David Klein: Israel’s macro economic policy and the European standards

Speech by Mr David Klein, Governor of the Bank of Israel, for the Euro Conference, Tel Aviv, 4 September 2001.

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Israel is an open economy, more than many other countries in the world. A few indicators tell the story:

- The share of exports plus imports, relatively to GDP, is almost 100%;
- The stock of Israeli assets, shares and loans, private and public, held by foreigners, amounts to US $130 billion - more than our GDP;
- The stock of foreign assets, shares and loans, held by Israel’s residents, amounts to some US $65 billion.
- Exchange controls have been almost fully removed and the exchange rate is freely determined in a growing interbank foreign currency market;
- Israel is party to bilateral and multilateral international agreements, with the US, the IMF, the EU, and the WTO, committing the economy to open trade in goods and services and open capital account.

This background is, of course, not accidental. Economic thinking in Israel was very much influenced, in the last decades, by the agenda of the more developed industrial economies. Early on we realized that free trade agreements and low custom duties, although painful in the short-run, are a necessary condition for sustainable growth of a small economy like that of Israel. This state of affairs is taken to-day as given and nobody contemplates seriously protecting Israeli industry from foreign competition by tariff and non-tariff barriers, as we used to do in the past.

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Nevertheless, there is still a bridge that we have not completely crossed. We already understand that to get integrated with the world economy we have to follow some rules. Paramount among them are Maastricht-like criteria relating to fiscal discipline, public debt and price stability. However, since we are not a member of the EU, and not even one of the accession countries that wait to join in, there is no external pressure to abide by these rules. Hence, we have to do it on our own, which turns out to be a rough process.

The major hurdle to-day is fiscal discipline. The essence of this rule, as is well known, is to limit the general government deficit in order to reach a reasonable level of public debt ratio to GDP. The public debt ratio of Israel is still high, above 90%, although it was a lot higher before we embarked on this road. This means that we cannot pause, and certainly not change direction, in our attempt to maintain a low deficit. Raising the deficit is not an option, especially because our public spending level is already one of the highest, if not the highest, in the world. Our estimate is that in the current year, 2001, our ratio of public spending to GDP amounts to 54%, compared to an average of 42% in 20 of the OECD countries, where all of the individual countries ratio are lower than ours.

So what can the government do, given the current slowdown, to help the economy get out of the recession? The only viable option is to change the composition of spending so that growth-enhancing expenditures will get priority. Government investment in infrastructure, for example, ought to get precedence over government programs to support those who are not working. This does not mean that these programs should be scrapped altogether. But it does mean that they should be refocused. The question should not be how the state can help those who are not working to maintain a modest standard of living, but rather how the state can help them join the labor force.

Another example, often quoted, relates to the efficiency of our public education programs. International comparisons indicate that, in some instances, we get less for our money, compared with other countries. Furthermore, we still grapple with the question whether, and to what extent, there is room for private sharing of educational expenses - not necessarily to save public money but, for example, to focus more on education in development towns.

These are only some aspects of fiscal discipline or, as it is sometimes called, fiscal consolidation. They serve to illustrate why it seems, sometimes, easier to bypass the need to be more efficient, and just increase overall government spending and the deficit.

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A good reason to resist the temptation to give up fiscal discipline is its implications for financial markets:

- The first, and most immediate, effect of increased deficit is an increase in the interest rate on government instruments to finance the deficit. This has already started to take place in the last few months. The outcome holds not only for the increase in public debt, but also for that part of the debt that needs recycling every year. Interest payments take already some 15% of the government current resources, and are larger than the education budget and very much larger than government investments.

- The increased interest on government instruments reverberates to private ones. This is the second effect. We know that the yield on government bonds serves as a benchmark for pricing long-term loans, like mortgages. The increased deficit level in the current year casts already some doubts about the future trend of the cost of mortgages. Another example has to do with the government initiative to commission private entrepreneurs to invest in infrastructure (the so-called P.F.I.). These will need capital resources, or long-term loans, and they will be priced based on the yield on government securities. Hence, increased budget deficit will increase the cost of capital also for privately financed long-term investments.

- The third effect is on inflation and/or on the balance of payments. It takes more time to materialize, but it is a certain outcome. We went through such a period in the middle of the last decade where, following an expansionary fiscal policy in the first half of the decade, supported by an expansionary monetary policy, we got a large and non-sustainable deficit in the balance of payments and increasing inflation. To avert crisis, we had to back off and the economy slowed down. This is why it is so important that the government added to its decision, to increase the deficit in 2002, a commitment to lower it in the three consecutive years. The only question now is whether the markets will believe.

- If the credibility of the government is in doubt, we will get the fourth effect of a higher government deficit, this time in the foreign currency market. We often note the relative stability of this market, despite the decline of long-term capital inflows and the regional tension. But we should not overlook the factors that hold the balance in this market:

- On the one hand we have foreign investors who started, in recent months, to buy foreign currency on a relatively large scale, apparently to hedge their exposure to the shekel, due to their long-term investments in Israel. The timing may reflect a concern lest the stability of the currency will be impaired due to the rising military tension.

- This added demand for foreign currency is met by supply of Israelis, mainly from the business sector. They sell foreign currency, in the spot and future markets, that they get either from their export receipts, or from foreign currency loans, or from drawing on their foreign currency deposits in Israel or abroad. It seems clear that Israelis who sell foreign currency have more faith in the stability of the shekel than their foreign counterparts. This is what keeps the market in a relative balance.

Here is where the credibility of the government enters:

- In the eyes of the Israelis - if their trust in the government's ability to maintain fiscal control will be shaken; and if they will loose their confidence that the government is indeed committed to price stability - they will draw the conclusions. The relative balance in the foreign currency market will be replaced by excess demand.

- From similar episodes we know that it is the domestic sector that reacts first, but that foreigners follow suite. Right now they just reduce their domestic currency risk. The situation does not justify going beyond that, although foreigners have reduced some of their traded portfolio in Israel.

On the wayside stand foreign analysts and rating agencies. They publish newsletters, interview policymakers, collect data and offer their considered view to their customers and the public. We know their agenda: fiscal discipline, price stability, low public debt, stable financial system, structural reforms. They are not very good in seeing the future, but they are very quick to join the party in its early phases. For them too, perhaps especially for them, the credibility of the government is all-important.

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Hence, a government that starts by raising the deficit, especially after a year where the deficit is expected to be larger than planned, is already on an inferior ground and has to do more to convince the public that its commitment, to reduce the deficit in the following years, is credible. What can it do?

The first thing is to confine the increased level of spending to investment, put a lid on current expenditures, and show it explicitly. The government ought to ratify not only the ceiling on total spending for 2002, but also its breakdown to current and capital expenditure, and present the figures in comparison to the estimated figures for 2001. It is one thing to borrow more for investment, and completely another - to borrow more to finance current spending, even if it is called teachers' salaries, hospitals' maintenance and poverty reduction programs. The approved capital spending aggregate ought to be accompanied with a list of projects and time-table for their implementation. Finally the government ought to discuss, and publish to the public, a quarterly report on the budget execution, compared to its plan.

The second thing is to make absolutely clear that the government is committed to price stability. Hence:

- If somebody says that short-term interest should be reduced, he should also add: provided that it does not undermine price stability;
- If somebody says that we should follow in the footsteps of the US central bank that reduced interest rates in 2001, he should also quote the Fed's emphasis that, given the conditions in the U.S economy, these interest-rate reductions are consistent with price stability;
- And if somebody says that price stability is important and so are growth and employment, he should also explain that if we have more than one target we should employ more than one instrument, and we should not expect to attain all targets using one instrument. Partial statements may convey the message that an interest rate reduction is an end to itself, regardless of the consequences, thus increasing skepticism regarding the intention of government policy. But clear statements are not enough. The government should strengthen the ability of the Bank of Israel to maintain price stability and go on with the reform required to change the structure of the domestic financial markets. The main elements of the reform are well known:
- Removing the obstacles preventing the creation of a non-bank money market, that will include short-term bills (Makam), commercial papers, certificates of deposit, repos and various derivatives;
- Enhancing the competitive structure of long-term institutional investment, by gradually abolishing the issuance of non-tradable government bonds to pension funds, and reduce concentration in this industry;
- And abolish the remaining controls on foreign currency transactions, including the archaic exchange rate band, thus reaching full convertibility of the Shekel.

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The mission to lead the economy out of the recession is indeed awesome. Nevertheless, we should not loose sight of our ultimate destination: durable growth, based on a competitive market, integrated with the world economy and operating based on the same ground rules. Such an economy should be also better equipped to deal with poverty reduction and other sensitive social issues.