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CENTRAL BANKING IN A DEVELOPMENTAL STATE:

THE CASE OF THE BANK OF ISRAEL IN THE POSTWAR PERIOD

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Central Banking in a Developmental State: The Case of the Bank of Israel in the Postwar Period

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Abstract: During the post-WWII period dozens of central banks were established in developing economies. The common conception is that most of these central banks were weak institutions that functioned as a technical arm of the government. In this paper I seek to reframe this conception. I argue that despite the fact that central banks in developmental states were not endowed with the autonomy to pursue price stability, they possessed extensive regulative powers in the issue-area of banks' supervision. These extensive powers were used to execute selective credit policies, which deemed essential for industrialization. The analysis has the potential to shed a new light on the transition of central banks from the developmental to the regulatory state. While most accounts of this transition underline the rupture, the analysis presented here identifies potentials of continuities.

Key words: Central Banking; Developmental State; Regulative State; Israel; Policy Translation; Legal Transplant; Administrative Infrastructure; Legal Infrastructure.

Central Banking in a Developmental State: The Case of the Bank of Israel in the Postwar Period

Introduction

During the postwar period (1946 to 1975), more new central banks were established than in any other three consecutive decades. From 49 in 1946, the number of central banks grew to 131 in 1975. Most of these central banks were established in developing countries after they became sovereign states.[1] What were the considerations that led policy makers in the newly established sovereign states to establish central banks?

The common conception among economists is that during the postwar period central banks were relatively weak institutions and that they functioned as "a junior branch of the Treasury" (Capie, Goodhart, and Schnadt 1994, p. 24). Particularly, in developing countries the central bank "was subservient to its government and used, in the main, to fill a large gap between government expenditure and conventional tax revenue" (Fry, Charles. A.E Goodhart, and Almeida 1996, 112). This conception has been often adopted by political scientists and sociologists (Maxfield 1997; Polillo and Guillen 2005; Maman and Rosenhek 2009;).

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[1] During the postwar period the numbers of central banks in the world almost tripled. From 49 in 1946, there were 131 central banks in 1975. Most were established in developing and postcolonial countries: 26 in sub-Saharan Africa, 18 in the Middle East and North Africa, 16 in Latin America, and 14 in East Asia and the Pacific. The rest were founded in South Asia and Europe. The dates of central bank inception were taken from Morgan Stanley 2002. Regional division of the World Bank (web.worldbank.org).

Contrary to the evaluation of contemporary scholars, policy makers and experts that were engaged in the creation of new central banks during the 1950s and the 1960s, had a completely different opinion regarding the power of central banks. Robert Triffin, an economist in the Federal Reserve System, who was engaged in monetary consultation to Latin American countries, wrote that the new bills provided to central banks "broad powers almost without precedent" (Triffin 1946, 72). Bloomfield, an economist in the Federal Reserve Bank of New York, who also provided consultations for developing countries (Alacevich and Asso 2009) stated that new central banks "are characterized by unusually wide and flexible powers" (Bloomfield 1957, 191. See also Brimmer 1971; Kim 1965). This view, if valid, can explain the choice of policy makers in large number of developing countries to establish a central bank. Central banks, according to this view, provided states with essential capacities in order to regulate their financial systems.

This interpretation implies that instead of distinguishing between "strong" and "weak" central banks as absolute adjectives, central banks should be classified according to their objectives, capacities and instruments. Such approach is more inductive in the sense that it does not assume what the objectives of central banks should be, but it generalizes on the basis of concrete cases. According to this approach, I suggest that central banking practices in developing countries, at least in many of them, were sufficiently unique that it is justifiable to construct an ideal type of *developmental central banks*. The ideal type of the developmental central bank is distinguished from the orthodox model of central bank that was promoted by Bank of International Settlements (BIS) and the IMF in the Bretton Woods era, and which was common in advanced market-oriented economies, most of them European. However, the primary aim of this letter would be characterize the central banking practices in the case of Israel, rather than tracing the process by which the two ideal types of central banking were constructed. [2] This distinction between two ideal types of central banking

[2] This is my task in another work in progress, "Reconsidering the Southern side of embedded liberalism: the issue-area of financial regulation".

practices emphasizes the fact that any analysis of the establishment of a central bank in a developing country, has to address not only for the question why policy makers decided to establish *a* central bank, but also the question why they decided to endow it with certain powers and not others.

The historical analysis regarding the policy-making process that led to the establishing of the BoI has some broader implications regarding the transition of developmental states into regulative states in the case of Israel and other cases. Most accounts portrayed this transition as a rupture. Within the rupture the position of the central bank changed from that of a "technician" to that of a powerful and independent actor (see for example, Maxfield 1997; Polillo and Guillén 2005; Maman and Rosenhek 2009). However, the argument I present here highlight the continuities that prevailed within the process of transition. It suggests that in the passage to the neoliberal era the BoI indeed gained new capacities but it also gave up capacities. This approach is consistent with the view that the passage from the developmental to the regulatory state – or from the Welfare to the neoliberal state – did not lead to the demise of the state but rather that to its transformation (Majone 1994; Levi-Faur 2009; Braithwaite 2008).

The paper proceeds as follows. The first section provides an economic rational for the variation of central banking practices between market-based financial systems and credit-based financial system. It explains why differences between structures of financial systems are likely to bring about a divergence of financial regulation practices. The second section addresses the opposite question: why, despite structural differences, states are benefited from transplanting imported institutions. The section introduces the concepts of *administrative and legal infrastructures*. It claims that central banks were, among other things, administrative and legal transplants that contributed to the capacity of states to achieve various objectives in the issue-area of financial regulation. The third section presents the prevailing explanations for the why policy marking in developing countries would have decided to establish a central

I develop the notion of distinction between the "orthodox" and "developmental" central banking more fully in another work in progress about the diffusion of central bank in the Bretton Woods period.

bank. I argue that prevailing explanations underlines process of policy transfer, diffusion and convergence but they do not explain the variation.

The fourth to the ninth sections present the case the Bank of Israel (BoI). The fourth section describes the period prior to the establishment of the BoI. It explains the reluctance of the government to establish a central bank. The fifth section addresses the issue of credit control. It demonstrates that the helplessness of Israel policy makers vis-à-vis the banking system. The sixth section explains why administrative infrastructure was essential for credit control. The seventh section describes the legal measures, which the BoI used in order to reform the banking system and create favorable conditions for cooperation between the state and the large banks. Finally, the eighth section assesses the effectiveness of the BoI's credit control strategy.

1. Varieties of financial structures

To explain why varieties of central banking were likely to emerge in the postwar period, it is necessary to account for the differences between the institutional conditions in the newly established states and the economies in which central banking were developed. Two aspects of the financial institutional conditions have to be discussed. First, the structure of the financial system itself and second the apparatus by which the authorities govern it.

John Zysman distinguishes between three ideal types of financial structures: market-based, credit based state-managed and oligopolistic credit-based financial structures. Market-based structures are common among advanced economies. Late-developers are likely to adopt credit-based structures and therefore they are more relevant for us. The credit-based state-managed is a system "in which market interrelations are dominated by government administered prices". In this case the state

> intervenes to accomplish particular purposes and the resulting financial structure institutionalizes its discretionary influence in the financial market. The political implication is that the state"s entanglement with industry becomes part and parcel of the financial system. *The borderline between public and private blurs, not simply because of political arrangements, but because of the very structure of the financial markets.* The arrangements between bureaucracy and finance which blur this

> borderline can occur in widely different state structures (Zysman 1984, 72, emphasis in the original).

In such cases the state administered prices directly, often by nationalization of the banking system, as in the case of France.

The oligoplistic credit-based system is one in which "a limited number of financial institutions dominate the system without themselves being dependent on state assistance". In such cases the "government does not have the apparatus to dictate allocative choices to the financial institutions and consequently it has no independent instruments in the financial system with which to influence companies. Banks, however, can serve as policy allies for government, on terms negotiated between the government and finance" (Zysman 1984, 72). In order to gain such capacity the state may create an alliance between the state and the banking system. "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" (Zysman 1984, 77). The political implication of this situation is that in some cases "the state's entanglement with industry becomes part and parcel of the financial system" (Zysman 1984, 72). This ideal type correspond to the case of Germany. Zysman's argument implies, then, that development and growth necessitate either dominant market players or a strong state.

To a certain extent, Zysman's classification can be extended to developing countries in the postwar period. Countries such as Korea Taiwan controlled the banking system directly through ownership (Choi 1993; Cheng 1993) while countries such Thailand, Chile and Mexico maintained a private but regulated banking system (Hastings 1993; Maxfield 1993; Armijo 1993). However, in both cases government employed various instruments in order to control credit (Wade 1992; Evans 2004; Haggard, Lee, and Maxfield 1993). The management of the credit's prices and its allocation by the state was justified, according to this view, on the basis of the fact that in late industrialized economies credit markets were small, undiversified, and unable to adopt the longer-term perspective required to underwrite some socially profitable investments (Haggard and Lee 1993, 6). To solve these problems governments had to step in and to (1) restrict the overall supply of credit, (2) lower the interest rate trough the control over the banking system, and (3) channel the cheap credit to nationally preferred branches and/or individual enterprises.[3]

2. *Transfer of administrative and legal infrastructures*

The structure of the financial system affect policy choices but it does not determine them. Another factor that affect a policy choice is the robustness of the political and bureaucratic systems and their capacities. Despite similarities, European late industrialized economies differed from the Southern cone late industrialized states by the robustness of their political and bureaucratic systems. In the cases of the of France and Germany the political structures were developed enough to enable the state to take an active position in the economy either by nationalization or through a corporatist structure. Developing countries in the post-colonial period possessed neither developed markets nor sufficiently robust bureaucracies.

The literature on the developmental state explains the capacity of the state on the basis of the existence of "elite state bureaucracy staffed by the best managerial talent available in the system", and by a bureaucracy that is "given sufficient scope to take initiative and operate effectively". Unlike the socialist states, the developmental states did not plan the economy but rather employed "market-conforming methods of state intervention in the economy". Market-conforming method are based, among other things, on "the creation of numerous, formal, and continuously operating forums for exchanging views, revising policies, obtaining feedback, and resolving differences" (Johnson 1999, 38-39). All these measures require robust bureaucracies.

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[3] Many economists rejected the notion that preferential credit polices have even been more effective than market instruments in any economy (McKinnon 1973; Shaw 1973; Fry, Charles. A.E Goodhart, and Almeida 1996). The question regarding the best practices does not have a direct implication on the argument I present here. I discuss the effectiveness of the developmental central banks vis-à-vis allocation of resources which local policy makers and experts believed to be the most effective in the current conditions. I do not discuss the effectiveness of developmental central banking vis-à-vis growth and other long-term national economic objective.

A robust bureaucracy is a resource that many developing countries lacked. In Japan, the case according to which the ideal type of the developmental state was formulated (Johnson 1982), the bureaucratic system had had a long tradition. In Johnson's account of the developmental state the bureaucracy is the explanatory variable of the state's capacity. This was also the case in France (Loriaux 1999). The post-colonial states, however, lacked an institutional bureaucratic tradition. Constructing a robust bureaucracy on the basis of local resources is a long, expensive and uncertain project. It was much cheaper, then, for many developing countries to import resources needed for the consolidation of robust bureaucracy.

The literature about policy diffusion (Meyer et al. 1997; Dobbin, Simmons, and Garrett 2007; Elkins and Simmons 2005; Holzinger and Knill 2005) and social learning (Dolowitz and Marsh 2000; Rose 1993; Bennett and Howlett 1992) is abundant with examples that demonstrate why transfer of institutions can be nationally advantageous and "cheaper" than local innovation. The import of institutional arrangements is accompanied by the import of administrative resources just like the import of technological project is accompanied by the import of know-how that promotes local technological capacity in general.

The adoption of an institutional transplant, however, bears the risk of institutional monocropping (Evans 2004), which in some cases can have negative effects on economic performance (Rodrik 2000; Dunning and Pop-Eleches 2004). Therefore, to maximize the local benefit from a transplantation of a policy instrument a balance has to be achieved between copying of a blueprint and local innovation. The balance can be described as a process of translation of a policy instrument.[4] In this section I point out the contribution of institutional transplantation to the state's capacity to govern.

Administrative infrastructure. By adopting an institutional transplant the state may gain administrative infrastructure. The term administrative infrastructure is adopted from the work Michael Mann and Evans and Rauch. Mann defines infrastructure

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[4] The concept of "translation" is employed here in rather loose sense. It includes all cases in which the imported knowledge and practices are being altered. To use Rose classification, it includes emulation, hybridisation, synthesis and inspiration (Rose 1991 table 1).

power as the "capacity of the state actually to penetrate civil society, and to implement logistically political decisions throughout the realm" (Mann 1986, 113). Evans and Rauch points out several bureaucratic features, which contribute to the state capacity to intervene. These features include the production of information about the object of intervention and generalizations that facilitates the formulation of collective actions and their justification. It includes the diffusion of common norms among the state agency and the promulgation of corporate coherence and *esprit de corps*. In includes the existence of material benefit for civil servants such as long time horizons for public servant, predictable and rewarding careers, existence of career ladder and competitive salaries to nurture elitist self-perception with the bureaucracy (Evans and Rauch 1999, 752).

In principle these institutional feature can be created locally. However, the establishment of a central bank as an institutional transplant was an opportunity for government to create a strong administrative instrument supported by foreign forces such as the authority of international institutions and epistemic communities. Like central banks in industrial countries the personnel of the central banks enjoyed from an apolitical status in the local political system which provided them with the legitimacy to intervene and regulate the behavior of private actors in the name of the common or national good.

Legal infrastructure. Legal infrastructure is defined here as set of laws and regulations by which state intervention is legitimized. The literature about legal infrastructure is associated with the conviction that binding law and private property rights are necessary condition for the functioning of the market and economic prosperity (for a survey, see Ogus 2004). This association is based on the assumptions that markets are embedded in institutions such as the law (Polanyi 1985). Neo-institutional economics has shown that strong enforcing institutions cut down transaction costs, the costs of negotiating by enforcing long-term contractual arrangements (Williamson, 1985; North 1990 and 1991).

Central banks have been recognized as part of the legal infrastructure that has facilitated the efficient functioning of market economies in the advanced countries. Central banks functioned as an institutional mechanism of "credible commitment" (North and Weingast 1989). The sovereign committed not to reject its liabilities to private property owners by "delegating" its monetary authority to a private institution. The principle of "commitment through delegation" (Cukierman 1994) assumes that the purpose of central banks is to restrict the authority of the sovereign to intervene to confiscate private property. The legal autonomy of the central bank, according to this view, is a proxy to the commitment of the sovereign the principle of property rights.

The modern theory of central banking, therefore, assumes that any breach of property right is a deviation from the most fundamental principles of central banking. This assumption is the reason why most contemporary economists have described central banks during the postwar period in general and in developing countries in particular as "weak" institutions. Fry et al. underline the instances in which central banking practices in developing countries led to a breach of private property rights. Monetary expansion is described as "seignorage". Seignorage is an ancient term that describes the rate the sovereign charge for minting gold into coins. Therefore, seignorage was a type of a tax. "An analytically intriguing aspect of seignorage as a tax lies in the ability of the central bank to raise the tax rate by expanding the currency issue" (Fry, Charles. A.E Goodhart, and Almeida 1996, 32). Preferential credit policy is described as "financial repression", as unlawful act against private actors. The epistemic and normative assumptions underlines those evaluations are that the central bank has to be the guardian of private property and it should not participate in actions with taxation effects.

However, legal infrastructure is important not only in market-based financial systems but also in credit-based system. This is the despite the fact that the content of the legal infrastructure might be different in credit-based financial system. The legal infrastructure in developmental state did protect private actors and private property rights, but rather it legitimized and coordinated the breach of property rights when the national interests, as were formulated by the bureaucracy, justified it.

According the this conceptual framework, central banks in developing countries provided legal infrastructure just like central bank in market-economies, but this infrastructure legalized different type of regulatory practices. Therefore, the process of establishing a central bank in a developing economy may well be described as a case of *translated legal transplant*. When legal transplant is translated, "legal concepts and practices are transferred on some conceptual levels but not others"

(Langer 2004, 30). This hypothesis can explain the incentives of developmental states to establish relatively autonomous central banks. In credit-based financial systems in developing countries the autonomy of the central bank was likely to enhance the capacity of the state rather than protect the civil society.

3. *Alternative explanations for establishment of CBs in developing countries*

Several explanations have been suggested for the diffusion of central banks in developing countries in the postwar period. First, after the retreat of the colonial powers, central banks were one among others symbols of sovereignty and national prestige. Therefore, local policy-makers believed that central banks and independence currencies would contribute to the respectability of the country in the international community (Helleiner 2003; Uche 1997; Marcussen 2005). Second, developing countries had incentive to establish a central bank in order to attain monetary flexibility, just like advanced country possessed. During the colonial era, currencies in the colonies were managed by currency boards. In most cases, as in the British colonies, the boards pegged local currencies to the imperial key currencies and they held reserve of 100 percent. This monetary arrangement restricted the capacity of local governments to pursue industrialization policies. Therefore, as Helleiner points out, "many policymakers in the South rejected currency boards because they precluded the kind of activist monetary policy that was seen as necessary to serve domestic goals of economic development" (Helleiner 2003, 260).

Scholars like Helleiner and others acknowledged the fact that central banks in developing countries fulfilled developmental practices. However, for economists the developmental practices were subsidiary (Fry, Goodhart and Almeida 1996, 112), for others they implied an abuse of central banking practices[5] and for others the fact that the central bank carried out these practices rather than the Treasury was completely incidental (Maman and Rosenhek 2009). However, no study has been conducted that

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[5] In the index of central banks independence devised by Cukierman et al. central banks that were involved in developmental practices, received lower grades of independence (Cukierman, Webb, and Neyapti 1992).

shows that the developmental practices were the product of a premeditated conception of the role of central banks and the reason for their inception.

The case of Israel does not refute the prevailing explanations, but it demonstrates that they are only partial and that they cannot explain all cases. The case of Israel demonstrates that, first, the government achieved monetary flexibility without establishing a central bank but rather by establishing a small department that were in charge of issuing notes, and, second, that the government could resist the symbolic pressures to establish a central bank for several years.

The analysis of the case of Israel will establish, therefore, the following points: (1) Israeli policy makers did not establish the central bank in order to maintain price stability, or to gain monetary flexibility; (2) Israeli policy makers established a central bank in order to solve the local problem of credit control; (3) once the Bank was established this was its key objective, and it achieved it successfully; (4) the BoI achieved this objective by restructuring the banking system, promoting an oligopolistic banking structure, and nurturing an alliance between the large banks and the state; (5) finally, the BoI could achieve this objective due to its administrative and legal infrastructure.

4. The Bank of Israel: Expected costs and benefits

The economic performance of Israel during the first decades has often been described as “miraculous”. The gross national product’s (GNP) average annual rate of growth was 9.1 percent for the period 1951 to 1964. During the same period the GNP per capita rose in an annual average rate of 4.9 percent (Ben-Porath 1986, 28). The rapid growth is partly explained on the basis of “import of capital”. During the period from 1949 to 1959, the import of capital comprised 68 percent of the import, of which 72 percent were unilateral transfer originated in the reparation from the Western Republic of Germany, Jewish Organization and the government of the United State (Michaely 1963, table 10, p. 23 and table 18 p. 39). The reliance of the economy on state-led import of capital made the capacity of the state to allocate resources an essential link in the process of industrialization.

In the first years following the establishment of the state the government engaged in two large-scale activities that were conceived by policy makers nationally urgent. First, immediately after the declaration of independence, Israel was engaged in war with its Arab neighbours. According to one estimation the war necessitated around 40 percent of the GDP between 1948 and 1949 (Greenberg 1988, 69). Second, during those years the population of Israel grew from 900 thousands in 1948 to around 1.7 million in 1953 (Halevi and Klinov-Malul 1968, table 7, p. 40). The rapid population growth required high share of the public expenditure.

The government financed its high expenditure through taxes, import of capital, and deficit spending ("money printing").[6] The reliance on deficit spending created a disincentive to establish a central bank. Instead of a fully-fledged central bank, the Israeli currency was managed by the *issue department*. The issue department was established after the British currency board was abolished as soon as the British mandate was terminated (Gross 1999, 201-02). It was run by Bank Leumi, the largest commercial bank in Palestine at the time.

Initially, the law instructed the department to maintain 100 percent cover, 50 percent of which had to be in gold or key foreign currencies. After the first year, this arrangement turned out to be too restrictive, and the requirement for gold and key currency reserves was cancelled. Instead, the government issued non-commercial "land bonds" (Shitrot Mekarke'in), which they could use as reserve in exchange for loans from the issue department (Kleiman 1977; Barkai 2004).[7] As there was no practical limit to amount of land bonds the government could have issued, the monetary flexibility of the government was restricted only by its own discretion. Indeed, during the years 1949-1951, the volume of money, M_1, increased at an average annual rate of 34 per cent (Barkai 2004, 51).

[6] Until 1952 the main sources of capital import were from Jews in the Diaspora and the US government. From 1953 the reparations from Germany almost equalled transfers from the Jewish Diaspora. See (Halevi and Klinov-Malul 1968, 246, table 11) See also (Barkai 2004, 51)

[7] Officially, this arrangement implied that the government used the territory of the country as collateral for its loans. In practice, it meant that there was no technical limit to the supply of money.

Another factor that played a role in the decision to postpone the establishment of a central bank was the membership in the IMF. Joining the IMF was a double edge sword from the point of view of local policy makers. On the one hand, they feared that joining the IMF would involve "intervention" in the Israeli policy-making process and "restriction" of the government discretion, as it was explained in the Finance Committee (Finance Committee, 4.11.53). Although in hindsight the IMF did not exert strong pressures on members countries (Ruggie 1982; Helleiner 2003), in the early 1950s policy makers experience uncertainty regarding the expected rigidity of the IMF towards the peripheral countries. On the other hand, joining the IMF was an opportunity to improve the country's "prestige in the international financial world" and to open up an access to "these large amounts of money that the World Bank lends to countries who seek development" (Finance Committee, 4.11.53).

Taking into account the expected costs and benefits, policy makers in the government were inclined to postpone the establishment of a central bank. As late as 1952, the Minister of Finance said that the time "is not ripe" to establish a central bank (Parliament, 9.7.52, 2601). Another member of parliament explained that "the experts with whom I was talking to said that objectively this is not the time" for establishing a central bank (Parliament, 18.2.52, 1340).

It should be pointed out that the question whether to establish a central bank or not was separated from the question regarding the type of policy the government had to pursue. The question at stake was not, which type of policy the government should pursue – austerity of expansionary – but which body should have the authority to decide about that matter. The reluctance of the government to establish a central bank stemmed from the view that whatever the desired policy was, it should be authorized by the government and not by a professional body. As one of the MP asked, "what is the constitutional basis, as well as the moral, that endows this group of people – be it genius and with unique banking skills as it may – with the authority and the right to be in conflict with the public and the government? Is it its perfect objectivity?" (Finance Committee, 29.7.54, p. 6)

The reluctance of policy makers to establish a central bank suggests that in the early 1950s policy makers in Israel still conceived central banks to be conservative and independent institutions, very similar to the traditional British model. The primary objective of central banks according to the British model was price stability (or exchange rate stability). These types of central banks had the authority to reject the government's demand for loans (Capie, Charles Goodhart, and Schnadt 1994, 10; Sen 1952, 2; Eichengreen 1996). In the interwar period this model was globalized by a collaborative effort of the the Bank of England, the Federal Reserve Bank, the League of Nations and the Bank of International Settlements (BIS). During this period central banks that followed the British model were established in Latin American countries and other areas (Schuker 2003; Marcussen 2005; Drake 1989; Plumptre 1940, pp. 183-201). In the postwar period the appeal of the British autonomous central banks significantly impaired but did not vanish. The BIS still had some capacity to influence policy makers, mainly in European countries, to adopt a more conservative financial regulation practices. In 1956, Per Jacobsson, a major figure in the BIS, became the Director of the IMF and continued to promote the adoption of more conservative central bank in European countries (Auboin 1955, 29-32; Gilpin 2002, 46; James 2003, 80, 84). Therefore, the fear of policy makers in the early 1950s that a central bank might undermine the monetary flexibility of the government was not without foundation.

5. *Local problem: The political economy of Selective Credit control*

The decision to establish a central bank was eventually taken in February 1953. The government decided to nominate David Horowitz, who had been previously the Director General of the Ministry of Finance, to establish the Bank and direct (Government n.d., 8.2.53). What were the factors that led to the change of mind?

Between 1950 and 1953 the government made repeated attempts to restrict the volume of credit and to differentiate between "productive" and "unproductive" credit. For that purpose it used the powers granted to the department of bank supervision that was part of the Ministry of Finance. The banks' supervisor instructed commercial banks to increase their reserve ratio requirements. Initially, in 1950, the ratio was set on 45 percent. Later on it was increased to 75 and to 90 percent. However, this instrument proved to be ineffective. The commercial banks attracted deposits and savings form the public and therefore they could expand credit without breaching the reserve requirement. There was also a suspicion that the commercial banks did not obey to the banks' supervisor instruction (Bar-Yosef 1955, 420 check; see also, Bar-Yosef 1953; Bar-Yosef 1961).

The incapacity of the government to restrict the growth of credit led to a confrontation between the government and the banking system. The representative of the government in the *Banking Committee* – a voluntary body for coordination between the government and the banking system (Bar-Yosef 1953) – accused the banks that they "provided credit beyond the reserve requirements" and that this was the cause for the "inflationary signs" in recent months (Banking Committee, 23.8.1953). The director of the large banks put the blame back on the government. The banks, they claimed, provided credit to the government itself and to factories that had been built with government support and "would not be able to operate unless they get bank credit" (Banking Committee n.d., 26.1.1954).

Israel has often been referred as a "strong state" (Migdal 1989; Kimmerling 1983; Migdal 1996). "The Israeli state's internal strength is demonstrated by its high capacity to recruit internal human and material resources for collective goals", observed Kimmerling (Kimmerling 2005, 3). However, despite the strength of the state in certain issue-areas, it did not possess the capacity to control the banking system. Controlling the banking system in a mixed economy required market conforming methods of regulation, that the state lacked.

The conflict between the government and the banking system was aggravated due to the diffused structure of the Israeli banking system. As a study conducted by the Federal Reserve Bank of New York showed, a "commercial banking system consisting of a small number of banks with widespread branch networks lends itself more readily to [selective credit control] than a unit banking system consisting of a great many independent banks" (Fousek 1957, 78). The banking system in Israel was indeed decentralized and in the period up to the establishment of the BoI new banks had been established.

Moreover, in the early 1950s the small banking institutions in the periphery were quite successful in attracting short- and long-term deposits. Between 1950 and 1956 the small institutions, most of them were Credit Associations, were quite successful than the large banks in attracting deposits. During this period, they increased volume of deposits in 464 per cent while the commercial banks online in 335 percent (Het 1966, tables 24 and 34, p, 107, 124).

There are two factors that explain the success of the small banking institutions. First, the geographical distribution of the small banking institutions, most of them credit associations, enabled them access to areas in which the large banks did not have branches. Secondly, in the era under discussion the law dictated that the maximal interest rate allowed was 9 percent.[8] In practice, the large banks complied with the law as they were under the close surveillance of the supervisor of banks and the government. Moreover, the two largest banking institutions were owned by semi-public institutions. This affiliation provided them with a edge over the small institutions, but it also required them to be more "disciplined".[9] Therefore the large banks could not charge higher interest rates than the 9 percent decreed by the law. The small and peripheral banking institutions, on the other hand, provided credit in higher interest rates and therefore they could have offered higher interest rate to depositors.[10]

The success of the small banking institutions posed a problem not only to the large banks but also to the state: not only that they provided expensive credit but they also provided it for consumption. The large banks claimed that "a way has to be found to enforce the credit restriction instruction on all institutions" (Bank of Israel, 21.12.1954, p. 2). They also threatened that if something will not be done, "after they

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[8] The Ottoman interest law did not forbid higher interest rate than 9 percent but it stated that the lender was not entitled to legal support (Barkai 2004, 79).

[9] Bank Leumi was owned by the Jewish Agency and Bank Hapoalim was owned by the Labour Federation, which was controlled by the dominant party, *Mapai*. See Het, *Banking Institutions in Israel*, p. 40.

[10] There is no direct evidence for the practice of the small banking institutions besides the discussions in the Advisory Committee in the BoI in which the members distinguished between a small number of "loyal" and "disciplined" banks and the others. The director of the largest bank in Israel and the Chairman of the Committee warned that if this problem would not be solved also the large banks would have to raise the interest rate. "The loyal banks waited years and they will not wait anymore. After they warn the government and the Bank of Israel they also will raise their interest rate" (Bank of Israel, 7.3.1955, p. 3).

warn the government they will also raise their interest rate" (Bank of Israel, 7.3.55, p. 2). Therefore, up until the establishment of the BoI the banking system developed in a path that was not was not consistent with the national strategy of industrialization.

6. Administrative resources

The driving force for hastening of the establishing of the central bank was the expectation of policy makers that a central bank would assist the government to allocate credit. More than any other government member, the person who was engaged in the issue of allocation of credit was the Ministr of Agriculture. In 1953 the Minister of Agriculture managed to convince several commercial banks to cooperate with the government and to create long-term cheap credit for agriculture. The banks committed to channel 20 per cent of their credit to agriculture with a government collateral. His experience of negotiating with commercial banks over credit allocation led the Minister to the conclusion that "allocation of credit would be one of the most important [policy instruments] during a very long period" (Government n.d., 12.5.54, p. 15). The Minister of Agriculture, therefore, assumed that a central bank would serve as "an instrument of credit control" (Government n.d., 12.5.54, p. 14).

The question arises as to the specific resources and capacities that the central bank was expected to provide the government. A distinction should be made here between general administrative infrastructure and specific legal infrastructure, which provided the state with specific capacities in the issue-area of financial regulation.

As for general administrative infrastructure, the central bank was expected to enhance the capacities of the state by providing it with three types of resources. First, the BoI provided epistemic resources that enabled formulation, execution and the legitimisation of public actions that necessitated the confrontation of dominant societal actors. Specifically, the Research Department of the Bank enabled to produce independent surveys and analysis about the banking system, and thereby challenge the banks claims in case of disagreements.

Experts in the field of central banking highlighted the importance of information for central banking in developing countries:

> The right to inspect and demand information form banks is not a separate instrument of control, but it is valuable as providing the raw materials of control. If the central bank is to secure prompt, effective and continuous control over the money market, it must have full knowledge of the material facts of the market. It must possess complete information about the portfolios of the bank.[11]

Secondly, the BoI was a hub for the consolidation of cohesive and loyal bureaucracy that shared common beliefs and norms regarding policy making in Israel. The salaries of the BoI's employees were unique to the Bank and higher than that of civil servants in the government. Moreover, the budget of the BoI was not overseen by the government or by the parliament.[12] The financial autonomy of the BoI contributed to its status vis-à-vis the political and societal actors.[13] The superior employment conditions in the Bank enabled it to attract young students and graduates from the Hebrew University's Economics Department. The Economic Department was inaugurated in 1949 and was directed by the Don Patinkin, a leading American economist who emigrated to Israel and nurtured an cohesive epistemic community of economists that shaped the Israeli policy discourse (Krampf, forthcoming).

Thirdly, the central bank bill dictated a very hierarchical and centralized management structure. It endowed the governor with a wide legal inventory of policy instruments and discretionary flexibility. Specifically, the central bank bill unified the monetary authority and the supervisory authority and delegated it to the governor. The powers of the governor made "it possible for the Bank to act arbitrarily and indeed in a

[11] David Horowitz, the first the governor of the BoI and the key figure in the formulation of the Bank's bill quoted this paragraph from S. N. Sen's, *Central banking in underdeveloped money markets* (Sen 1952). David Horowitz,. 1954. Comments on Gass" and Lerner"s report on Bank of Israel bill. May 2. State Archive, 5617/13-ג.

[12] The Bank financed its expenses from its profits on deposits in foreign banks. The profits were transferred to the state, after the Bank discounted its expenses (interview with BoI emplyee).

[13] Cukierman uses the variables "who determines the budget of the central bank" and "who determines the salaries of high central bank officials" as indices of the actual independence of the central bank.

discriminatory and tyrannical manner towards banks with which it is for any reason displeased".[14] It was claimed that the bill provided to the Bank with "unbalanced authorities". It was endowed with, "on the one hand, dictatorial authorities over the banking system, on the other, [with] restricted authorities to regulate the economic and financial policy of the government" (Perger 1973, 1952).

The excess of powers was not unique to the Israeli case. Rather it was one of the characteristics of the emergence model of central banking in developing countries. As it was pointed out by Sen, central banks in developing countries have been "granted, either by statutes or by mutual agreement, the authority to exercise a general control over the lending policies of the commercial banks, including the power to restrict the grant of loans for particular purpose… These powers are more far-reaching than any that have been entrusted to a central bank at any time.[15]

7. Reforming the banking system

In the period after the BoI was established, the banking system went through a rapid and intense process of concentration, which was described as "revolutionary" (Gross 1995, 238). Within a short period of time the system went through a radical process of centralization. In 1950 there were 108 banking institutions (commercial banks and credit associations) with 96 branches. Until 1953 the number of banking institutions continued to grow and reached 118 institutions (Het 1966, 47, table 11). In 1956 the trend reversed and the number of banking institutions dropped sharply. By1960 the number of banking institutions declined to 53, while the number of branches increased exorbitantly to 559 (see graph 1).

The "revolutionary" change is also demonstrated also by other indices of central bank centralization during this period. Graph 2 presents four indices of the centralization

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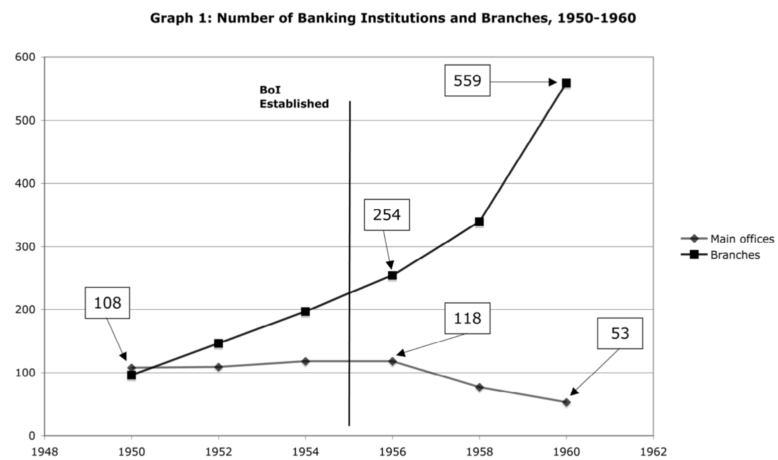
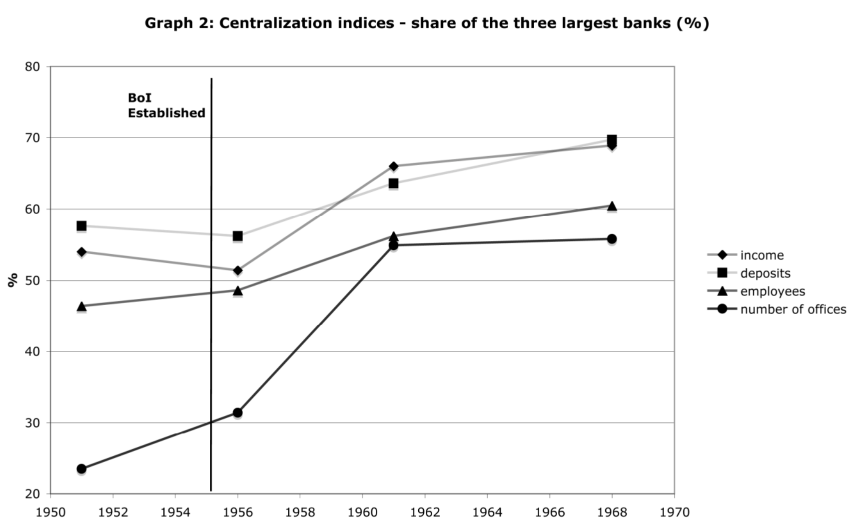
[14] Lerner, Abba P. 1954. Memorandum, Economic Advisory Staff. Economic Advisory Staff, April 27. State Archive, 5617/13-ג.

[15] Horowitz, David. 1954. Comments on Gass" and Lerner"s report on Bank of Israel bill. May 2. State Archive, 5617/13-ג., p. 20, emphasis in the original.

level of the Israeli banking system during the 1950s: the share of income amongst the largest three banks, the share of deposits, employees and number of branches. Two of the indices demonstrate that the centralization level of the banking system fell between 1951 and 1956. Then the trend changed and the concentration level rose rapidly. The index of the number of branches increased also before the establishment of the Bank, but in a slower pace. Only the index of share of employees, increased in almost steady rate throughout the whole period from 1951 to 1958.



Source: Source: (Het 1966, table 11, p. 47).



Source: (Het 1970, table 8, p. 58)

The reform of the banking system and its timing suggests that the policies of the BoI were responsible for the structural change. For our purpose it is important to examine exactly what were the instruments by which the reform was achieved, what were the purposes of the reform, and whether these purposes were achieved successfully.

7.1. Legal instruments of financial regulation

Generally speaking, a process of centralization of banking systems can be explained on the basis of the principle of imperfect competition. According to this explanation large banking institutions produces economies of scale in which the cost of a marginal unit of service is cheaper for large institutions than for smaller, offer cheaper products and their profits rise. With time, the competition leads to mergers and bankruptcies of small institutions and eventually to concentration of the system (Yosha, Blei, and Yafeh 2004, 150-151). However, in the case under study, this explanation is not sufficient. First, as we have seen, before the establishment of the BoI it was rather the smaller banking institutions that flourished rather than the larger ones. Secondly, the timing in which the trend changed (graphs 1 and 2) suggests that the policies of the BoI affected this process. This hypothesis was raised by several historians and economists (Shuv 2003, 8; Het 1994; Yosha, Blei, and Yafeh 2004), however, so far no study has traced the specific policies that let to this outcome.

The analysis I present here is based mainly on the examination of the minutes of the Advisory Committee of the BoI. Despite the fact that officially the Committee was only an advisory body, in practice it functioned as a board of directors. The unwritten rule was that any decision of the Committee had to be approved unanimously. This rule implied that each member had a veto power. In addition to the governor, the most influential members in the Committee were the directors of the two largest commercial banks, Bank Leumi and Bank Hapoalim. The director of Bank Leumi was also the chairman of the Committee. Due to the fact that the bankers were the only members in the Committee that had hands-on experience in banking, and due to their power as economic actors, their power in the Committee surpassed their relative voting power. In practice, any decision necessitated the agreement of the governor and the large banks. Hence, for practical purposes, the Committee was a forum in which the governor and the large banks negotiated issues of financial regulation in Israel.

In the first years after the establishment of the Bank, it did not deal with monetary policy issues. According to Barkai, the Bank started using its monetary powers only in the beginning of the 1960s (Barkai 2004, 89). In the 1950s, the Committee was mainly engaged with the issue of financial regulation, credit allocation and the restructuring of the banking system. Three types of consideration, with different levels of significance, shaped the policies of the Committee. First, the directors of the large banks represented the interests of the large banks and to a lesser extent the interests of the banking system at large. They sought after profit and economic dominance. The governor represented the national interest as he conceived them. There were two competing aspects to the national interest: maintaining a competitive banking system and the creation of developmental credit. Shortly after the BoI started its operation the governor realized that the two aspects were not consistent with each other. The governor realized that he had to sacrifice the goal of maintaining a competitive banking system in favor of developmental credit. This was the basis for collaboration between the BoI and the banking system: the BoI protected the system from competition and in exchange the commercial banks cooperated with the selective credit policies.

This strategy was not preplanned. Rather it was the product of cumulative process of negotiation between the governor and the large banks. For our purpose, the crucial point is that the negotiation power of the BoI was based on its legal instruments. During the years 1955-1958 the BoI used its legal supervisory powers in a way that affected the redistribution of income in favor of the large banks. This was done, in most cases, after the large banks exerted pressure on the governor. In hindsight, this series of policies cumulated to what can be described as a strategy. It is possible to identify five instances in which decision made by the Advisory Committee (and in one case by the government) led to redistribution of income among banking institutions in favor of the large banks.

Rediscount loans. An important instrument by which the BoI allocated credit was the rediscounting of bills. In market based financial systems rediscounting of bills was used to affect the demand for money through the mechanism of the interest rate (Sayers 1950, 49-50; Fousek 1957, 13-30). In Israel, as in other developing countries, it was used as an instrument credit control (Het 1966, 95). Only certain companies were eligible to rediscount bills. In most cases, eligibility was determined according the branch of activity. The commercial banks that participated in the transaction as intermediaries between the BoI and the company profited from gap between the interest rate charged by the BoI and interest rate they charged the credit receiver.

Initially, the governor planned to distribute the right to execute rediscount loans according to an "objective criteria" such as "in proportion to [the banks"] volume of deposits… or their credit reserves". Otherwise, he was concerned that the BoI would be accused of "not treating all banks equally" (Bank of Israel, 11.1.55). The directors of the large banks rejected this criterion. "In such action" they claimed, "one should not take into consideration what is good for the banks, but rather what is good for the economy". The bankers in the Committee assumed that the national interest justified discrimination between banks and that only the "trustworthy" ones would be used as financial intermediaries. "The BoI has no choice but to discriminate to some extent between the banks" (Bank of Israel, 11.1.55). The position of the bankers was supported by the advice of an expert sent from the *World Bank*. His opinion was that "we should not divide it amongst all banks because some of them would receive only small portions, and we would not be able to supervise them effectively" (Bank of Israel, 18.1.55, p. 2). Eventually the governor and the banks' supervisor accepted this opinion. It was decided that out of 118 banking institutions only 22 were participated in execution of rediscounting bills. In practice, most transactions were carried out by the five largest banks, and 60 percent of the loans were executed through the three largest banks (Bank of Israel, 29.11.55).

The issue of the rediscounting loans was the first case in which the national interest justified discrimination between small and large banks. It was also the first case in which the Committee employed professional considerations and legal powers in order to justify discriminatory policies.

Licensing new banks and branches. As the BoI was established, the governor did not oppose licensing of new banking institutions. "We have never decided against licensing of new banks" (Bank of Israel, 24.1.56). However, when the cooperation between the BoI and the large banks consolidated, the position of the governor changed. In 1959 the governor argued that "our policy is that no licenses for new banks would be issued, but only in exceptional cases" (Bank of Israel, 20.1.59). The restriction of licensing new banks was accompanied by the policy of none intervention in regard to new branches. This was despite the fact that the governor, as well as the banks' supervisor, held the view that there was no "difference between opening of new branches and opening of a new bank" (Bank of Israel, 24.1.56).

Credit Associations fees reform. Another case in which regulatory measures were used to centralize the banking system was the reform of the credit associations' fees bill. In October 1954, two months before the official inauguration of the BoI, the Ministry of Finance prepared a bill, which canceled the privileged status of credit associations in relation to commercial banks. Until the law was enacted credit associations were regulated by the *Registrar of Cooperative Societies* and they were exempted from fees. The bill was justified by the Ministry of Finance on the basis of legal and technical considerations: some credit associations were as large as small banks and therefore it was argued that they had be regulated and taxed as regular commercial banks. Parliament members, both from the right and form the left, argued that the fees' ladder proposed by the law was regressive, in the sense that smaller institutions were charged higher percentage than the larger. This was indeed the case. The largest credit association, for example, with total membership fees of 1,000,000 Li and beyond, payed only 0.8 percent or less tax. A credit association with a total membership fees of 100,000 Li had to pay 3 percent tax (Parliament, "Fees Bill", 1955, vol. 17 p. 1776). The critics of the bill claimed that law would lead to the abolishing of the small banking institutions and to "transfer economic resources to fewer hands" (Parliament, 23.5.55, vol. 17, p. 1689).

Reserve requirements reform. The most significant policy initiative of the BoI during its first five years was the credit control system reform. Until the BoI was established, the supervisor of banks employed two types of credit control: reserves ratios that were declared publicly and were homogenous in the banking system, and "volume" or "ceiling" instructions, that were not published and were different from bank to bank. The combination of the two types of control caused discrimination between small and large banking institutions in favor of the large. Small banking institutions attracted more deposits than large banks. However, due to the fact that they reached their "ceiling" requirements they could not expand credit, and therefore their reserve ratio were significantly higher than those of the banks. In early 1957 the average reserve ratio held by credit associations was 57 percent while among commercial banks it was only 36 percent (Bank of Israel, 9.4.57, p. 3).

In 1956 the governor and the banks' supervisor decided to eliminate the "ceiling" instructions that were discriminatory and cumbersome and use only the reserve ratios. Such a change was expected to affect the distribution of income amongst banking institutions in favor of the small banks as they would be able to expand their credit. The reform raised harsh opposition within the Advisory Committee. The reform, it was claimed, would "change radically the structure of the banking system" and it would "shatter the banking system and damage reputable banks" (Bank of Israel, 11.9.56). The governor accused the Committee members for promoting the interests of the large banks rather than the national interests and he pledged them to enable the Bank "to use the reserve ratios as an efficient instruments for allocation of credit" (Bank of Israel, 18.6.57). At that period most of the Committee member were associated with the large banks in that way or another.[16]

The pressure of the Committee members forced the governor to compensate the large banks for their expected losses. First, it was decided that banks would be able to use both domestic and foreign currency as reserve assets irrespective of the currency of the deposits. This arrangement favored the large banks as they held larger portions of foreign currency.[17] In addition, the governor agreed to exempt deposits of public organization from reserve requirements (Bank of Israel, 16.5.57). Like in the previous case, also in this one it was the large banks that were benefited from this concession, as they held larger share of the government's deposits (Het 1966, 136-137). In addition, the governor exempted the credit that the banks provided for exporters ("documentary credit", or "letter of credit") from the reserve requirement (Bank of

[16] Hoofien, the chairman of the Committee, was the director of Bank Leumi, Zbarski was the director of Bank Hapoalim, Bejerano and Ostenshinsky served in the board of directors of Bank Leumi, Ernst Nevenzal was the legal advisor of Bank Leumi and Giora Yoseftal was a member in the Executive of the Jewish Agency which owned Bank Leumi (Krampf 2009)

[17] In 1961 86 percent of "foreign residdent"" ("Patach") deposits were held by the five largest banks and 80 percent of the short-term foreign currency depostits ("Pazak" and "Tamam") were held by the three largest banks (Het 1966, 129). Therefore, this concession contributes to the income of a small group of banks that held the dominant portion of foreign currency.

Israel, 23.4.57). This exemption benefited mainly the large banks that were eligible by the government to provide credit in foreign currency.

The five instances discussed above had three things in common. First, all cases involved the regulatory powers of the central bank. Second, most of them were the outcome of a negotiation between the governor and the large banks. Thirdly, they all affected the distribution of income within the banking system in favor of the large banking institutions. These policies increased the centralization of the banking system and the latter acquired an oligopolistic structure.[18] This structure facilitated the control over the allocation of credit. Between the BoI and the large commercial banks a pattern of cooperation was consolidated. As the governor described this cooperation, "[the BoI] examines the value of the loans from the perspective of the national economy. The commercial banks examine the security of the loans" (Bank of Israel, 29.11.55). The collaboration between the BoI and the commercial banks led to a relationship of mutual-dependence: the BoI was dependent on the cooperation of the banking system for effective allocation of credit, while the commercial banks were dependent on the BoI for their profitability.[19]

One of the important questions that arise from the analysis is whether the practices of the BoI were an abuse of its power or rather the performance of professional principles. According to orthodox theory of central bank those practices were indeed an abuse of powers. However, if we accept that central banks in developing countries

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[18] In parentheses, it is interesting to point out that this instituional solution was not essentially different from the process of the establishment of the Bank of England. As Broz has shown (Broz 1998), even if in retrospect the existence of the Bank of England led to the consolidation of an institutional arrangement of "constitutional commitment", as North and Weingast have claimed (North and Weingast 1989), in order to overcome the problem of free riders, the government had to endow a small group of private actor with privileged position in the banking system in exchange for funding the national debt. Despite the differences, the principle that a monopolistic financial structure is a solution to problem of free-riding in cases when the state attempts to realign private and public interests hold in both cases.

[19] The pattern of "mutual-dependence" I describe here is very similar to what Weis describes as "governed interdependency" (Weiss 1995) and Evans as "linkages" between the state and private institutions (Evans 199).

were designed to achieve different objective by different instruments, we may argue that the BoI operated according to professional principles.

8. The effectiveness of the BoI"s strategy

The question whether the practices of the BoI were politically or professionally oriented is not a simple one. There are no clear and simple criterions to distinguish between cases developmental states and predatory states (e.g., see Evans 1992). In both cases state institutions intervene in the market in a way that negates the will and interests of individual actors. However, in the first case it is assumed that the state's actions promote the long-term interests of the nation at large, while in the second it is assumed that the state is captured by societal groups and the long-term interests of the nation are jeopardized.

To assess whether the BoI was developmental or predatory we may examine the success of the BoI to create developmental credit. We will compare the availability of developmental credit before and after the establishment of the Bank. Developmental credit is identified by three factors: its allocation, its price, and its temporal structure. If the allocation of credit to productive purpose grew significantly, interest rate was lower and the volume of long-term credit expanded after the establishment of the BoI, we may conclude that the BoI was developmental rather than predatory, and therefore that it functioned according to professional considerations and it was it relatively autonomous vis-à-vis political and private actors.

Table 1 presents the distribution of "regulated" and "unregulated" credit according to branches in selective years between 1951 and 1961. The data demonstrates the improvement in the capacity of the state to channel credit to "productive" branches through the banking system. In 1951, 43 percent of the commercial banks' credit and 33 percent of credit associations' credit was channeled to unproductive purposes ("others" in the table). In 1955 the percentage fell to 12 and 27 respectively. The share of credit to agriculture and industry rose from 29 percent in 1951 to 54 and 58 percent in 1955 and 1958 respectively (calculated from table 1). It should be pointed out that during the decade the overall volume of credit surged. In 1958 the volume of credit was almost 4 times higher than in 1951. The fact that both the general volume of credit and the share of productive credit increased, suggests a greater capacity of the state to control the credit.

Table 1: Distribution of credit by banking institutions according to branches - "controlled" vs. "non-controlled credit" at the end of selective years (%)

	1951	1955			1958			1961		
	all credit	"unregulated"	"regulated"	all credit	"unregulated"	"regulated"	all credit	"unregulated"	"regulated"	all credit
Banks										
1. Municipalities	6.5	2.5	14.7	7.0	2.5	10.3	6.4	6.3	18.4	11.4
2. Agriculture	16.0	18.1	50.7	30.1	16.4	33.4	24.9	11.9	29.7	19.3
3. Industry	14.1	34.7	18.5	28.7	29.9	39.0	34.5	33.0	27.7	30.8
4. Construction	8.1	6.3	5.8	6.1	6.7	4.5	5.6	6.6	4.5	5.7
5. Tade and commerce	12.6	22.7	5.7	16.4	22.9	9.3	16.1	17.7	15.1	16.6
6. Others	42.7	15.7	4.6	11.6	21.6	3.5	12.5	24.5	4.6	16.2
Sum	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Sum (Milion Li)	120.3	158.9	92.4	251.3	234.8	236.4	471.2	514.3	368.9	883.2
Credit Associations										
1. Municipalities	4.1	2.1	14.0	6.5	1.7	4.9	3.3	4.4	4.4	4.4
2. Agriculture	14.7	17.9	62.7	34.4	14.8	50.0	32.5	17.6	53.1	32.4
3. Industry	7.7	11.7	7.0	10.0	13.8	21.5	17.7	20.5	17.6	19.3
4. Construction	33.2	9.8	5.5	8.2	8.1	2.2	5.1	6.3	9.5	7.6
5. Tade and commerce	6.9	20.0	2.5	13.6	18.6	10.4	14.5	18.0	7.3	13.5
6. Others	33.4	38.5	8.3	27.4	43.0	11.0	26.9	33.2	8.1	22.7
Sum	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Sum (Milion Li)	25.6	66.9	20.0	86.9	40.0	35.0	75.0	65.9	35.7	101.6

Source: Het, table 66, p. 185.

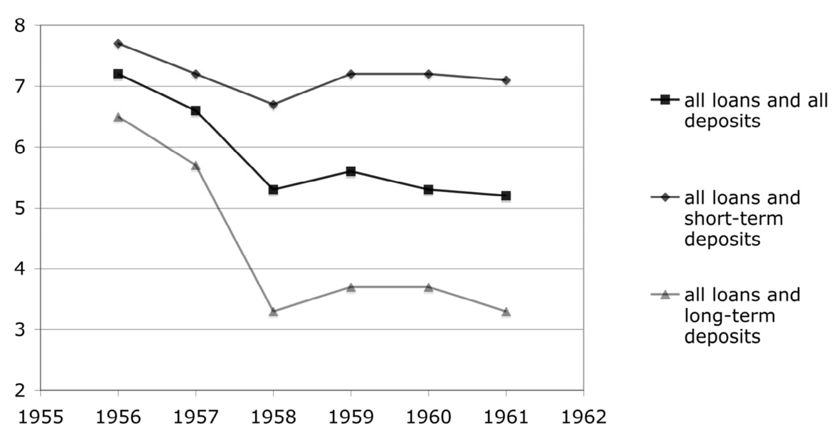
Another aspect that characterizes developmental credit is its temporal structure. Industrialization requires long-term credit in order to facilitate long-term investment project. Underdeveloped banking systems tend to prefer short-term loans, which are less risky (Gerschenkron 1962; Haggard and Lee 1993). The oligopolistic structure of the banking system and its linkage with the BoI created conditions for the provision of larger share of long-term credit.[20] During the period 1952 to 1956, the share of short-term loans of the commercial banks' assets decreased from 39 to 29 percent. During

[20] Richard Tilly argues that such financial system facilitated the industrialization of Germany in the in the late-nineteenth and early-twentieth centuries (Rin 1996, 31). In Germany, however, it was a bottom-up process that initiated by the private actors while in the case under consideration it was top-down process initiated by the state.

the same period the share of long-term loans expanded from 17 percent to 29 percent (Het 1966, tables 67 and 68, pp. 187-8).

Finally, industrial credit requires low interest rate. Graph 3 presents the spread between the debitory interest rate commercial bank charged for loans and the creditory interest rates they payed customers for their deposits. The spread fell from an average of 7.2 percent in 1956 to a minimum level of 5.3 percent in 1958. Another way to estimate the changes of the spread is the profits of commercial banks from financial asset in relation to profit from financial services. In 1950, 80 percent of the commercial banks' income was generated by their financial assets (loans, deposits and securities); the rest, 20 percent, was generated by fees charged for financial services. In 1954, the percentage of income from financial assets fell to 68 percent and then to 63 percent in 1958 (Het 1966, table 83, p. 213). We may deduce that during this period the spread between debitory and creditory interest rate decreased.

Graph 3: Spread between debitory and creditory interest rates (%)



Source: (Bank Israel check 1963, table 20, p. 40)

Two complementary factors can explain decreasing spread. One explanation is that the banking system was "repressed" in the sense that banks were pressured to reduce interest rate they charged for loans and to increased interest rate they paid for saving. The second explanation is that due to the oligopolistic structure of the banking system, the commercial banks could increased the fees for financial services without being concerned by risk of loosing customers. The explanations complement each other: the banking system was repressed and in order to compensate it, the BoI promoted an oligopolistic structure in order to guarantee the profitability of the large banks.

To sum, the evidence suggests that the strategy of the BoI was successful and effective as far as the creation of developmental credit was concerned. During the first decade the capacity of the state to channel credit to preferential purposes through the banking system significantly improved. The share of long-term credit expanded and the interest rate decreased. Therefore, it is justifiable to argue that the BoI fulfilled the expectation of policy makers. This capacity was accomplished with a price. The banking system became centralized, less competitive and the regulatory practices were discriminatory. The policy of the BoI reflected a choice made by the governor to sacrifice the competitiveness of the banking system for purpose of creating developmental credit without nationalization of the banking system. The choice was made on the basis of professional considerations which were shaped by prevailing economic ideas and common practices in the 1950s. The BoI functioned as regulatory agency that enabled the state to execute this strategy more effectively than the government could have executed it.

Conclusion: State, the banking system and central banks

The key question discussed in the paper is what were the considerations that led policy makers in Israel during the 1950s to establish a central bank, and whether the expectations of the policy makers from the central bank were fulfilled. I argued that the BoI was established primarily in order to create developmental credit and that it fulfilled this role successfully. The BoI, I suggested, should best be conceived as a translated institutional transplant. Translation of a transplant is a case of policy transfer that, on the one hand, avoids monocroping by translaiton (Rodrik 2000; Evans 2004; Dunning and Pop-Eleches 2004) and, on the other hand, take advantage of the putative contribution of the imported institution to the consolidation of state's autonomy and capacity. The adoption of the institutional unit of the central bank provided two types of resources, which were scarce in the institutional environment of the young state: administrative and legal infrastructures. These resources enabled the BoI to carry out discriminatory practices on the basis professional principles. The legal and institutional infrastructures were particularly essential in a state that sought industrialization but made the choice not to nationalize the economy.

The analysis explains why most contemporary economists and political scientists have described the central banks during the postwar era, and particularly in developing countries, as weak institutions,[21] while policy makers and experts that were engaged in the creation of these institutions described them as powerful. Most contemporary scholars evaluate the “power” of central bank according to contemporary theory of central banking. The theory assumes that the key objective of central banks is to maintain price stability. According to this approach, the “power” of the central bank is measured by its indepedence vis-à-vis the Treasury to achieve price stability. The conception that central banks were weak during the postwar period is based on the fact that on average, during the postwar period central banks were less independent than in the neo-liberal era (Cukierman, Webb, and Neyapti 1992). However, Cukierman, who was involved in forging the first and the most widely used index of central bank independence, underlines that the index of central bank independence does not measure the power of central banks to do anything they please, but only “the ability of the bank to stick to the price stability objective even at the cost of other short-term real objectives” (Cukierman 1992, 370). Therefore, there is no contradiction between claim that central banks in the postwar period lacked capacities to pursue price stability and the claim that they possessed extended capacities to achieve developmental objectives. In this article I argued that this was indeed the case. As one observer described it, the BoI possessed “unbalanced authorities” (Perger 1973, 1952).

There is nothing new in the claim that central banks in developmental states functioned as agents of development. This is indeed a common conception. However, no study so far has addressed the question what was the institutional advantageous of

[21] One exception is Gerald Epstein. See (Epstein 2005; 2009)

carrying out developmental practices by the central bank rather than by the government directly. In most accounts it was only incidental fact that central banks carried out credit control practices rather than the government. In this paper I sought to show that it was not incidental but rather structural. Central banks provided governments with an apolitical institutional basis, which increased the capacity of the state to confront societal and market players. They enabled governments to confront private actors without completely infringing the principles of market economy.

In that sense, the position of central banks in developmental states was very similar to that of the MITI in the case of the Japanese developmental state (Johnson 1982). Like the MITI, the developmental central bank functioned as a semi-autonomous institution and it possessed wide discretionary latitude. However, unlike Japan, many developing countries lacked the institutional heritage of a robust bureaucracy, and the establishment of a central bank as a translated institutional transplant contributed to the consolidation of the state bureaucracy.

On a more abstract level, developmental central banks were designed under the assumption that the civil society, particularly the market, had to be harnessed to the development of the nation and that this task would require confronting the interests of private actors. Central banks in market-oriented financial systems, on the other hand, were designed primarily to *protect* the civil society and the market from allegedly unlawful sovereign actions. In both cases the central banks employed knowledge, prestige and their legal position in order to achieve those two different objectives.

The analysis of developmental central banking has the potential to shed a new light on the conceptualisation of the transition from the developmental to the regulatory state (Majone 1994; Loughlin and Scott 1997; Hood et al. 1999; Moran 2002; Braithwaite 2008; Levi-Faur 2009). Prevailing accounts of this transition have emphasized *rupture* and the discontinuities. This research direction manifests itself also in studies about the global wave of central bank reform during the 1990s (Polillo and Guillén 2005; Maxfield 1997). Maman and Rosenhek, in their work on the BoI also reaffirm this approach. They explain the central bank reform as the product of the "entering of new actors, local and foreign, that had the power to introduce and promote a new agenda that included, among other things, the increase of the central bank independence" (Maman and Rosenhek 2009, 72). However, any explanation of transition has to account also for the elements that remained constant. Otherwise, the explanation turns into a mere description.

Highlighting the similarities and differences between the central banks in advanced market-based and developing credit-based economies is likely to enable us to identify the continuities that prevailed in the process of central banks reform during the 1980s and 1990s. This conceptual framework rejects the narrative of the "emergence" of independent central banks, in favor of a more complex picture. The global wave of central banks reform was part of a broader transition of the matrix that consisted of domestic governments, markets, central banks and financial systems. When the transition took place, practices of central banks as financial regulators were redefined: their objectives, the instruments and their legal status. The reform of central banks' bill provided central banks with new powers but it also abolish old powers. Concretely, central bank gave up their capacity to regulate the banking system. In the case of Israel, shift of emphasis from banking regulation to monetary regulation left the banking system and the capital market unchecked (Ben-Basaṭ, Blei, and Balas 2007). As Levi-Faur argues (Levi-Faur 1998a), the transition from neo-mercantilist to the liberal regimes of regulation did not put an end to regulation but rather it redefined the goals and the instruments of regulation. The transition of central banking serves a manifestation of this process.

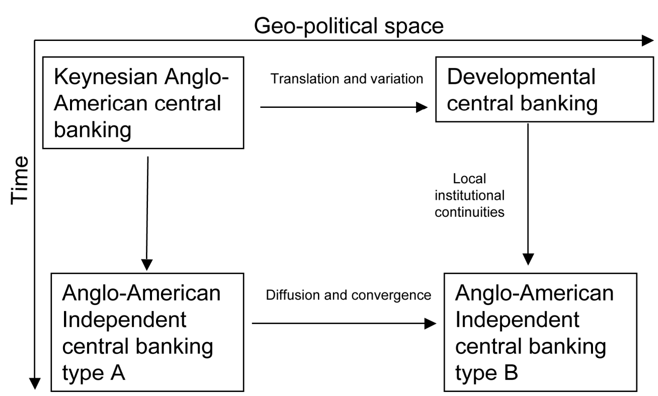


Fig. 1: Time-space distribution of central banking models

The analysis has also the potential to contribute to the understanding of cross-national variation of regulative structures in the neoliberal era. Central banking in post-developmental states are the product of a combination of local institutional continuities and global pressures of convergence (Fig 1). Various studies have explained how mechanisms of diffusion during the neoliberal era led to convergence of central banking practices (Polillo and Guillén 2005; Maxfield 1997; Marcussen 2005; Rapaport, Levi-Faur, and Miodownik 2009). However, convergence implies a temporal trend, not a static condition of homogeneity. Studies have shown that central banking practices differ not only in their independence levels but also in their level of transparency and accountability (Haan and Eijffinger 1999; Eijffinger and Geraats 2006). Other studies point out the cross-national variation of the relationship between monetary authority and the banking supervisory authority (Barth et al. 2002). These variations are likely to be explained on the basis of domestic legacies of central banking.

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