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More problems for Israel:
How should the Bank of Israel be structured?

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The litany of problems facing the state of Israel is so long and well known that anyone would be reluctant to add to the list. However, the legislation pending in the Knesset to revise the central bank law could add economic policy making to the list. Although the proposal looks like a helpful effort to bring the Bank of Israel into the modern era by creating a monetary policy committee, it could also mandate policy priorities that reduce the bank's independence and ability to pursue appropriate objectives.

The Federal Reserve in the U.S. has the Federal Open Market Committee, the Bank of England has the Monetary Policy Committee, and the European Central Bank has the Governing Council. Why shouldn't a council make monetary policy decisions at the Bank of Israel? It should. Monetary policy decisions are too important to be left to one individual; so an overhaul of the Bank of Israel law is due.

The ECB, created just a few years ago, exemplifies best practices that are a model for the rewriting of any central bank law: independence from the political process, clarity of a price stability objective, and decision by committee. Together, these give monetary policymakers the tools they need to insure first-rate macroeconomic performance. The new Bank of Israel law should clearly embrace the first two principals as it introduces a committee for decision making.

Politicians are loath to delegate something as powerful as monetary policy, and especially to a group of unelected technicians. But experience teaches us that it is the right thing to do! Moreover, in recent decades, country after country has come to this conclusion and introduced mechanisms that guarantee the independence of the central bank. After years of poor inflation performance, responsibility for monetary policy decisions was given to a Bank of England committee that is independent of the government.

First and foremost, politicians need to be kept out of the day-to-day job of making monetary policy. Central bank independence is indispensable if we are to see high-quality policymaking. When it comes to discretionary policy, with the flexibility to change interest rates frequently, politics and economics do not mix. Politicians necessarily care about the short-term, and want to insure their popularity through at least the next election. We do not hold this opportunism against them. In fact it has its benefits under many circumstances. But we do need to recognize that politicians act in ways that are popular with their constituencies. And monetary policy that is aimed at a longer-term goal is just as likely to require raising interest rates as lowering them. Good policy can be unpopular.

The simple fact is that central bank independence delivers lower inflation. But independence means appointing policymakers for relatively lengthy terms that insulate them from political pressures. The problem is that independence is at odds with representative democracy. Yes, it is possible to find wise and skillful men and women to run monetary policy, but how can we guarantee that they will do their best for the country and its population? How can an institution that is free of political influence remain accountable to the people?

Looking around the world, we see the answer to this very important question. If they are given a clear mandate, central bankers become accountable. And the best mandate is one of price stability. Since the Reserve Bank of New Zealand first adopted it in the late 1980s, the use of an explicit inflation target has become a widespread framework for monetary policy and an essential complement to central bank independence.

Central bankers cannot be given a long list of goals that they are expected to meet simultaneously. While there can be secondary goals, the primary objective should clearly be price stability. Even the Maastricht Treaty, the legal foundation for the ECB, allows for this when it states that the central bank can support general economic policies in the country, but it must do so without prejudice to the primary objective of price stability. Crucially, though, elected officials determine the target level for inflation. The job of the central bank is to achieve this objective, and it is that which they are held accountable for.

The third pillar of central bank design is the creation of a Monetary Policy Committee that is explicitly charged with the technical job of determining interest rates. The argument against allowing a single individual to make such important decisions has been compelling and led every major central bank in the world to adopt a committee structure. A common attribute of most such policy committees is that they are dominated by central bank professionals or others with closely related experience, rather than representatives of particular constituencies.

The monetary policy council members should be able to use their technical expertise and independent judgment to stay narrowly focused on the goal of monetary

stability. The new Bank of Israel law should give legal standing to the primacy of a price stability objective

Why should the central bank have such a narrow focus? First, there is the very basic precept that monetary policy, with its ability to control a single interest rate, cannot be used for multiple and inconsistent goals. Importantly, it cannot be expected to substitute for responsible government budget policy. Moreover, exchange rate policies, which have a direct and rapid impact on inflation, are the purview of the central bank. A central bank with a narrow focus on price stability precludes using mistaken interest rate or exchange rate policies to relieve the government from making hard budget decisions.

Second, and most importantly, price stability is essential for long-term growth. High growth and low inflation are not competing goals. Over anything but the very shortest time horizon they go together. The monetary policy council should be able to look beyond the few months to an election and take the steps that will keep the country focused on its goals – the monetary stability that provides the environment needed for economic growth.

The Knesset is not facing a choice between creating create a committee to make monetary policy or leaving the decision-making authority solely in the hands of the Governor of the Bank of Israel. Rather, the task is to be guided by recent world experience: independence, a price stability mandate, and a modest-sized committee should be the central features of any new system. There is no need for the central bank structure to become another problem facing the state of Israel.