



BANK OF ISRAEL

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Address by the Governor of the Bank of Israel at the 2008 Herzliya Conference

The topic of this session relates to the challenges that our economy faces in the globalization era. Indeed, since the early 1990s the Israeli economy has undergone a successful process of integrating into the global economy, and today we are already a part—albeit a small part—of it.

As part of this integration, the Bank of Israel headed a campaign of liberalization of capital flows and disinflation until price stability was obtained. The various governments adopted, and have been practicing to this day, an approach of budget discipline and pushed through a series of structural reforms.

Israel's successful integration into the global economy is manifested, among other things, in rapid growth; in exports, which reached about 45 percent of GDP; foreign investment; a flow of foreign investments into Israel; a high credit rating; favorable evaluations by international financial institutions; and an invitation from the OECD to begin the process of joining. These important achievements are contributing to the strong growth and stability of our economy.

In one important field in the process of globalizing our economy, however, little has been done thus far: **passing a new and modern Bank of Israel Law**. The Law in effect today was passed in 1954; it is antiquated and does not meet the accepted norms in the advanced economies.

Various governments in Israel and the Bank of Israel have done a great deal of work on the new Bank of Israel Law. In this context, two important milestones are noteworthy:

1. In late 1998, a committee under the late Justice Dov Levin presented the government with recommendations for a new Bank of Israel Law. This was the aftermath of professional work based on other countries' efforts in this field, among other things. The members of the commission included Prof. Haim Ben-Shahar and Prof. Alex Cukierman, and several noteworthy personalities appeared before it, including the former President of the Bundesbank, Hans Tietmeyer; the Deputy Governor of the Bank of England, Mervyn King (today the Governor); and even myself.

2. On October 2, 2005, shortly after I took up office as Governor, the government resolved to adopt the principles of the new Bank of Israel Law in the spirit of the Levin Committee's recommendations and developments in this field abroad.

Before turning to the new law, I will mention two basic changes in central bank thinking over the last twenty years: (1) the emphasis on the **independence** of the central bank as a major component of its success in fulfilling its functions and achieving its targets; and (2) the need for central bank **transparency and accountability** in its interest rate policy, including the analysis of the information it had available that provided the basis for its decision, and the results of its interest policy.

I. CENTRAL BANK INDEPENDENCE

Studies were carried out in the 1990s, among others by Prof. Cukierman, to examine and make international comparisons regarding the link between central bank independence, inflation, and economic growth. The significance of the concept of independence in the context of a central bank is that it has the authority to make its decisions without needing to obtain any external confirmation or approval.

The research findings were clear: the relation between central bank independence and inflation is a negative one, and this, without paying a price in terms of growth. In other words, countries that reinforce their central banks' independence attain low inflation with no impairment to growth.

This lesson and experience gained in countries with independent central banks, particularly in Germany, also influenced decision makers. With the establishment of the European Monetary Union, the founding of the new republics following the collapse of the Soviet Union, and the process of democratization in Latin America, new laws were enacted relating to many central banks, and in all cases, the emphasis was on their independence. The best known and most impressive instance is that of the Bank of England: the first economic decision taken by the new Labour Government after the election in 1997 was to grant independence to the Bank of England. Till then the central bank had not been independent, and decisions on the interest rate were taken by the Treasury. It is clear from the marked improvement in the performance of the UK economy over the last ten years, with regard to both inflation and steady growth, that the decision was wise and justified.

The independence of a central bank is very important for its success in performing its functions and achieving its objectives. This is because democratic governments have an "inflation bias," for two main reasons:

- a. Since an expansionary interest rate policy, i.e., lowering the interest rate, tends to have a positive effect on GDP and only later does it contribute to higher inflation, and since democratic governments generally have a short horizon, they prefer to

reduce interest rates, particularly when there are elections looming. An independent central bank can make decisions with a view to the long term and without paying regard to political timetables.

- b. Governments find it more convenient to ask the central bank to print money in order to finance their activities than to impose taxes or raise capital in the financial markets. Such behavior, however, ultimately leads to higher inflation.

Here I would like to quote the well-known words of Keynes in the period of hyperinflation in Europe after World War I:

A government can live for a long time... by printing paper money... It is the form of taxation which the public finds it hardest to evade and even the weakest government can enforce.

This scenario was highly typical of Israel of the early 1980s, until it was put to an end in 1985 when as part of the Economic Stabilization Program, a law known as the “No Printing Law” was enacted, which prohibited the Bank of Israel from granting loans to the government. This was in effect the first step toward the independence of the Bank of Israel.

In the past twenty-five years many central banks around the world have been granted independence, and governments thus relinquished the ability to obtain finance from the central bank and to influence interest rate policy. They did so because they realized that (a) without giving their central banks independence, they would probably find themselves in situations of high inflation, as happened in the 1970s and 1980s; (b) the economy performs better with an independent central bank; and (c) as a by-product of the above, globalization had the effect of increasing the importance of central bank independence, in light of the weight that domestic and foreign investors give to that factor as a major consideration in their decisions about the countries in which to invest.

This approach received further support from a 1995 study that examined data covering fifteen years and found that central bank independence and price stability are positively correlated. Central bank independence was also found to be positively correlated with high, stable growth and low rates of interest.

I would like to stress: an integral feature of central banks’ independence throughout the world is their administrative independence. This is a vital condition, as it determines the resources required for the bank to fulfill its functions.

II. CENTRAL BANK TRANSPARENCY AND ACCOUNTABILITY

The independence of a central bank, especially in democracies, must be accompanied by the bank’s responsibility to account for its policies and the achievement of its

objectives. For that purpose it is necessary to provide it with clearly defined targets against which its performance can be measured.

It is thus important that the central bank submit a regular report to the legislature, government and public on its policy and the achievement of its goals. The report should describe the decisions made and the reasons behind them, the instruments employed and how they were operated, the resources employed and how they were used, etc. Thus, for example, with regard to interest rate policy, central banks, including the Bank of Israel, usually publish annual reports, economic forecasts, periodic inflation reports, minutes of interest rate discussions, press releases on decisions taken, etc.

This framework of transparency and accountability ensures an open channel of communication between the central bank and the public in general, and the financial markets in particular, and constitutes an important mechanism of control over the central bank, its management and its policies. It enables the central bank to stay attuned to public criticism, and it enables the public to better understand the functions, policy, decisions and achievements of the central bank.

The two subjects I have spoken about so far, central bank independence and the requirement for transparency and accountability incumbent on the central bank lead me to my main subject this evening.

III. THE NEW BANK OF ISRAEL LAW

The new law will clearly define the independence of the Bank, its goals, and the mechanisms for decision making, and should impose on the Bank a comprehensive framework of transparency and accountability. The new law should thus contain the correct mixture of independence, transparency and control mechanisms for the Bank of Israel, all, of course, according to the generally accepted standards in the advanced economies.

In my first few months as Governor of the Bank we cooperated with the Ministry of Finance, the Prime Minister's Office and the Ministry of Justice in drafting a bill. We decided to shelve the matter temporarily until a wage accord at the Bank was concluded, but now we are taking it up again. I hope that we will soon work out a final draft.

1. Independence of the Bank of Israel

The new law will give the Bank of Israel independence in making decisions about the interest rate as needed to perform its functions and reach its goals. This independence must also be reflected in the management of the Bank, as that is the means by which it creates the instruments required to meet its goals.

2. Definition of the objectives of the Bank of Israel

The new law will clearly define the Bank of Israel's targets, along the lines of the targets of other modern central banks. The modern approach, and that adopted in the major central banks such as the Bank of England and the ECB, generally define three targets: 1) the achievement and maintenance of price stability; 2) subject to that, support for the government's other economic objectives, headed by growth and employment; and 3) support for the economy's financial stability.

3. Decision-making mechanisms at the Bank of Israel

The law will establish new decision-making mechanisms for the Bank. In Israel today, as in a few other countries including New Zealand and Canada, the Governor makes the interest decisions alone, under law. He also runs the Bank, and is responsible for all administrative decisions. Research has shown that decisions made by committees of experts are, on average, better than those made by one expert acting alone.

The new Bank of Israel Law will establish two decision-making mechanisms—one in the policy area, and the other in the area of management of the Bank.

a) Interest rate policy—the Monetary Committee

In most countries decisions on the interest rate are made by a monetary committee that operates in the central bank. Generally the monetary committee has some members from outside the central bank and some from within, with the governor of the bank heading the committee. This is the preferred model, which will be specified in the new law. The participation of external members, who are not beholden to the central bank or its governor but are committed to the attainment of the target set for the bank, is an important part of the mechanism of external control over the Bank's policy.

(b) Management of the Bank—the Administrative Council

The new Bank of Israel Law will specify an Administrative Council alongside the Monetary Committee, with an absolute majority of external members, one of whom will serve as chair of the council. The Governor and Deputy Governor will serve as members. This model is the one followed in several central banks in the advanced economies, including the Bank of England.

The role of the council will be to make decisions related to the management of the Bank, such as approving work plans, the Bank's budget and wages. The council will also appoint an audit committee from among its external members. All this is intended to provide another system of external control over the activities of the Bank.

To adhere to the principle of the Bank's independence, and its professional expertise, it is essential that the external members of the Monetary Committee and the Administrative Council, who will be appointed by the government, should be experts in the relevant fields, free of conflict of interests, and independent of the government and political institutions.

4. Transparency and accountability

The new Bank of Israel Law will require the Bank to account for its decisions, policies and achievements to the Knesset, the government and the public. In this context the Bank will have to explain the considerations underlying its decisions, including the relevant information available at the time, economic forecasts, and how it views expected economic developments. The reports will include inflation reports and other periodic reports, summaries of the discussions of the Monetary Committee, fundamental decisions by the Administrative Council, press releases, etc.

In light of the importance of transparency and accountability, The Bank of Israel, even prior to the enactment of the new law, has already adopted a level of transparency and accountability that is broader than current law requires. However, this should be enshrined in new legislation.

Allow me to conclude. There is nothing to gain by wasting time talking about the new Bank of Israel Law. The time has come to roll up our sleeves and get to work on completing the bill and passing it into law promptly. By so doing, *we will have completed the final and most important stage in the global integration of Israel's economy*. It will be an important achievement and a badge of maturity for Israel's economy.