David Klein: Three differences between Israel and the US in the 'quality of the environment' in managing monetary policy

Address by Mr David Klein, Governor of the Bank of Israel, to the Israel-America Chamber of Commerce, held in Tel-Aviv, 10 May 2001.

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The background

On 3 January, 2001, after the US Federal Reserve announced the first interest-rate cut of the year, the demand was made that the Bank of Israel follow suit. The demand was reiterated after the additional interest-rate reductions that followed. No such demand had been made in 1999 and 2000, when the Fed raised interest several times, so that it had to be assumed that the demand to follow suit was no more than an attempt to vary the list of reasons, which changes from time to time, behind the demand that is always on the agenda in Israel to reduce the interest rate, and the faster the better. Nevertheless, it may be instructive to consider the differences between Israel and the US in referring to the management of monetary policy. Understanding these differences can shed light on the question of whether it is reasonable to automatically imitate the Fed–naturally only when it reduces interest.

The differences

What, then, are the differences?

1. The culture of inflation

Ever since the trauma that Americans experienced in the wake of the oil crisis of the 1970s, when the inflation rate reached an intolerable level of 13.5 percent in 1980, there has been no argument in the US regarding the need to keep inflation low. The US has no formal inflation target, and the law – which has not changed in this respect in the last 50 years – instructs the central bank to relate to growth and employment, too. Despite all this, throughout the 1980s the American central bank focused on getting the annual inflation rate down, to the 2-3 percent that has characterized the last eight years. The unemployment rate ranged from 5 to 7 percent all those years, and still the central bank did not relent. The message was: employment is generated not by accepting inflation but by making structural changes and raising productivity. Thus, ultimately, the unemployment rate declined to 4 percent, and the US economy showed that maintaining price stability does in fact go hand in hand with reducing unemployment.

The upshot is that the US consumer is prepared to invest time in comparing prices and to travel quite a long way to buy the same product for less money. At any rate, the Cent is still legal tender, and the efforts to replace the one-dollar note with a coin have not succeeded.

As you know, the Agora is no longer legal tender in Israel, though it still features in prices, and an interesting debate is currently being held about the rules of price-rounding when payment is in cash. Anyone who thinks that the rules of price-rounding are simple – after all, this was settled in the Bank of Israel Law – should study the proposed law on the subject that has already passed its first reading in the Knesset. In addition, the note with the smallest value is the NIS 20, and it is quite a long time since the NIS 10 note was replaced by a coin. Despite the differences in average income, the attitude of the Israeli consumer to money and prices seems to be somewhat less careful than that of his American counterpart, and he is also somewhat less confident that the low inflation rate will persist.

It is hardly surprising. When actual inflation deviated upwards from the target people said that this constituted a proof that it was impossible to lower the inflation rate in Israel. When the deviation was downwards, they said that the Bank of Israel had failed – as if monetary policy was an exact science and the interest rate a laser beam. When the inflation rate diverged upwards from the target, people said that the target had to be raised, and that a little more inflation was preferable to a little more unemployment; and when it diverged downwards from the target people said that a commission of inquiry should be set up and, naturally, the Governor dismissed. The Chairman of the Federal Reserve in the US once defined 'price stability' as a situation in which no-one considers inflation as something that has to be taken into account in economic decisions. Apparently we have not yet reached the stage where we regard low inflation and price stability as natural. We still require proof, and that obliges Israel's central bank to be a little less indifferent than its US counterpart to threats to price stability.

Thus, anyone who claims that the Fed thinks that there is substitutability between inflation and growth, and that it now tends to prefer growth to inflation, is mistaken. The Fed is reducing the interest rate aggressively because it is indeed convinced that it is needed in order to shorten the period of slowdown in the US economy, but this policy is undertaken on the assumption that it will not accelerate inflation. This assumption is based on both the rise in productivity that characterizes the era of information technology and the longstanding credibility that the Fed has acquired in its struggle to maintain price stability. In that, too, we are very different from them.

2. The dollar and the shekel

The dollar, as you know, is a currency that many people in many countries are prepared to use as a means of payment and hold in order to maintain the value of their assets. The shekel, as you know, has not yet attained that status. It is true that because of the decline in the inflation rate we have stopped running after the dollar, but the habit of linking the prices of certain goods and services to the dollar has not yet disappeared.

That provides the background for the fact that the balance-of-payments deficit has been part of the American scene for many years. In the last year, for example, it amounted to $ 400 billion – about 4.5 percent of GDP. Till now the Americans had no real difficulty financing their import surplus. The world was willing to take the difference in dollars, which were invested in various assets in the US. Foreign investment in US Treasury bonds alone is nearly a massive $ 1,300 billion.

Our situation is, of course, very different. Although for us, too, a balance-of-payments deficit is a matter of routine, we cannot finance it with our currency. In other words, both we and the Americans need dollars in order to cover the import surplus. The difference is that they can print them. We need to borrow them or, as has happened in recent years, benefit from the foreign investment in Israel that has enabled us to maintain an import surplus without increasing our foreign debt, and even to accrue foreign-currency reserves and reduce our past foreign debt.

Naturally, all this was possible because our balance-of-payments deficit shrank significantly. This was not the case in the mid-1990s, for example, when the deficit amounted to 6 percent of GDP – a rate that was taken as signalling an approaching crisis. The fears were so great that in deciding on its economic policy targets for 1997 the government placed the need to reduce the balance-of-payments deficit first, before growth, and certainly before reducing inflation (the inflation target set for 1997 was 7-10 percent). That balance-of-payments deficit had grown because fiscal and monetary policy was loose, there had been economic growth because of the rise in consumption and the standard of living, and that had brought both the balance-of-payments deficit and inflation in its wake. Only the policy shift saved us from certain disaster, teaching us once again the lesson that we have learned several times in the past: growth led by consumption cannot be sustainable in Israel.

The Americans, on the other hand, are building on that alone to revive their economy. Both their monetary and their fiscal policy are expansionary – the former by rapid interest – rate reduction and the latter by tax reduction – in order to stimulate growth through an increase in private consumption. If as a result there is a rise in the balance-of-payments deficit, so be it. It is true that from time to time somebody stands up and says that things cannot go on like that, but so far it has worked. Maybe because the alternatives are less appealing. Another angle of the same situation is that US Secretaries of the Treasury advocate a strong dollar, while Israeli Ministers of Finance prefer a weak shekel.

3. The financial markets

The third difference lies in the structure of the financial markets. It is widely known that the US has the most developed financial markets in the world. In the last few years the Nasdaq has attracted widespread publicity, but the main point is that the Americans have a developed system of non-bank financial intermediation, comprising inter alia a huge market for both Treasury and corporate bonds. There are also markets for the financial instruments that have developed in the last twenty years, primarily derivatives of various kinds on interest rates, exchange rates, and share prices. In addition, there is an institutional system outside commercial banking that includes investment banks, financing institutions, asset- and financial-management services, and brokers of various kinds, offering a variety of financial services. And what about us?

- The stock market may be replete with companies registered for trading, representing a large number relative to the size of our economy, but with a small turnover and a concentrated ownership structure. All this is despite the fact that the management of the stock exchange has done all it could – and even more – to introduce trading and clearing systems that are among the most advanced in the world.
- The market for government bonds is drying up a little more each year because of the proliferation of non-tradable earmarked government bonds, and if nothing is done it will gradually die. The market for tradable bonds will dwindle even more rapidly once the switch (commendable in and of itself) from a pay-as-you-go pension system to a pay-as-you earn one gains momentum, and especially once the proposal to introduce an obligatory pension scheme in the present institutional structure is accepted.
- Israel's Treasury bill market is paralyzed by the folly of the ceiling on the amount that may be issued, so that while the market for Treasury bills is one of the most developed in western money markets, ours is unable to take off, and the spreads between the bank borrowing and lending rates are higher than they should be.
- The market for commercial papers has barely reached lift-off.
- The market for mortgages and the financing of other long-term investment has not managed even to get to the drawing-board.
- The banks' control of the provident and mutual funds is as tight as ever, regardless of their performance.
- And on top of all the above, serious distortions were created because of tax regulations that were introduced at a time when the government was involved in everything, and that really was a long time ago. Our ability to change these regulations seems to be further away now than ever.

The reason why I am bringing all this up here is because monetary policy only begins when the central bank sets 'its' key interest rate. Shifts in this interest rate should have an impact via the changes it causes in the behavior of households and firms. One of the differences between us and the US is that the Americans are involved in the financial markets to a far greater extent – whether as borrowers or as investors – than Israelis. A rise in share prices, not to mention in bond prices, means a fall in the cost of capital, and vice versa. This of course affects both investment and consumption. The result is that the interest-rate changes that are initiated by the central bank have another channel of transmission in the US that does not in effect exist in Israel, namely, the channel of the financial markets. As you know, the interest rate is one of the factors influencing the financial markets-when these exist, of course. This additional channel intensifies the impact of interest-rate changes on the economy, and shorten the lags with which a given interest-rate change affects economic activity.

In Israel, the Bank of Israel has had to conduct its interest-rate policy primarily vis-à-vis the banks, and even the little that can be done via the capital market cannot be achieved to the full because of the ceiling that limits Treasury bill issues. It is obvious that a policy conducted in such conditions is far less effective, and as an instrument the interest rate is more blunt.

A concluding remark

When at some future date you hear that someone has told the Bank of Israel to imitate the actions of the Fed – of course, only when it reduces the interest rate – I suggest you recall the saying: Israel is not America. It is no empty phrase, at least as regards interest-rate policy. A lot needs to be done here before we resemble America, and we are talking here also about improving the welfare of the consumer – whether individuals or businesses – and this is definitely up to us.