David Klein: The framework of Israel's economic policy for 2002

Speech by Dr David Klein, Governor of the Bank of Israel, to The Financial Forum, Tel-Aviv, 11 July 2001.

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Every year, in the framework of the budget discussions, the government passes two resolutions regarding macroeconomic policy for the coming year. If we take last year as an example, on 16th August 2000 the government reached a decision (no. 2182) about “Economic policy for 2001-budgetary aggregates-fiscal policy.” This decision, with no preamble, determined:

1. The extent of the budget deficit for 2001 in absolute terms (NIS 8.2 billion) and as a share of GDP (1.75 percent);
2. The extent of government expenditure (NIS 194.2 billion);
3. The extent of the budget deficit for 2003 (1.25 percent of GDP).

The next decision (no. 2183), on the same date, refers to “Economic policy for 2001-monetary policy.” The approach to monetary policy differs from that to fiscal policy in two respects: First, the decision regarding monetary policy has a preamble specifying the “objectives of economic policy for 2001,” and mentioning three of them:

- Maximizing the economy’s ability to grow on a sustainable basis;
- Increasing business-sector employment;
- The inflation targets for 2001, 2002, and 2003, with the one for 2003 (1-3 percent) being defined as ‘price stability,’

There is no interest-rate target because there are other factors that also affect inflation. Hence, no specific interest rate is invariably consistent with the inflation target, and it must therefore change as the circumstances require. It is somewhat odd to regard monetary policy alone as having a role to play in determining growth, employment and price stability targets, keeping fiscal policy detached from them. In the past we proposed that the goals of macroeconomic policy should be presented as relevant also for fiscal policy, and should feature in the preamble to both decisions. Second, the two decisions-on fiscal and monetary policy-differ in another respect: the monetary policy decision states that the Bank of Israel must submit reports on the performance of monetary policy to the government and the public, **inter alia** explaining deviations from the inflation target and their policy implications. The Bank of Israel does this in the framework of its semi-annual **Inflation Report**. The absence of a parallel reporting requirement with regard to fiscal policy is noteworthy. As a result, for example, this year there is some vagueness regarding the expected deviation from the budget deficit target, and estimates of the actual deficit currently range from 2.5 to 3.5 percent of GDP. This vagueness is accentuated by additional factors:

- An interpretation that has been submitted to the State Controller by the Ministry of Finance is that the budget deficit target is binding only at the planning stage. Does this mean that there is no practical significance to the question of how the budget is implemented relative to the target?
- It is not clear what the implications are of the departure expected this year for the path of the deficit target in coming years, and for the medium-term real interest rate;
- Has there been a change-and if so, who made the decision-in the definition of the rules by which the deficit should be managed, so that what is binding is only that part of the government’s decision that relates to its expenditure ceiling but not to the budget deficit? The justification for ignoring the income side appears to be based on the assumption that changes in actual relative to planned revenues always derive solely from the gap between predicted and actual growth-an assumption that is unfounded also with respect to 2001.
- The experience of 2001, when the inflation reserve may be utilized in order to increase expenditure in real terms, illustrates the need to review the necessity of including an inflation reserve in the expenditure budget. If this tradition persists, it should be given a place of its own in the government’s decision noting the assumption of inflation and its implications for

tax receipts too. This last estimate is required this year, for example, in order to answer the question of what role is played by the deceleration of inflation, relative to the rate assumed in the budget, in explaining the underperformance of tax receipts. This factor, rather than slower growth, may explain most of the shortfall.

Thus, it is necessary to update the formulation of the fiscal policy decision, not only because of the change in the data but also in order to strengthen the discipline of fiscal policy as well as its transparency.

These remarks refer to the accepted format of the macroeconomic framework that was in place till now, and that may be submitted to the government once again when the budget for 2002 is discussed. It appears to us that the perspective should be expanded in several directions.

As far as fiscal policy is concerned, the routine decision regarding the deficit and expenditure for 2002 may take the following directions:

- The definition of the budget deficit should also be presented according to the definition used in the rest of the world, making it possible during the discussion to present data that are comparable with those available elsewhere. After the changes that have been made to date, there is only one outstanding difference in the definition: in the rest of the world it is customary to include all the government's interest rate costs on the expenditure side, while we include only real interest. This definition, which is unique to Israel and serves to make our budget deficit smaller, has misled many people in the past, and sent out a reassuring message about the size of our budget deficit. Furthermore, even when the deficit is presented in accordance with our definition, over time it must be given in consistent terms, and preferably in accordance with the most recent definition. Thus, for example, the reduction of the deficit from 1999 to 2000 was not from 2.5 percent of GDP to 0.5 percent of GDP, but from 3.5 percent-a rate which is equivalent to the definition according to which the budget is calculated at 0.5 percent for 2000.
- What is needed is a blueprint for the deficit and government expenditure for the next ten years. The purpose of this would be to make it possible to fix the national debt at 60 percent of GDP, and reduce the consequent debt servicing burden. The government's long-term plan for reducing the tax burden would also derive from this draft. The discussion of the national debt and its developoment, as well as of its repercussions on the tax burden, on the one hand, and the need to release significant budget sources for servicing the past deficit rather than solving the problems of the future, on the other, would shed additional light on the proposals to further increase the deficit for these and other purposes.
- It is important to deal with the matter of private members' bills since they generally increase government expenditure or reduce its revenues. The attempt to make the discussion of these bills contingent on alternative financing has failed miserably. These proposals upset the conduct of fiscal policy and arbitrarily alter the priorities set by the government and ratified by the Knesset.

Dealing with this issue does not mean dismissing, or even restricting, the possibility of tabling private members' bills. It must, however, evaluate these proposals in the context of national priorities as a precondition for approving them. A proposal of this kind was submitted by the Bank of Israel (as a draft bill), in effect determining that a private member's bill should take effect only after being reviewed in the framework of the budget debate.

Before continuing, I would like to note that we are referring here to the outer wrapping of fiscal policy-that which serves as the focus of the government's decision when the budget is being discussed. We have not spoken about content-priorities in expenditure, the government's social policy, and the composition of tax receipts-and its contribution to the process of economic growth. These topics have not been discussed in the framework of the government's budget discussions in the past, even though they should have been.

With regard to **monetary policy**, since the government has decided on convergence towards price stability from 2003 on, the emphasis must be shifted from a discussion of the inflation target to an analysis of the conditions for creating an environment of financial stability. Financial stability is disturbed when the equilibrium of one or more of the asset markets-securities, foreign currency, or real estate-is upset, as expressed in price volatility in that market. Concurrently, there is distress, and possibly even bankruptcies, among financial institutions. This scenario, which is known to us from many countries, is the outcome of two basic causes:

- The unchecked behavior of agents active in these markets and those who finance them. The best-known examples of this in Israel were the bank shares crisis of 1983, credit for buying mutual funds at the height of the bull stock-market in 1993, the provident funds ‘crisis’ in 1996, the stampede to replace local-currency credit with foreign-currency credit in 1994-97, and the unchecked expansion of the real-estate industry in the wake of the influx of immigrants in the early 1990s.

- Another constant source of financial instability was created by the regulations introduced by the government. These may have been all well and good in their time, but eventually turned out to stand in contradiction to the logic of the market. When there is neither the strength nor the sense to abrogate them in time, or when for reasons that are not relevant they are stubbornly left in place-and regrettably both these reasons apply in our case-they constitute a destructive force causing a financial crisis.

In instances like these a large segment of the population may suffer serious damage, which could have been avoided or at least limited had timely action been taken. Permit me to cite just the main issues which should be decided by the government in the framework of the debate on financial stability:

1. **Closing existing pension funds to new members and opening purely market-based funds**: only in the wake of this decision will it be possible to proceed with the discussion of the proposal to make membership of a market-based pension plan compulsory for all employees. The pension funds which are to be closed-and this refers to those of them that were opened since 1995-will be eligible for earmarked bonds in their current format until their task is completed. The purpose of this decision is to keep the tradable bonds market from continuing to dry up, together with the savings and credit channels based on it, including the provident funds and the mortgage market.

2. **Concluding the process of making the NIS a convertible currency by abolishing the last vestige of foreign-currency control**: this refers to the restriction preventing the provident funds, insurance companies, and pension funds from investing more than 5 percent of their asset portfolios abroad or in foreign currency. This restriction lost its logic long ago, and its existence harms the stability of the market and the robustness of long-term saving in Israel. This is the last stage on the road to full convertibility of the NIS.

3. **Abolishing the exchange-rate band**: its continued existence is in complete contradiction to the liberalization of foreign currency and long-term capital flows which were-and continue to be-the fuel of the engine of Israel’s growth, the high-tech industry.

   The continued existence of the exchange-rate band imperils Israel’s financial stability. Three assessments prevail in this connection:

- The first assessment is that “There is an area where change can be speedily expressed on the ground … The price of money…is determined solely by the Bank of Israel. The instruments it controls affect another important variable: the exchange rate” (opinion in **Ha’aretz**, 8.6.2001). The automatic reiteration of the view that the interest rate by itself affects the exchange rate does not make it true. Note, for example, that between the end of 1998 and June 2001 the Bank of Israel reduced its key interest rate by some 7 percentage points, and the spread between the interest rates on the NIS and the dollar narrowed by some 6 percentage points-large changes by any criterion-without this having any real effect on the exchange rate. In order for a reduction in interest to affect the exchange rate the public must feel that we have abandoned the target of price stability and that the circumstances have been created that prevent us from restoring it in the foreseeable future. That, as you know, has not been the case in the last two and a half years. If a situation is created in which the public is given to understand that steps have been taken to prevent us from being able to maintain price stability, even at the present interest rate there will be a shift in capital flows that will cause more rapid local-currency depreciation. However, a change of this kind in the exchange rate will not bring the benefits those who have been clamoring for it for years expect – a reduction in the interest rate in order to create devaluation – because stimulating economic activity by encouraging exports requires real depreciation, i.e., nominal depreciation without an increase in prices.

- The second assessment is that “Currently, the Bank of Israel is reducing the interest rate because the exchange-rate band exists” (interview in **Yedioth Aharonoth**, 6.7.2001). In other words, the reason why the Bank of Israel reduces the interest rate is to keep the exchange rate away from the lower limit of the band. This view could have a foundation if the reduction of the interest rate did in fact generate devaluation. As you know, this has not been the case in the last two and a half years, when there was a continuous downward trend in the interest rate. Consequently, this consideration was never relevant for interest-rate decisions. The fact that the interest rate was reduced, and the extent to which this was done, was determined solely on the basis of inflation expectations and the consideration of matters pertaining to financial stability. If, because of the existence of the exchange-rate band, on the other hand, inflation could accelerate-a reasonable outcome in certain circumstances-the band would oblige us to change the interest-rate policy. There is absolutely no doubt that without the band Israel's interest rate could be lower than with it.

4. **Abolishing the ceiling on Treasury bill issues**: this limit, like the lower limit of the exchange-rate band, is intended – as various government representatives repeated at the recent Caesarea conference – to restrain monetary policy. The story sounds somewhat Kafkaesque: on the one hand, you set a target, while on the other you impose limits in order to make it more difficult to attain. The quantitative restriction on Treasury bill issues does indeed hamper monetary policy, as it obliges us as policymakers to influence the market via the banks. As a method, this is very expensive and not very efficient. Its practical significance is that the economy has to function with a higher interest rate in order to maintain price stability, so that the country pays unnecessarily for this restriction.

   No less important, however, is the effect of the Treasury bill ceiling in checking the development of the money market as a substitute for banking intermediation. The absence of a deep Treasury bill market is one of the reasons for the spread in the unindexed local-currency segment and for the absence of a market for short-term corporate bonds based on Treasury bill prices. The upshot is that anyone depositing money in a bank receives lower interest, while borrowers pay higher interest. This does further-and quite superfluous-harm to the capital market and the economy.

5. **Annulling tax distortions on individuals' financial income received directly and via institutional investors**: because of the attempts to connect these changes with a 'large' tax reform that also addresses taxation on work income, this subject has also come to a halt. What we are talking about here is equalizing tax rates and making taxation dependent as far as possible on nominal income, and these changes should be neutral as far as government revenues are concerned. There are intolerable gaps in Israel today between taxation on income from different financial instruments, as well as between taxation on investment in Israel and abroad. These distortions must be removed in order to bolster financial stability and make the financial markets more competitive. In some cases it is necessary to increase the tax rate, and in others to reduce it, and the combined results need not necessarily affect government revenues.

6. **Establishing a joint body to coordinate the various authorities supervising the financial markets**: obscuring the limits between the various spheres of activity of Israel's financial institutions, as well as Israel's integration within the global economy – including the involvement of foreign financial institutions in the domestic market – require greater coordination and exchange of information between the supervisory bodies in order to make the system more efficient. Several financial crises have developed due to the exploitation of the boundaries between the various supervisory bodies.

In the last decade Israel's governments have adopted the norms of macroeconomic management that have become accepted throughout the world. These include:

- Fiscal discipline, thereby keeping the national debt and debt-servicing costs at a reasonable level;
- Price stability;
- This framework must be completed by committing ourselves to a competitive financial system and financial stability. Empirical studies indicate that there is a positive relation between sustainable growth and developed financial systems.

Not only are these norms not superfluous in an economy that wishes to maximize its growth potential and reduce unemployment, they are essential. We had better not delude ourselves that we can attain sustainable growth and create more jobs suitable for a modern economy if we give in just a little as regards the budget deficit, and perhaps conceal this by changing definitions; if we accept a rise in inflation, at first by talking about it, then by hiking up the target, and finally in actual terms; if we dismiss the changes required to ensure financial stability, and in order to make it quite clear where we are headed we also constrain the Bank of Israel.

If we choose to retreat from accepted macroeconomic practice in the world, we will find that the world can manage perfectly well without us and, what is worse, that Israeli companies and individuals prefer to secure their economic future outside Israel's borders. This should be particularly worrying to those who are sensitive to the country's social problems and who are forever demanding more resources. Even the Jewish genius cannot produce something from nothing. When the government meets next to determine the framework of economic policy for 2002 it would be well advised to think about this.