Globalisation and its effects on monetary policy: the case of Israel

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Introduction

During the last decade the forces of global economic integration have profoundly changed Israel's economy. Globalisation, together with large-scale immigration that consisted largely of technically highly skilled immigrants from the former USSR, caused a structural change in the country's economy by significantly increasing the importance of the high-tech export sector (Graph 1). This has not only increased the country's dependence on the state of the global real economy, but has also raised the sensitivity of its economy to developments in financial markets, especially in the United States.

Globalisation has also forced a change in the mindset of politicians and policymakers and made them aware of the following: (a) the importance of financial markets (domestic and foreign) as a disciplining force on policy; (b) the reduced freedom to conduct countercyclical macroeconomic policy even in a severe recession; (c) the importance of an independent central bank; and (d) that the exchange rate could no longer be managed by the authorities. These changes also affected three major aspects of the central bank's monetary policy: (a) its primary objectives; (b) the general framework in which it is carried out; and (c) operating procedures and the response of monetary policy to shocks. This paper will briefly examine how globalisation has affected each of these aspects, stressing the constraints and challenges that they place on the Bank of Israel (BOI) in an era of greater volatility - one of the more important consequences of globalisation.

I. The effect of globalisation on the Bank of Israel's primary objective

Israel has suffered from chronic high inflation throughout much of its history. The need to respond to the pressures of globalisation and the desire to integrate successfully into the global economy made it necessary to reduce inflation to the low levels currently prevailing in many developed and developing countries. Globalisation was also a key factor in the disinflation process in two major ways. First, it precipitated the removal of barriers to free trade in goods and services. This in turn unleashed competitive forces which resulted in lower prices of imports and import substitutes. As argued recently by Rogoff (2003), the competitive pressures not only had a one-off effect of lowering prices, but, through the political economy channel, helped to make monetary policy more effective. Second, globalisation also meant the (gradual) removal of capital controls. As a by-product, the foreign exchange (FX) regimes - initially fixed and then heavily managed - were abandoned in favour of a free float (the BOI has not intervened in the FX market since June 1997). Since the previous FX regime also served as an anchor for prices, a substitute had to be found. This brought about the adoption of inflation targeting as the framework in which monetary policy is conducted, with the primary goal of first reducing inflation and inflation expectations, and then maintaining price stability. The main advantage of inflation targeting is that it provides a transparent framework for monetary policy; it is very useful as a communication tool (Graph 2). The gradual disinflation process involved a long period of high short-term real interest rates (Graph 3). The tight monetary policy stance was very controversial and was opposed by many, including several Ministers of Finance. Those opposed to the policy claimed that it violated the intent of the 1954 Bank of Israel Law which put growth, employment and other goals on an equal footing with price stability. The position of the BOI has been that it is high time to enact a new central bank law explicitly making price stability the central bank's primary objective. However, the Bank maintains that even within the current legal framework it can best

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contribute to sustainable growth and employment by striving for and maintaining price stability. The main reason that the many challenges to the BOI's monetary policy have been successfully staved off is the disciplining force of financial markets, domestic and foreign, which have grown in importance as a consequence of the liberalisation and deregulation induced by globalisation (see next section).

II. The effect of globalisation on the framework and effectiveness of monetary policy

The process of liberalisation and deregulation of the Israeli economy affected the framework and effectiveness of monetary policy in several important ways. First, Israel's greater dependence on world financial markets increased the pressures for more fiscal responsibility. These forces reduce the dangers of fiscal dominance, thus heightening the effectiveness of monetary policy. Second, globalisation has exposed Israel's economy to a variety of worldwide shocks and has thus increased the challenges faced by monetary policymakers. Third, the forces of globalisation have accelerated the deepening of the domestic financial markets, increasing opportunities for and the effectiveness of risk-sharing and thus increasing the economy's resilience to shocks.

1. The effect of globalisation on the relationship between monetary and fiscal policy

For monetary policy to be effective there must be an appropriate fiscal framework. In particular, as emphasised recently by Woodford (2001) and others, the situation of fiscal dominance must be avoided and monetary dominance must be assured. This essentially means convincing the public that jumps in the price level are not a legitimate solution to the intertemporal government budget constraint (see Liviatan (2003)). Following the ideas of the Maastricht Treaty, Israel enacted a law stipulating that the budget deficit/GDP ratio must move along a declining path. The law has no teeth, however, and the declining path has been changed many times, including the most recent change limiting the growth of government expenditure to 1% per year and the deficit/GDP ratio to 3%. Despite the many breaches of and adjustments to the declining path (Graph 4), the perception of the Israeli public and financial markets - both domestic and foreign - is that the government recognises the importance of fiscal rectitude. This means that the public is confident that there will be a return to a declining trend of the debt/GDP ratio. This ratio declined throughout most of the last decade but has increased in the last few years mostly because of exogenous effects such as the world economic slump and the conflict with the Palestinians (Graph 5 and Figure 1).

The main reason that confidence persists is the public's awareness that the government pays a great deal of attention to how rating agencies and financial markets view fiscal policy. A clear expression of this was the trip to London in 2002 by the Minister of Finance to convince the rating agencies not to downgrade Israel's rating. The government also pays serious attention to Israel's risk premium (Graph 6) and to the yields on long-term government bonds (Graph 7). There is no doubt that the constraining forces that the financial markets and rating agencies exert on policymakers in Israel are the result of globalisation, liberalisation and deregulation.

2. Dealing with external shocks

Globalisation, and especially liberalisation of domestic capital markets, exposes small open economies such as Israel's to worldwide shocks and to contagion effects. These shocks put at risk both price stability and financial stability and pose serious challenges to central banks everywhere. Israel has coped with these challenges by: (a) adopting a fiscal policy framework in which the main goal is to assure the public that fiscal policy is prudent and that it will reduce the government deficit and debts; (b) convincing the public and financial markets that monetary policy is focused on maintaining price stability; and (c) undertaking structural reforms, such as the recent pension reform, to impress upon the public that policymakers are also dealing with the long-term challenges.[2] As a

[2] The government recently succeeded in reforming the pension system in Israel; the reform will improve the soundness of the country's pension funds and turn them into serious players in the domestic capital market.

result, despite many negative shocks, nominal stability has been maintained, by and large. Two aspects of this relative stability can be seen in the graphs of (market-based) inflation expectations and the probability of large depreciations of the new shekel (derived from new shekel/dollar FX options; Graphs 8 and 9). This stability should not be taken for granted. Inflation expectations, at any moment in time, are conditional on many variables, including monetary policy. These variables change constantly and the fact that the expectations have remained relatively stable reflects well on the credibility of macroeconomic policy.

3. Deepening the financial markets

The mutually reinforcing pressures of globalisation and deregulation have had a marked effect on the deepening of the financial market in Israel. The greatest effect has been on the FX market, including its various derivatives. The FX market is the country's most mature, with a daily turnover of USD 2,655 billion (Graph 10). Both domestic and foreign entities, including foreign banks, participate in this market. A major reason for the deepening of the FX market is the non-intervention policy of the BOI; the central bank has not intervened in this market since June 1997. As a result it is becoming clear to FX market participants that FX uncertainty is something which banks and the private sector have to deal with by themselves. This policy has led to the rapid growth of hedging instruments such as FX forward contracts and FX options. The notional value of these instruments is 1.5 times the quarterly value of imports plus exports. This means that exporters and importers have the means to hedge against FX uncertainty. A second market which is still developing and growing is the government bond market, with a daily turnover of currently about ILS 705 billion. This market consists of regular as well as CPI-indexed bonds, and yields on government bonds serve as an important benchmark for long-term mortgages as well as long-term investment projects. What is still lacking is a well developed money market.

The deepening of the domestic financial markets has had two important effects on the monetary policy framework. First, financial markets provide important indications regarding the future, which are incorporated in the policy decisions of the BOI. For example, inflation expectations, derived from the difference between the yields on regular and CPI-indexed bonds, are an important input in the monthly interest rate decisions of the central bank. Second, financial markets also serve as an effective two-way communication system between policymakers and the public. By acting in financial markets, the BOI signals its intentions to the public. Equally important, if not more so, is the information transmitted from financial markets to policymakers - both the monetary and fiscal authorities. In this role financial markets serve as a daily vote (backed by money) notifying policymakers how their policies are perceived. Financial markets have thus turned out to be an important guardian against irresponsible macroeconomic policy.

III. Operating procedures and response to shocks

An important outcome of increased economic integration induced by globalisation is that it exposes to competition not only the private sector but also governments and central banks (Wagner and Berger (2002)). This has had several important implications for the operating procedures of the BOI and its reaction to shocks.

First, worldwide developments in goods and financial markets, such as actual and anticipated policy decisions, currently influence the policymaking of the BOI much more than in the past. Thus the interest rate differential, at all maturities, between Israel and the United States is an important variable in the central bank's monthly policy deliberations.

Second, it has become more important to identify external shocks and to determine rapidly whether they warrant a monetary policy response.

Third, financial stability, that is the stability of institutions and markets, is of crucial importance for maintaining public confidence in the actions of the central bank. Thus, ongoing monetary-policy decisions and prudential supervisory issues are more interlinked than before. This means that central banks must pay close attention to how their policy decisions and operating procedures affect financial stability. In Israel this has meant increased importance of interest rate smoothing on the one hand, and fostering the credibility of the BOI's resolve to maintain price stability on the other. Given Israel's history of high inflation and high debt/GDP ratios, this means that the BOI, in its monetary policy decisions, may give less weight to business cycle considerations than might be given in other countries.

Fourth, the degree of immunity of Israel's financial system to external shocks largely depends on the existing risk-sharing capacity. This means the capacity to share risk in the face of various situations: fluctuations in the FX market induced by external events, sudden large changes in domestic interest rates as result of outside forces, etc. The capacity for risk-sharing in Israel has increased as a result both of a fused macroeconomic policy and of microstructural reforms.

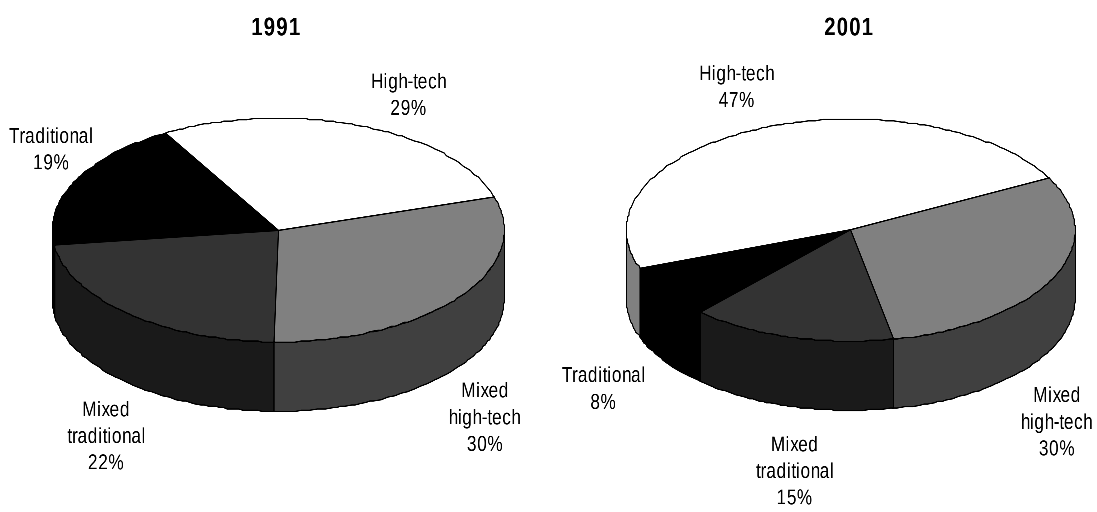
Fifth, the importance of transparency and communication skills has grown in the globalised environment. In this setting, policy should attempt to minimise surprises (in this regard, boredom is bliss!), and it should be conducted with market-type instruments which lend themselves to mark to market valuations.

IV. Conclusion

There can be no doubt that globalisation has been a major cause of an enormous structural change in Israel's economy. This change has also transformed policymaking in the country, including monetary policy. It left no framework for monetary policy other than inflation targeting. This framework was very important in bringing inflation and inflation expectations down to the current low levels. Globalisation created a situation where, in contrast to earlier periods, monetary policy is not dominated by fiscal policy. In the face of globalisation, governments find it increasingly difficult to ignore the verdict of financial markets, which can be very punishing if issues such as large deficits and debts are perceived as being neglected. Finally, globalisation means increased competition not only in the domestic private sector but also for Israeli policymakers. This tends to promote greater efficiency and greater transparency in all facets of policymaking.

Graph 1

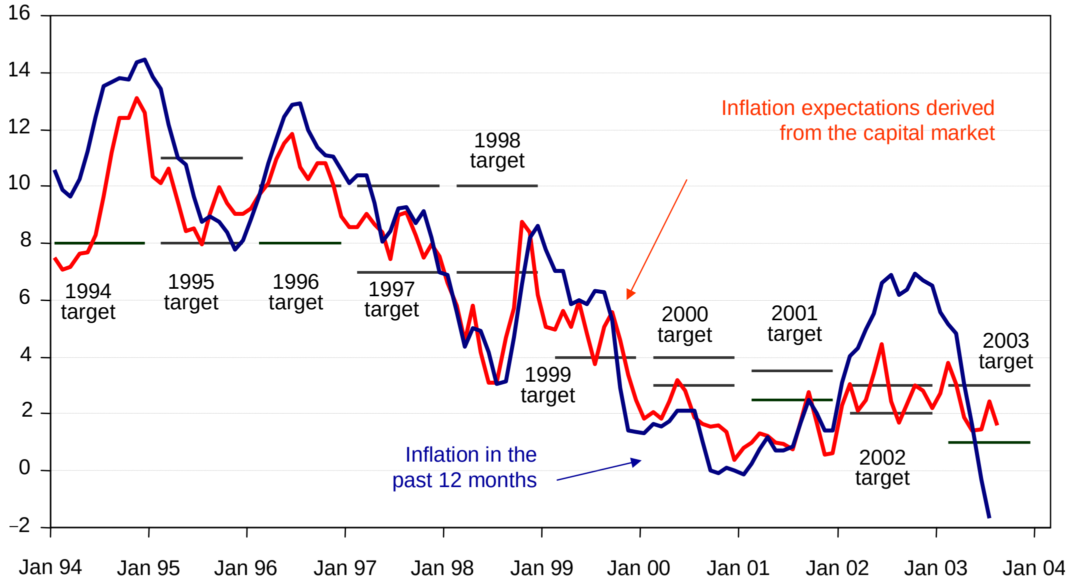
Industrial production according to technological intensity



Source: Bank of Israel.

Graph 2

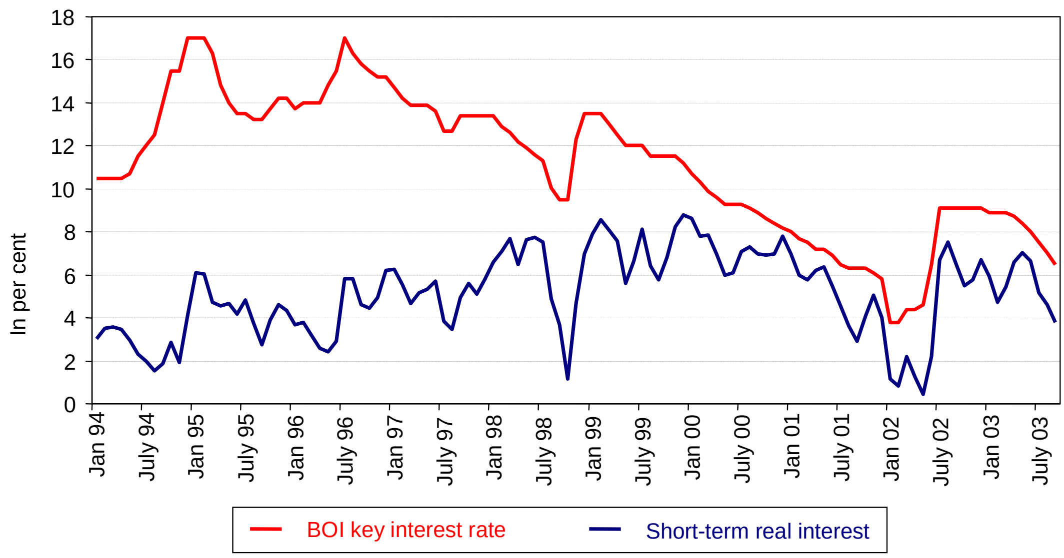
Inflation and inflation expectations



Source: Bank of Israel.

Graph 3

BOI key interest rate and the derived real short-term interest rate

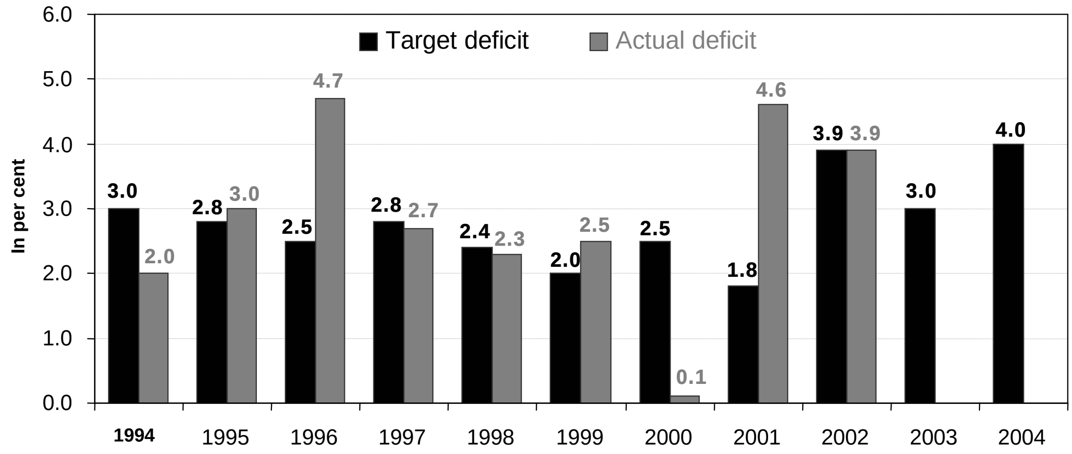


Source: Bank of Israel.

Graph 4

Budget deficits[1]

1994-2004



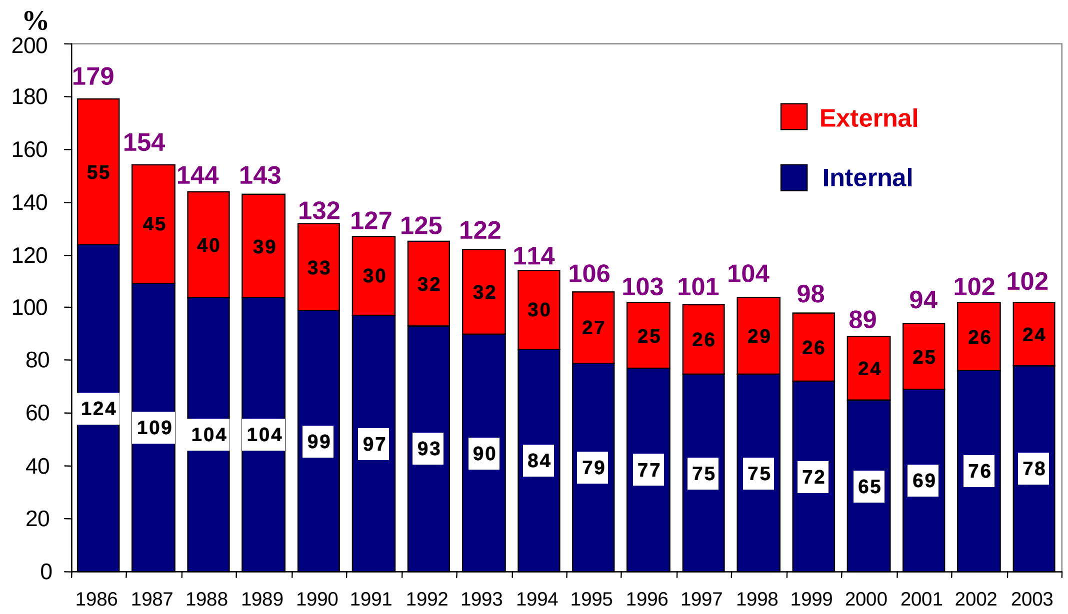
[1] Until 1996, domestic budget deficit ceiling; in and after 1997, overall deficit including Bank of Israel profit, by law; since 2001, overall budget deficit.

Source: Bank of Israel.

Graph 5

Government debt

As a percentage of GDP



Source: Bank of Israel.

Figure 1

Government debt equation

$$\text{Change in government debt (internal + external) to GDP Ratio} = \text{The primary deficit to GDP ratio} + \underbrace{\left(\text{The long-term real interest rate} - \text{Yearly GDP growth rate}\right)\cdot\left(\text{Total government debt to GDP ratio}\right)}_{\text{Interest payments on the total government debt}}$$

2001 data:

4.5% ≈ –0.86% + 5.2%

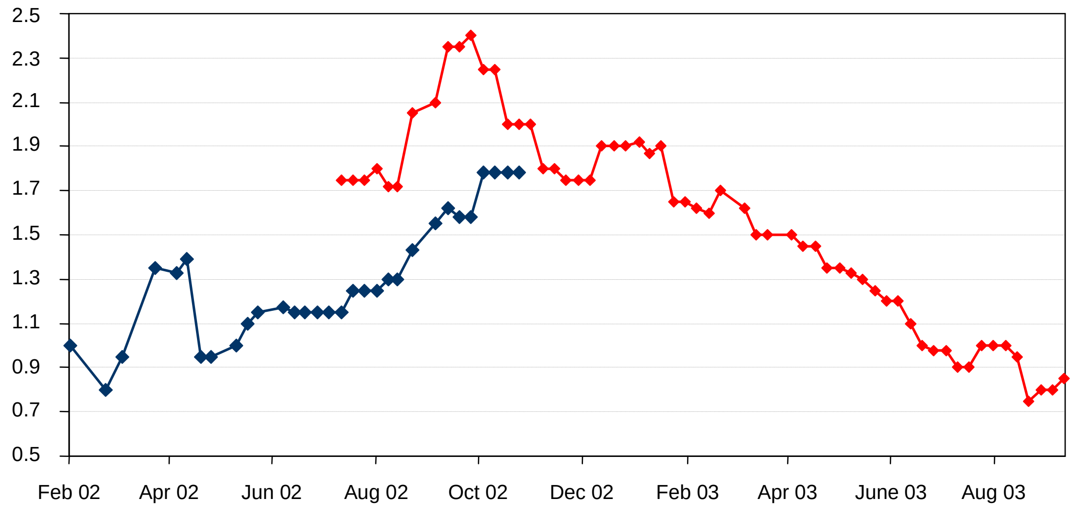
2002 data:

5.7% ≈ –0.4% + 6.1%

Source: Bank of Israel.

Graph 6

Israel's risk premium as measured by yield spread[1] and five-year credit default swaps

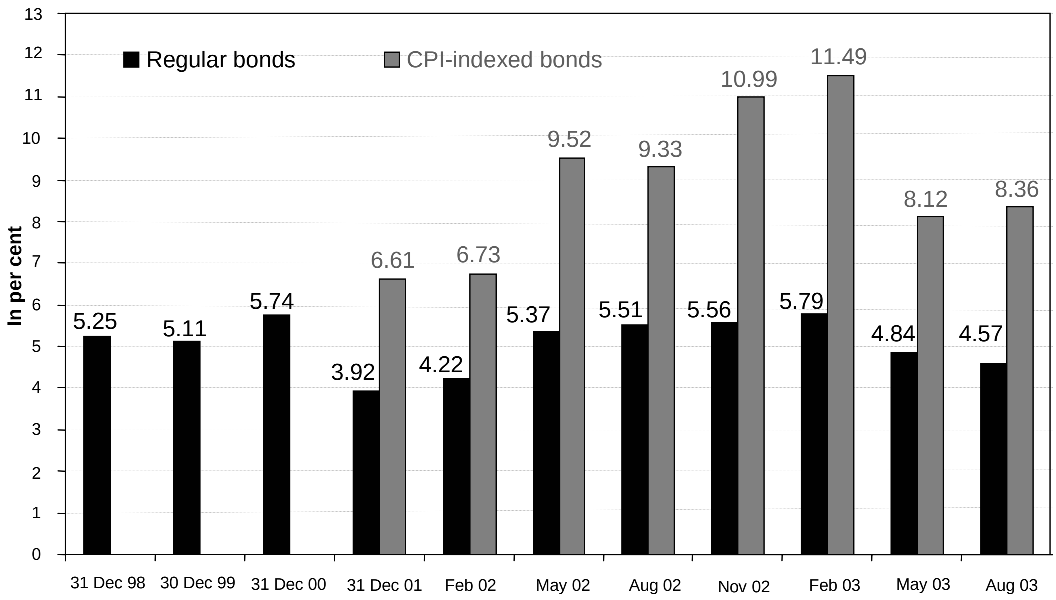


[1] The spread between yields on five-year government bonds in foreign currency and five-year TSY US Treasuries.

Source: Bank of Israel.

Graph 7

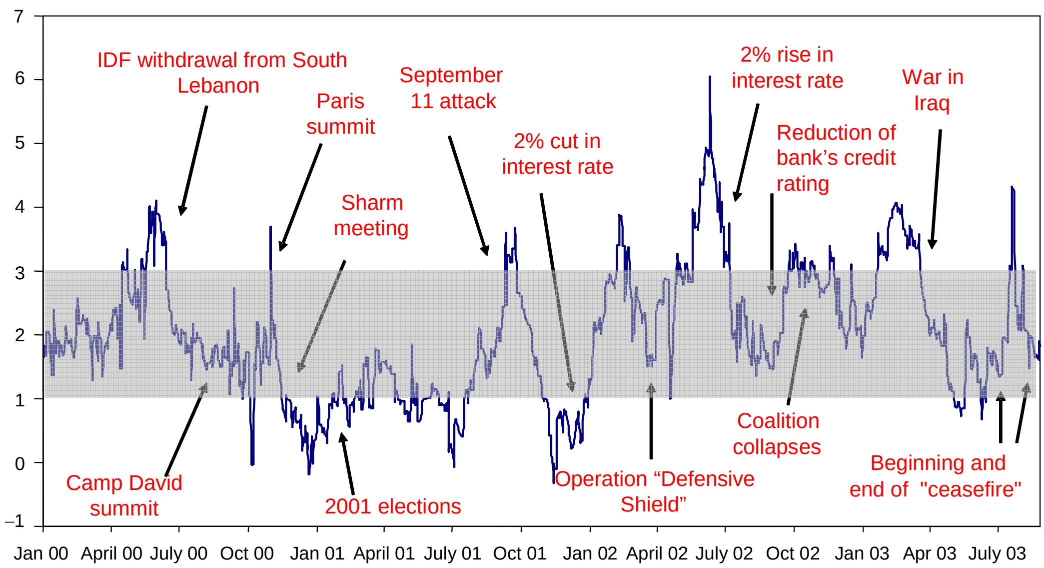
Yield to maturity on regular and CPI-indexed bonds, 10 years to maturity



Source: Bank of Israel.

Graph 8

Twelve-month inflation expectations, economic and political events

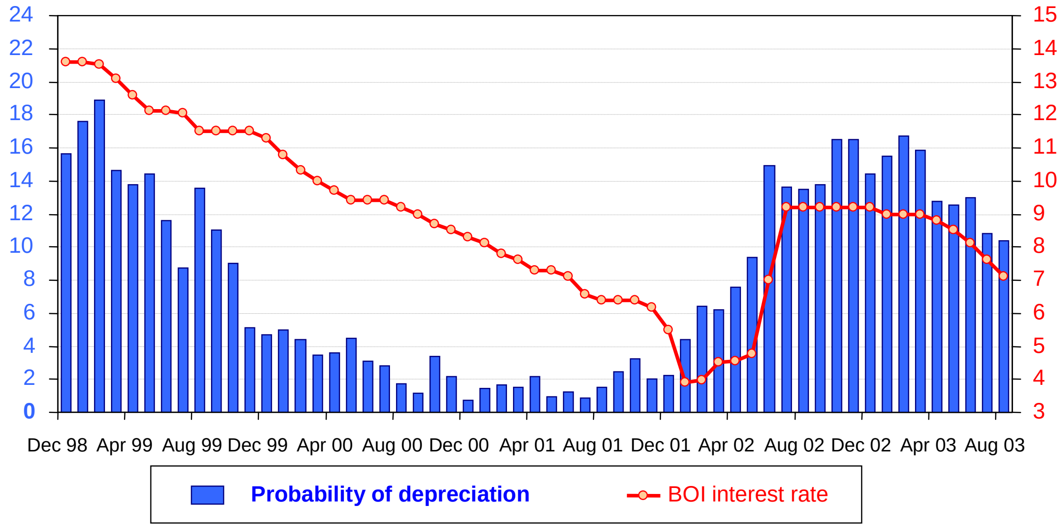


Source: Bank of Israel.

Graph 9

Probability of 10% depreciation and the BOI interest rate

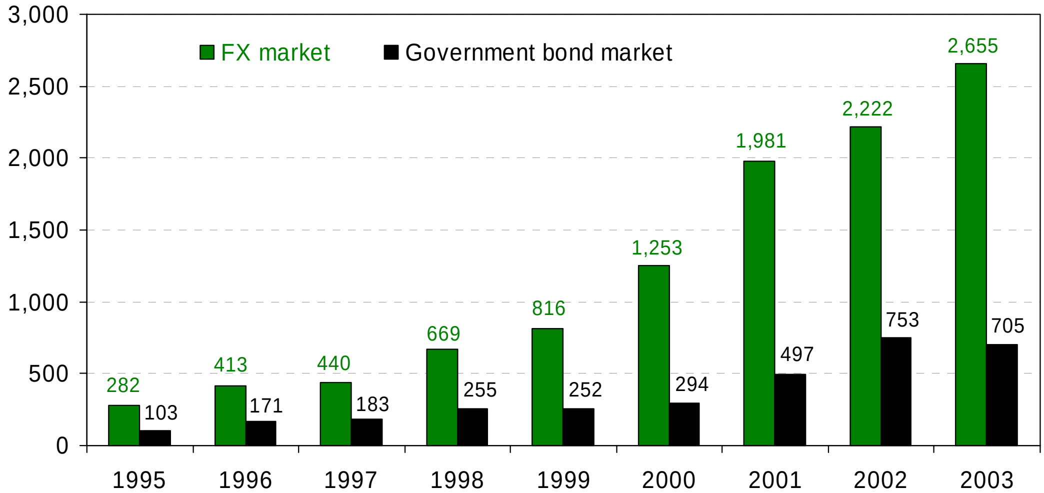
In per cent



Source: Bank of Israel.

Graph 10

Average daily turnover in the FX market[1]
and the government bond market[2]



[1] In millions of US dollars. [2] In millions of new shekels.

Source: Bank of Israel.

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