overly restrictive fiscal and monetary policies, aimed at attracting capital inflows and creating a surplus in the current account. However, it might be feasible to improve liquidity by long-term government borrowing aimed at building up foreign reserves. Moreover, it is advisable to achieve this goal by changing the structure of the external debt, and specifically by increasing the weight of long-term debt, rather than increasing reserves. But changing the structure of the external debt takes time and entails costs, especially if a country finds it difficult to raise long-term debt. Therefore, any application of these rules has to be gradual.

Optimal reserves in the context of a floating exchange rate regime

The exchange rate regime per se is not of crucial importance for setting the optimal level of reserves. It seems that the main factor is the extent of long-term proven stability. Obviously a fixed exchange rate regime

makes liquidity essential. However, an economy with a floating exchange regime which has not yet achieved long-term proven stability will also need huge liquidity. Worse still, a floating exchange rate regime can bring about nominal instability if the underlying financial situation of the economy is not strong. In this case, one of those factors which will strengthen the financial situation is the liquidity position of the economy.

Therefore, while the rules mentioned above were developed against the background of a managed exchange regime of one type or another, they can also provide a rule of thumb for the optimal level of foreign exchange reserves in emerging markets that maintain a flexible exchange rate regime. A possible definition of the optimal level of reserves here would be “the minimum level that ensures access to international capital markets for the economy, when needed”.

This definition might be adequate for the financial environment in which we live. When a country is faced with the need to finance a deficit in its current account and refinance its outstanding foreign debt, long-term stability is dependent on its success in ensuring adequate external financing. One important way to ensure the availability of financing is for the government to borrow long term while holding short-maturity liquid assets. Against this background, it seems that Guidotti’s rule or “liquidity at risk” might serve to set a minimum level of reserves, which is also optimal. Maintaining this level can decrease the risk premium for the whole economy and, as a result, bring the net cost of external financing down to a low level.

It should be emphasised that adopting such rules of optimal level of reserves (when the reserves are not actually intended to be used) seems to be a very costly strategy. It is clear that borrowing will generally be more expensive than investing, all the more so as the maturity of the loans is significantly longer than the maturity of the assets. Moreover, does holding liquid assets make sense at all while it is possible to borrow in the deep international financial markets, should the need arise? I think the answer is yes, as access to the capital markets cannot be taken for granted, and capital might not be available precisely when it is most urgently needed. Moreover, as mentioned before, holding high levels of reserves can lower the cost of borrowing for the economy as a whole, making the strategy optimal for the country as a whole.

This effect can be gauged indirectly from the impact of the level of reserves on the country’s rating as published by rating agencies –

which are known to take this variable into consideration in their assessments – and the effect of the country's rating on the cost of borrowing abroad.

The Israeli experience

The concept of the optimal level of reserves in general, and for Israel in particular, has evolved over time. Fifteen years ago “three months of imports” was considered the optimal level of reserves for Israel, which would imply a level of close to US\$ 11 billion in 1999, compared with an actual level of \$22 billion. Based on research conducted by Ben-Bassat and Gottlieb (1992a, b) at the Bank of Israel, taking into account the volatility of capital flows, “window dressing” effects and country risk, the optimal level of reserves at the beginning of the 1990s was estimated at \$5–6 billion. At that time, the Bank of Israel managed the exchange rate inside a narrow band.

Currently the exchange rate is floating (within a very wide band – see below). Nevertheless, it seems that the optimal level of reserves today is much higher than it was at the beginning of the 1990s, and rather close to the current level of \$22 billion. This level is higher than that of the short-term debt (including principal and interest payments on short- and long-term debt in the following year). As can be seen in Table 1, the level of foreign reserves has grown in comparison to all major financial variables. For example, their average level in 1999 was larger than the level of short-term liabilities of the country and exceeded the level of the central bank's domestic liabilities to the private sector.

Why is the optimal level of reserves so much higher today than it was at the beginning of the 1990s? First of all, with the globalisation of capital and money markets, it became much more difficult to predict the volatility of capital flows, as was shown by the financial turmoil of recent years. An additional argument would be the ‘Cosí fan tutti’ one. Most economies deem it necessary to maintain a higher level of foreign reserves than in the past. And even if such a higher level would not be necessary from a strictly economic point of view, in an open and transparent world, not abiding by the new rules might cost a country dearly.

How did the improvement in the liquidity position take place and what were the forces behind it? In the case of Israel, debt has

Table 1
Israel's foreign currency reserves relative to various aggregates
Annual averages, in percentages

	Bank of Israel's shekel liabilities ¹	Monetary base	Unlinked shekel assets	M1	Foreign currency credits	Short-term external debt	Gross external debt	Months of imports
1991	..	328	64	223	76	59	21	3.2
1992	..	283	50	177	67	55	18	2.7
1993	..	219	37	145	62	44	15	2.1
1994	..	208	33	142	66	43	15	2.1
1995	139	295	34	183	62	50	19	2.5
1996	107	288	32	190	55	49	21	2.6
1997	110	466	48	316	75	84	33	4.6
1998	111	520	55	392	82	108	39	5.9
1999	105	506	50	392	77	103	39	5.8

¹ Includes the monetary base, time deposits of commercial banks and government deposits connected to outstanding balances of short-term loans.

already been of long maturity for many years; but reserves increased dramatically during 1995 to 1997 as a result of heavy intervention, aimed at avoiding the exchange rate impact of huge private sector capital inflows. Therefore, this improvement of the liquidity position was a by-product of a tough monetary policy coupled with the constraints of the prevailing exchange rate regime.

The exchange rate is currently allowed to float within a very wide band (its width is 36% – relative to the average of its boundaries – and it is increasing by 4% a year). The Bank of Israel has committed itself not to intervene in the foreign exchange market as long as the exchange rate remains within the boundaries set by the band. Some commentators criticise what they perceive to be the central bank's failure to use the stock of foreign reserves in order to stabilise the exchange rate. But more to the point, questions are raised concerning the need for such a high level of reserves if they are not "used" by the central bank.

The answer to this legitimate concern is that high reserves are doing their job by just being there. Precisely this very level of liquidity was one of the factors that protected Israel from the financial turmoil of the last few years, and helped it to maintain a relatively low risk premium on its foreign debt. But then, the thorough economist might wonder; why are foreign reserves needed at all if the exchange rate is basically a floating one? The answer is that the rather large government debt, and the practice of rolling it over, call for high foreign reserves, as they help in proving the country's economic stability.

But then again, our thorough economist might keep wondering, would a hypothetical elimination of the government debt render holding foreign reserves unnecessary? Regrettably the answer would be negative: Israel lacks a tradition of price stability, and economic agents still have not completely kicked the habit of adjusting local prices upwards following a depreciation. Therefore, those accountable for price stability in Israel, unlike their luckier colleagues in other developed countries, cannot be indifferent to rapid and/or large changes in the exchange rate. For the last two years the Bank of Israel has not intervened in the foreign exchange market, even during a period of considerable turmoil in the foreign exchange market in October 1998. Nevertheless, I believe that the relative stability of the exchange rate is connected to the existence of the foreign exchange band and to the public awareness of the Bank of Israel's commitment to defend its

boundaries if the need arises. And the credibility of the Central Bank's commitment depends to a large extent on the level of its foreign currency reserves.

Conclusion

The transition process from an inflationary and highly regulated economy to a liberalised low-inflation economy is a long one and new financial vulnerabilities cannot be avoided. Such vulnerabilities are connected to aspects of moral hazard and to the process of learning the new rules of the game. The vulnerabilities stem from many sources: a managed exchange rate regime, liberalisation of financial markets – especially the foreign exchange market, the learning process of risk management, rapid growth of domestic monetary aggregates and foreign capital inflows which are the source of this growth, etc.

While such vulnerabilities cannot be avoided, even when the transition process is very successful, they can be contained and dealt with through proper policy measures. Prudent macroeconomic policies and successful supervision of the banking system are the first and second lines of defence in coping with the vulnerability of the system. Nevertheless, the first signs of weakness of the system always appear in the foreign exchange market. Therefore, maintaining a strong foreign liquidity position plays an important role in assuring the economy's good health.

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