

## David Klein: A “package deal”? - the policy changes needed for 2002 and thereafter

Prepared by Mr David Klein, Governor of the Bank of Israel, as background to a meeting with “Haaretz” economic journalists, Tel Aviv, 20 November 2001.

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### Clarification of the term

The term “package deal” was the name given in the past to a plan of action agreed between the government and non-government entities-the employers’ and employees organizations-to achieve certain objectives. The objectives were usually to lower inflation and reduce the deficit in the balance of payments.

Today we are facing a different situation: the economy is in recession, there is high unemployment, and there is no significant improvement in sight. In other words, it is clear that the current policy needs to be revised. Is a package deal necessary for this, or does the government have the required tools at its disposal to act alone?

It is best to answer this question after identifying the policy changes needed to boost growth and raise employment without undermining stability and without increasing the balance of payments deficit.

### What characterizes the current policy?

Policy is reflected by laws, government decisions, and agreements, some old ones, and some new. What set of laws, decisions, and agreements is relevant to today’s objective?

There are two anchors to macroeconomic policy:

**1. Fiscal policy, aimed at reducing the government’s size and debt.** The implementation of the appropriate policy in this sphere will enable the tax burden and interest rates, mainly the medium- and long-term rates, to be reduced. Both of these factors are vital to growth.

We know that the budget for 2002 is not positioned on the path needed to attain these goals:

- The deficit will be greater than planned because the estimate of revenues is based on an unrealistic growth assumption. Moreover this will be the second year in succession with a deviation in the deficit, which undermines confidence in the government’s commitment to return to the downward deficit and debt path from 2003.
- By far the greatest part of additional government expenses is directed to current expenses, and only a small part (less than one tenth) to financing investments. What is needed, therefore, to attain the objective, is:
  - To adjust the budget for 2002 to ensure that the deficit set by the government is adhered to;
  - To alter the composition of government expenses so that the addition directed to investments increases.

To do this, another subject must be addressed:

### Private legislation

It has been shown conclusively that existing laws do not prevent private legislation from changing government decisions on budgetary aggregates (tax benefits are granted which reduce revenues, and laws are passed which raise expenses), imposing an order of priorities on the government different from the one it approved, and adversely affecting growth and employment. An amendment to the law is required which will ensure that all initiatives by Knesset members will have to be checked in the light of the budget policy determined by the government. All the private bills introduced in the last two years must be covered by this amendment.

## **2. Monetary policy, aimed at preserving price stability and supporting financial stability.**

The more firmly established this stability, the lower the rate of interest needed to maintain it. Stability and low interest are another essential key to sustainable growth. Without stability, there is no investment, and without investment, there is no growth. Certain additional steps are required to complete monetary policy, just as in the case of fiscal policy:

- The abolition of the ceiling on Treasury bills issues.
- The abolition of the exchange-rate band.
- The abolition of the remaining foreign-currency controls, and making the NIS fully convertible.
- Unification of tax rates on interest income of individuals and mutual funds, without affecting total revenue from this source.

These adjustments would shift the center of gravity of monetary policy from the banks to the financial markets, and enable price stability to be achieved at a lower rate of interest. Furthermore, and no less important, these changes would make the financial markets more efficient, improve their competitive structure, and thereby encourage savings and support growth.

## **3. In addition to the two anchors mentioned above, we must give attention to various aspects of the labor market and wages policy in the public sector.** The relevant topics are:

- a. The law currently in force determines that the minimum wage is updated according to the average wage. To avoid exposing the minimum wage to irrelevant changes in the wage structure in the economy, and to comply with the original concept underlying the Law (ensuring a minimum income for workers at low wage levels), it would be better to link the minimum wage to the Consumer Price Index (CPI). In order to share the fruits of economic growth with those at low wage levels, the possibility of adding the rise in productivity should be examined. Efficient methods of enforcing the Law should be introduced. At the same time, the salaries of the most senior public-sector office holders, which are currently indexed to the average wage, should also be switched over to linkage with the CPI.
- b. The policy of reducing the number of foreign workers, in particular the illegal ones, should be implemented.
- c. The policy aimed at replacing income support with a program to increase the participation rate in the labor force should be implemented.
- d. A special work plan should be drawn up to retrain those who have been unemployed for more than a year.
- e. The programs of support for small and medium-sized businesses should be reviewed and strengthened, with special attention paid to those in outlying areas.
- f. Wages policy should concentrate on the public sector. To carry out the policy of maintaining the real wage, the rules for determining wage drift (compensation for seniority; large differentials between grades; the pace of advancement through the grades; and other related expenses) should be amended.

## **4. Dealing with factories in difficulties**

A governmental approach must be determined to deal with the problems of factories in difficulties:

- a. A legal framework is necessary ("Chapter 11").
- b. A process must be instituted to distinguish between factories whose continued existence cannot be justified on economic grounds, and those facing temporary difficulties.
- c. Any recovery program for a particular factory should require the participation of the owners (including investors in the capital market), creditors, and employees, and not just the government. On the other hand, they are all, including the government, entitled to some benefit if the recovery program proves successful.

### **What is the next step? The professional team and working teams**

In a meeting called by the Minister of Finance which took place on 14 November, 2001, with the Chairman of the General Federation of Labour in Israel (the New Histadrut), the President of the Manufacturers' Association, and the Governor of the Bank of Israel, a decision was reached to appoint a professional team. The team's role would be to formulate a work plan such as that which I have outlined above. A work plan is not the same as an operative plan, and working teams must be appointed to go over the details. Four such teams can work in parallel:

1. One team will be led by the Budget Department, and will include representatives of the Prime Minister's office. This team will formulate the change needed in the budget for 2002, both in the aggregates and in the composition of expenses; it will also deal with the amendment which will regulate the rules governing private legislation.
2. The second team will include representatives of the New Histadrut, and representatives of the Wages and Labor Agreements Department of the Ministry of Finance, and will formulate the overall changes needed in public-sector wages so that the policy of maintaining the real wage can be implemented.
3. The third team will include representatives from the Ministry of Finance, the New Histadrut, and the manufacturers. Its task is to look into the changes needed in the Minimum Wage Law, and ways of reducing the number of foreign workers in Israel.
4. The fourth team will include representatives from the Bank of Israel and the Ministry of Finance, and its function is to propose changes to remove the obstacles obstructing the conduct of monetary policy and to boost the development of the capital market.

The working teams can complete their tasks in a few weeks, so that the professional team will be able to submit its proposals to the forum which appointed it by the end of the year.

### **Summary**

The main changes required must be instituted as part of the normal process by which the government reaches decisions. This necessitates the political agreement of the various members of the coalition, but not the agreement of the employees or employers. What is under consideration this time is not a package incorporating a wage and price freeze, a large devaluation, a change in the short-term interest rate, or the adjustment of subsidies, as was the case in the package deals of the 1980s. Some of these are not necessary at this time, some cannot be implemented on a practical basis, and some would cause more harm than good. In any event, the importance of the required change in fiscal policy far outweighs that of the changes mentioned above. In certain areas, mainly those connected with the labor market, it would be preferable, now as it was with earlier packages, to arrive at solutions with the agreement of the employees and employers.

The package under discussion on this occasion is thus different from its predecessors. In the past, the issue was one of clearly defined, quantified, steps introduced for a specific time period. In the past it could have been asked "Who is giving, and who is receiving?" Today's package must incorporate changes in the operating rules-laws, decisions, and agreements-without time limits being imposed. This is an adjustment to the policy path, and not just ad hoc changes, because the problems being dealt with are not ad hoc problems. Investments, growth, and creating job opportunities cannot be realized from today to tomorrow; creating a climate which will encourage them requires a transparent and credible long-term policy.