David Klein: The opening of the financial markets and the efficiency of Israel's macroeconomic policy

Address by Mr David Klein, Governor of the Bank of Israel, to the Herzliya Interdisciplinary Center, Herzliya, 17 May 2001.

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The policy targets and the financial markets

We have become accustomed to examining the reform of the financial markets, which we have been implementing at intervals for over a decade, from the consumer's point of view: more competitive markets mean better service, a higher return for savers, lower costs for borrowers, and narrower spreads for financial intermediaries.

Those, however, are the direct benefits. There are also indirect ones, deriving from the fact that developed financial markets make for more efficient macroeconomic policy. It is these that I will address here.

Fiscal policy

The aim of fiscal policy is to reduce the burden of government debt from its current 95 percent of GDP to 60 percent of GDP. This is now overshadowed by the restriction embodied in the obligation to issue earmarked government bonds for the pension funds. Why is this a restriction?

- Because the reduction of the debt burden is achieved by diminishing the budget deficit; only by doing that will it be possible to decrease borrowing by issuing bonds. Since the obligation to issue earmarked bonds does not depend on the deficit financing needs but only on accrual by the pension funds, which has risen every year, limiting borrowing through issues of government bonds can be done only by reducing issues of tradable bonds.
- In the first half of the 1990s there was a trend change in the composition of long-term saving: the share of the pension funds increased relative to that of the provident funds. There are several reasons for that structural change, which has not yet been concluded. These include fewer fears regarding the stability of the pension funds as the old funds with their large actuarial deficits were closed and new ones, which were supposed to be actuarially balanced, were opened, starting in 1995. Another reason was the poor performance of the provident funds-which are not entitled to get earmarked bonds-in the transition to a low inflation rate and in view of the fluctuations in the stock market. This structural change in itself reduces the stock of tradable bonds and enlarges the amount of earmarked bonds.
- Moreover, the accrual by the pension funds could rise even further in the future, exceeding its natural rate of increase, for the following reasons:
- A change in the tax regulations which will reduce the benefits of saving in provident funds by self-employed persons (currently withdrawals are possible after 15 years, not only upon reaching retirement age, as is the case with wage-earners), and on the other hand, the fact that since 1995 the pension funds have been opened to self-employed persons.
- The reduction of tax benefits for capital saving (a one-off withdrawal upon retirement instead of the right to a monthly pension) for employed persons, in provident funds and insurance schemes.
- The transition from a pay-as-you-go to a pay-as-you-earn pension scheme.
- The introduction of a Compulsory Pension Law.

This problem embodies another one. As is generally known, earmarked bonds are indexed to the CPI. On the one hand, because of the low inflation rate and declining demand for indexed bonds, most borrowing by means of tradable bonds is through unindexed bonds. The result is that the pension funds have a monopoly on obtaining indexed liabilities from the government – an increasingly rare asset, yet nonetheless one whose price is not subject to market forces. On the other hand, the crisis which has affected other markets is being exacerbated, the most prominent instances being the banking system's market for mortgages and indexed loans for financing long-term investments. They do not have sufficient indexed sources because the accrual in savings schemes and provident funds has been negative for some time.

Since the purpose of most gross borrowing by the government in a given year is not to finance the deficit but to recycle bonds that have reached maturity, in the future this recycling will be achieved not on a voluntary basis by issuing new, tradable bonds but by compulsory borrowing by means of earmarked bonds. Holders of tradable bonds that have reached maturity will find it difficult to recycle them by investing in a similar asset. The result will be that the nontradable bond component of government debt will grow, while that of tradable bonds will shrink.

In any event, each year brings us nearer to the point where the government will no longer need to issue tradable bonds to finance the deficit, and then to the point where the government will have surplus funds since it cannot control the amount of earmarked bonds issued. Even beforehand there will be a time when things will be right for part of the year, because of the seasonal nature of the deficit during the year, and this will give rise to fluctuations in yields and an increase in the risk of holding government bonds.

This process will also fetter the pension funds themselves, since they are required to invest 30 percent of their portfolio in the market, and part of this is naturally directed to government bonds. Some people are against sending the pension funds to the capital market because of the risk involved, but the prevailing earmarked bonds arrangement is the main reason for the existence of this risk.

Thus, the earmarked bonds arrangement:

- Constitutes a growing obstacle to the government's ability to finance the budget deficit in a rational manner;
- Raises the cost of net borrowing to finance the deficit, and hence of debt-servicing, thereby reducing the government's ability to allocate resources to social and economic objectives;
- May bring the government back to being a financial intermediary, because of surplus budget finance, and we have a wealth of experience of the negative implications of that;
- Systematically destroy the market for tradable government bonds, the yields on which constitute a benchmark for determining the bank rate on long-term investments and loans;
- Prevents the development of a market for both long- and short-term corporate bonds, which in every worthwhile stockmarket is based on the existence of a developed market for government bonds;
- Hampers the chances of the stockmarket, which is based on the possibility of borrowing and trading in debt instruments as well as in equity;
- And hence undermines the economy's ability to grow.

There is no choice but to bring the chapter of earmarked bonds to a close. This arrangement not only damages the economy but also constitutes a very high barrier to the development and expansion of the funded pension savings route which, as is known, is itself far from being as widespread in Israel as it should be.

Monetary policy

In August 2000, for the first time in Israel's history, the government decided on a target of price stability for the economy. This target was defined as between 1 and 3 percent, and was supposed to come into effect in and after the year 2003.

Three obstacles deriving from the structure of the financial markets currently obstruct the conduct of monetary policy.

- One final stage remains to be implemented in the foreign-currency market. The process of the liberalization of foreign exchange proceeded along two parallel tracks: gradually reducing foreign-currency control and gradually making the exchange-rate regime more flexible. The restriction on investment abroad or in foreign currency in Israel by institutional investors (provident and pension funds, and life insurance schemes), which currently stands at 5 percent of their assets, is yet to be removed. There is no reason to delay this measure, which is required in order to finally make the the NIS fully convertible. Concurrently, it is possible to abolish the exchange-rate band. In any event, it will be impossible to defend it, should the need arise, and there is no point waiting and deluding people on that score, allowing them to make decisions on the basis of that erroneous assumption.

These changes will not have a dramatic effect on the economy if they are introduced at a time when the foreign-currency market is not exceptionally volatile, and they will make monetary policy more efficient. This is because it will not be necessary to make monetary policy subservient to attaining targets in the exchange-rate sphere-as we had to do in the past-and which could conflict with price stability. Thus, capital flows will be less influenced by short-term, 'speculative' considerations, and will contribute to Israel's financial stability in the long term. Long experience, and logic, have taught us that speculation and shocks in the foreign-currency market are an inevitable by-product of exchange-rate regimes that are not subject to the discipline of the market.

- Another obstacle exists in the form of the quantitative ceiling imposed on the issue of Treasury bills. This ceiling currently obliges us to administer most of our monetary policy vis-à-vis the banks. Interest-rate changes are introduced via shifts in the money supply, which are currently caused by changes in the extent of banks' deposits with the Bank of Israel. If we were to introduce these changes in the capital market by changing the quantity of Treasury bills we would expand the market markedly, strengthen the substitutes for the public's deposits with banks and bank credit, and contribute to reducing the spread between the borrowing and lending rates.

  The spread would narrow not only because of the higher borrowing rate but also because of the lower lending rate. A deep and liquid market for Treasury bills will make it easier to create a parallel market for commercial papers, which constitutes a substitute for borrowers for short-term bank credit.

- A third obstacle is endemic in the absence of any financial intermediation outside the banks. The reference here is to financial services involved in raising short- and long-term capital, whether on a one-off basis or in the framework of investment funds; the management of asset and liabilities portfolios for individuals or firms, and intermediation in the capital market-all of them outside the banking system. In order to create significant nonbanking intermediation it is necessary to return to the problem of the current concentration of the financial services, and introduce the measures we have mentioned on various occasions for dispersing the foci of financial power in Israel's economy. Because of the process of globalization that Israel is currently undergoing, this involves building cooperation with international financial institutions rather than reducing the existing size of commercial banks.

Why would this make monetary policy more efficient? Because the aim of monetary policy is to influence the public's economic decisions. The existence of developed nonbank financial intermediation enables the interest rate to have a direct effect, not only via the banks, on the behavior of savers and borrowers. A better balance between banking and nonbanking intermediation also improves management by the business sector, because the public, which provides firms with capital sources via the capital market, has long-term considerations, while the banks, which provide firms with loans, have short-term ones. The combined outcome is that monetary policy is provided with another channel of influence, which could produce more rapid results than in a situation where it operates solely via the banking channel. This promotes lower fluctuations in the interest rate and greater stability in the financial markets. This stability is one of the major preconditions for sustainable economic growth.

Conclusion

Opening the financial markets is necessary for the benefit of both the individual and the business sector, not only because of the advantages ensuing from a more competitive market. This policy also enables more efficient use to be made of policy instruments, and everyone benefits from that. Note in this context that the process of the structural change of the financial markets, only part of which has been mentioned here, has come to an almost complete halt. The reasons for this should be examined, the necessary conclusions drawn, and steps taken to return to the implementation of the changes required for a modern country that wishes to integrate in the global economy.