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Financial Liberalization in Israel

by

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Abstract

Subsequent to the Economic Stabilization Plan of 1985 Israel began to undertake a liberalization of its domestic financial markets and to reduce the degree of foreign exchange control so as to promote the integration of domestic and international financial markets. This paper briefly reviews this program which has included, *inter alia*, initiatives to deregulate the banking sector, to reduce the Government's ownership share of the major commercial banks, to address concerns about the operation of provident and mutual funds, to remove restrictions on external current account transactions and to reduce capital controls.

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In the period since the Economic Stabilization Plan (ESP) of 1985, Israel has undertaken a substantial liberalization of its domestic financial markets. Moreover, Israel has introduced measures to reduce the degree of foreign exchange control and to promote the integration of domestic and international financial markets. Benefiting from the experience of other countries in similar circumstances, the Israeli authorities recognized that for a program of financial sector liberalization to succeed, the public sector must first reduce its use of inflationary finance to sustainable levels. 1/ As regards the sequencing of the liberalization program itself, the authorities operated on the premise that it was best first to remove domestic distortions and to reduce restrictions on external current account transactions, before finally liberalizing the capital account.

Under the 1985 ESP, the general government's balance improved from a deficit of 13.9 percent of GNP in 1984 to a surplus of 4.0 percent of GNP in 1986, while consumer price inflation was reduced from 374 percent to 48 percent over the same period. With the fiscal accounts in a more sustainable position, in September 1986 the authorities began to implement some financial liberalization measures, which eventually became seen as being part of a larger program. 2/ Over time the authorities' program has included, inter alia, minimizing and where possible abolishing government involvement in the functioning of financial markets; replacing administrative monetary policy instruments with market-based ones; reducing

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1/ See Mathieson and Rojas-Suárez (1993), McKinnon (1991), Edwards (1989) and Frenkel (1982 and 1983).

2/ Israel previously attempted an ambitious capital account liberalization in October 1977 but, given the imbalances in the economy at the time, the liberalization measures were quickly reversed. See Sussman (1992) for a discussion of that episode.

reserve requirements toward international levels; enhancing competition in the banking sector; addressing concerns about conflicts of interest in the operation of provident and mutual funds; removing restrictions on external current account transactions; abolishing restrictions on borrowing from abroad; and progressively liberalizing restrictions on outward capital flows.

This note briefly describes the structure of Israel's financial system and reviews Israel's financial liberalization program with the first section covering the liberalization of the domestic markets and the second the integration of domestic and international markets. While Israel's financial liberalization is far from complete and has not been free from difficulties, it can offer a valuable case study for other countries pursuing such programs. Many of the economies in transition, for example, also have highly concentrated financial systems with public sectors that play dominant roles. Problems with conflicts of interest are prevalent in the banking systems of the countries of the former Yugoslavia. The Israeli efforts at seeking to accelerate bank privatization and reduce government interference in the financial system could, in particular, provide useful examples for these countries.

1. The liberalization of domestic financial markets

a. Financial system structure

The financial system in Israel is dominated by a few large banking groups through the banks they own and the other financial institutions they control. There are five major banking groups: Bank Hapoalim, Bank Leumi, Israel Discount Bank, United Mizrahi Bank, and the First International Bank of Israel. Except for First International, all of these banks--which at end-1992 accounted for 90 percent of bank assets--became majority-owned by the public sector as a result of the 1983 bank share crisis.

During 1977-83, banks in Israel had difficulties in raising capital because of competition from indexed government securities. In response to this problem, many banks began to support the prices of their shares on the 'el Aviv Stock Exchange to ensure that shareholders received high rates of return. In mid-1983, market participants concluded that these shares had become overvalued and that a currency devaluation was imminent and they started to sell off domestic currency assets including bank shares. In October 1983, the price of bank shares collapsed threatening the solvency of the banking system. To ameliorate the crisis, the Government stepped in and, in effect, exchanged the bank shares for state-guaranteed bonds. 1/

1/ The process by which the Government obtained the actual ownership of the shares involved several intermediate steps. See State Comptroller's Office (1993) for details.

According to a report by the State Comptroller's office, the cost to the Government of rescuing the banks was over US$9 billion.

Public ownership of the banking system has, nevertheless, not implied government control. By October 1988, the Government had obtained most of the equity of the four largest banking groups. However, because of historical characteristics of the ownership structures of the banks, the Government did not obtain a majority of the voting rights and the banks' original managements were largely left with control. After protracted negotiations between the Government and the owners of the majority of voting rights, compacts to equalize the voting rights of the shares were agreed upon during 1990-91. But even then the Government did not assume control of the banks because, as part of the original rescue operation, the Government had agreed for its shares to be held--until October 1993--by trust companies established by the banks' managements. Finally, as described below, in May 1993 the Government made a decision to ensure that the banking system would remain independent of government interference even after October 1993.

The second important characteristic of the Israeli financial system is its high degree of concentration. 1/ At end-December 1992, the three major banking groups' share of assets was 81.6 percent, while the five largest groups' share was 96.2 percent. These shares implied a Herfindahl Concentration Index (H Index) of 0.26 (the average for comparable countries is about 0.14). Since 1987, the H Index has been on a downward trend even

1/ The rest of this subsection is largely based on Ruthenberg (1994).

though there has been no entry of new banks into the system. Rather the share of the three largest banks has decreased, while the share of the five largest has been stable. Studies suggest that economies of scale are exhausted at the level of intermediate-sized banks, which are considerably smaller than Israel's three largest banks.

In regard to the entry of new banks, while foreign banks have been permitted to operate in Israel for some time, none have chosen to do so. Foreign banks' operations in Israel are conducted through Israeli banks. There are a number of possible reasons why foreign banks have not entered Israel: geopolitical risk including the Arab boycott; foreign exchange controls; the past domination of the financial markets by the Government; and the strength and sophistication of the domestic banks. However, the role of many of these factors is diminishing and, in any case, the Bank of Israel encourages foreign banks to establish operations in Israel.

While in other countries the banking system may show somewhat similar degrees of concentration, in Israel there are fewer alternatives to the banking system. In Israel, banks are largely universal banks that are able to participate in all areas of the capital market and to control business sector activities. Furthermore, other important parts of the financial system, which are also highly concentrated, are controlled by the banks. For example, at end-1992 the banks managed NIS 66 billion out of the provident funds' total assets of NIS 82 billion.

There has been some trend toward disintermediation from the banking system. On the asset side, bank credit relative to overall credit from the banks and other financial companies decreased from 74.6 percent in 1988 to 69 percent in 1993. On the liability side, the public's assets at banks relative to the public's total assets decreased from 56 percent in 1989 to 37 percent in 1993. Because the banks are universal and not just involved in traditional commercial banking activities, the banks themselves have encouraged this trend. In particular, with the bull stock market banks have gained a larger share of their income from securities-related activities.

Another characteristic of the financial system is the high involvement of the Treasury and the central bank although, as explained below, the degree of official intervention has diminished in recent years. The Government's share of the market has decreased as the declining fiscal deficits have reduced the borrowing requirements of the Government. In addition, as described below, the authorities have reduced reserve requirements and liberalized banking system regulations. In response, intermediation which was directed in some way by official policy declined from 58.2 percent of the total in 1990 to 48.2 percent of the total in 1992.

b. The Government's reform program

The characteristics noted above have been the underlying motivation for the authorities' program of domestic financial sector liberalization which can be broken down into three inter-related parts for ease of exposition:

deregulation measures to reduce public sector involvement in the financial system and to increase market efficiency; measures to enhance competition; and, measures to reduce potential conflicts of interest.

(1) Deregulation

The very large budget deficits and high public debt ratios prevailing prior to the 1985 economic stabilization plan resulted in a heavy dose of government intervention in the capital and foreign exchange markets. 1/ The basic purpose of this intervention was to mobilize the resources required for financing the budget deficit, to which end a set of administrative rules was imposed to ensure that a large portion of private sector savings was channeled to the public sector. A second role for intervention was to affect directly the allocation of resources within the private sector, to which end administrative measures were adopted to direct credit to investment and exports, which were defined as priority sectors.

1/ As noted by Leiderman and Bufman (1994), public intervention in the financial market took the following four forms: (a) the pension funds, provident funds, and the insurance plans, which held a substantial part of the private sector's savings, were required by law to hold almost all of their portfolio in the form of government-issued securities, most of which were non-negotiable and nontraded; (b) the Bank of Israel attempted to control the volume of financial assets by imposing heavy reserve requirements on deposits, which averaged 47 percent on domestic currency deposits and between 80-100 percent on foreign currency deposits; (c) with the objective of insulating the domestic financial market from potentially competing and destabilizing capital flows and to ensure that capital flight did not occur, international capital flows were severely restricted; and (d) in an attempt to promote exports and investment, special directed credit arrangements were introduced by the Bank of Israel.

The successful strengthening of the public finances in the context of the 1985 stabilization program allowed the authorities to start deregulating the financial system in April 1987. The two basic objectives of this reform were (a) to reduce the degree of government intervention and segmentation in the financial markets and (b) to stimulate competition and to introduce market-based mechanisms in capital market allocations. To this end, as an initial step, the mandatory investment requirement was reduced for institutions such as pension plans, provident funds, and insurance plans to invest in government securities. 1/ In addition, nonfinancial firms were permitted to issue bonds, while commercial banks were allowed to sell bonds up to a specified ceiling.

In the period after 1987, many other restrictions were eased. Ceilings on overall domestic foreign exchange loans to Israeli residents and ceilings on guarantees banks could issue on nonbank loans were abolished. Maturity constraints on loans were eliminated as well as on most deposits. Reserve requirements have been (and are still being) reduced to the level needed for prudential considerations. Special credit arrangements have been ended and the Bank of Israel has also reduced its involvement in determining the prices of financial services.

The scope and comprehensiveness of the aforementioned set of reforms can best be gauged by examining the various indicators of credit flows,

1/ This section is based on Ben-Bassat (1993), Leiderman and Bufman (1994), and Klein (1994).

changes in reserve requirements, and the narrowing of interest rate spreads since the start of the reform process. Among the more striking changes that have been induced by the reform program are the following: (a) whereas "directed" bank credits, whose terms are decided by the Government, whether or not the loan is financed from government sources, amounted to 55 percent of total bank credit to the public in 1987, the share of these credits declined to 13 percent of the total by end-1993 (Chart 1); (b) while average reserve requirements on bank deposits had reached 63 percent at the end of 1987, they had declined to 29 percent by end-1993 (Chart 1) and the necessary legislation is in place to ensure that over time the level of these requirements will automatically fall further toward levels more common in other developed economies; (c) the former mandatory requirement of pension funds, provident funds and insurance plans to hold practically their entire portfolio in government bonds has been reduced substantially, with the provident funds, for example, now only required to hold around 50 percent of their portfolio in government paper; (d) the spread between the domestic borrowing rate in U.S. dollars and Libor narrowed from 11.8 percentage points at end-1987 to 3.5 percentage points by end-1993 (Chart 2); (e) the spread between interest rates on local and foreign currency domestic loans declined from 16.4 percentage points at end of 1987 to 6.8 percentage points by the end of 1993 (Chart 2); and (f) the spread between the unindexed domestic currency borrowing and lending rates of the commercial banks declined dramatically from 34 percentage points at end-1987 to 7 percentage points by end-1993 (Chart 2).

An important by-product of reduced public sector deficits and government intervention in financial markets has been the increased effectiveness and autonomy of monetary policy. In particular, monetary policy has now begun to be conducted as in most developed economies through the use of market-based financial instruments. In Israel's case the primary monetary policy instruments are now the repurchase agreements between the commercial banks and the Bank of Israel and a version of the discount window where each bank has an allocation based on its relative size. These instruments allow the Bank of Israel to conduct monetary policy primarily through the cost of credit rather than through administrative controls.

(2) <u>Enhancing competition in the banking system</u>

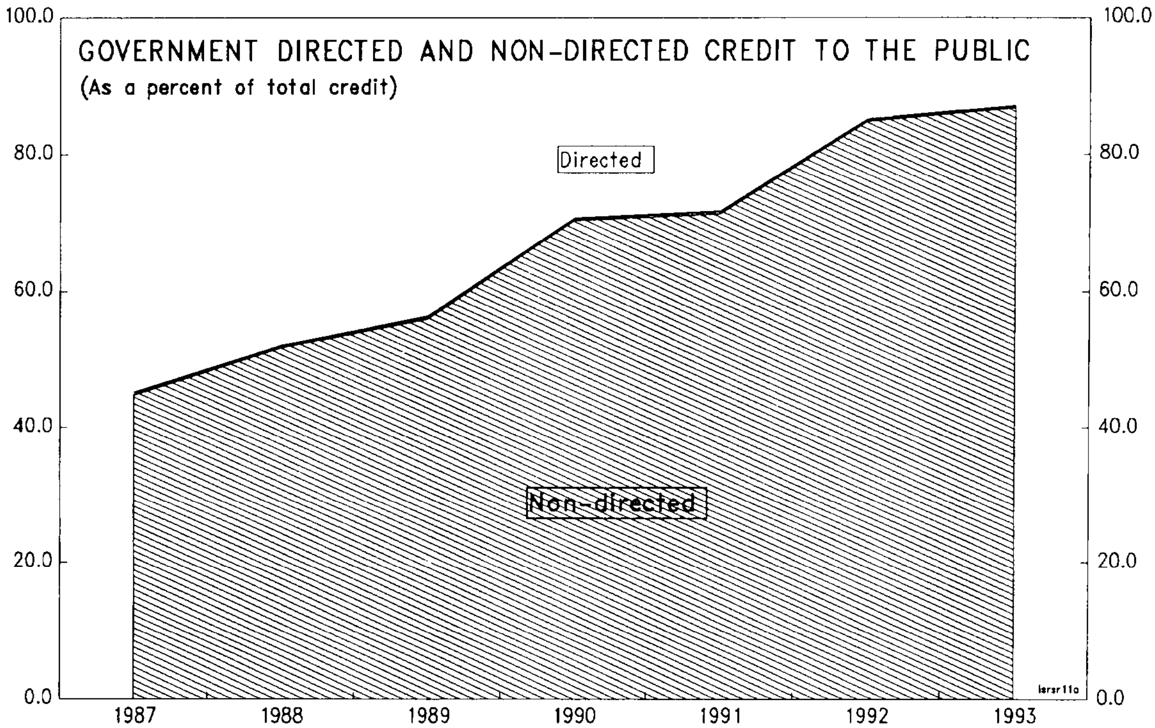
As noted above, the Israeli financial system is highly concentrated and the authorities intend to reduce this concentration. As early as 1987, the Bank of Israel had hoped to begin restructuring the banking system so as to enhance competition. However, the discussions between the Government and the former owners of the banks became protracted. It came to be seen that a restructuring of the banking system would be easier to implement at the time of the expiration of the ten-year bank shares arrangement and thus this aspect of the authorities' reform program is only now underway.

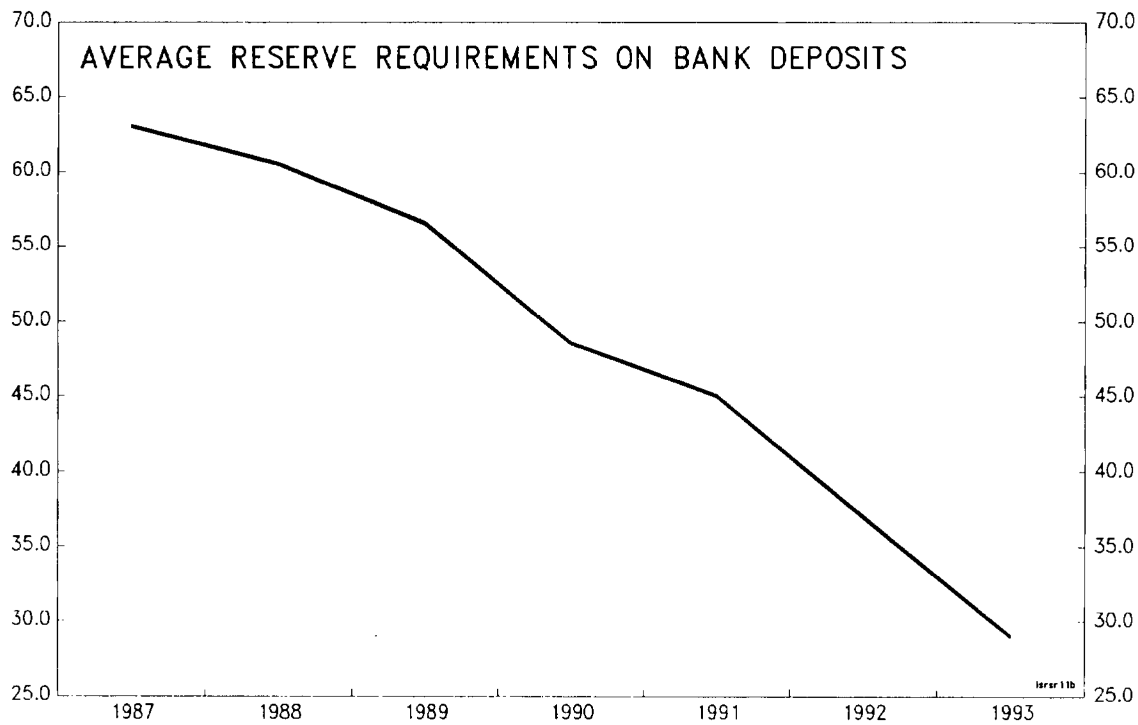
One important reform measure to enhance competition in the authorities' program is the separation from some of the major banking groups of smaller

CHART 1
ISRAEL

CREDIT AND RESERVE REQUIREMENTS

(In percent)



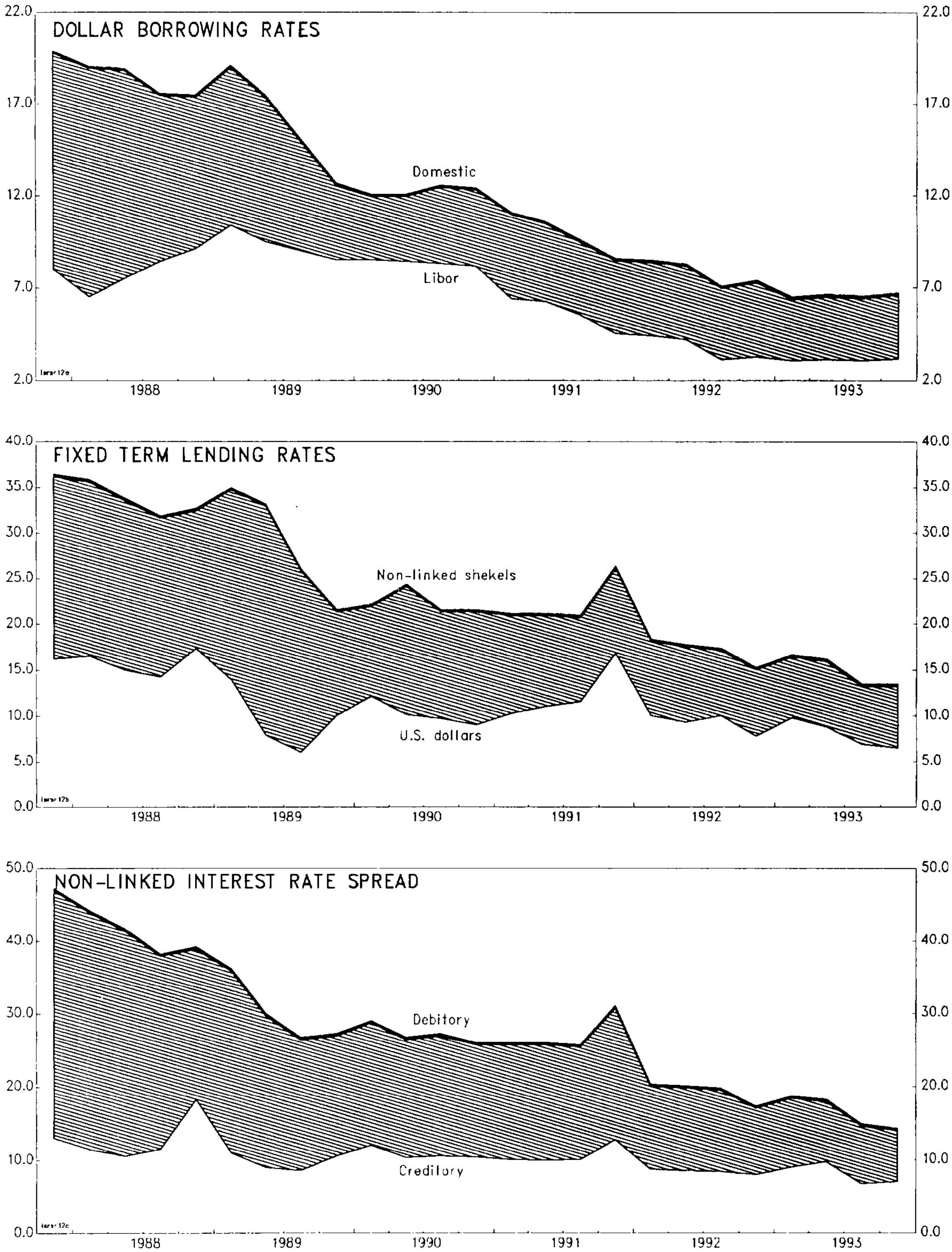


Source: Klein (1994).

CHART 2
ISRAEL

INTEREST RATES

(In percent)



Source: Klein (1994).

units, which could be expected to survive as independent banks. The Government has already sold the Union Bank, which was part of Bank Leumi, and it is considering selling two other small banks. There are some difficulties in this process, however. For example, in some cases the existing subsidiaries are too small to survive independently and some must be combined before they can be sold. In other cases there are minority shareholders, which complicates the proposed sales. Moreover, the Bank of Israel does not believe it would be practical to further break apart the large banks because of the time the process would take and the technical difficulties involved.

The authorities are also seeking to increase competition by upgrading the licenses of some existing financial institutions so that they can compete as commercial banks. For example, the Industrial Development Bank, which is owned by the Government but controlled by three of the major bank groups, had its license changed so that it could compete as a commercial bank. Similarly, mortgage banks are now able to expand their lines of business into home equity-type lending.

The Government is also seeking to privatize the large banking groups. With the spin-offs from the large banks creating more competitors, encouraging more profit maximizing behavior within the large groups themselves should promote competition in the banking system. Recently, 23 percent of Bank Leumi was sold by the Government to the public and employees and about 18 percent of Bank Hapoalim was sold. The authorities' intention is to privatize all the banks over time, to which end further substantial bank share sales are envisaged in the Government's 1994 budget.

Even while the Government still remains the formal owner of banks, it will not have control over them as its shares are to be held by independent public trustees. 1/ In May 1993, the Government decided that after October 1993, the Government's shares in each bank would be held by a board of trustees, which would exercise the Government's voting rights and would protect the interest of the public. The board of trustees of each bank is to be appointed by a public committee chosen by the Government. The Ministry of Finance will retain certain rights including the authority to sell the government's shares.

(3) Reducing conflicts of interest

Because of the concentration of the financial system, beyond wishing to enhance competition in the banking sector, the authorities are also concerned about potential conflicts of interest, particularly in regard to the provident funds whose assets total about US$30 billion. These provident funds, which require a minimum 15-year investment period and which are heavily favored by tax incentives to savings, have up to now been predominantly controlled by the three main bank groups. Moreover, information on the yields of the provident funds is not available on a timely basis. 2/

1/ The previous trustees were chosen by the banks' managements.

2/ In contrast, mutual funds--which in aggregate are only 1/3 the size of the provident funds--are negotiable instruments and information on their yields is available in the newspapers on a daily basis.

In a situation where about 80 percent of the provident funds are controlled by the banks, and information on the investments the funds are making is not readily available to the public, the authorities are endeavoring to eliminate the potential for conflicts of interest. To this end, the Government has decided to establish "corporate separateness" between the provident funds and other banking activities. For example, provident funds will not be able to invest in the shares of the bank group which controls the fund, while all of the funds that a given bank controls will not be able to own more than 10 percent of the capital of any other bank group. The authorities are also enacting limitations on the investment activities of the provident and mutual funds in order to disconnect the decision-making power in these funds from bank management. The majority of the members of the Board of Directors of provident funds must be outsiders and the provident funds' Investment Committees must be composed entirely of outsiders.

A further major focus of the current bank reform, which is aimed at promoting competitiveness within the economy as a whole, relates to the commercial banks' direct involvement in the nonfinancial enterprise sector of the economy. To that end, stricter limitations on the banks' control of nonfinancial enterprises are presently being enacted. Under the banking law of 1981, banks were forbidden to control nonbanking corporations and their holdings in these enterprises were limited to no more than 25 percent of the enterprise's capital. In addition, a banking corporation's total interest in nonbanking corporations could not exceed 25 percent of the bank's capital. However, because of interim provisions included when the 1981 banking law was passed, bank control of enterprises is still widespread in Israel. The decision has recently been taken to effectively require all banks to reduce their holdings to no more than 25 percent of a company's capital within a two- to three-year period. Moreover, the banks' relationship with the nonfinancial corporations is to be subject to further review by the Bank of Israel and the Ministry of Finance in order to determine whether additional measures might be required in this area to promote competition.

2. The integration of domestic and international financial markets

The rationale for proceeding first with current account liberalization and secondly with the removal of capital controls is, in part, based on the assumption that goods markets adapt more slowly to external market conditions than financial markets. As discussed in Mathieson and Rojas-Suárez (1993), in many countries a premature opening of the capital account led to capital inflows, which caused an appreciation of the real exchange rate and the destabilization of the domestic economy. In the case of Israel, for the most part the authorities have had the opposite concern--that, with a liberalization of the capital account, Israeli residents might seek to diversify their portfolios by shifting large amounts of capital abroad at a faster pace than inward capital flows would result. For this reason, Israel has proceeded by moving more boldly with respect to inward capital restrictions, where by now all controls on foreign borrowing by residents have been eliminated, than on outward capital restrictions. While substantial progress has been made in the latter respect, important restrictions still remain, especially regarding the ability of the provident funds to invest abroad.

Prior to recent current account reforms, restrictions on current account transactions included limits on foreign currency travel allowances, restrictions on wage payments abroad, and limitations on the rights of tourists to buy foreign exchange against proof of the prior conversion of foreign exchange into shekels. Two multiple currency practices were also in place, namely, a 4 percent tax on imports of tourist services levied at the time of the exchange transaction and an exchange rate insurance scheme for exporters. After 1987, the existing current account restrictions and multiple currency practices were gradually eliminated with the last, the exchange rate insurance scheme, being abolished on September 1, 1993. This process facilitated Israel's acceptance of the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement on September 21, 1993.

Regarding the capital account, in general foreign currency transactions are forbidden unless explicitly permitted. 1/ While the eventual goal of the authorities is full capital account liberalization, the nearer-term goal is to move to a regime where all foreign currency transactions are permitted unless explicitly forbidden. Virtually all restrictions on the inward

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1/ See Klein (1994) and Leiderman and Bufman (1994).

movement of capital have already been eliminated, as a result of which foreign borrowing by Israeli residents is not restricted. 1/

Regarding capital outflows, residents are now allowed to keep foreign exchange obtained through earnings or borrowing in foreign currency accounts in domestic banks, while exporters may maintain foreign bank accounts for amounts of up to 10 percent of their turnover during the previous year. At the same time, corporations can invest up to 40 percent of their capital in assets abroad, while mutual funds in general are now permitted to invest up to 10 percent of their assets in foreign securities and those specializing in foreign markets are allowed to invest 50 percent of their assets abroad. 2/ Moreover, individuals are currently not restricted in buying foreign securities provided that these are deposited in Israel with an authorized dealer.

1/ Important elements of the liberalization program on inward capital movements included (a) the elimination of the minimal loan period and maximal loan limits; (b) the elimination in 1990 of the capital import tax; (c) the authorization to foreign residents to invest in traded private Israeli bonds in addition to their allowed bank transactions in foreign currencies and their investments in shares at the Tel Aviv Stock Exchange; and (d) allowing foreign residents to convert their capital gains into foreign currency. By the end of 1993, foreign residents were estimated to hold a portfolio of domestic securities, mainly shares, worth about US$1 billion and in addition they also held a controlling interest in Israeli companies, in term of shares traded, of around US$3 billion. The main financial asset of foreign residents in Israel, however, consists of foreign exchange deposits in domestic banks, totaling around US$11 billion by end-1993.

2/ In response to the easing of exchange controls, the Israeli corporate sector is estimated to have invested abroad around US$3 billion, or an average 14 percent of its capital, by end-1993. As of the same date mutual funds had a foreign financial portfolio of around US$0.7 billion. At the same time, Israeli corporations have been relatively successful in raising capital on foreign exchanges, as indicated by the estimated US$0.8 billion raised between 1991 and 1993.

As noted above, the liberalization measures reviewed in this note have led to a closer link between domestic and external interest rates. With a view to further using capital market liberalization as a means of fostering competition in the domestic financial system, the authorities are at present studying the issue of moving to full external convertibility of the shekel. Their intention is to proceed as rapidly as conditions permit, but they have yet to announce a timetable.

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