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Independence of the Bank of Israel in Historical Perspective:

A Tale in Three Acts*

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The history of the Bank of Israel is often told as a transformation from "politicization" to "independence". According to this story the bank was established as a rather weak, dependent and politicized institution, which served as "an arm of the government" and only in 1985 became an independent institution. Indeed, in 1985 the Bank of Israel—as the Israeli economy at large—went through a deep change. However, does this notion of a linear and progressive historical narrative capture sufficiently well the institutional change that the Bank went through?

This is not to say that the narrative of "From politicization to independence" is wrong. Under certain conservative assumptions regarding the definition of an independent central bank, it is valid. However, this narrative, which focuses on the *level* of central bank independence, conceals a much more complex and rich history, which focuses on alternative questions such as: how did the notion of central bank independence change over time? How did the central bank respond and adapt itself to the changing domestic and international economic conditions and problems? How did the Bank respond to the emergence of new economic ideas that shaped its actual objectives and instruments?

The Bank of Israel was indeed established as an "arm of the government"; but isn't it the case that central banks are ALWAYS some kind of an "arm" of the government? After all, central banks are established by governments. But, while being an arm of the government, central banks possess a certain level of independence from the government as well as from other domestic actors. Paradoxically, it is their relative independence that makes central banks a useful arm.

The question, therefore, is not whether a certain central bank is an "arm" of the government or not; rather, the question is what kind of "arm" it is, and why governments make a choice

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to establish such an “arm”, with a certain level of independence, in order to achieve a goal that they—the governments—cannot achieve without a central bank.

In this presentation I argue that the answer to this question—why governments establish and maintain the independence of central banks—is not a historical constant. Rather, the answer changes over time and it depends on changing—sometimes contingent—historical factors.

To demonstrate this point I trace the history of the Bank of Israel, through three key episodes, each of which was a transition period:

1. The establishment of the Bank in 1954.
2. The amendment of the bank law in 1985.
3. And the reform of the law in 2010.

Concerning each period, I will pose three questions:

1. What was the key policy problem the BoI was expected to address?
2. What kind of policy ideas shaped the law and the policies of the Bank?
3. How was the independence of the Bank institutionalized?

This presentation is based, among other things, on my book, “The National Origin of the Market Economy” that came out earlier this year in Magnes Press. The book traces the consolidation of the Israeli capitalism and explains its evolution on the basis of two key factors: the national interests and the import of market-oriented economic ideas form the United States. The encounter between the economic ideas and the local policy problem, I argued in the book, gave rise to the Israeli capitalism as we know it.

The second half of the book is dedicated to the study of the establishment of the Bank of Israel, which is first part of my lecture.

First episode: Bank of Israel law (1954)

The central bank of Israel was established in 1954, six years after the state of Israel. Israel was a developing country, which dealt with two major resource-demanding problems: the absorption of 700 thousands immigrants that doubled the Jewish population and a security problem. Luckily for Israel, it had a source of foreign currency—the reparation payments from West Germany—which enabled the government to employ an interventionist and expansionist fiscal policy of full employment, while at the same time it also maintained a relatively low public debt and stable currency.

Under these circumstances, the key policy problem in the area of financial and monetary policy was not how to tie the government's hands and restrict its capacity to print money; rather, the main problem was how to control the financial intermediaries, the banking system.

Prior to the establishment of the BoI, the government did not have the capacity to control the banking system, which was highly decentralized. Therefore, it also did not have the capacity to control the volume of credit, its price and its allocation. Instead, the government employed a strategy described in the literature as financial repression: the government mobilized the credit from the largest banks, and allocated it to the government and the Histadrut sectors (Figure 1). But this solution had a severe drawback: the private sector did not have access to cheap credit and thereby hampering economic development.

As John Zysman once wrote, "Unless it [the state] has direct influence on the allocation of credit by the financial system, it must either make the financial institutions its allies or confront them as political opponents to its interventionist strategies".[1] Once the BoI was established, it was provided with extensive supervisory powers, which it could use in order to confront the banking system. The Bank confronted the banking system with both sticks and carrots, and was able to turn the banking system—particularly the large banks—into its ally and the commercial bank cooperated with the preference of the government to channel cheap credit to productive purposes (Figure 2).

This strategy was successful according to the goals set. Whereas in 1951 the banking system allocated less than 30% of total credit to productive industries, in 1958 almost 60% of the credit were allocated to productive purposes (Figure 3). Moreover, the strategy of the Bank was successful in squeezing the spread between loans and deposits interest rates, a fact that contributed both to investment and to saving (Figure 4).

The Bank thus served the government's preferences, and therefore many observers argue that it was not independent. However, the Bank was independent in a different sense: it was independent from the Histadrut sector—the traditional political ally of the government—and therefore it was able to resist pressure from the Histadrut companies for credit. It was not by accident that the Advisory Committee of the BoI did not include any representatives of the Histadrut sector (Table 1).

To conclude, when established, the BoI did not have the powers or the capacity to maintain price stability. In that sense it was weak and politicized; however, the Bank had extensive supervisory powers and it used them to confront the banking system. In that sense, the Bank revolutionized the structure of the banking system. Whereas it succeeded in

[1] John Zysman, *Governments, Markets, and Growth: Financial Systems and the Politics of Industrial Change* (Ithaca and London: Cornell University Press, 1984), 77.

controlling the credit, the cost was a more centralized structure of the banking system (Figure 5).

This approach to central banking was not unique to Israel. Israel learned from other small developing countries that established central banks at that time. The idea that central banks should take an active role in the allocation of credit was supported by a large number of economists, including American ones, the most prominent of which was Robert Triffin. Triffin, as other economists in the Federal Reserve Bank during the 1950s and the 1960s encouraged central banks in developing countries to use their powers in order to control credit, its volume, price and allocation.[2]

Second episode: Amendment 15

During the 1970s international conditions changed, and this, coupled with domestic trends, led in Israel to an economic dead-lock manifested in the so-called "lost decade". Until the 1980s the dead-lock turned into a fully-fledged crisis. The response to the crisis was the Stabilization Plan, which revolutionized the Israeli economy. It was in this context that amendment 15 of the BoI law was enacted.

The crisis in the first half of the 1980s manifested mainly in two areas: the mounting public debt and the instability of the currency. During the two decades since 1965 the external public debt rose from 20% of GDP to 80%. The total public debt reached 250% of GDP in 1985. Inflation was on the rise since 1975, and it reached almost 450% annually in 1985.

The Stabilization Plan announced on July 2, 1985 sought to address these two key problems—the mounting debt and inflation—simultaneously. The Plan, as it is well known, was prepared by a collaboration of Israeli and American economists: Stanley Fischer and Herbert Stein, on the American side; and Michael Bruno and Eitan Berglas as well as small teams from the Bank of Israel and the Finance Ministry from the Israeli side.

On the same occasion, the government reached a decision to amend the law on the Bank of Israel. The bill did not attract significant opposition. However, Members of Parliament, from left and right, were skeptical regarding its usefulness. They argued that the BoI had had the powers to resist government's requests for loans also without the amendment. Chaim Ramon asked the governor, Moshe Mandelbaum: "According to the current law you do not have to lend money to the government, you are allowed to. Are you certain that under the new law the government will not issue bonds to the Bank of Israel in exchange

[2] Arie Krampf, "Translation of Central Banking to Developing Countries in the Post-World War II Period: The Case of the Bank of Israel," in *The Globalization of Knowledge in History*, ed. Jürgen Renn (Max Planck Research Library for the History and Development of Knowledge, Studies 1. Berlin: Edition Open Access., 2012), 459–82.

for loans?”.[3] MP Ephraim Shalom pointed out in the Finance Committee: “the law does not solve the main problem—the size of the budget and the size of the deficit… because the law does not restrain two things: first, there is no limit on foreign currency loans and there is no limit on issuing bonds”.[4]

Despite the skepticism, the approval of amendment 15 contributed the confidence of the BoI vis-à-vis the government. Already during the year 1984 the BoI tried to fight inflation through exorbitant annual interest rates of 1400% (marginal interest rate). After the announcement of the Stabilization Plan the bank added another tool to its arsenal: the Reserve Ratios. In July the Bank increased the reserve ratio from 11% to 30% and then to 45%. It stayed at such a high level until the end of 1986.

The governor, Moshe Mandelbaum, and the head of the Monetary Department, Victor Medina, conditioned the lowering of the interest rate by government’s implementation of the budget cuts. “If the government does not cut the budget enough, the interest rates will stay at high levels and the private sector will carry the burden”, warned Mandelbaum.[5]

The conflict reached a peak in November, when the unity government was about to submit the new budget. The Ministry of Finance, headed by Yitzhak Modai, a Likud member, opted for severe budget cuts. The ministers from the Ma'arach (Labor bloc) sought a softer budget cut. This was a decisive point, in which the BoI used its clout to support the Finance Ministry’s position. In addition, a group of 15 economists signed a public letter in support of the position of the Bank and the Finance Ministry.

To conclude, amendment 15 indeed increased the independence of the BoI as well as its conservativeness. But it was not only the letter of the law—the formal powers given to the governor to refuse the government request for loans—that affected the Bank’s behavior. After the amendment was passed the Bank used instruments it could, formally, have used before. The actual independence and its conservativeness were also the result of the new intellectual atmosphere in the Israeli policy discourse, the changing approach within the Finance Ministry and the support of the Israeli and American economists.

Mandelbaum was the last governor who fulfilled political position prior to his nomination. After him all governors were academic economists and/or were bank employees: Michael Bruno, Jacob Frenkel, David Klein, Stanely Fischer and currently Karnit Flug. This change in itself increased the actual independence of the Bank.

Did it also increase it conservativeness and its adherence to the rule of price stability? For a while it did. But the financial crisis changed the trend. This brings us to the third episode.

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[3] Finance Committee, 17.6.85.
[4] Finance Committee, 17.6.85.
[5] Maariv, 6.8.1985.

Third Episode: the BoI Law

From the mid-1980s until the onset of the Global Financial Crisis, the advanced economies enjoyed the macroeconomic situation known as the Great Moderation. Following the disinflations of the early 1980s, central bank legislation and practice in many countries followed closely on academic developments in macroeconomics. Central bankers, however, differ in the emphasis they put on inflation targeting, or, in their conservativeness. Some of them were "inflation nutter", to use the term coined by Mervyn King, whereas others employed a more flexible approach.

From 2008 to 2010 the global economy suffered the Global Financial Crisis and then entered into the Great Recession. In response to the crisis central banks worldwide employed "unconventional policies". Within a few years, these unconventional policies consolidated into a "New Normal", a "new world of central banking" or a "new paradigm". Though not in contradiction to the Flexible Inflation Targeting paradigm, since developments are certainly not inflationary, the new normal goes well beyond policies inherent in the Flexible Inflation Targeting approach.

From a domestic perspective, during the crisis the Israeli economy performed quite well in terms of the aggregate variables. The Finance Ministry embraced a "sound money policy" approach, and in some cases the government took a more conservative economic position than the central bank. Therefore, contrary to the conditions in 1985, inflation was not considered an immediate threat.

The nexus between the Flexible Inflation Targeting approach and the new normal served as the context in which the new central bank law of 2010 was formulated. The new law included two innovations that should be discussed here.

First, the objectives of the Bank: the new law states that the first and main objective of the Bank is price stability. The goals of growth, employment and the reduction of social gaps are secondary. At first glance, and consistency with the Financial Inflation Targeting approach, this formulation implies an increase in the independence of the Bank as well as in its conservativeness. In the previous law price stability was one objective among other objectives: external stability of the currency, growth, employment and the promotion of foreign investment.

However, the law qualified the objective of price stability in two ways. First, the Bank has to achieve price stability "over the course of time", which means within two years. This qualification, obviously, increases the flexibility of the Bank. For comparison, the mandate of the European Central Bank states the objective of price stability without any qualification.

The objective of price stability is also qualified by the fact that it is the government—in consultation with the Governor—that determines the precise inflation range target. For comparison, the mandate of the ECB also does not state explicitly the inflation target, but it is the Governing Council that defines it.

The two qualifications increase the flexibility of the central bank regarding the objective of price stability. Fischer explained this approach in the Finance Committee that "It is important not to focus only on inflation".[6] The Annual Report of 2009 also discussed this issue and it referred to the "problematic nature of monetary policy that focuses too narrowly on price stability".[7]

Another factor that contributes to the flexibility of the Monetary Committee is the objective of financial stability. Fischer explained to the Finance Committee that financial stability is, in fact, a traditional role of central banks, as they served as Lenders of Last Resort. The central bank is like a "mother", he said: "a mother to which we [the banks] run to when a financial crisis occurs".[8]

However, the inspiration for the new objective was not necessarily Walter Bagehot's book on the Lombard Street. In an address in 2009 Fischer interpreted the Federal Reserve's Quantitative Easing policy designed by Ben Bernanke as a policy of "credit easing", which is "closer to the lender of last resort function than to pure quantitative easing" because its purpose is not to spur demand but to restore market confidence.[9] To fulfil this function the Bank is allowed to "take any other action… deems necessary provided it obtains the approval of the Committee for the type of action at issue; if the Governor believes there are grounds for said action under circumstances of special urgency".[10]

In addition, the new Law granted the Bank with the authority to intervene in the foreign exchange markets and handle to determined, with the approval of the Minister of Finance, the foreign currency reserves of Israel.

By adding the objective of financial stability to the Banks' list of objectives and by endowing the Bank with more instruments, the law reduces the conservativeness of the central bank, at least "on paper" and it provides the Monetary Committee with more room for discretion. The objective of financial stability is a multi-faceted concept and its attainment requires

[6] Finance Committee, 23.32.2010.
[7] Bank of Israel, *Annual Report - 2009* (Jerusalem: Bank of Israel, 2009), 135.
[8] Finance Committee, 23.32.2010.
[9] Stanley Fischer, ".Preparing for Future Crises: Speech at the 33th Annual Conference of the Federal Bank of Kansas City" (Bank of Israel, August 23, 2009).
[10] Stanley Fischer, ".Preparing for Future Crises: Speech at the 33th Annual Conference of the Federal Bank of Kansas City" (Bank of Israel, August 23, 2009).

more discretion and flexibility on the side of the governor and the Committee than the transparent and simple monetary rule of price stability targeting.

Whereas the new law increased the Committee's flexibility it also institutionalizes the independence of the bank. First, the law included a detailed description of the procedure by which disputes between the Bank and the Finance Ministry over salaries and terms of service of the Bank's employees will be settled.

Second, the institutional independence of the Bank was also supported by the establishment of two Committees: (1) the Monetary Committee as the main policy decision making organ of the Bank and (2) the Management Committed as the main administrative oversight committee. The composition of the Monetary Committee, which comprises a mixture of bank's employee and public representatives who have formal economic credentials, contributes to the Bank's position as a professional and apolitical policy maker (Table 2). The Management Committee serves as a form of Board of Directors for the BoI.

Hence, the enactment of the 2010 law increased the legal independence of the Bank, but at the same time provided the Monetary Committee with greater flexibility regarding the prioritization of objectives in the short-run and regarding implementation of monetary policy. At a more fundamental level, the new law acknowledges the potential trade-off between desired policy objectives, and it trusts the Monetary Committee to prioritize them. This approach was not unique to the Israeli central bank, but it was part of a global trend.

As a report of the Committee on International Economic Policy and Reform—an independent and non-partisan group of experts hosted by the CIGI and the Brooking Institute, published in 2011 stated:

> Central banks are more likely to safeguard their independence and credibility by acknowledging and explicitly addressing the tensions between inflation targeting and competing objectives than by denying such linkages and proceeding with business as usual.[11]

To what extent are these conclusions also supported by the actual policies of the Bank? In the period 2008 to 2010 the BoI employed three types of "unconventional policies": foreign currency purchasing, government bond purchasing and regulatory intervention in the mortgage market.

From early 2008 to 2011 the BoI increased its foreign reserves from less than US$30 billion to a little bit less than US$80 billion. What was the justification for this purchasing program? The report of 2009 states that the first aim of the purchasing program was to

[11] Barry Eichengreen and et al., "Rethinking Central Banking," The Committee on International Economic Policy and Reform (Washington, D.C.: The Brookings Institution, 2011).

increase “the economy’s foreign exchange reserves”.[12] The report, however, does not explain why more reserves were necessary. Fischer, or the BoI, has never made it explicitly, but it is likely that the foreign exchange hoarding was designed to provide a “financial cushion” against external shocks.

In 1999, shortly after the Asian crisis, Fischer stated that “the first line of defense in dealing with capital flow reversals… is to use the foreign exchange reserves… [I]t is very likely that countries seeking to draw the lessons of the present crisis [the Asian crisis] will decide they should hold much larger reserves than before”.[13] Following the Asian crisis emerging small economies started to increase their foreign currency reserves.

A second reason for the foreign currency purchasing program provided by the Bank was the exchange rate of the Shekel: The Annual Report of 2009 explained that: “The timing of the commencement of the program, from the first quarter of 2008, was determined in light of the large and continued appreciation of the shekel”.[14]

From a purely legal perspective the foreign currency purchasing program was not outside the BoI mandate. However, this policy reflected a distancing of the BoI from the conservative paradigm of the 1980s and the 1990s, and a shift towards a new paradigm that broadened the scope of central bank responsibilities.

The second unconventional instrument used by the Bank was government bond purchases. In February 2009 the Bank announced a government bond purchasing program in the secondary market for an amount of $20 billion. The Annual Report of 2009 explained that “The bond purchase program was intended to support a decline in longer-term interest rates, and thereby alleviate credit terms in the economy and promote economic activity”.[15] The scope of the program is quite modest in size and the Bank did not repeat it since.

Finally, the third unconventional instrument employed by the central bank, implemented by the Banking Supervision Department, was the regulatory intervention in the mortgage market.

In October 2010 the BoI and the supervisor of banks announced a directive that entailed “a requirement for a higher capital provision for floating-interest loans granted with a high loan-to-value (LTV) ratio”. The policy was explained by the governor as “macro-prudential measure” “in the area of housing credit in the last few months”. The justification for the directives was the “concern that we were starting to see a bubble being formed in the

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[12] Bank of Israel, *Annual Report - 2009*, 119.
[13] Stanley Fischer, “On the Need for an International Lender of Last Resort,” *The Journal of Economic Perspectives* 13, no. 4 (October 1, 1999): 85–104.
[14] Bank of Israel, *Annual Report - 2009*, 119–20.
[15] Ibid., 119.

market, and that a large share of the financial crises around the world resulted from price increases that developed into bubbles in the real estate market”.[16]

The unconventional policies during 2008 to 2010 show that already before the new law was passed, the BoI started to align itself with the new paradigm of central banking that was consolidated. As the Report of 2009 specifically explained:

> apart from specific action taken by the Bank of Israel, its clear intention to use the tools at its disposal as much as necessary in order to support economic activity and guarantee the resilience of the financial institutions and the markets played an important role in restoring the confidence of the public as a whole and investors in particular in the financial markets and in the economy, and thereby contributed to the economy’s recovery from the crisis.[17]

Indeed, the BoI’s unconventional policies led to criticism directed towards the Bank that it was losing its independence, and Fischer himself referred to these criticism . However, the BoI was not the only central bank that faced such kind of criticism: the president of the Bundesbank and other German economists also accused the ECB under the presidency of Mario Draghi of sacrificing its independence.

Epilogue

This topic brings us back to the starting point of my presentation. If we adhere to the conservative definition of central bank independence, then central banks in the New Normal are less independent because they do not follow a simple and transparent rule.

However, the historical survey I presented here should lead us to a different conclusion. Central banks are independent to the extent that they serve a public function. In a certain historical context—the context prevailed in the 1980s and the 1990s—central banks provide the public good of a stable currency. But in the long-run, the function that central banks fulfil changes along with economic circumstances and new policy ideas regarding the desired role of central banks.

In the post-crisis New Normal central banks had to adapt themselves in order to fulfil a different function. Whereas in the 1990s the reputation of the central bankers was based on their conservativeness, in the post-crisis period they had to establish the trust of investor that they would be willing to employ extreme measures to stabilize the financial system.

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16 Stanley Fischer, “Summary of Address by the Governor of the Bank of Israel, Professor Stanley Fischer, to the Bank of Israel Research Department Conference” (Bank of Israel, December 30, 2010).

17 Bank of Israel, *Annual Report - 2009*, 122.

Hence, we should conceive central banks as adaptive state organs, or arms, if you like. This arm can do different things, and it changes over time.

Indeed, this historical conception of central banks poses some problems: how can a society formulate a mandate of an institution, whose function is not fully determined? How can the transparency and accountability of central banks be maintained, if their objectives are not stipulated in a simple way? These questions, I believe, are the political challenges that should be addressed within the New World of central banking that we are in.

Figures

Figure 1:

Financial Repression: Prior to the establishment of the Bank of Israel

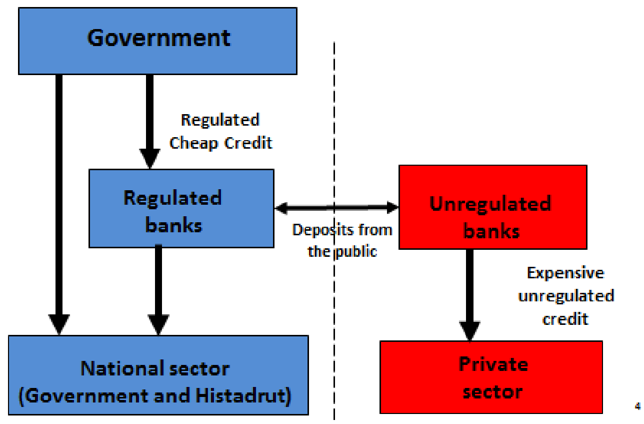


Figure 2:

Selective Credit Policies: allocation of credit *after* the establishment of the BoI:

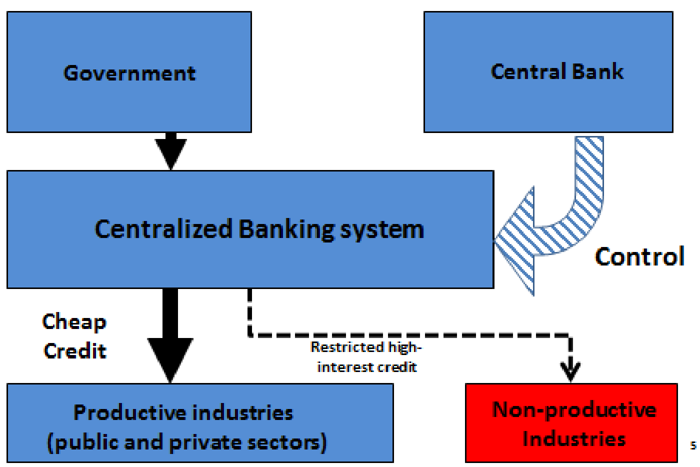


Figure 3:

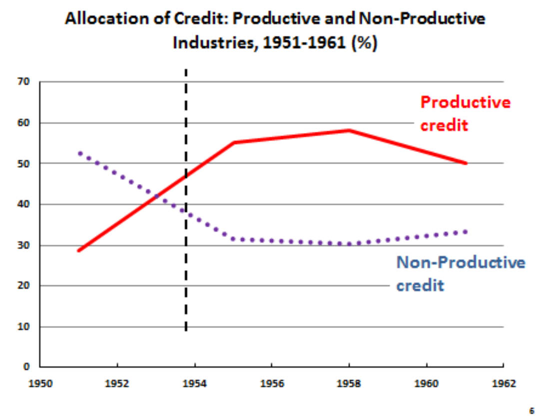


Figure 4

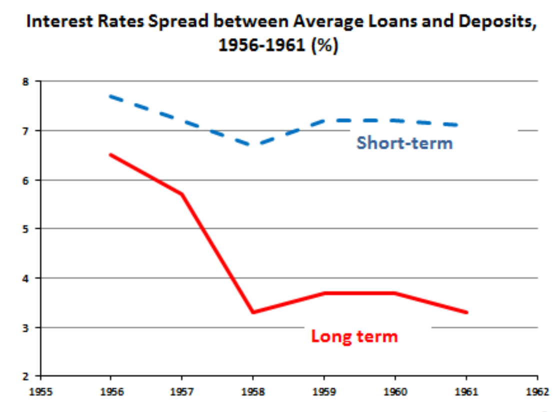
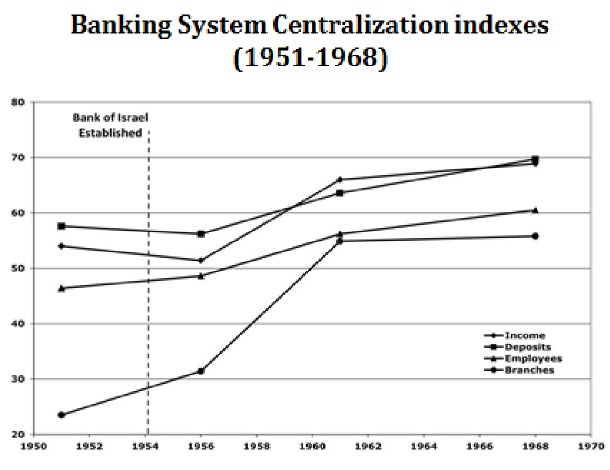


Figure 5:



Tables

Table 1:
Bank of Israel Advisory Committee Composition (as of 1954)

Advisory Committee Member	Position outside or before appointed to the committee
Eliezer Hoofien (chairman)	Chairman of Bank Leumi Board of Directors
Avrham Zbarsky	Director of Bank Hapoalim
Yitzchak (Ernst) Nebenzahl	Legal consultant; Bank Yefet (1933-1943); Board member of Bank Leumi
Giora Yoseftal	Jewish Agency executive board member (1947-1952); Secretary General, Mapay (1956-1959)
Kadish Luz	Ministry of Agriculture
Shimon Bejerano	Industrialist; PM, General Zionists; Member at the Industrialist Association; Bank Leumi, board member
Elyakum Osteschinsky	Agronomist

Table 2:
Monetary committee (as of October 2011)

Member	Position
Stanley Fischer	Governor
Karnit Flug	Vice Governor
Barry Topf	Advisor to governor
Reuben Gronau	Hebrew University
Rafi Melnick	Vice President, IDC
Alex Cukierman	Tel Aviv University