Statement by J. de Beaufort Wijnholds, Executive Director for Israel
March 22, 2000

1999 was a favorable year for the Israeli economy. Economic activity rebounded and Israel further escalated its pace of macroeconomic stability and structural reform. This stability was strengthened by the continued implementation of a prudent and responsible monetary policy combined with fiscal consolidation efforts. These policies are part of the sustained effort to achieve the economic stability which is the preferred way to promote a sustained favorable performance in a period of globalization and in accordance with the norms of most industrialized economies. Indeed, monetary policy, which has been conducted during the past few years within the inflation targeting framework, brought inflation closer to the target and acted to consolidate the inflation environment. Meanwhile, fiscal consolidation efforts also progressed in accordance with the declining trend in the budget deficit as a proportion of GDP. In the area of structural reforms, further progress was made by the government's adoption of a wide-ranging structural reform agenda, particularly by increasing competition in several previously overly-regulated sectors and through the continued sale of the remaining state holdings of several banks in 2000.

Developments in 1999 and early 2000:

In 1999, the inflation environment[1] returned to the 4 percent level prevailing before the fall of 1998 when the Bank of Israel (BoI) raised its interest rate which was one of the major factors that prevented a renewed inflation acceleration. Prices during 1999 increased by only 1.3 percent, reflecting decreases at the beginning of 1999 which partly offset the exceptional price increases at the end of 1998. With inflation returning closer to the inflation target of 4 percent set for 1999 and the relative calm in the world financial markets, the BoI eased monetary policy and starting in February 1999, consistently decreased its nominal interest rate by a total of 2.3 percentage points through December 1999. In late 1999 and early 2000, inflation declined further and reached a level consistent with the 3 to 4 percent target set for 2000 and 2001. This development enabled the continuation of the process of monetary easing at a faster pace so the BoI could further decrease its interest rates by another 1.3 percentage points during January – March 2000. If inflation persists in its current target range for a longer time, the process of reducing nominal interest rates can continue, thereby also leading to a decline in the real interest rates.

With respect to fiscal policy, the gradual but consistent fiscal consolidation underpinning the government's fiscal policy remained intact. Although the 1999 budget deficit of 2.25 percent of GDP slightly exceeded the government's 2 percent target, the deficit not only was lower than the revised projected deficit but also continued its declining trend as in previous years.

---

[1] As based on the combination of actual inflation, inflation forecasts from several banks and other independent private forecasters, and the expected inflation as derived from capital market indicators.

Following the authorities' appropriate response to the recent world financial crises in the fall of 1998 and the liberalization of capital flows in May 1998, Israel successfully became integrated into the global economic and financial systems. Israel withstood the world financial crises by continuing its strategy of non-intervention, a free-floating exchange rate and a prudent monetary policy. In 1999, this strategy not only restored the tranquility of Israel's financial markets, contributed to safeguarding the lower inflation rate already achieved in early 1998 and created a real depreciation, but also significantly enhanced credibility and improved the effectiveness of its monetary policy. Foreign direct investment increased rapidly reaching an all time high, while Israel's credit rating has been stable since 1995 with Moodys and S&P granting a positive outlook last month. The number of foreign banks and financial institutions grew, with Citibank and Merrill Lynch opening branches in Israel and Intel making its largest cash acquisition. In the area of the monetary policy framework, this strategy led to: a shorter period for monetary policy transmissions; a less automatic pass-through from exchange rate changes into prices; a greater accounting by firms of exchange rate risk thereby allowing the monetary authorities to focus on the inflation consequences of exchange rate changes; and enhanced integration of the inflation targeting regime within the public.

These favorable developments, in particular the strengthened macroeconomic stability and the increased outward-looking nature of the economy in addition to the already low current account deficit, the real depreciation that occurred and Israel's sound banking system, have made the Israeli economy fundamentally ready to execute both a lasting renewed growth of output commensurate with its potential and an increase in employment. Developments during the year showed an upturn from the earlier downward trend, in spite of the current attitude of cautious monetary easing. Economic activity has rebounded strongly as expressed by GDP growth from the second half of 1999 and by the expansion in industrial production. This expansion has been driven by domestic demand and non-residential investment. In this regard, the continued increasing trend of hi-tech exports to a peak of 70 percent of industrial exports in 1999 should also be mentioned. Moreover, according to preliminary figures, the demand for workers increased substantially in the last quarter of 1999 and the number of workers employed full time grew markedly, while the number of those employed part time decreased. Because employment is an economic indicator that responds with a lag to economic changes, employment will further increase in the near future.

<u>Policies in year 2000:</u>

Looking ahead, the authorities are determined to continue their cautious macroeconomic policy directed at bolstering their achievements in economic stability. They recognize that in order to sustain and strengthen the nascent economic recovery and increased employment, a macroeconomic policy that is based on long-term considerations is the appropriate approach. The authorities' continued commitment to this long-term approach is reflected in the year 2000 guidelines underlying the fiscal, monetary and structural reform policies.

Fiscal Policy

In light of the slight further decrease in the deficit in 1999 as a percentage of GDP, the government intends in 2000 to use revenues exceeding projections to further reduce the deficit in order to achieve greater progress on the budgetary front than required by the Budget Reduction Law which defines the deficit at its maximum level permissible.

The budget for the year 2000 aims to promote economic activity based primarily on the achievements of the business sector and a reduced government share in the economy through a continued gradual reduction of the budget deficit, government expenditures and government debt as a share of GDP. It also includes a reduction in the current expenditures and increases in investment outlays in the transportation infrastructure by a total of 40 percent, compared to 1998. These investments will be allocated for intensified investment in roads, railways, and public transportation. Additionally, the government plans to rationalize the tax system through extensive reforms by broadening its tax base both to bolster revenue and to improve income distribution. The public committee appointed to deal with this issue is expected to finalize the details at end-April.

Monetary Policy

In the year 2000 and onward, monetary policy will continue to be committed to meeting the inflation target set by the government as part of the authorities' approach to gradually lowering the rate of inflation to the levels of most industrialized countries. The inflation target of 3 to 4 percent set for the years 2000 and 2001 is meant both to achieve further progress towards price stability and to solidify the accomplishments of the last few years in the fight against inflation.

The BoI sees scope for a continued reduction in its interest rate only if the inflation environment for the coming two years remains consistent with its 3 to 4 percent target range for the years 2000 and 2001. The combination of a prospective continued reduction in nominal interest rates and the continued current inflation environment at its target range constitute the preferred setting for the process of lowering real interest rates and thereby this combination is the only way in which monetary policy can increase its support of economic activity.

Monetary policy is being eased while taking into account the existing risks to the inflation outlook that consist of: (1) the remaining uncertainty on the inflation and financial sector fronts regarding a possible abrupt change in the composition of the assets and liabilities portfolio held by the public, especially in view of the continued trend of increasing interest rates worldwide, (2) the risk generated from potential budget overruns and possible excessive wage increases, and (3) the continuing existence of a high inflation culture which indicates that the risk of exceeding the inflation targets is still greater than the downside risk. Firmly establishing inflation in its target range requires adjustments in economic decisions in various areas over a long period of time, particularly in the area of wage policy, the setting of prices apart from indexation considerations, the adjustment of accounting procedures and the composition of the public's portfolios.

On monetary policy and economic recovery, Staff indicates that the economy has "turned the corner..(para. 4 of the Staff report)" and is now growing at 4 to 5 percent. Yet, in para. 19, Staff feels that "the still-fragile state of the economic recovery" and other factors demonstrate the need for a more ambitious, but still gradual, approach to reducing interest rates. The BoI believes that the easing of monetary policy also has to now ensure that the recovery does not exert pressures on the inflationary outlook.

The BoI has further improved its monetary policy framework. It has based its decisions for interest rate changes on a wide spectrum of economic indicators. It has assessed the expected inflation rate for 2000 and 2001 by analyzing different inflation forecasts for one year and beyond, based on a multiple indicator approach. Only developments in those indicators that affect the assessment of the expected inflation rate for the year ahead and beyond are relevant for the purpose of deciding interest rate changes. The relevant multiple indicators consist of the growth rate in M1, exchange rate developments, inflation expectations as derived from the capital markets, price trends abroad, fiscal developments and the economic activity level.

The BoI has also further increased its monetary policy transparency. In addition to the publication of a bi-annual inflation report, it has initiated the publication of the inflation expectation figures which it uses in its decisions. Moreover the BoI in its recent monetary policy announcements, indicated its path for the interest rate and highlighted its interest rate benchmark. These will enhance the ability of the public to form its outlook on inflation, better envision the interest rate path and predict the prospective monetary policy response. Given credible targets and policies, the inflation target and the point estimate of the inflation outlook are by definition identical in a country, such as Israel, adopting an inflation targeting regime. Thus publishing an inflation outlook which differs from the target contradicts the essence of the regime because a deviation between the two should prompt a respective policy reaction to correct it and ensure that the target is met. The possible exception to this statement is a case where the time frame is too short to correct an apparent deviation. Therefore the authorities' inflation outlook over a time frame that allows for policy action is the inflation target and the only way "the BoI could take a more prominent role in the formation of the public's outlook on inflation ... (para. 22 of the Staff report)" is by its continued adherence to meeting the government's inflation targets and through its consequent enhanced credibility.

As Staff has suggested "that the inflation target horizon should be lengthened ..." (para. 20 of Staff report), the horizon of the explicit inflation target from its length of one year to 2 years was extended as in other countries. Although this extension does not change the aim that inflation target should be met for years 2000 and 2001, it further improves the way monetary policy reacts to target deviations, as compared to the one year horizon. Under the extended horizon, a deviation of inflation from its target could prompt a more gradual monetary policy reaction because of the increased credibility that the extended horizon target offers, namely by more strongly anchored inflation expectations over a longer time horizon. In this respect, it should also be mentioned that the government's decision on the target was made an integral part of its fiscal policy decisions for the first time.

The government could further improve the monetary framework by reaffirming the operational autonomy of the BoI in a spirit similar to recent central bank legislation in other countries. Comprehensive amendments to the current central bank law should be along the lines recommended by the Levin Committee, particularly, emphasizing operational independence as the primary objective of monetary policy and ensuring that the suggested Monetary Policy Commission consist of experts free of political interference or other potential conflicts of interest.

Structural reforms

One of the major objectives of structural reform in Israel is the promotion of higher growth and lower inflation by enhancing the role of the private sector in the economy through increasing competition, improving economic efficiency and accelerating privatization. After successfully implementing reforms in recent years, further progress will be made in this area in the year 2000. The government intends to implement a wide-ranging structural reform agenda in various principal sectors as detailed in para. 26 of the Staff report. The momentum of privatization will continue. The main privatization initiatives include disposing of the remaining state holdings in several banks in the year 2000. The degree of concentration in the financial system will be further reduced particularly through the breakup of the large banking groups and other provident and mutual funds under their control leading to a more competitive environment which will also induce more foreign banks to open branches in Israel.

The banking system in Israel is sound and healthy. Following the exchange rate depreciation in the fall of 1998, banks and their customers have substantially increased the hedge on their foreign currency exposure. At the same time the BoI further enhanced its prudential supervision. It made the reporting requirements on credit denominated in foreign currency more stringent, and in early 1999 it increased the minimum capital adequacy ratio from 8 percent to 9 percent. At end-1999, the actual average ratio held by the five major banking groups was well above the minimum required by regulation.