

Karnit Flug: Policy dilemmas and the role of the central bank in advising government

Remarks by Dr Karnit Flug, Governor of the Bank of Israel, at the farewell conference marking the end of her term, Jerusalem, 4 November 2018.

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This conference touched upon two areas that are at the center of the BOI responsibilities: one which is unique among central banks and that is the governor of the BOI being the economic advisor to the government. The second is the core business of central banks, namely Monetary Policy making. Although the BOI has many other areas of responsibility, I would like to offer a few reflections on each of those two very important areas.

In the first part of this conference, we have seen a sample of two research projects conducted by researchers from our research department, and we have heard Laurence Boone, the chief economist of the OECD covering policy issues related to inclusive growth.

The two research projects give a glimpse of the type of research that tackles specific policy issues; in this case public housing policies and EITC, or income support for the working poor.

The work performed at the OECD on inclusive growth has touched upon important policy dilemmas and tradeoffs, and provides some insights on what policies could be pursued in the quest for inclusive growth: The need to enhance education and promote life-long learning and acquisition of skills; enhancing access to affordable housing; and ensuring adaptation and diffusion of technologies across the board – in particular for small and young firms. These are lessens that we, as the economic advisors to the government have grappled with over the years:

Some research projects conducted by BOI researchers may focus on a very specific policy question and directly help design a better policy. Others are of a more basic nature and provide a better understanding of the interaction between relevant variables; while yet others estimate and quantify these relationships or help assess the speed or extent to which a policy action may impact on relevant variables. What is common to all of this work is that it lays the foundations, and builds the infrastructure, to a more informed policymaking and thus helps design better policies.

A natural question that arises in this respect is why at the Central Bank? Should the economic advisor to the government be the Governor of the Central Bank?

This question was debated within the bank of Israel, among some of the people sitting here today. While we were discussing the new Bank of Israel Law, Stan was initially of the view that the role of an economic advisor to the government puts the bank in a constantly contentious position *Vis a Vis* the government and may undermine the banks' independence in its core responsibility. I was the Director of the Research Department at that time, and argued in favor of maintaining the role of economic advisor in the law, which was eventually what was decided. Several years later, when I became Governor, I met Stan (in Basel, at a BIS meeting) following one of the heated debates I had with the government, and told him that now I understand and sympathize with his initial view against having the role of the economic advisor. Stan surprised me when he said that looking from the outside, he is even more convinced of the importance of this role of the Bank of Israel.

This question was also posed to an independent evaluation committee which was invited to evaluate the BOI's research department back in 2012. In their report, they said, and I quote: "We came to the Bank very skeptical of any central bank having the responsibility of being an advisor, much less *the* advisor, to the government on economic policy". Following a thorough discussion

with many relevant stakeholders within and outside the bank, they concluded: “Absent fundamental changes in other Israeli institutions, we agree that the Bank **must** continue to play the critical role of advisor to the government policy”

Indeed, the argument against the CB’s role in economic policy advice because it enhances the friction between the Bank and the government and thus may undermine the Bank’s independence in its core responsibilities is not unique to the role of economic advisor. In fact, this debate resembles the discussion regarding the question that is debated extensively among central bankers as to how wide should our responsibilities and mandates be defined. I have heard the argument that in some issues the decisions reflect political priorities as opposed to pure economic welfare maximization decisions, and therefore should be left to the politicians, or that they may undermine the central banks’ credibility or independence. These are valid arguments, and certainly, my tenure as governor has demonstrated that providing a well-grounded position on some sensitive or publically debated policy issues does raise the level of friction with the government.

However, when we think about designing institutions, we should not think in the abstract, and we never start from scratch. We should take the starting point into account, and assess what is the likelihood that a change will get us closer to some “ideal institutional design” (if such exists). Given that this role has been defined in the original BOI law from 1954 as one of the main responsibilities of the BOI and its Governor, the basic infrastructure of knowledge and highly professional staff, and reputation has been built at the BOI to serve this responsibility. I also believe that the credibility of the central bank is enhanced, not damaged, by the quality research and policy recommendations it provides. In that regard, it may even contribute to the public support of an independent central bank. And as to friction between the central bank and the political system, during my term it was in fact most intense around issues related to the core activity of the Bank of Israel in supporting financial stability. The quest for enhancing competition in the provision of financial services, which we all share, led to heated debate as to the scope, the speed and the specifics of the financial sector reform. It centered around our insistence on ensuring that the reform does not undermine financial stability that was sometimes taken for granted by our partners in the design of the reform. In the past, the friction was most intense regarding the disinflation process, and Jacob Frankel who sits here, can certainly testify to that.

So, we’ve had frictions in the past and will probably have them in the future, and we should be able to withstand them. We should provide a quiet, behind closed doors policy advice in some cases, and contribute to a better-informed public debate on key policy questions. I believe that within the current political context, where policies tend, more than in the past, to focus more on short term benefits and ignore longer term risks and costs, it is **essential** that an independent well regarded institution provides solid policy analysis and advice, and helps explain this to the public. So, I believe that retaining the economic advisory role by the Central Bank in the 2010 BOI law has served the country well.

In the second part of the conference, we have heard an extensive discussion of the panel of very distinguished speakers on monetary policy and Inflation Targeting in the post GFC era. Thus, I feel it will be somewhat ambitious on my part to try to add to this extensive discussion.

The only thing I would like to say is that monetary policy making in Israel over the last 5 years that may have seemed boring at times to bystanders, has in fact been a fascinating journey to those involved in making it. Early on, we reduced the interest rate to 0.1%—a record low for Israel, a move that won me the title of “the most surprising governor in the world” according to one of the international news wires.

Later on we had prepared to use unconventional policy tools, an option that eventually we decided not to use in light of the solid growth, healthy developments in the labor market, and the assessment that the low inflation was not reflecting weakness of demand but rather, at least in

part, the result of positive processes such as the intensifying of competition. During this period we have also introduced some changes to the MP communication strategy: For example, we launched a quarterly press briefing following rate decisions, and made use of forward guidance. We have also made use of FX intervention, in times mildly, and in times intensively, according to our assessment of the nature of FX fluctuations. Each policy decision followed a very thorough and deep discussion, and although many times the debate got heated, and sometimes disagreements arose, I was always sure that every member of the MPC had only the best interest of the Israeli economy in his or her mind. Now, following almost 4 years of keeping the interest rate at 0.1 %, it seems as if the era of gradual normalization is approaching. I can already visualize the heated debates that are likely to take place within the monetary committee as to the exact pace and path that this process will take. The committee's challenge will be to move not too fast, so as not to choke the process of entrenchment of the inflation environment within its target range; and not too slow so as not to find themselves behind the curve. I assure you I will be watching this process closely with great interest.

Let me now thank the organizers Michel and Nadine, for initiating and organizing this excellent conference, and thank all the presenters from the BOI as well as our distinguished guests, who came from far away.

Thank you for the very kind words you said, I am moved and honored by all of this.

And thank you all for coming.