A decade of monetary reform in Israel (1987–97): evolving operating procedures

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1. In the beginning[1]

When I took office in September 1987 as Senior Director, Monetary Operations and Exchange Control at the Israeli central bank, I enquired about the, to my mind, strange title of my new post: Exchange Control. I was told, there's not much to do there. You remember the utter failure of the attempt to liberalise the capital account ten years ago, in 1977? What is more, don't forget that a fixed exchange rate is our nominal anchor for stabilising prices. For that you need foreign currency reserves. You know our people: the day we liberalise the capital account we won't have even one dollar in the coffers.

What about the Monetary Operations part, I asked? Well, I was told, since a fixed exchange rate is our main policy instrument, interest rates should assist in stabilising the exchange rate to stabilise prices. But, I wondered, if the capital account is under control, and capital flows are forbidden, what can interest rates do to affect the exchange rate? Aha, they said, when it really matters, exchange controls are not terribly effective. Furthermore, we still have an annual inflation rate of 15–20%, and the public doesn't trust the fixed exchange rate regime too much; as a result, from time to time we undergo a wave of speculative attacks against the domestic currency, forcing us to devalue. We have to keep interest rates high. That much I admittedly knew – the short-term real interest rate was indeed high, at around 25%.

If this is the case, I kept wondering, how come the economy is not collapsing? Well, I was told, not everybody is paying a real rate of 25%. Is that so, I said. Yes, I was told, and the trick is directed credit. Exporters,

[1] The dialogue referred to in this section is, in fact, a summary, from the viewpoint of a policy-maker, of several internal discussions held mainly over the period 1988–91.

importers, industrialists, agriculturists, local authorities, home-buyers, long-term real investors – they all enjoy special credit facilities, carrying below-market rates, arranged by the Treasury and by us at the central bank. Look at the balance sheets of commercial banks: most of them are composed of special government programmes, insulating borrowers from the influence of current interest rate policy.

But – I was still trying to understand the conceptual framework – if from time to time we have a speculative assault against the domestic currency and, despite the high interest rates, we have to bow before market pressures and devalue, in what sense is the exchange rate a nominal anchor, and how are we going to get rid of our double-digit inflation? Oh, that, I was told, is simple: what is needed is a well-rounded economic policy package. Remember how we reduced inflation from 445% in 1984 to 20% in 1986? We combined fiscal, monetary and incomes policies, stabilised the exchange rate and exercised price control. We should employ a similar programme once again to reduce inflation from 20% to 2%. To do that we need an opportunity, and in the meantime we sit tight and wait.

I wanted to ask: how do we recognise an opportunity when we see one, so that we can seize it? I also wanted to enquire how we seize an opportunity once we identify one. But at that point I thought that the general nature of the overall approach was already clear to me, so I decided to leave it. I did not expect, anyway, to get an operationally meaningful answer.

2. Developing a consistent strategy

Shattering this conceptual and practical edifice turned out to be a long-term project. Hyperinflation in the first half of the 1980s was a traumatic experience which helped form a relatively broad consensus around an IMF-type recovery programme in 1985, strongly supported by the US Government. No such consensus could be marshalled when, in the second half of the 1980s, the pace of inflation was "stabilised" at an annual average of "only" 18%. Was the sit-and-wait strategy to attain price stability the only one under the circumstances?

In principle, there was an alternative to the "package" approach. A well-synchronised programme is necessary when, facing an imminent crisis, you make a quantum jump down from hyper- to moderate inflation. But normally a government has macroeconomic targets, and instruments are used to attain them. The use of one instrument should not depend, on a daily basis, on the use of other ones – as long as there is a coherent macro strategy. In such a framework monetary policy should aim, mainly if not exclusively, at other attaining price stability, while fiscal policy should take care to create other conditions for durable growth. But, one could ask back in 1987, how can one conduct an active monetary policy when government involvement in financial affairs is so wide and deep? The symptoms were there for everybody to see:

- the cost to domestic residents of borrowing foreign currency in the domestic market was more than *twice* the cost of borrowing abroad;
- the real cost of short-term domestic-currency borrowing was more than *three* times the cost of long-term borrowing in domestic currency; and
- the rate paid by short-term domestic-currency borrowers was almost *four* times the rate paid to domestic currency depositors.

It was obvious that these gaps were sustainable only through a massive administrative intervention in the financial markets by the authorities. That gave us a starting-point. We realised that we could not offer, yet, a viable monetary policy to replace the exchange rate as the nominal anchor. But we could claim, in the name of efficient resource allocation, that such high interest rate differentials were distortive and should therefore be minimised. The name of the new game was deregulation. Thus, towards the end of 1987, we had the beginnings of an agenda.

It is not our purpose here to elaborate on our deregulation policy.[2] Strong and often vehement objections were raised time and again, by the staff of the central bank and the Treasury, to each and every one of the steps taken. Nevertheless, we were able, in the last decade, to free a good deal of the money and capital markets from government intervention, and that includes meaningful progress in capital account liberalisation. This policy, coupled with making the exchange rate regime continuously more flexible, opened the way for an independent monetary policy in the 1990s.

[2] The main details are presented in Klein, David (1994): "Financial deregulation in Israel: policy and results". In Baliño, T. J. and C. Cottarelli (eds): *Frameworks for monetary stability*. Washington D.C.: International Monetary Fund.

However, to be able to exercise it, we had to pay attention to one additional element: creating the appropriate tools. For the conduct of monetary policy it is a necessary, but not a sufficient, condition to have normally functioning financial markets. For that purpose one also needs market-based instruments. In 1987 we had practically none, and we knew it when we started our deregulation policy. We knew that it was not enough to clear the landscape; we also had to construct new modes of travelling through it.

3. Instruments of monetary policy

(i) Setting up the infrastructure for market-based instruments

In approaching the design of policy instruments, we decided to learn, as far as possible, from the experience of others. We thought that it was enough of a challenge to adapt the new tools as required to our specific circumstances, and we did not feel any urge to invent instruments that had not been tested elsewhere.

By the end of 1987 we had taken care of four essential items:

First, we established a fixed maintenance period for meeting, on a monthly average, the reserve requirements, which were the main policy instrument at the time. To be sure, there had been a maintenance period before, but it was shorter, its starting-point was not constant and, therefore, not identical for all the banks, and it was possible for certain periods to escape being covered by any given maintenance period. It was, indeed, a bizarre and confusing arrangement. In addition, the cost of not meeting the requirements was not clear-cut, and we straightened out that aspect too.

Secondly, we changed the discount window arrangement. Instead of having, as previously, one window on which every bank could draw unlimited amounts at a given interest rate, we established a ladder of windows, each one carrying a higher interest rate, and a quota in each window, for each bank, depending on its size.

Thirdly, we instituted a repo-like instrument, namely a loan to commercial banks for one week, collateralised by bank deposits held with the central bank. The interest rate and the allocation of the offered quantity among the banks were determined in an American-style auction, where each bank paid the rate bid by it in the auction. For us it was a wholly new instrument and, in the course of time, the interest rate determined at these auctions became the key short-term interest rate in the economy, with various bank rates closely linked to it.

Fourthly, we reversed a policy of the central bank that had severely restricted an interbank trade in liquid assets. To promote an active market we offered the banking system our clearing services and, as a by-product, we came to know on a daily basis who was selling to whom, how much and at which interest rate. It turned out to be a very thriving market and a highly efficient channel for transmitting policy-induced changes in short-term interest rates.

(ii) Further adjustments

In addition to these four basic elements that created the infrastructure for linking the short-term money market to our monetary policy, we acted to shift the emphasis in our instrument portfolio towards greater flexibility. In this connection there were two items on our long-term agenda: reducing the exorbitant reserve requirements, and developing our ability to operate in the capital market.

Reducing reserve requirements

Towards the end of 1987, average reserve requirements on commercial banks' deposits amounted to 63%, either held in the form of deposits with the central bank, most of which were remunerated at below-market rates or invested in government bonds. The requisite percentage depended mainly on the nature of the deposit (foreign currency, index-linked or non-linked) and not on its time to maturity.

Following the practice in most other countries, and for the same reasons, we decided to cut reserve requirements to what we labelled "business" level, that is, the level at which banks will want to hold reserves even if there is no formal obligation to do so. Furthermore, we wanted the new requirements to be only in the form of deposits with the central bank and only in non-linked domestic currency. Ten years after we started, the job is almost completed. The average requirements in 1997 are 3%, all of which is held with the central bank, and only the part held against foreign currency deposits of foreign residents still in foreign currency.

The gradual reduction of reserve requirements also led to another change. Bank deposits with the central bank were the collateral for the loans extended to the banks in the framework of repos. As those deposits dwindled, we moved over to accepting government bonds as collateral.

Open market operations

Developing instruments that would transmit the message of monetary policy through the capital market proved to be particularly difficult. The capital market itself was still in the early stages of development and the Treasury monopolised whatever was there to finance the budget deficit and recycle the large government debt. Any activity on the part of the central bank in this market was perceived as "competition" and thus could not be allowed.

Nevertheless, in this desert grew a small tree, although it was nothing much to write home about at first. In 1984, when everybody was looking for ways to deal with hyperinflation, the Treasury agreed to enact a special law creating a new monetary instrument. Under this law the Treasury could issue a short-term note (Treasury bill, as it is called in other countries) the maturity of which would be up to one year. This note, so the law stated, would serve only monetary policy needs and not the financing of the budget deficit. However, to make sure that the central bank would not turn it into a major instrument, the law put a nominal ceiling on the quantity that could be issued, and added that any increase in that ceiling would need the approval of the Minister of Finance and Parliament.

Over the years we were able to improve the lot of this instrument, the only one available to us in the capital market. Today the ceiling is updated automatically, twice a year, according to the change in the means of payment or the change in consumer prices, whichever is higher. However, it is still not a major instrument and it will not be until we have a free hand in determining the quantities. Nevertheless, there is a reasonable daily trading in this instrument, and its yield serves as a benchmark for pricing another, longer-term, variable rate, non-indexed government bond. Furthermore, the short-term note serves as the underlying asset for another instrument that we at the central bank have developed – one that enables trading in interest rate futures.

Other than that, we are not operating in the capital market as part of our monetary policy. Taking into account the growing importance of non-banking intermediation in Israel, open market operations as an instrument of monetary policy should assume more importance.

Updating the use of repos

This brief survey of our instruments would not be complete if we did not cover more recent developments in our use of repos.

Towards the end of 1990 we added a daily auction to the weekly one which we launched in 1987. Both served us well for five years, until, in the mid-1990s, we started to experience a period of capital inflows. Owing to the constraints of the exchange rate band, we had to buy foreign currency and sterilise the resultant increase in the money supply. The sterilisation reduced our loans to commercial banks almost to zero and prompted us to use reverse repos, i.e. we began accepting deposits from the banks, rather than extending loans to them through the same auction system.

4. The situation in the late 1990s

Most, if not all, policy-makers in Israel, nowadays accept that precisely synchronised, all-embracing, multifaceted economic programmes that clearly distinguish, on a given day, between the past and the future, are suitable only for crisis management. Regular economic policy should be based on some division of labour among government institutions, operating within a coherent framework to attain known targets.

Much has been done over the last decade to put in place the infrastructure required for such a modus operandi. Concentrating on monetary policy, the following items are noteworthy:

- the setting of annual monetary targets aimed at price stability in the long term was introduced in 1992;
- understanding of the channels through which the short-term interest rate, our operating target, affects inflation, our final target, is increasing.[3] As a result, we regularly follow a set of indicators as the basis for the daily, weekly and monthly meetings at which we discuss the need, if any, to adjust policy;

- in the meantime the central bank continues to co-operate with the Ministry of Finance to complete the deregulation of financial markets and the liberalisation of the capital account. The near-term agenda includes reforming pensions, changing the nature of exchange control to permit any foreign currency transaction unless explicitly forbidden, and further examining and adapting our exchange rate regime.

The main task ahead of us is, still, to convince the Government and the public that price stability is conducive to durable growth. Otherwise we will be required as before to take care also of unemployment, growth, balance-of-payments deficits, the well-being of the stock exchange and even the redistribution of income to reduce inequality. As long as this remains the case, the road to price stability is going to remain a rough and long one.

[3] The staff of the Monetary Department are engaged in quantifying, through econometric and other research methods, the relationships between policy instruments and the target. Some of the findings are reported in Klein, David (1998): "Transmission channels of monetary policy in Israel". In "The transmission of monetary policy in emerging market economies". *BIS Policy Papers*, No. 3, Basle: Bank for International Settlements.