



PHOTO: ALEX KOLOMOISKY

## Embrace Debate

*Karnit Flug stresses the importance of accountability and transparency in central banking*

**SOON AFTER HER APPOINTMENT** as governor of the Bank of Israel in 2013, Karnit Flug walked back from a meeting with the government on economic policy and wondered if she should make her remarks public. But before reaching the central bank, she saw that her comments had already been reported by the press. “I understood then there is no such thing as private remarks at meetings of the government,” she recalls. “It’s always better to be in control of the narrative than have your remarks taken out of context to serve someone else’s agenda.”

Central banks around the world are coming under unprecedented scrutiny as they seek to

fend off inflation and global recession. Flug talked to F&D’s Nicholas Owen about the importance of central bank accountability and transparency, the policy successes and failures of the past, and her own personal progression from research economist to the first female governor of Israel’s central bank.

**F&D: The last major spike in inflation in Israel was in the 1980s. Do you see parallels with today?**

**KF:** The macroeconomic circumstances and the institutional structures have changed drastically since then, so it’s hard to draw parallels. At the time of our peak inflation in 1984, when prices had increased by 445 percent, we had a huge public deficit of about 15 percent of GDP. Debt was 280 percent of GDP. There was no central bank independence. As part of the stabilization program, there was a change in the Bank of Israel law, known as the “no printing clause,” which prevented the central bank from financing government deficits. So the circumstances are completely different today.

However, some people in the Knesset, our parliament, are pressuring the central bank to introduce new initiatives, like exempting single homeowners from increases in mortgage interest rates. I hope that these do not advance. Even if they don’t, the discussions may lead to self-restraint that makes monetary policy less effective. And even if they don’t change monetary policy, they may affect expectations, and that in itself may make monetary policy less effective. These kinds of initiatives are not helpful.

**F&D: Your reforms as governor were controversial. What’s your advice for today’s central bankers at odds with policymakers?**

**KF:** When I was governor, inflation and interest rates were very low, so there was no controversy around monetary policy. However, the Bank of Israel’s governor is also economic advisor to the government, based on the original 1954 central bank law. It’s not a typical role, and it does create friction with the political system, specifically with the Ministry of Finance. According to tradition, this advice is very public: it’s part of the discussion with the government but also contributes to public discourse.

My main advice is to be transparent and professional in your analysis. And you must also be active in public debate on the basis of high-quality research.

**F&D: Is it realistic these days for central banks to remain largely unaccountable? Should there be more debate about the costs of tightening monetary policy as the world heads for a painful recession?**

**KF:** There are different forms of accountability. Accountability can be advanced by the requirement for transparency and by expert evaluations. And lively public debate is part of accountability. But what you're really asking is whether central banks should be independent in applying monetary policy in order to reach an inflation goal. On this point I think politicians still have an inflation bias. This led to high inflation in the 1970s and '80s. Politicians believed that you could tolerate a little more inflation in order to have a little more economic activity and employment. But actually it proved very hard to control. Higher inflation can start a spiral of inflation expectations, resulting in even higher inflation. This basic inflation bias is still there. I don't think you can exploit this trade-off to engineer just slightly higher inflation for higher activity. Once inflation starts accelerating, it's very hard to control. Then the costs—including welfare costs—can be very high.

**F&D: Did central banks get it wrong in the past? We're told we must trust central banks today as they raise rates. But central banks pumped money into economies through low interest rates and quantitative easing. Aren't we paying the price for this today?**

**KF:** I think the response of monetary policy to the global financial crisis was broadly correct and actually saved the world from a much deeper and longer recession. The leadership of Ben Bernanke and the lessons he learned from the past were extremely important. In some places, monetary policy was accompanied by macroprudential policies aimed at mitigating the effect of very low interest rates on some asset markets. In Israel, we introduced a set of restrictions in the mortgage market to make sure excessive risk did not build up.

After COVID-19, a massive response was needed again, in both monetary and fiscal expansion. Here I think the withdrawal of the extreme fiscal and monetary support came too late. The recovery proved very strong, but despite this some governments continued with extremely expansionary fiscal policy while monetary policy remained extremely accommodative. And when the very strong increase in demand was met with supply constraints—because

of factory closures in China and elsewhere, and then because of the war in the Ukraine—inflation started rising rapidly. There was a delay in the realization that demand was playing an important role, and it wasn't just supply shocks. And that's partly why inflation climbed rapidly and necessitated a faster withdrawal of the expansion that has still not been achieved everywhere.

**F&D: I'm curious about your own journey from being a research-focused economist to a central banker who's forced to make difficult policy decisions daily. Has your experience changed how you approach economic research?**

**KF:** My background, especially managing the research department at the Bank of Israel for 10 years, helped me use research effectively when making policy decisions. It helped me understand what questions models can answer—but also the limitations of using models to get answers. A research background can help assess where you can use models in the decision-making process and where you need to rely on basic theory or simple analysis of the most recent data.

**F&D: You were Israel's first female central bank governor. Was that important for you and the country?**

**KF:** When I was appointed, I was more aware of the fact that I was the first governor from the ranks, someone who started as a young economist at the bank and rose all the way to the top. Before me, all the governors were well-known economists appointed from the outside. I was focused on the big shoes I needed to fill.

At the Bank of Israel, I didn't sense that being a woman interfered with my career advancement at any point. But I did realize early on that it was important—there was a lot in the press about being first female governor, and I was always asked about it when I met with students. I realized that I served as some kind of role model.

I was surprised by how few women governors there were when I attended governors' meetings at the IMF or the Bank for International Settlements. Sometimes being the only woman in a room with 35 or 40 male governors was a little intimidating. But with time, I got used to it. And as time went by there were also more women in the room. **FD**

*This interview has been edited for length and clarity.*