Potential Lessons from Israel's Economic Stabilization for Argentina

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Three Initial Remarks

- Our main focus will be on lessons from Israel's transition from a fixed- or crawling-exchange rate regime to a flexible exchange rate under a monetary policy based on inflation targeting

- One must be careful in making cross country comparisons of stabilization programs. In my view, the initial conditions for Argentina's program at the start of this year have been more difficult and even adverse when compared to those of Israel in 1985

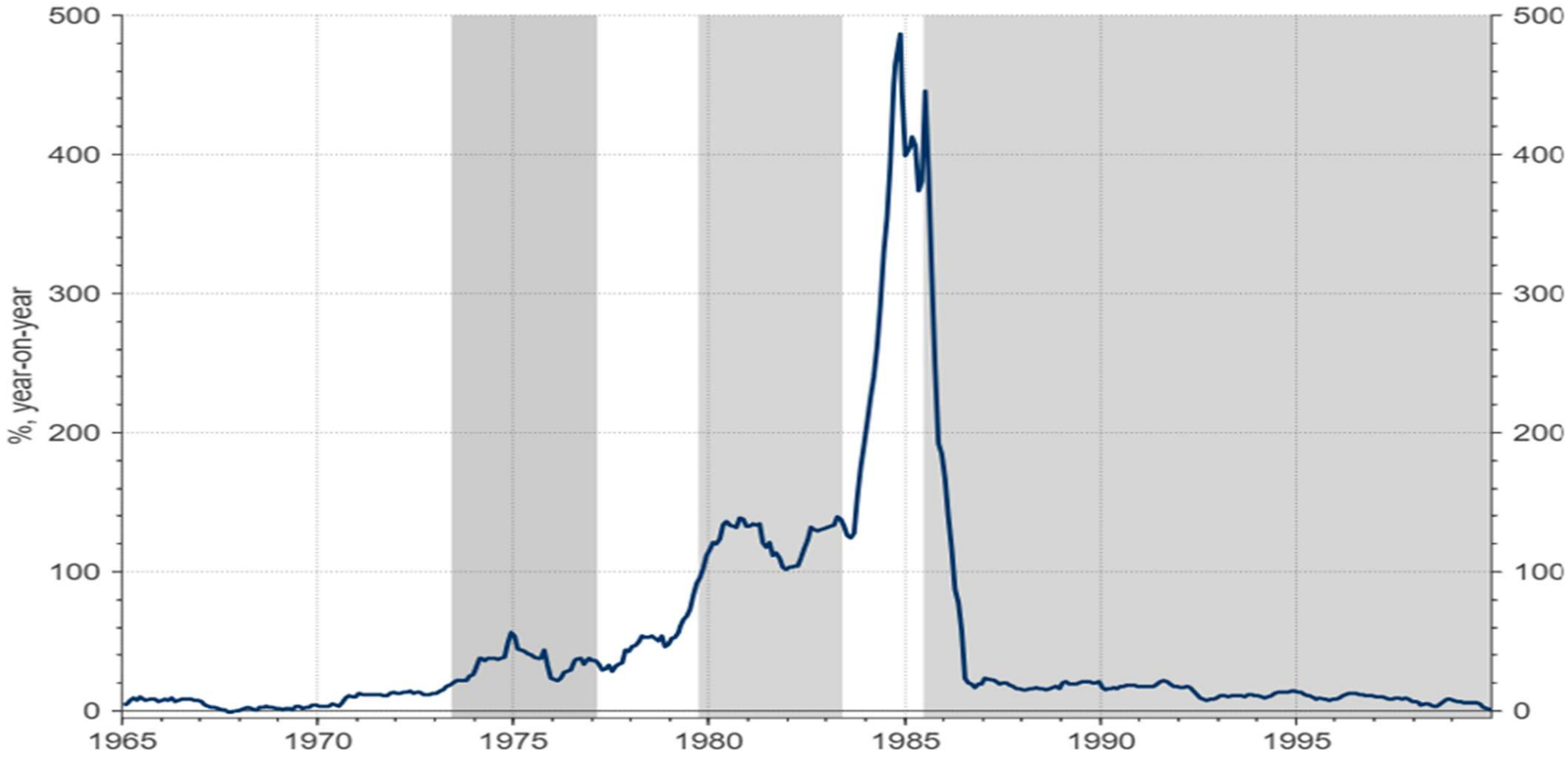
A Third Initial Remark:
Is there an "ideal" inflation stabilization program?

- What would be an "ideal" program? One that comes out of broad political consensus and results in quick disinflation with no marked rise in unemployment or fall in output

- There is no such thing as an "ideal" program! All stabilizations involve trade-offs and dilemmas and it is for policymakers to decide how these should be resolved

- In spite of its remarkable success, Israel's stabilization involved costs and trade-offs that were far from being negligible

Chart 1: Annual Rates of Inflation in Israel (% per year)



Source: Central Bureau of Statistics, Israel

Two key factors behind the sharp rise in inflation

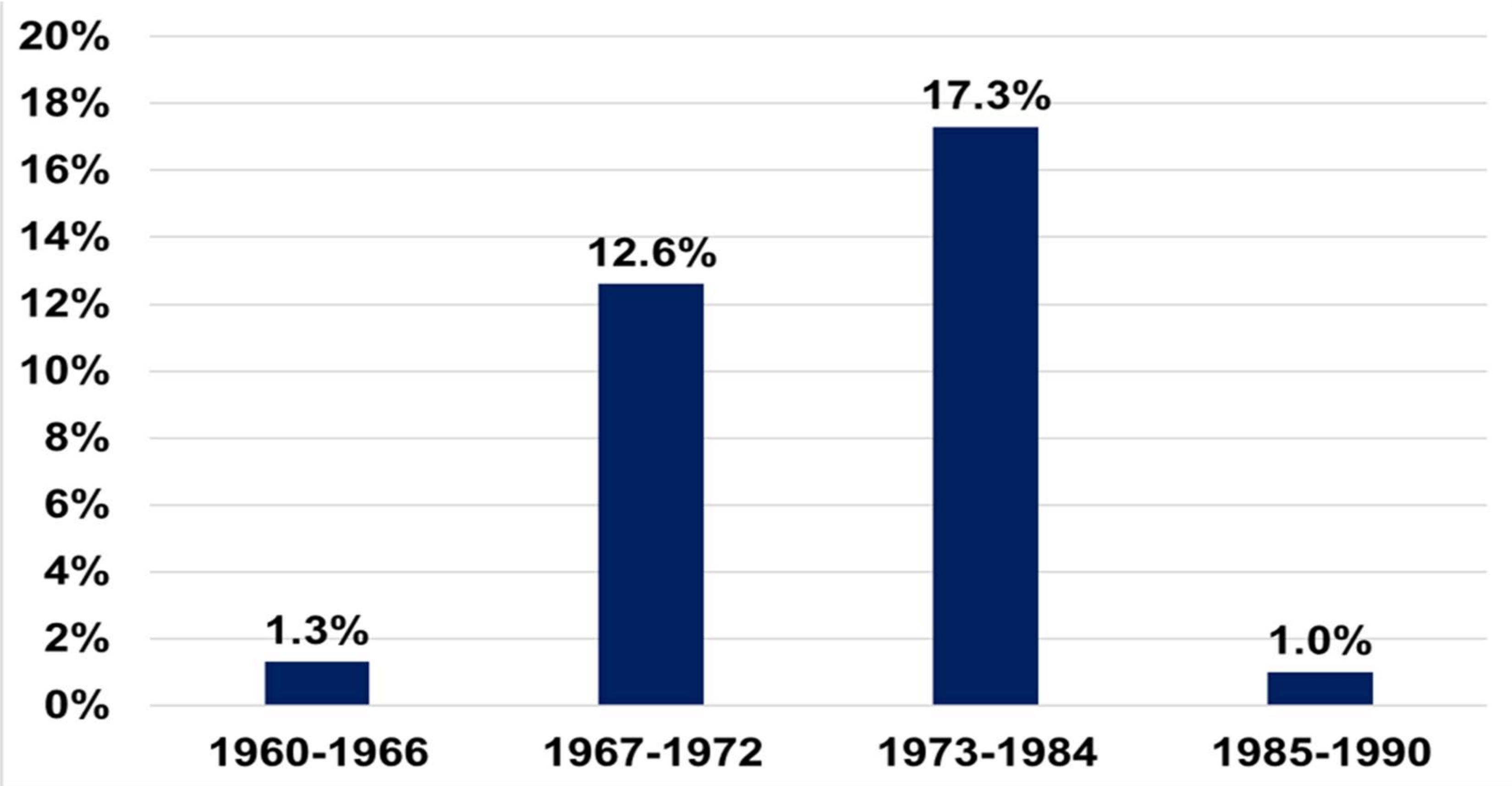
- **First**, an increase in government spending (mainly on defense) and a rise in money-financed public sector deficits. Another case of **fiscal** dominance, with debt to GDP reaching well above 200%

- **Second**, the existence of a wide system/regime of **indexation** that translated one-time jumps in the price level into an elevated rate of inflation.

- Hence, stopping inflation required a program that deals **simultaneously** with both factors of above

- This was done under a broad national coalition government

Chart 2: The Government Budget Deficit as percent of GDP



Source: Bank of Israel

Chart 3: Government Debt a Percent of GDP

Source: Trading Economics, Bank of Israel

Toward an heterodox stabilization program

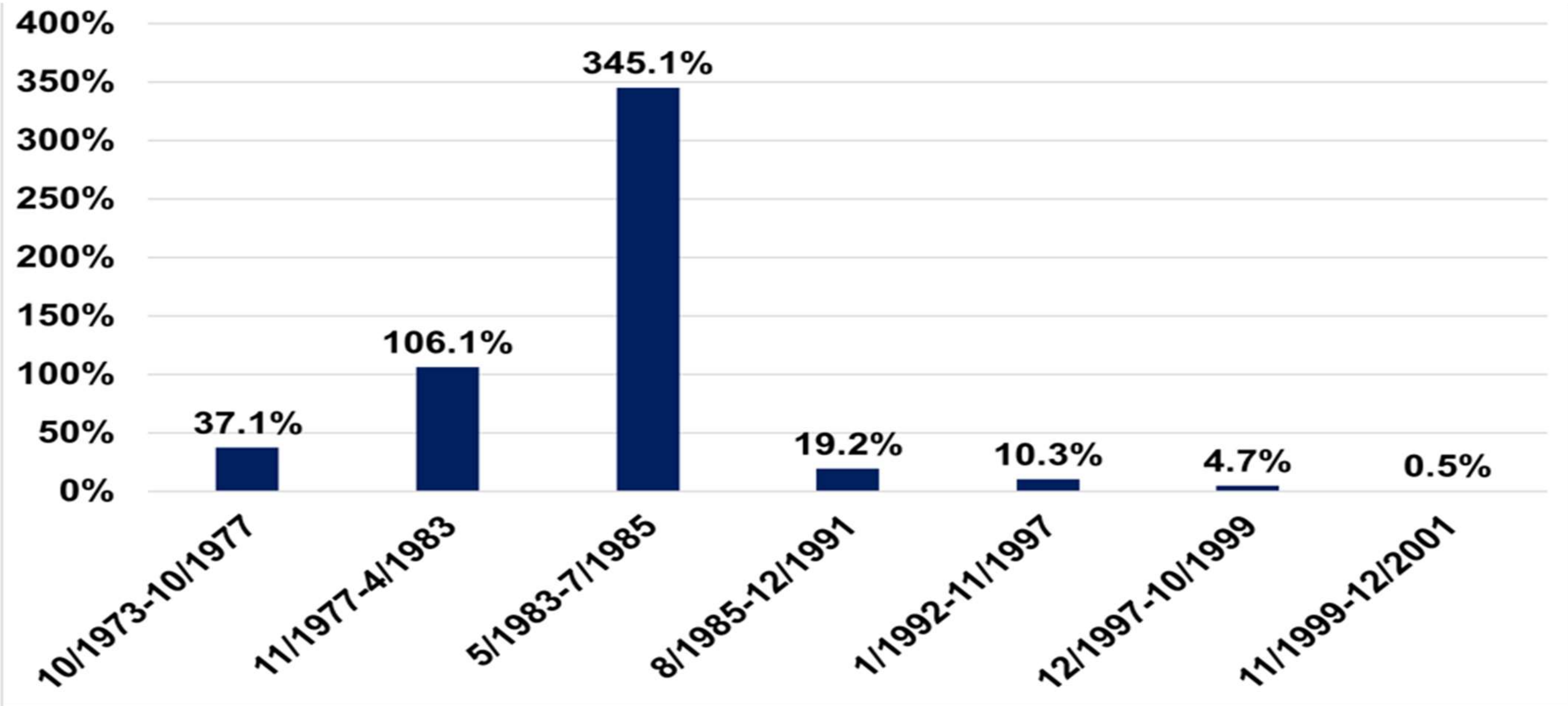
- Having an orthodox plan would not be sufficient to stop inflation inertia and could result in substantial social and economic costs

- Under the leadership of Professor Michael Bruno (first as an academic and then as Governor of the Bank of Israel) an heterodox program was designed relying on fiscal cuts and 'multiple nominal anchors'

- After a marked fiscal contraction and a devaluation of about 20%, agreements were reached for a temporary freeze of wages, prices, exchange rates, and credit. This was a kind of a 'social pact'

- Bruno referred to this approach as ***'therapy by consensus'***

Chart 4: The Evolution of Average Annual Inflation in Sub-periods (% per year)

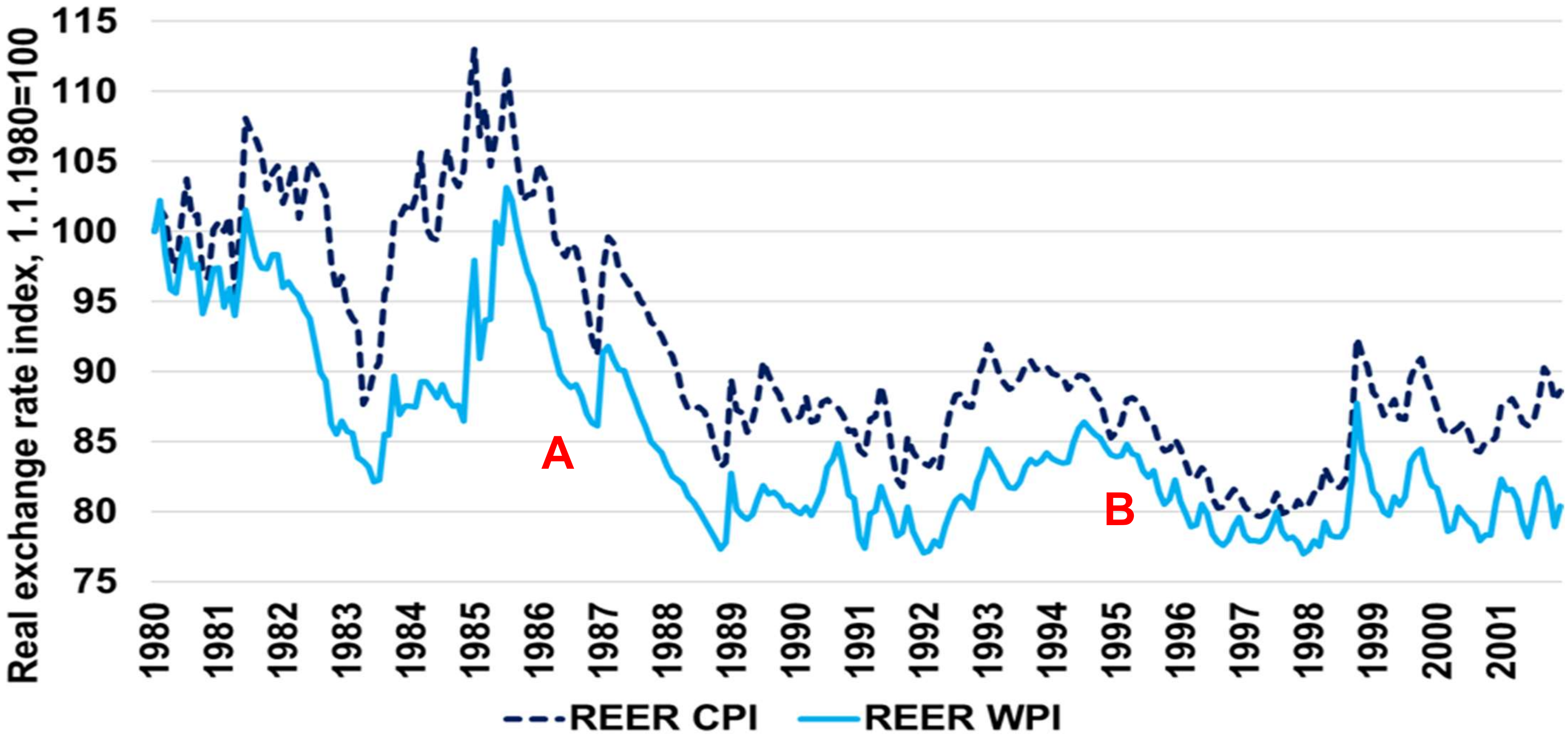


Source: Central Bureau of Statistics, Israel

Key outcomes

- Sharp fiscal contraction
- Rapid disinflation
- Real exchange rate appreciation
- A mixed path for real wages
- A temporary private-consumption boom
- No major negative impact on growth and the unemployment rate

Chart 5: Real Exchange Rate Index for Relative CPIs and WPIs
(A decline means real exchange rate appreciation)

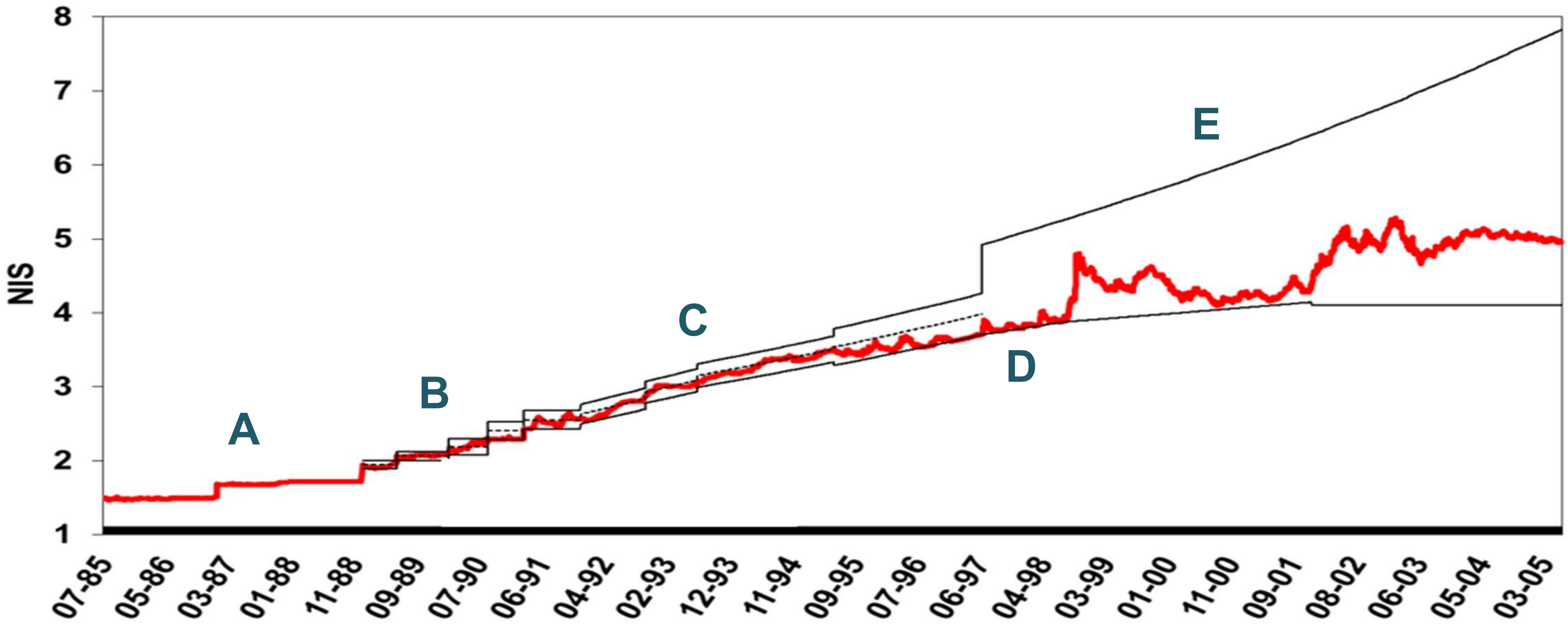


Source: Central Bureau of Statistics, Israel

Exchange Rate Policy: A Transition to Flexible Exchange Rates

- A fixed exchange rate was maintained at the start of the program for about a year
- No clear exit strategy from this regime was announced but it was stipulated that there could be discrete devaluations from time to time
- These were seen as necessary adjustments should the rise in prices and wages continue over time
- From 1989 to 1991 a horizontal exchange rate band was established and there were frequent devaluations of the central parity rate
- Given the need for frequent exchange rate (ER) adjustments, a crawling band was adopted at the start of 1992
- The width of the band was increased over time and in the early 2000s the band was eliminated and a full float was adopted

Chart 6: From a Fixed ER through a Crawling Band to a Full Float
(Shekel ER against a basket of foreign currencies)

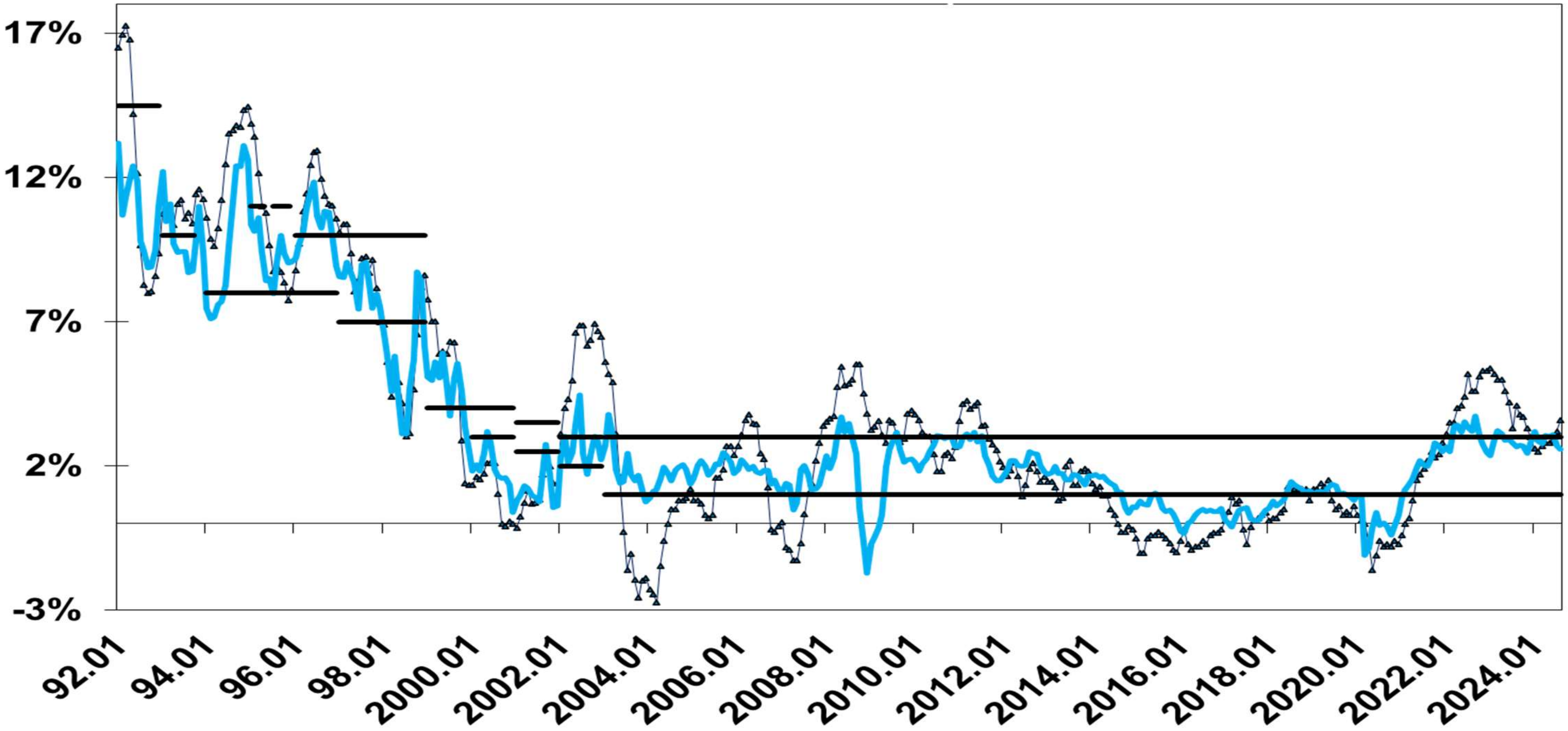


Source: Bank of Israel

Inflation Targeting as the Framework for Monetary Policy

- With the aim of generating a <u>convergence</u> of domestic inflation to that of Israel's major trading partners, an <u>inflation-targeting regime</u> (IT) was adopted in the early 1990s
- The Bank of Israel played a key role in advancing this goal
- Initially a point target was set annually. Later on, a target range was used in a multi-year fashion
- Targets decreased from annual inflation of 10% for 1993 to a range of 2-3% per year in 2002. The current target is 1-3% per year
- From the end of 1994, the Bank of Israel began to use the interest rate as a tool for attaining the inflation targets
- *The monetary policy framework became then similar to those of other IT countries at the time, like Canada, the UK, Sweden*

Chart 7: Year-on-Year Inflation (graph in blue), Inflation Target Range, and Breakeven Inflation (graph with markers)

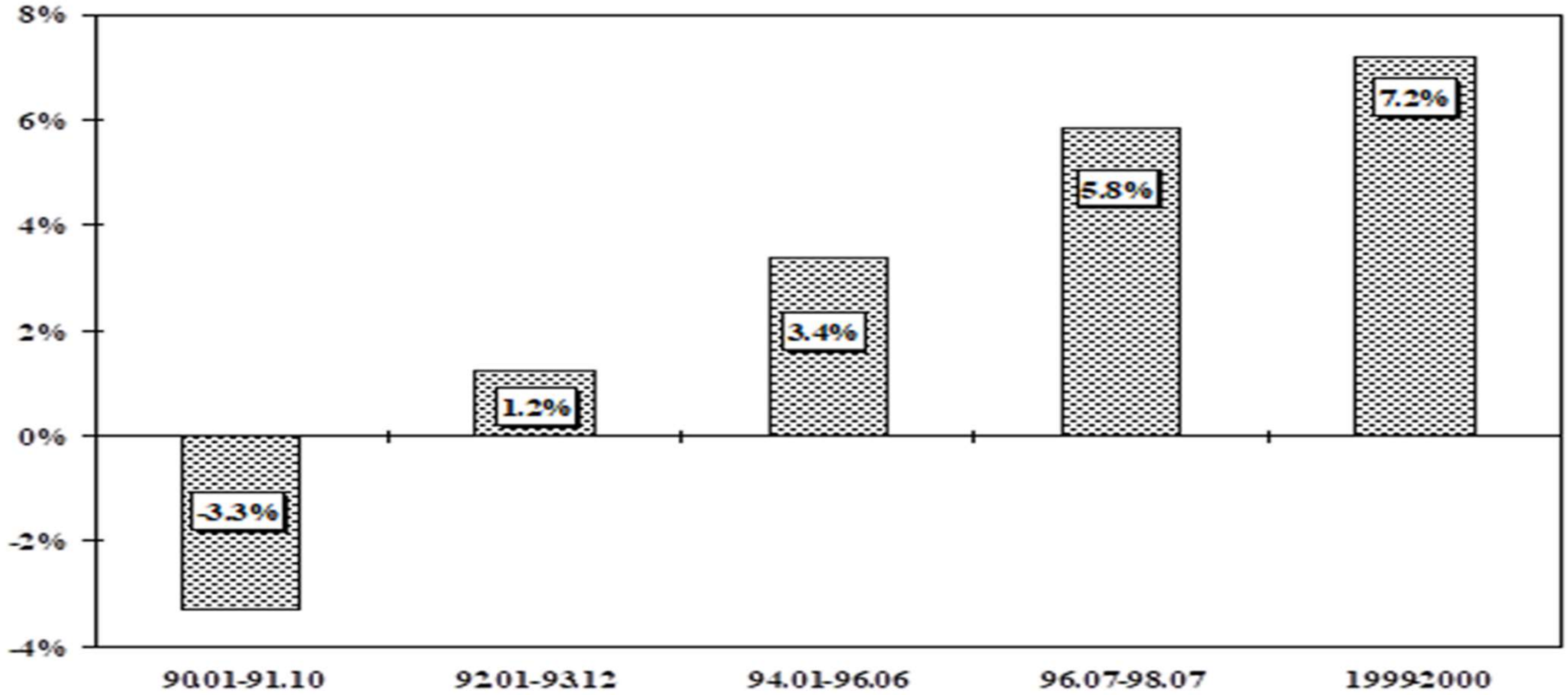


Source: Bank of Israel

Constraints on Monetary Policy in View of the Co-existence of an ER Band with an Inflation Target: the 1995-1998 episode

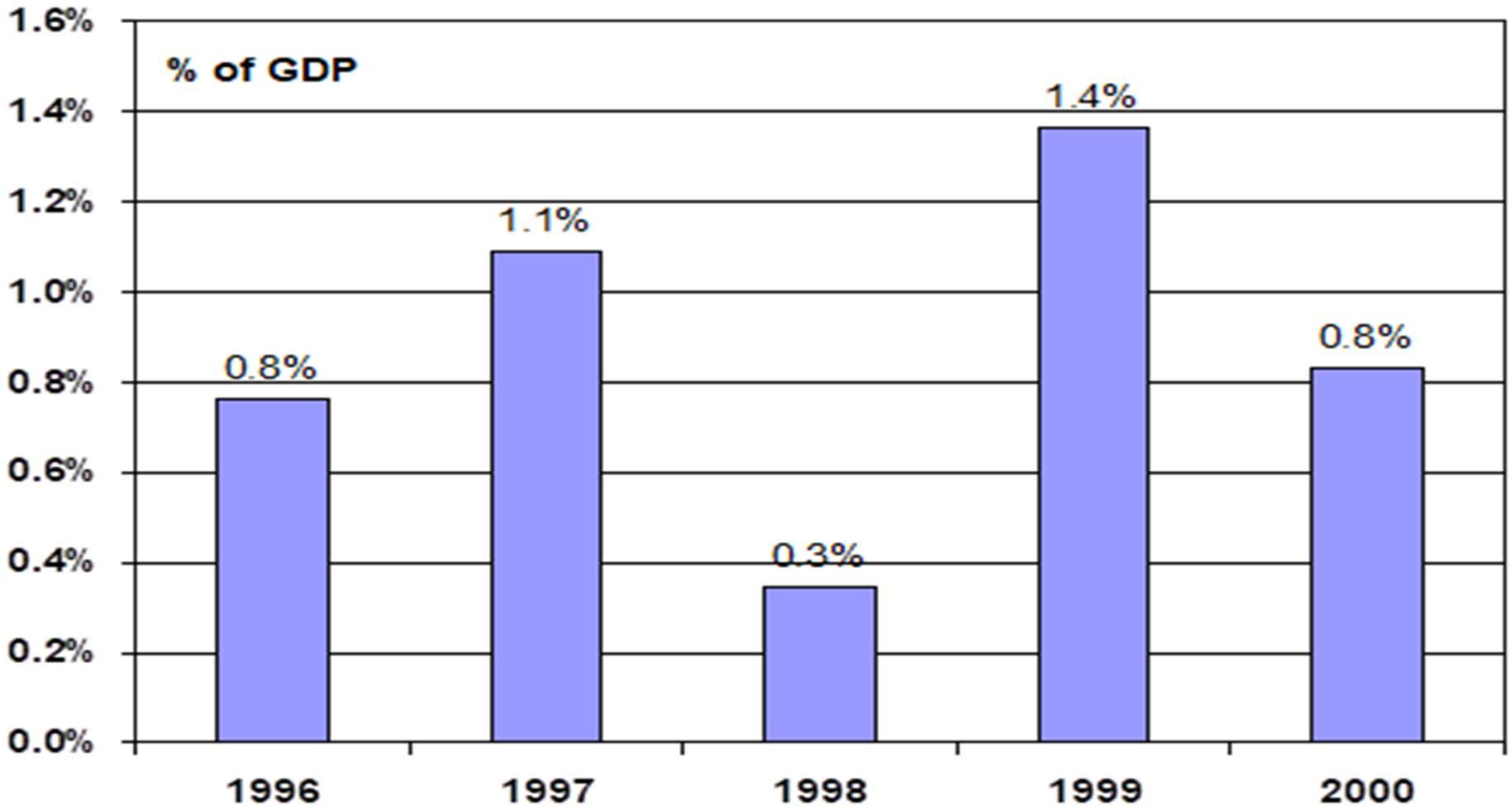
- It is well known that dilemmas and/or conflicts can arise in the presence of <u>multiple goals</u> for monetary policy
- Faced with a rise in inflation forecasts and market-based expectations, the Bank of Israel tightened policy by hiking the policy rate
- As a result of the increase in the interest rate differential, capital inflows and a carry trade surged, resulting in <u>sharp ER appreciation</u> to the lower (most appreciated) limit of the band
- In order to 'defend' the band, the central bank intervened in the FX market, purchasing part of the increased capital inflow
- Most of the FX purchases were <u>sterilized</u>, thus resulting in higher market rates and a substantial <u>quasi-fiscal cost of sterilization</u>

Chart 8: High Real Interest Rates Were Required to Ensure Convergence to Low Single-Digit Inflation in the Second Half of the 1990s (% per year)



Source: Bank of Israel

Chart 9: High Quasi-Fiscal Costs of Sterilization (as % of GDP)



Source: Leiderman and Bufman research work.

Potential Lessons for Argentina

- Strict fiscal discipline should continue to be the pillar of stabilization

- There is a need for a clear exit strategy from the current multiple-targets regime of monetary and exchange rate policies toward free capital markets under a full float and monetary policy based on IT

- Patience is advised with the decline in inflation ahead. There is a substantial non-linearity in the process

- A period of high real interest rates and real exchange rate appreciation will be required in the short run as part of the transmission mechanism that will help cement disinflation

- Good luck!