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Statement by the Hon. JACOB A. FRENKEL ,
Governor of the Bank for ISRAEL ,
at the Joint Annual Discussion

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Statement By The Governor of the Bank of Israel

Jacob A. Frenkel

Mr. Chairman, distinguished Governors, Mr. Michael Camdessus, Managing Director of the International Monetary Fund, Mr. James Wolfensohn, President of the World Bank Group, delegation members, ladies and gentlemen: it is a great honor to address you once again as Governor for Israel.

The world economy is in a period of increased uncertainty and growing risks. Many emerging markets have experienced storms and crises. Capital markets have dried up and spreads have risen to new heights. The level of uncertainty is evident also from the extraordinary large revisions in forecasts regarding the state of the world economy. The September World Economic Outlook projection of world output growth is 2 percent, and world trade volume is now expected to grow by only 3.7 percent, as compared with the May 1998 projections of world output growth of 3.1 percent and expansion of world trade by 6.4 percent. These downward revisions reflect the rapid changes in the shape of the world economy. Yet, this changing external environment should not affect every economy in a similar manner. We are once again reminded about the critical importance of fundamentals such as sound macroeconomic policies, structural reforms, sound banking and financial institutions, the development of markets for the intermediation process and the trading of risks, while avoiding moral hazard. The increased fluctuations in financial markets around the globe and the high costs of the crisis for those countries involved, underscore once again, the importance of conducting policies that are designed to achieve stability as a necessary condition for sustained growth. Yet, because all countries belong to the "global economic system", good domestic policies do not always provide the guarantee that each and every economy is shielded from storms that originate by systemic difficulties and by foreign misconduct of policies. This interdependence has heightened in recent years by the high degree of integration of capital markets. Many difficulties are systemic and systemic problems require systemic solutions. The multilateral organizations provide the best and most appropriate framework for dealing with such global issues.

We live in a globalized world. Globalization is much broader than that of markets, it is also a conceptual globalization about the institutional structure, the legal structure, knowledge, information, norms, and understanding of what good economics means.

In the era of globalization, we see that information flows fast, capital flows may change directions rapidly and markets react instantly to news world-wide. In this framework there must be a renewed commitment to strengthening the multilateral institutions by reinforcing their financial base, and increasing cooperation in the form of timely, accurate and transparent information, unified regulation and the promotion of sustainable policies.

Under the leadership of the multilateral organizations, the world has greatly benefited from the removal of protection walls and from adopting the strategy of openness. The test of the commitment to this strategy comes during a period of a slowdown as the one that is prevailing today, and then it is important to remember that it remains very wise and crucial to maintain open markets and resist the temptation for an inward looking approach that breeds protectionism and capital controls. In this era of globalization there is great opportunity for countries to increase investment, improve technological developments, and increase domestic competition by opening their markets to global competition and opportunities. In the global world, capital markets are intolerant to policy mistakes and are generous to good policies. Therefore, the incentive to policy makers to pursue the right policies increases when the economy is open to capital flows. In the old days it used to be said in the capital markets that in the competition big fish beat small fish. Today, fast fish beat the slow ones. The issue is not whether one is big or small, but whether one is fast or slow, and this gives incentives to adopt structural policies that enhance the flexibility of the economic system, and provides opportunities to small countries like my own, Israel, to successfully participate in the world capital market. The new openness also requires a new approach to the supervision of banks and other financial intermediaries (including hedge funds), as well as renewed attention to the operational meaning of the social safety nets.

The globalization of capital markets has changed the thinking about the concept of time. What used to be a distinction between the short and long runs, has become very blurred because the job of well functioning capital markets is to translate the future into the present. Capital markets trade expectations about the future and thus transform it into the present. This conceptual revolution has made the short run indeed very short and much less relevant for policy makers. Policies must be consistent with the long run. One cannot "buy" sustainable growth by accelerating inflation but rather inflation means in the long run less growth. We have all learned, therefore, that economic policy must be cast within a medium-term framework, that “fine tuning” does not help, and that sustainable growth can only be obtained under conditions of stability.

There is also a fundamental change in the relation between policy makers and the markets. In the old days, in order to be successful as a policy maker you had to surprise the market, you had to have your deliberation very secret and to announce it over the weekends, when the markets are closed, and if there was a leak then you failed. This is not the case any more. In the global economy, where markets are so big and strong, one must respect the market and communicate with it. Policy makers have a continuing dialogue with the market and not an adversarial relations based on manipulative surprises. It follows that good policies must to be credible, transparent, and accountable and have a clear and well defined known objective.

In the era of global markets it is important that governments do not provide a sense of insurance to market participants without charging the appropriate insurance premium. In a risky world, agents in the market are operating according to incentives. If the government provides the message, implicit or explicit, that it stands ready to bail out, then of course the private sector will tend to assume risk to a degree that is excessive from the society's perspective. It is true in every area , including the foreign exchange markets. A promise to fix the rate of exchange against market forces which reflect the "fundamentals" can not be sustained but still may induce market participants to take foreign exchange positions that are inconsistent with the "true" risk in the system, just because they assume to be protected by the government. A strong financial system, including a sound system of financial intermediaries, including banks and other intermediaries and developing mechanisms where risk is priced correctly by market forces, are crucial not only for financial stability but also for the real economy. In this context it is important to note that there is great importance to deal with difficulties in a timely manner as to avoid the “too big to fail” syndrome, deal with it appropriately.

In my own country, Israel, we worked to prepare the economy to the changing world and to increase stability in a multi-year setting. In Israel we have adopted a multi year trade liberalization process, a multi year budget-deficit reduction scheme, and a multi year inflation targets. This approach has served us very well. The real budget deficit as a fraction of GDP is being reduced according to the preannounced path, a 2 percent deficit in 1999, as was recently approved by the Cabinet, and 1.5 percent deficit by 2001, and the basic aim is to limit and reduce the tax burden. The inflation target was set at 4 percent for 1999, with further progress towards price stability in subsequent years. Thus, economic anchors were set both in terms of structural policies and macroeconomic policies. These policies are complementary and work together to increase both flexibility and stability to the economy.

In 1997, and the first half of 1998, these important positive developments that are noteworthy: the current account deficit was cut from a critical level of 5.4 percent of GDP to 3.3 percent in 1997 and is continuing to decline in 1998. This improvement in the current account deficit was made possible by fiscal tightening, the budget deficit was reduced from 4.7 percent of GDP in 1996 to 2.8 percent in 1997, and the target for 1998 is 2.4 percent. The inflation rate in Israel was reduced considerably from 10.6 percent in 1996 to 7 percent in 1997 and is likely to be significantly lower percent this year. In parallel to these positive developments the economy is slowing down, growth amounted to 2.2 percent in 1997 and is estimated to be between 1.5 and 2 percent in 1998, unemployment rose to 7.7 percent in 1997 and is estimated to reach 9.3 percent in 1998.

There are several reasons for the slowdown in the economy. The period of rapid growth, of around 6 percent per year in real terms, in the first half of the decade, was made possible by an expansionary impulse of immigration, that came in large numbers primarily from the former Soviet Union. In addition to the end of this expansionary impulse, especially in investment (including housing) and consumption, several factors contributed to the slowdown. Tight macroeconomic policies were needed since 1997 because of the large budget and current account deficits in previous years. The economy is undergoing a structural change from the more traditional industries toward the high-tech markets. In addition, with the restoration of geo-political stability in our region and with further progress in the peace process we all hope that such stability will be the positive elements of the economic processes and will be reinvigorated.

By making in time the necessary correction in the current account, the budget, and the rate of inflation Israel undertook a strategy of adopting a medium term approach and of preparing itself to the new opportunities of being a player in the global markets. This year on the occasion of the 50th anniversary of the state, the Government of Israel together with the Bank of Israel announced fundamental liberalization of foreign exchange control. This culminated a multi-year effort to remove controls, developed financial markets, while adapting the appropriate regulatory requirements including the evolution of the exchange rate system. Controls were lifted and except for a limited list of restrictions, activities in foreign exchange are freely allowed. This underlines the strategy to increase competition, increase openness, avoid protectionism of all kinds, and conduct policy in a manner consistent with the long term perspective for achieving sustainable growth with stability.

We are not users of Fund resources, but we benefit from the Fund's advice. I would like to express our appreciation to the Managing Director of the Fund, to the President of the World Bank, and to their dedicated staff. I wish them success in addressing the present turmoil and I am confident that under their leadership the battle will be won for the benefit of the entire world economic and financial systems. Finally, I would like to thank the Executive Directors and the Joint Secretariat, and to wish them all continuing success.