David Klein: The changing exchange rate regime - background, policy and implications; the case of Israel

Speech by Mr David Klein, Governor of the Bank of Israel, at the Euro-Mediterranean Seminar, Eurosystem and Mediterranean country national central banks, organised by the Bank of Italy and the European Central Bank, Naples, 14-15 January 2004.

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The exchange rate regime is an important component of macro-economic policy. After experiencing a period of sluggish growth and rapid inflation in the ‘70s and the first half of the ‘80s of the last century, Israel changed its economic strategy. In a series of agreements with the European Union and the United States, all barriers to international trade were removed. Unilaterally Israel removed those barriers on trade with other countries as well, and cemented all these changes in a number of agreements in the framework of the WTO and by accepting Article 8 of the IMF Articles of Agreement. Furthermore, in the ‘90s and the first few years of this decade, Israel gradually abolished all exchange controls. The concept behind this economic strategy was that a small economy like that of Israel, can exhaust its growth potential only by being open to the world.

As a result of this basic strategy, the central bank, which was its main promoter, had to overhaul its policy to maintain price and financial stability. The change entailed replacing the exchange rate by an inflation target as the nominal anchor. To do that a few steps had to be implemented simultaneously:

First, to render the exchange rate regime more flexible. We realized that removing exchange controls would make it difficult, if not impossible, to maintain a fixed exchange rate. This meant moving from a fixed exchange rate regime through a horizontal exchange rate band, to an upward sloping diagonal band, to an ever-widening band and, finally, to a floating exchange rate regime. The gradual approach was required to give time to an inter-bank foreign currency market to develop, including the creation of financial instruments, traded and over the counter, to hedge against the exchange rate risk.

Second, in order to go along with the lifting of the foreign exchange controls, the central bank and the government had to implement an extensive deregulation of the domestic money and capital markets. This meant abolishing numerous directed credit facilities, and extensive commercialization of government debt in the framework of capital market reform.

Third, working with inflation and price stability targets required shaping of appropriate monetary policy instruments. In this context we scraped the high and rigid reserve requirements, and replaced it by daily, weekly and monthly auctions of monetary loans and deposits of commercial banks with the central bank. In the last two years we are gradually replacing these monetary auctions with treasury bills which will be our main instrument for conducting monetary policy vis-a-vis the market as a whole.

Judging from the results, the outcome is rather satisfactory:

- Israel enjoys price stability.
- The foreign currency market functions smoothly, with relatively narrow spreads and low volatility. At the background, the central bank watches the market but does not intervene and the shekel, the domestic currency, is fully convertible.
- The foreign currency position of the Israeli economy is positive: the current account is roughly balanced; FDI

and portfolio investment started to go up again in the wake of the rebound in world financial markets; and foreign exchange reserves held by the central bank are ample.

To sum it up: the decision to regard the exchange rate as a policy instrument or let it be a market-determined variable is an integral part of the general strategy of macro-economic policy. In our case we let it be determined by the interbank market and used the short-term interest in its stead.

A final word on the financial relations among Mediterranean countries. While the potential for intra-regional trade does not seem to be large at this stage, there seems to be some scope for furthering financial ties, especially under the auspices of the European Central Bank:

- One example can be joint missions and consultations to review the stage of development of various financial markets.

- Another example, based on the trend toward a flexible exchange rate regime, is a framework for collaboration among central banks to promote the stability of the financial system and open information channels among supervision authorities.
- A third example deals with the sequencing of liberalizing the capital account in connection with changing the exchange rate regime.

The initiative of Bank of Italy and the European Central Bank should, therefore, be seen as a successful beginning. This is the most suitable forum to discuss and strengthen financial ties between the Eurosystem and Mediterranean Central Banks.