David Klein: From price stability to financial stability: the situation in Israel

Remarks by Mr David Klein, Governor of the Bank of Israel, at the Ninth Annual Economic Conference, Caesaria, 21 June 2001.

*   *   *

En route to price stability

After a fairly protracted process, we are beginning to grow accustomed to the concept of price stability.

- At the outset there were heated discussions on whether it was at all possible to achieve price stability in Israel.
- When we asked ourselves what were our objectives regarding inflation, we answered, following the Economic Stabilization Program of 1985: "we will make every effort to lower it."
- Towards the end of 1991 we set out on the path of annual inflation targets without knowing where it led or what obligations it entailed.
- Every year we came back to the questions of what was the appropriate target for the following year, when should it be decided upon, and whether we could allow ourselves to look further ahead than the next year.
- We debated whether inflation was the be-all and end-all, and whether it was possible to buy more growth at the price of higher inflation.
- We discussed whether inflation in Israel should be the same as that in the OECD, with or without Turkey.
- More than once we were uncertain whether it was right to adjust the inflation target upwards.
- We saw almost the whole world, advanced and emerging economies, gradually adopt the norm of price stability as a trait of properly run countries wishing to integrate into the global economy.
- On 16 August 2000 the government made the decision: a regime of price stability suits us too.
- As is our wont, we chose a roundabout route to price stability: before we finally come down to earth in 2003, the decision said, let's first fly a little higher in 2001–02, perhaps for old time's sake. It is not very clear why we first had to raise inflation before it could come down, maybe it was a yearning for the old, pointless arguments about how we may be able to create a few more jobs by juggling with inflation.

Price stability does not arrive like manna from heaven, and we must remember that several obstacles still obstruct the path to achieving it, and these have to be removed. Some derive from the arrangements which were intended to make living with inflation more comfortable – these now make it more difficult to beat inflation. Some of them arose out of attitudes widely ascribed to in the past regarding the effect of the rate of interest on real activity. One obstacle which has attained prominence recently is based on the almost mystic belief that the rate of interest has the power to offset far-reaching real effects – for example the effects on high-tech and related industries of the slowdown in the US, and the effect on tourism, construction, and agriculture of the security-related events – without our having to pay the price of a rise in the balance of payments deficit and accelerated inflation. Above all we must bear in mind that price stability is a system based on habit, and it takes time to acquire new habits.

What is financial stability?

As awareness of the importance of price stability increased in recent years, so did worldwide recognition of the fact that a country aiming for sustainable growth must attain financial stability too. Financial crises have been a standard feature of advanced and emerging economies in the last two decades, Israel among them.

Such crises are characterized by wide fluctuations in prices of assets (real estate and shares) and in the exchange rate, and by bankruptcies, or severe hardship, of financial institutions. A list of the most prominent examples of such crises in Israel in the last twenty years includes:

- Persistent government difficulties in selling bonds at the beginning of the 1980s against the background of a two-digit deficit in terms of GDP, and three-digit inflation;
- The bank shares crisis of 1983;
- The unrestrained acceleration of real estate prices which accompanied the large-scale immigration of the 1990s;
- The bursting of the stock-exchange bubble in 1994;
- The imposition of limitations on the old pension funds in 1995 as part of a recovery program, in the light of their huge actuarial deficits;
- The provident-fund crisis in summer 1996.

Several smaller crises also occurred en route, such as:

- The banks' "special offer" of loans for the purchase of mutual funds in 1993;
- The large devaluation in October 1998, and the growing awareness of the significance of exchange-rate risk, which had hitherto been considered a problem for the Bank of Israel to tackle. This referred to the threat to banks' stability not as a result of their own exposure, but of their customers' unrestrained exposure.
- The lack of resources in the mortgage market which added to the problems facing the real estate industry in trying to adjust in the period following the influx of immigrants.

The threats to financial stability in Israel

Financial crises occur for two main reasons:

The first is mismanagement of financial institutions. Dealing with this falls within the province of supervision, and I will not here go into the question of supervision of the financial markets, except to say that a mechanism for proper coordination between the various supervisory authorities in Israel's economy is sorely needed, and it is a pity that it has not yet been activated.

The second is artificial restrictions that were imposed by the authorities at some time or other on the mechanism of the market. The removal of such restrictions is essential if financial crises are to be avoided. The major ones are:

1. Earmarked bonds

The arrangement regarding bonds earmarked for the pension funds provides the clearest example of such restrictions on the market mechanism. This arrangement systematically destroys the market for tradable government bonds, the existence of which is one of the preconditions for a market for private bonds, providing the banking system with a basis for pricing for the system of medium- and long-term deposits and credit.

This phenomenon of earmarked bonds will spread even more quickly

- if the required tax reform assigning the tax benefits on pension savings mainly to savings for retirement is introduced;
- if the budget constraint on tax relief requires a distinction to be made between savings which entitle the member to a pension and lump sum savings for retirement;
- if the move from unfunded to funded pensions follows the planned path;
- and if a Compulsory Pension Law is passed incorporating the rules which apply currently to the pension funds.

The best way out of the earmarked bonds arrangement is similar to the method used in the life insurance field in the transition from guaranteed yield life insurance schemes to profit-sharing schemes. That is:

- not to change the rules in the existing new pension funds, but to close them to new members;
- to ensure that pension funds established from now on are based only on the market. If the government can support pension savings and wishes to do so beyond granting tax benefits, it would better do so directly vis-à-vis pensioners, and on a means tested basis.

2. The crawling exchange-rate band

The band is intended to contain, currently within fairly wide limits, possible fluctuations of the rate of exchange. It is well known that the conditions which brought about the creation of the band disappeared long ago:

- Initially the band served as an advanced version of the exchange rate, as a nominal anchor for inflation. The exchange rate has not had this role to play for many years;
- Then, with the transition to an upward-sloping band, the slope of the band was defined as reflecting differences between inflation in Israel and that in other countries; these too have disappeared;
- Next, in the wake of the development of high-tech industry, capital import for investment began on a large scale. This capital inflow is not connected with differences in interest rates or in inflation between Israel and other countries, so that it is illogical to limit exchange-rate fluctuations because of it;
- While these changes were taking place, and as we agreed in 1994 to allow the market to determine the rate of exchange, a domestic foreign-exchange market developed. It involved domestic banks and foreign financial institutions. Daily turnover is growing, and the market has low volatility. The fact that the Bank of Israel avoids market intervention, and the experience of external financial shocks have led to a better awareness among the public of exchange-rate risk. This had a dual effect:

  a. Speculative activity is a rarity in the market.

  b. When assets and liabilities portfolios are being put together, interest-rate differentials between Israel and abroad, which have existed for a long time and still exist are outweighed by exchange-rate risk. Consequently, it is difficult to discern a change in the composition of assets and liabilities portfolios in response to changes in interest-rate differentials around their current level, so that this component of capital flows has hardly affected the rate of exchange.

  In other words, interest-rate differentials do not explain why the actual rate of exchange is close to the bottom limit of the band. The main reasons for the closeness lie in the inflow of long-term capital coupled with the upward slope of the limit of the band. For the sake of accuracy we should add the recent weakness of the euro against the dollar.

On the other hand, protecting the lower limit of the band will cause financial complications:

- The purchase of foreign currency to lead towards a new equilibrium must be undertaken while prices are falling. The current positive slope, even if it falls to zero, does not allow this to happen, so that it is a non-stabilizing factor.
- The obligation to purchase foreign currency means that the initiative in implementing monetary policy is transferred to the importers of capital, although they have no intention of participating in such management. They import capital according to their own needs, and not to inject into the economy in an ordered manner the liquidity it requires. It is clear that under such conditions monetary control may be affected.
- The instruments of absorption available to the Bank of Israel to neutralize the injection deriving from the purchase of foreign currency are in the form of the banks' deposits in the Bank. The banks already deposit about a fifth of their unindexed sources in the Bank of Israel as a result of the problematic defense of the lower limit of the band in the years 1995–97. A recurrence of such an episode would increase the banks' dependence on the Bank of Israel, a complete contradiction of the successful policy of deregulation pursued in the first

half of the 1990s. Such increased dependence may raise questions concerning the banks' stability.

- Under such circumstances the Bank of Israel would again have to choose how to deal with the losses inherent in such an activity. It could transfer them to the banks by paying them a similar rate of interest on their NIS deposits in the Bank of Israel to the rate it receives on its foreign-currency investments. The banks would of course pass this on to their customers by cutting the interest they pay their depositors and raising the interest they charge borrowers. And then there would be complaints about the high banking spread. Alternatively, the Bank of Israel could record the losses in its books, as it did on the previous occasion. In the final analysis this cost is of course borne by the taxpayer, and I believe that the last thing the government wants to do is to raise the tax burden in such a roundabout way.

We should bear in mind that we cannot evaluate in advance the importance of such a course of action. We know that on the last occasion, the Bank of Israel purchased $ 16.5 billion. An increase of only $ 1 billion in the money supply would currently mean a rise of about 4 percent, whereas an annual increase of 10 percent is considered too fast. The simplest solution is to abolish the exchange-rate band. If the Bank of Israel has to defend it, the end result would be its abolition in any case, but after incurring a high and unnecessary price. It is preferable to take such a step on our own initiative, and not under pressure from the market.

3. The ceiling on Treasury bills issues

By law Treasury bills are an instrument for carrying out monetary policy, but we cannot fully use them for this purpose because the creator of the tool also limited its quantity. In other words: Yes, you have an inflation target. You want tools for the job? Improvise!

The outcome is that instead of implementing monetary policy via the capital market, we do so via the banks, a more expensive and less efficient method. Why must we act in this tortuous way? To find the answer to this question we may have to go back to the traditional work methods of the pre-State era.

If the story were to end with the improvisations of the Bank of Israel, so be it. The rate of interest would be, all in all, a little higher than it could have been. But this absurd limitation causes consumers and the economy real harm. In any normal country the Treasury bill market provides the basis for the government bond market. As such it also provides the infrastructure for nonbank financial intermediation. In Israel, it strengthens the banks' monopolistic hold over the money market.

The implications are unequivocal:

- The banking spread in the unindexed sector is higher than required, to the disadvantage of depositors and borrowers;
- It is another obstacle to the development of the market for tradable securities, short-term commercial paper, as an alternative to bank credit;
- It harms the economy's ability to withstand financial crises, as the economy is totally dependent on the banks for financial intermediation.

The Treasury bill ceiling causes persistent damage, and it should be abolished. It increases the cost of monetary policy, and causes harm to consumers and the economy as it acts as a millstone around its neck and prevents the development of a nonbank money market.

Can the horizon of monetary policy be broadened?

Price stability is measured by changes in the CPI. The question is whether there is a connection between the stability in the stock market and foreign currency market on the one hand, and price stability on the other.

It should be emphasized that the question is not whether the central bank should also have objectives in the securities market (for example, to prevent sharp falls in the stock market) and in the foreign currency market (for example, to navigate the exchange rate along a particular route). It should not!

As long as the arrangement of earmarked bonds, the exchange-rate band, and the Treasury bill ceiling exist, the central bank must steer clear from any intervention in the financial markets, both in its actions, and in its statements. A similar conclusion applies, and to a similar extent, if fiscal discipline is not maintained, and if the performance of the budget does not lead to a lowering of the government debt/GDP ratio towards the level accepted as the norm worldwide.

When these limitations no longer apply, we will have to reexamine the normal horizon of monetary policy. When there are no restrictions limiting the central bank's choice of policy instruments, and when the culture of price stability has taken root, the Bank of Israel will be able to include reference to the financial markets among its functions, with the aim of contributing to their stability.