Central Banks' Power and Purpose: Frenkel vs. Fischer at the Bank of Israel

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Abstract

This article challenges the rational choice and the sociological theories of central banking, and offers a historical theory that explains the factors that shape the behavior of central banks and changes of their behavior. The article argues that both the rational choice and the sociological theories assign to central banks essential and ahistorical features such as the rule-following behavior of central bankers and the adherence to monetary conservativeness. This ahistorical features, we argue, are inconsistent with historical evidence on the behavior of real central bankers. We offers a historical theory of central banking, which historicizes the purpose and the power resources of central banks. To test the theory, the article traces the behavior of the Bank of Israel between 1991 to 2013, during the governorship of Jacob Frenkel and that of Stanley Fischer. The article argues that during each of the two periods the bank behaved differently and that this difference is best explained by a change in the bank's purpose and its power resources.

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Central Banks' Power and Purpose: Frenkel vs. Fischer at the Bank of Israel

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The behavior of central banks following the financial crisis poses some critical questions, when this behavior is examined through the perspective of conventional political economic theories of central banking that were popularized in the 1990s. Whereas those theories predict that independent central banks are likely to follow strict and conservative policy rules, since the crisis we face the emergence of a new ethos within the community of central bankers. Rather than agent of continuity, central banks play a role of agents of change. Whereas in the past central banks were pride themselves of focusing on strinctly monetary policy issues, those days they are not shy of expressing their opinion, as central bankers, on social inequality and global warming.

The new ethos of central banking was interepted by some as an "erosion of central bank independence" (Amaro 2018), because they they deviated from simple rules that allegedly guided them until the crisis (Bayoumi et al. 2014; Weber and Forschner 2014). At the same time, others argued that the unconventional policies of central banks increased the power of central banks, beyond intention of the legislator (Jacobs and King 2016; Tucker 2018; Goodhart and Lastra 2018). Those seemingly conflicting account, we argue, calls for re-examination of the notions of central bank independence and central bank power.

The purpose of this article is to reconsider the factors that shape central banks behavior. Currently, there are two dominant theoretical frameworks that address this question: the rational choice theory, which underline the rule of formal rules, the mandate of the bank, and the sociological or constructivist theory, which underlines the role of global policy norms. Both the theories became dominant during the 1990s, while central banks became more independent. Whereas the two theories differ deeply in their normative inclinations and in their ontological assumption, as I argue below, both theories assumes that the independence

of a central bank is defined by its conservativeness. Therefore, conservativeness is conceived as an essential feature of "good," that is, indepdent central banks.

Against this background, we will offer a historical theory of central banking, which has two key features. First, rather than assuming that the independence of the central bank is defined by a specific objective, it assumed, based on historical research, that the *purpose* of central banks is an historical variable, that change over time and across countries. Second, our historicl theory avoid the use of the concept of "independence", which, we will argue, is a legal rather than political-economic term, and embrace the use of the concept of *power-resources*. The two factors—purpose and power—we will argue, offer better accounts for the mechanisms that shape the behavior of central banks.

To test the theory the article traces the the behavior of the Bank of Israel between during two and half decades, from 1991 to 2013. During this period the bank was governmed by two dominant governors—Jacob Frenkel and Stanley Fischer—both of which arrived at bank after fulfilling senior jobs in international financial institutions. First, the article will show that during "Frenkel's period" and "Stanley's period" the behavior of the bank differed. Then, the article will test, which of the three theories can explain the change of the bank behavior.

The article proceeds as follows. We start with a critical discussion of the public choice and the sociological theories of central banking and their shortcomings and with the a presentation fo the historical-constructivist theory. After a brief introduction to the case of the Bank of Israel (BoI), the article traces Fenkel's period and then Fischer's period. The two historical section are followeb by an analytic comparison of the the two periods.

Rational choice theory and central bank independence

The practice of separating the monetary and the fiscal authorities by institutional and legal means is not new and it goes back to the Financial Revolution in England (North and Weingast 1989; Broz 1998). However, the *theoretization* of the notion of central bank independence is rather recent. A milestone in this direction was made by economiss during the 1980s. Kenneth Rogoff was among the economists who argued that a society would be better off by appointing a conservative central banker that "places 'too large' a weight on

inflation-rate stabilization" (Rogoff 1985). Severl years later, Persson and Tabellini argued that government should mandate the central bank "to direct its policies towards achieving price stability" (Persson and Tabellini 1993, 54). In his highly quoted book, Alex Cukierman defined central bank independence as 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). Grilli and his collaborators offered an alternative index, but their index also underlined the link between the "constitutional position" of the central bank and its "its role in preserving monetary stability" (Grilli et al. 1991, 367). Masciandaro and Romelli confirm that most of the existing indexes of independence defines independence in terms of the bank's abilty to "implement the non-inflationary monetary policy without any external (political) short-sighted interference" (Masciandaro and Romelli 2015).

The assumption that the independence of the central bank is defined based on its ability to maintaion price stability is cornerstone of the publich choice theory of central banking, as it is expressed by academic publications of economists. At the time when the independence indexes became highly popular amon economists, central bankers and political scientists, some raised concerns regarding coherency of the definition of independence. Berger, De Haan, and Eijffinger (2001, 4) pointed out that the conventional definition mixes "independence" and "conservativeness." This implies that when a central bank is ranked high in the index, it means it is more likely to adopt a conservative monetary policy. This mixture suggests that the conventional indexes are inherently biased in favor a particular policy approach. Conti-Brown portrays this approach as the "Ulysses/punch-bowl account," which perceives the commitment of the central bank to an inflation targeting rule as an essential and quasi-universal feature of al central banks (Conti-Brown 2017).

The concept of "independence," as defined within the rational choice theory, therefore, is a normative rather than a description concept and therefore, it cannot be used by political economsits, who are interested in the capacity of the central banker to make policy choices without the interference of the government, irrespective of the content of this policy.

Sociological theories of central bank independence

From several perspectives, sociological theories of central banking challenge the public choice's premises. Sociologists rejects the positivist onthology of economists, as well as their normative point of departure. For sociologists, who embrace constructivist ontology, independence of a central bank is a "rational fiction" designed the increase the power of the technocracy and to restrict the capacity of the democratic political system to shape policies and outcomes (McNamara 2002; Marcussen 2005).

Unlike public choice scholars, sociologists are skeptical regarding the role of the mandate as a source of power of the bank. They assign the power of the bank to the its informal legitimacy as well. Legitimacy of central banks originates in their "power of expertise" (Maman and Rosenhek 2011, 107–8). Rodney Hall designates it as a "deontic power" that enables central banks to stipulate "constitutive and regulative rules" (Hall 2008, 11). Those rules gains authoritative power not only because they are stipulated in the mandates, but also because they are globalized by the global epistemic community of central bankers (Verdun 1999; Michael King 2005)

Sociological theory of central banking perceives the power of the central bank as a corollary of its "independence." The power of a central bank, David Howard argues, is "rooted in its independence" (Howarth 2009). Jacobs and King, economic historians, use the concepts of independence and capacities interchangeably. The Fed, they argue, "capitalized on its already considerable independence and administrative capacities to expand its institutional empire" (Jacobs and King 2016, 111). Maman and Rosenhek uses the two terms as complementary concepts when they argue that the Bank of Israel gained "greater independence and power" (Maman and Rosenhek 2011, 74).

The vagueness distinction between the power of a central bank and its independence, leads to historical puzzles. During the 1990s central banks became more independent in targeting price stability, but, as Epstein argues, at the same time they lost other capacities they had had (Epstein 1992, 1). Afther the crisis, an opposite process occurred: central banks lost their "independence," but they gained new capacities. As Christopher Adolph rightly observes, the conventional concept of independence, even when it is used by sociologists, assumes that all

central banks are "inflation hawks, and the only thing that mattered was how much power or 'independence' central bankers enjoyed" (Adolph 2013, xix).

Historicizing the political economy of central banking

What is needed is a more precise conceptualization of the notions of independence, power and conservativeness, in order to delineate between those concepts. In order to do this, we argue, it is necessary to distinguish—theoretically and historically—between the *capacity* of a central bank to implement any policy decision, and the *ideas* that guide the central banker regarding the content of those decisions. We will refer to the latter as the purpose of the central bank and the latter as the power resources fo the central bank.

Central bank purpose

Public choice scholars offer a normative theory of central banking, which make an assumption, that very low inflation is a public good, and therefore a central bank is defined by its capacity to maintain very low inflation. Sociological-constructist theories offers a description theory of central banking, which argue that central bankers, as a collective, advocate the policy rule of price stability targeting, because it contributes to their political power and legitimacy.

The argument on consensus among central bankers is based on the claim that during the 1980s or the 1990s the discourse on central banking went through a "revolution," which led to a convergence andf a new "consensus" regarding the desirability of very low inflation targeting (Cukierman 2007).

However, not all economists share this narrative of convergence. Historical studies that documented how central bankers actually behaved—rather than only on what they said—found that most central bankers most of the time cared about other variables than price stability.

Stanley Fischer rejects the argument concerning the "revolution" that took place in the 1990s, when central bankers allegedly stopped caring about growth and employment and focused exclusively on price stability. Convergence, he argued, took place only "among the theoretical economists." In practice, he continues, the "behavior of central banks [in the

ninetees] was not that different from that they had done in previous years" (Fischer 2011). Mervyn King, the governor of the Bank of England, coined the term "inflation nutter" to designate an overzealous conservative central banker (Mervyn King 1997).

In addition to growth and employment, central bank also care about eschange rate, the current account the capital account (Cohen 1983; Funabashi 1988). These variable affect the external stability of the currency (Bearce 2008; J. Frieden, Leblang, and Valev 2010). The significant point is that, given the Impossible Trinity, central bank cannot target domestic and external variables simultaneously. Therefore, central banks face an insurmountable trade-off between inward-looking and outward-looking policy objectives.

In order to narrow the trade-off and mitigate between domestic and interntional economic conditions, central bankers often engage in international monetary coordination. Coordination can be achived by various mechanisms. The historical literature demonstrate unequivocally that during the second half of the twentieth century most central banks participated in that way or another in coordination (Toniolo 2005; Mabbett and Schelkle 2019; J. A. Frieden and Broz 2013). This finding undermine the public choice theory that a professional central banker would focus exclusively on price stability and would ignore the international implication of its policies. In other occasions and to different degrees central banks took upon themselves the responsibility for financial stability as lenders of last resort as well as to the supervising of the banking system (Borio 2009; Bernanke 2013; Fischer 1994; Capie, Goodhart, and Schnadt 1994). In developing countries, central banks took a role in the allocation of credit (Epstein 2009).

The different goals of central banks put the central bank in highly complex institutional environment, in which there are "tensions between inflation targeting and competing [central banks'] objectives" (Eichengreen and et al. 2011). This claim implies that central bankers had to make a choice between different type of public goods, price stability is only one of them (Conti-Brown 2017, 4).. Therefore, it is highly likely that central bankers would differ in the weight they assign to those public goods. Christopher Adolph argues that central bankers may have different "policy preferences" that affect their policy choices (Adolph 2013, 22). Waltraud Schelkle suggests, for example, that the ECB's policy was guided by the principle of "monetary solidarity" (Schelkle 2018).

A historical theory of central banking must account for variation of the policy preferences of central bankers over time and across countries, to which we will refer below as the central banker's perceptions of the bank's purpose, or in short, the bank's purpose. The claim regarding a plurality of central banks' purposes, challenge the public choice theory, which assumes that a central bank must pursue the policy rule of low inflation targeting, if it is to contribute to social welfare. It also challenges the sociological theory, which makes the tacit assumption regarding the epistemic homogeneity of the community of central bankers. The historical approach highlights the debates within the community and argues that those debates are essential in order to explain the behavior of specific central banks and the change of their behavior.

Power resources

To be able to realize their purpose, central banks requires power resources. A survey of the historial literature on central banking enables us to identify six dominant power resources of central banks. A central banks can seldom use all of them simultaneously. Over time, however, central banks may change their key power-resources.

A dominant power resources of most contemporary central banks is their mandate. This power resources is explicates by the public choice theory. The mandate is a determinant of the bank's legal independence and it endow it with a capacity and legitimacy to attain certain policy objectives. However, it must be kept in mind that this power-resource can also limit the capacities of the central bank to attain objective, which are not listed in the mandate. For example, when the European Central Bank responded to the crisis by purchasing government bonds, it faced allegation of breaching its mandate. Therefore, as we argued below, the legal independence of the bank must be used as proxy to the bank's power. It is only one power-resource among others.

A second significant power resource of a central bank is its legitimacy and prestige, which draw on their professional credibility as well as from the symbolic power of the global policy norms produced and distributed by the global community of central bankers. This power resource is draws on Weber theory of bureaucracy and it is further developed by the

sociological theory of central banking (McNamara 2002; Marcussen 2005; Maman and Rosenhek 2011; Hall 2008).

Cenral bankers, have other power resources, which are less discussed. A third power resource of central banks is their *Output legitimacy*. As Fritz Scharpf argues, technocrats—policy makers in non-majoritarian institutions—gain legitimacy not only from their professional prestige, but also from the belief of the public that they have the capacity to attain goals, and avoid risks that "citizens collectively care about" (Scharpf, 1999). Erik Jones points out that output-oriented legitimacy depends not only on the successes or failures of technocrats but mainly on the public perceptions of the successes and failure of the technocrats (Jones 2009). This power resource is essential, we believe, to explain how and why central bank change their behavior even if there was not change in their mandate. Central bankers are not isolated from the society they operate in. Rather, they have an incentive to respond to problems the public cares about.

Fourthly, like any other actor in the political economic environment, central banks power depends on their capacity to mobilica support of other domestic actors. Each policy decision made by the central bank has a distributive consequence. Therefore, for each policy decision, the bank is likely to confront opposition of certain actors and support of other actors or social groups. This implies that irrespective of its mandate, a central bank would be able to operate affectively, if it confront all actors simultansly. In such a case, the bank would have re-calculate its policies. To support this hypothesis, there is an extensive literature that identifies a correlation between central banks conservativeness and the position of powerful actors regarding conservativeness (Masciandaro and Romelli 2015, 265). This literature, rather than explaining conservatinvess on the basis of the mandate, explains the mandate on the basis of dominant actors' position.

Fifthly, cenral banks power stems also from their veto-player position in the domestic political economy. As such, they can block government's initiatives and policies (Mabbett and Schelkle 2019). Central banks are mediators between the political system and the banking and financial system (Braun 2018), and this position contributes to their *institutional power*. Their instituitonal power enables central banks, given specific circumstances, to force the

government endorsing policies that it would have endorsed without the threat of the central bank.

Sixthly, central banks possess *tructural power,* that is*, a capacity to re-interpretate formal rules* (Adolph 2013; Mahoney and Thelen 2010). Even in cases when the mandate specifies clear rules, the central banker still has a discretion to re-interpret those rules. This discretion increases the bank's power.

The claim that central banks have other power resources than their mandate and the prestige of the gloal norms is essential to our argument, because it explain how central bankers can advocate central bank purposes, which are not formalized in the law and they deviate from the central banking orthodoxy in a particular point in time. It is the aim of the historical research to trace how a central bank change its purposes and its power resources over time.

Predictions

provides two specific predictions which can be tested empirically. First, the historical theory predicts that central bankers would be able to justify deviation from the monetary rule of very low inflation targeting on the basis of legitimate economic arguments. Such justification is likely to be objected by other central bankers, by politicians and by academic economists. However, the prediction is that those disagreements and debates would cut through the community of central bankers, rather than taking place between insiders and outsiders to the community. Evidence of such debates, we argue, cannot be accounted for by the public choice or the sociological theories.

The internal disagreements within the community of central bankers, create opportunities for cross-organization cooperation between central bankers and politicians that share similar views regarding the purpose of central banks. The second prediction of the historical theory is the existence of cross-organizational cooperation between central bankers and

politicians.[2] This prediction is distinguishes it from the public choice and sociological theiroes, which predict conflicts between conservative central bankers and myopic politicians.

To sum, each of the three theories present different concepts of power and purpose, with different testable prediction (Table 1). The article aims to test the historical theory in respect to the two other theories.

[2] This prediction should be qualified: according to the rational choice theory politicians formulate the mandate and appoint the governor, and therefore they are likely to share the preferences of the governor. However, once the mandate is approved, in the day-to-day policy making decisions, the prediction stated above holds.

Table 1: Three Political Economic Theories of Central Banking and their Prediction

	Rational choice	**Sociological**	**Historical**
Purpose:	The key purpose of independent central banks is price stability; Deviation from price stability is caused by political factors	The key purpose of independent and powerful central banks is price stability; Central banks are less likely to deviate from this norm	The purpose of central banks is a historical variable determined by including the policy preferences of the central bankers
Predictions:	Epistemic homogeneity and consensus among central bankers and experts	Epistemic homogeneity and consensus among central bankers and experts	Epistemic pluralism and internal debate
Power resources:	The mandate of the central bank that institutionalizes it capacity to resist political pressure from the government	Prestige and legitimacy as rule-followers; adherence to global policy norms; cohesive global community of central bankers	Institutional power of the bank; mobilization of actors; output-oriented legitimacy
Predictions:	Conflicts between the central bank and the government; when conflicts occur, the central bank is more conservative than the government.	Conflicts between the central bank and the government; when conflicts occur, the central bank is more conservative than the government; foreign central bankers provide support to domestic central bankers	Conflicts among central bankers; politicians may promote more conservativeness than central bankers

Source: author

The case of the Bank of Israel

To test the historical theory, the article focuses on the recent history of the Bank of Israel (BoI). Between 1991 and 2013 two dominant governors managed the bank: Jacob Frenkel and Stanley Fischer. David Klein, Frenkel's successor and follower, governed the bank from 2000 to 2005. As will be argued below, the behavior of the bank during Frenkl's and Klein's period—or in short, Frenkel's period—the bank behavior significantly different than during Fischer's period. The aim of the article is to examine which the three theories—public choice, sociological or historical—explain best this change.

One may object the case of the BoI is not generalizable because Israel is a small peripheral country, and the politics of central banking is shaped by domestic politics, rather than by general economic principles. We reject this objection on two grounds. First, it is often assumed by researchers that the cases of dominant central banks, such as the Fed or the ECB, are more generalizable than cases of central banks in small countries. However, in practice, those dominant central banks are unique and exceptional, in terms of the political and economic environments they operate in. Contrariwise, Israel is an emerging economy, which share many features with other middle-size economies in Europe, East Asia, and the Middle East. Therefore, there are more central banks that operate within an environment which similar to that of the BoI.

Second, contributing to the generalizability of the case of the BoI is the fact that during the period under consideration, it was managed by two globally reputable central bankers. Frenkel was the head of the IMF Research Department (1987-1991) and Fischer was a Vice President at the World Bank (1988-90), a First Deputy Managing Director of the IMF (1994-2001) and a member at the Group of Thirty. The two central bankers shape their views regarding central banking prior to their appointments, and they are not likely to change them due to the political circumstances.

The literature on the Bank of Israel in the neoliberal era focuses on the terms of Frenkel and Klein. There is an agreement between economists (Barkai and Liviatan 2007; Sussman 2007) and sociologists (Maman and Rosenhek 2011, 94) that during the this period the bank

became extremely independent and conservative. This finding is consistent both with the public choice and the sociological theories. Fischer's period does not discussed at all by Barkai and Livitan, and only briefly by Maman and Rosenhek. This study is based on an extensive archival research both periods, and includes documents that has not been studied by the existing literature.

Argument, method and key findings

The historical analysi presented below traces the behavior of the bank during the two sub-periods—Frenkel's period and Fischer period. We focus on three key policy area which central bankers are usually care about: monetary policy directed at targeting the inflation level, policy directed as financial stability and policy direacted external policy variables.

Our key findings (Table 2) is that since 1996 Frenkel and Klein were more conservative than Fischer in regard to price stability, that they had a minimalist understanding of the bank's responsibility to financial stability and that they indifferent to external variables. We also show that Fischer was more flexible on inflation, that he assign heavy weight to financial stability and that he was willing to target external variables.

In order to explain this change of behavior, we trace two independent variables: the purpose of the bank and its power resources. As for the central bankers' perceptions of the bank purpose, we find significant difference between Frenkel and Fischer. Frenkel saw the Maastricht Treaty as a model of the "new consensus" and sought to imitate it. However, Frenkel was not able to achieve that as his proposal was rejected by senior economists from within the BoI as well as by foreign experts. Fischer, on the other hand, rejected the Maastricht model and advocated the flexible inflation targeting approach. Also, Fischer assigned heavier weidght to financial stability, to growth and to export prior to the financial crisis and even more so after the crisis.

The two period differs also in the power resources of the bank. During Frenkel's first term he faced an expansionary fiscal policy of the center-left government of Rabin and Shochat, but during its second term he enjoyed the support of senior politicians, primarily of the

prime minister Netanyahu. Fischer, on the other hand, promoted a cooperative approach with the Treasury and he relied on output-oriented legitimacy.

A comparison of two periods require us to control for the changing circumstances. There are two historical events that can affect the comparision. First, the enactment of the new Bank of Israel law in 2010. To control for this factor, we will focus on Fischer's first term (2005-2010) and will show the the enactment of the law did not have a significant short-term impact on the bank's behavior. The second exogenous event that could have affected the behavior of the bank is the global financial crisis. We will show that whereas the crisis shaped Fischer perceptions of the bank purpose, it only accentuated existing features of his perceptions.

Table 2: Frenkel's and Fischer's period		
	Frenkel's period	**Fischer period**
Behavior of the bank	- Monetary conservativeness from 1995 until 2005. - Passiveness regarding financial stability. - Indifference to exchange rate and the issue of export.	- Monetary conservativeness from 1995 until 2005. - Passiveness regarding financial stability. - Indifference to exchange rate and the issue of export.
Purpose	- Embracing the Maastricht model: the inflation target is stipulated in the mandate. - No discretion to government regarding target. - "Division of labor" between the bank and the Treasury. - Minimalist interpretation of the bank's responsibility to financial and banking stability. - Minimalist interpretation of the bank's responsibility growth, employment and export	- The governor presents a moderate purpose regarding inflation targeting. - Justification on a Post-Keynesian economic rationale. - Opposition to the bank from external economists. - The bank and the governor express their view on a broad array of socio-economic and political issues.
Power resources	- Close ties between the governor and the centre-right prime minister. - Conflict between the governor of center-left politicians. - Centralized structure of the central bank - Conflict between the governor and the Research Department.	- Conflict between the governor and "old" bank's employees. - Exporters support the governor exchange rate policy - Cooperation between the Treasury and the governor. - Conflict between the governor and right-wing prime-minister. - The bank address in policy and speeches other objectives than price stability) Output oriented legitimacy)

The historical research is based on several sources of information. First, a valuable and yet unresearched source is the 18 archival files that contain the minutes of the Levin committee.[3] Levin Committee was appointed in 1997 to provide recommendation of the reform of the BoI law. The minutes include testimonies of Frenkel and Klein, as representatives of the bank, of senior economists from Research Department of Stanley Fischer and Charles Goodhard as foreign experts. The minutes enable us to map the position of the different experts as well as the justifications of those positions. In addition, we surveyed discussions in the Finance Committee of the Knesset (the Israeli parliament), discussions and bill submitted to the Knesset. We also surveyed BoI Annual Reports and news reports.

Frenkel's period

There is an agreement among scholars that the enactment of Amendemnt 15 to the Bank of Israel law (1985)—the "no printing law"—upgraded the legal and de-facto independence of the BoI (Maman and Rosenhek 2011, 43; Barkai and Liviatan 2007, 64–67). In next half a decade, the task of the governor, Michal Bruno, was to keep inflation at bay as well as to keep the exchange rate within a bans, in order to alleviate Israel's balance of payment problem.

Jacob Frenekl replaced Bruno in 1991 and he governed the bank until 2000. During his two terms, inflation level fell from around 18 percent to around 2. The government gradually reduced the inflation target and at the same time expanded the exchange rate band. By the end of Klein term, the government lowered the inflation target to the global standard of 1-3 percent.

Naturally, the task of lowering inflatin required a high-level conservativeness. However, as we will argue below, Frenkel's, and than Klein's, perception of the bank purpose reflected a more conservative belief than other economists and central bankers. We will further argue,

[3] Not all the files surveyed are quoted in the article: 9144/1-Gimmel; 9144/2-Gimmel; 9144/3-Gimmel; 9144/5-Gimmel; 9144/6-Gimmel; 9145/1-Gimmel; 9145/2-Gimmel; 9145/3-Gimmel; 9145/4-Gimmel; 9145/5-Gimmel; 9145/6-Gimmel; 9145/8-Gimmel; 9145/9-Gimmel; 9146/1-Gimmel; 9146/2-Gimmel; 9146/3-Gimmel; 9146/4-Gimmel.

the Frenkel's and Klein belief had an impact not only on the bank's anti-inflation policies, but also on its plicies in areas of financial stability and the exchange rate.

The question is then arises what were the factors that enabled Frenkel and Klein implementing a highly conservative policy, which was not supported by their fellow economists in the bank. We will argue that the key power-resource of the bank during the period 1996 and 2005 was the support of the governments. Crucial was the support Benjamin Netanyahu as a Prime Minister and than as Minister of Finance.

Frenkel and party politics

To trace the performance and the power-resources of the bank during Frenkel's two terms, it is convenient to distinguish between the center-left government (1992-1996) and the period of the center-right government (1996-1999). Frenkel was appointed by the center-right government of Itzhak Shamir in September 1991. But in July 1992 Rabin established a center-left government and appointed Avraham (Beiga) Sho'chat to the Treasury. The key task of the Rabin/Sho'chat government was to absorb the mass Russian immigration, and therefore it implemented expansionist fiscal policy. This policy was enabled by the a generous financial support from the United States in the form of guarantees or $2 billion.

Given the government preferences and Frenkel capacity to lower inflation was limited. It managed to lower inflaito to around 12 percent, but the Annual Reports of the bank were highly critical of the government policy (BoI 1994, 6-7, 13).

The tension between the bank and the political echelon escalated in 1995, when the bank raised nominal interest rates. The policy of the bank had several negative consequences: the shekel strenghthened and long-term interest rate rose. Frenkel and Klein, the head of the monetary department, faced an internal opposition from the Research Department (??). However, according to the law, the governor did not have to consult and he made policy choices singlehandedly.

To try to control Frenkel and the bank, during 1995 the parliament retaliated by putting forward three amendments to the Bank of Israel law. An amendment to prevent a "revolving door" (Amendment 17, 1995), to subject the bank to the authority of the State Cmptroller (Amendment 19, 1995), and to often amendment 15, which restricted the capacity of the bank to lend to the government (Amendment 18, 1995).

In addition, a year later, Sho'chat, now an MP in the opposition, submit with two other MPs, a bill proposal to reform the BoI bill and establish a monetary committee, three of its five members would be public representatives (Sho'hat, 1996). The fact that proposal was approved by the Knesset in first reading, reflected the common view that something must be done to end the "endless conflicts between the Treasury and the Bank of Israel are unbearable and must be stopped either by legal measures or in other ways" (Knesset, February 11, 1997).

In response to Sho'chat's proposal, Frenkel appointed an internal committee, headed by Zvi Sussman, previously the head of the Research Department (1970-77), and included Avi Ben-Bassat, head of the Research Department (1991-96) and David Klein, head of the Monetary Department. Despite the fact the members were employees or past-employees fo the bank, they did not reach an agreement regarding three decisive and devisive issues: the objectives of the bank, who—the government or the governor—should set the inflation targets and the composition of the monetary council. The report therefore, included several policy recommendations (Sussman 1996). Frenkel tried to conceal the report but it was leaked to the minister of finance (Lavie 1998).

The risk for Frenkel was that now, the Finance Committee would have to discuss Sho'chat's proposal, which received extensive support. At that stage, the prime minister Netanyahu decided to appoint a spcial committee of experts. Netanyahu was supportive and close to Frenkel. After his election, not only that Netanyahu approved Frenkel's second term despite the his controvercial policies, but he also appointed him the head of the prime minister's economic advisory council (MFA, 1996).

The special committee of experts chaired by Dov Levin, a former Supreme Court justice. The committee also included two senior economists who were known for their conservative views: Prof. Alex Cukierman and Prof. Haim Ben Shahar.

The analysis so far demonstrates that the Frenkel' faced harsh opposition from the center-left and that he received support from the center-right. Hence, the creation of the center-right government by 1996 by Netanyahu was a decisive turning point, that explain the incremental change in the behavior of the bank, and the fact after 1996 inflation level was lowered from 12 to around 2 percent.

The Levin Committee: internal opposition

The members of the Levin Committee heard the testimonies over 20 local and foreign economists, politicians and policy makers. The discussions, as well as the documents submitted to the committee are all open for the public in Israel State Archives. The documents offers a rare opportunity to trace the perceptions of those experts and politicians regarding central banking.

The BoI submit to the committee its proposal for a new bill, consisted of three three key elements: (1) the objective of the bank should be price stability, understood as very low inflation targeting; (2) the inflation target must be stated in the law, without discretion of the government; and (3) a majority of the monetary committee members must be employees of the bank (Recommendation 1997). Frenkel argued that those principles are derived from a new "consensus" (Levin, 1998A: 10), which is based on the Maastricht agreement (Levine, 1998A: 113). Therefore, he urged the committee to emulate the Maastricht agreement: "we do not want to re-invent the wheel" (Levin, 1998A: 10).

Frenkel's justification strategy supports the sociological theory. According to him a "consensus" existed and the its in itself is a reason to emulate common arrangements. However, the sociological theory fail the explain the fact that no other economist—besides Klein—supported Frenkel's policy.

Avi Ben Bassat was the head of the Research Department until recently. He portayed the Maastricht approach as a "fashion." "Yes, we hear about it a lot," he told the committee but

added: "I don't know if you have been informed how many countries adopted it, perhaps 12 countries. So where are 130 more countries that don't want to adopt the new fashion" (Levin, 1998C: 34). In practice, he continued, the "professional literature—the theoretical and the empirical—is full of disagreements" (Levin, 1998C: 32). He named Ben Bernanke, Alan Blinder, Paul Krugman and Michael Bruno as economists who opposed the Maastricht approach. Ben Bassat literally begged the committee "not to make a choice… between those views" (Levin, March 30, 1998C).

Zvi Sussman also undermined the Maastricht approach, which assumed a "division of labor" between the central bank and Treasury (Levin, February 4, 1998A: 16). Rather, he argued, the "problem is how to maintain the independence of the bank, while at the same time ensure cooperation [between the bank and the Treasury]" (Levin, March 30, 1998C).

One may suggest that Ben Bassat and Sussman are "local" non-informed economists from the "old" generation. But Frenkel's position was also rejected by the foreign experts that were at the core of the community of central bankers. In an answer to a question posed by Cukierman, Stanely Fischer stated unequivocally that "The Government should set the inflation target in a very formal way," because there must be "a connection between the goals of the democratically elected government and the goals of the central bank" (Levin, 1998B: 23). Charles Goodhart, the second foreign experts invited by the committee, also provided a straight forward answer that the same question: "the ultimate responsibility for the objective should be the Government's" (Levin, April 14, 1998D: 74). Goodhart also rejected Frenkel's demand for a majority of bank's staff in the monetary council. In such arrangement, he explained, "decisions become personalized, in the sense of the Governor" (Levin, 1998D: 87).

The Levin Committee rejected all three principles indicated in the proposal of Frenkel. The report stated that the "the government, in consultation with the bank, will define the policy objectives in the area of price stability and their formulation" (Levin 1998E, 14) and that monetary council should consist of three out five non-bank employees (ibid, 18).

The evidence, therefore, undermine the sociological theory key prediction that the community of central bankers is epistemically homogenous. On the other hand, we can find

support to the prediction of the historical theory, regarding the existence of competing purposes within the community of central banks. One may argue that the disagreements discussed here are minor and insignificant. However, the crucial point is that the actors we study here did not see them insignificant.

The conservativeness of the bank

The Bank of Israel law was enacted in 1954 and it provided the bank with limited legal independence as it had to lend to the government and the objective of price stability was its primary one. Amendment 15 upgrated the legal independence, but still price stability was not its primary goal. Nevertheless, Frenkel and Klein operated as if the objective of the bank was price stability. As Zvi Sussman put it, during Frenkel's era, the bank had "pretty high independence, de facto, perhaps not de jure." The de-facto independence was manifested in its adherence "to one objective of price stability" (Levin, 1998C: 6).

Sussman's assessment is supported by a study by the BoI Research Department argued that during the 1990s the bank had a hidden target of 4 percent, while the government instructed him to target 8 percent (Weitzman 2011). Natan Sussman assessed the actual inflation target in second half of the 1990s as zero (Sussman 2007, 63). Barkai and Liviatan confirm that there is evidence that the Bank of Israel "tightened monetary policy more than the American Fed, and ignored the aspect of unemployment which caused by the business cycle. Indeed, the bank policy contributed to the long recession of the Israeli economy since 1997" (Barkai and Liviatan 2007). Our own calculation shows the between 1997 and 2007 the bank was more conservative than during the first half of the 1990s or the Fischer's period (Table 3).

Table 3: Inflation Targeting: Percentage of Months

	Above upper target	In range	Below lower target
1992-1996 (%)	67	20	13
1997-2005 (%)	26	17	57
2006-2012 (%)	48	40	12

Source: Author calculation; Data: Monthly inflation from Annual Reports the Central Bureau of Statistics; government inflation targets from Bank of Israel Annual Reports

The capacity of Frenkel to lower the inflation rate was based also on the bank instituitonal power, that is, its position as veto-player (Mabbett and Schelkle 2019). Throughout Frenkel's period, the bank had to keep the exchange rate within the band, a fact that restricted its capacity to lower inflation (Maman and Rosenhek 2008; Klein 2014). From early 1997 Frenkel, rather than targeting the middle of the band, kept the exchange rate close to its lower end (BoI 1997, 12 Figure 3-A). By so doing, the governor could use its discretion witin the band as leverage in its negoation with the government regarding the width of the exchange rates and the inflation target (Klein, 2003). This practice reflected the banks structural and institutional power.

Financial stability, growth and export

Several policy choices made by the bank during Frenkel's period demonstrates its prioritization nof other policy objectives than price stability.

In early 1996, inflation rate rose to 15 percent, above the government 10 percent target. In response, the bank raised nominal rate to 15.4 percent. In the second half of the year, the bank adjusted its policy very slowly, let real rate stand at 9.5 percent (BoI, 1996: 165). Amid high real short-term interest rate, savers substituted their long-term savings by short-term deposits. Pension funds and providence funds had to sell their holding of government bonds,

the price of which fell and long-term interest rate increased. Throughout 1996 government bonds prices fell 12 percent (BoI 1996: 162). The crisis put at risk the whole financial system, if the instiutitonal investor would have to sell their assets.

The Treasury and MPs requested Frenkel to intervene by purchasing government bonds in the secondary markets, but the bank was reluctant to follow this course of action. Amnon Rubinstein, member of the left-wing party, Meretz, questioned Frenkel's authority, making reference to the lack of a monetary committee. "In a democratic state, even the most learned person must consult," he said (Knesset, July 17, 1996). Labor Party members, accused Frenkel, who promised a safety net" for not keeping his promise (Knesset, July 17, 1996; Finance Committee, July 18, 1996). Whereas Frenkel did not dismiss the role of the bank as Lender of Last Resort, his public anncouncement that bank will not provide a "concrete floor," indicated a passive reponse (Knesset, July 17, 1996).

Another indicator for the bank's perception of its responsibility to financial stability was its response to the collapse of two commercial banks in 2002. The first case a small bank, the Bank for Commerce (Bank Le'Mish'ar), collapsed after embezzlement of one of its workers. Klein and the bank supervisor, Yitzhak Tal, minimized the responsibility of the BoI for detecting embezzlements. "It is the responsibility of the bank management and other organs of the bank to detect embezzlements", they explained (Finance Committee, May 6, 2002). The supervisor argued that the supervision department is "a watchdog, not a hunting dog" (Korin-Liber 2003). The BoI also released a statement that the public should beware of small banks.

Several months later, a larger, but still small, bank, Bank for Industrial Development (Bank Le'pitu'ach Ha'ta'asia) went bankrupt. This time the process was gradual, and it took two weeks between the first government meeting on the issue and until it collapsed. When asked why the BoI waited, the supervisor of banks argued that the BoI "talked with anyone who could help to solve the problem of the bank, but we couldn't find any solution how to stop withdrawal of deposits" (Finance Committee, September 2, 2002). Senior economists—Arie Arnon, David Lev Ari and Ben-Zion Zilberfarb—voiced their view that had the BoI responded more swiftly and assertively it could have saved the bank (Rabiv, 2002). Bankers argued that

the central bank's prioritization of price stability prevented it from fulfilling its duty as a bank supervisor (Bar 2002).

Fischer's period

Fischer and the Treasury

Soon after entering office, Fischer visited the Finance Committee of the Knesset, and presented his outline for a new BoI law, as he perceived it. In his speech, Fischer accepted the recommendations of the Levin Committee. The bank, he said, will target inflation, "according to targets set by the government." In addition to inflation, the bank will have other objectives, "especially growth and employment" (Finance Committee, May 30, 2005). Fischer also agreed to a majority of public representative in the monetary council (Arlozrov 2005).[4]

The Treasury responded by making a reciprocal concession and canceled the exchange rate band, which had been an issue of contention between the two authorities during Frenkel's period (Avrieli 2005; Cohen 2005). The Director General of the prime minister office explained that "if there is cooperation between the prime minister, the governor and the economic ministries, there is no need for the band." The press quoted a Treasury staff that explained: "Fischer is not Klein… this is a move of good will" (Haaretz 2005A).

Restoring the bank output-oriented legitimacy

During the terms of Fischer and Flug, the governors voiced their positions on a broad range of socio-economic issues that had no direct bearing on monetary policy. Those issues included poverty, negative income tax (Haaretz 2005B), the need to increase transfer payments for the disabled (Haaretz 2006B) and the need to increase employment of Arab workers in the public sector (Haaretz 2007A). The Annual Report of 2007 called the government to take measures to improve public transportation in the metropolitan (Bank of Israel 2007, 73). During Flug term, the bank produces numerous documents—research and press releases, underlining the need to deal with the high levels of inequality in Israel, by raising labor productivity and public investement in infrastructure. Flug, the bank and the

[4] Fischer reneged on this concession at later stage.

research department were often attacked by the center-right wing government. The Annual Report of 2016 criticized the government for lack public investment in physical and human capital and for refraining "from reducing inequality relative to the norm in the OECD" (BoI 2016, 1).

From the perspective of the Public Choice theory, Fischer and Flug undermined the independence of the bank, as often argued David Klein, the previous governor (Klein 2014). However, the anomaly is that in practice, Frenkel and Flug revealed a better capacity to confront the policy of the center-right wing government. However, they confronted the government on the basis of economic argumentation that were not considered "conservative." We argue that by addressing policy problem that public, as a whole, cares about, Fischer and Flug restored the output-oriented legitimacy of the bank, which had been deteriorated durng Frenkel's period, when the bank had been described as a "monetary dictatorship."[5]

Flexible inflation targeting

The positon of Fischer regarding monetary policy can be traced to his publications prior to is his nomination. Already in 1995 he was critical of the Maasticht approach. A central bank, he argued, must not be "too independent" because it becomes "too insensitive to the possibility of stabilizing output" (Fischer 1995, 205). Instead, he endorsed the "flexible inflation targeting" approach or the "constrained discretion" approach, which stated that central banks should tolerate higher level of inflation if necessary to stabilize output (Fischer 2000).

On the basis of flexible approach, Fischer explained to the Finance Committee that the central bank should have two years to reach the inflation target. This relatively long period enabled the bank deviate from the inflation target in the short-run, if it was necessary to realize the bank's secondry objectives: growth and employment and financial stability. "It is important not to focus only on inflation," he explained. Fischer was also willing to accept the suggestion of Shelly Yechimovitch, a member of the Labor Party, and include the reduction of social gaps

[5] This term was used by David Brodet, former General Director of the Ministry of Finance (Levin, July 14, 1997).

as a secondary objective of the bank (Finance Committee, February 23, 2010). As table 3 demonstrates, Fischer's flexibile approach was not empty words.

Banking supervision and lender of last resort

During Klein term, the supervisor of bank, Yo'av Lehman, played a key role in the Ba'char Committee, which was appointed by the government to reform capital markets. The centralization of the banking system, the report stated, was the key problem of the Israeli financial system, and it recommended to address this problem by separating the banking insitutions from the institutional investors—pensions funds and providence funds (Government 2004). When Fischer entered office he was reserved regarding Lehman's emphasis of competition and his disregard for systemic risk (Haaretz 2006A). A report prepared by a delegation of the International Monetary confirmed Fischer's concern and recommended a "stronger enforcement" and "more independence for supervision" (IMF 2007). In response, Fischer dismissed Lehman. When Fischer reformed the bank's structure, the supervision department subjected to him directly (Basuk 2008b)

After the sub-prime crisis Fischer's asserations regarding the role of the central bank as a Lender of Last Resort became bolder. In his 2009 Jackson Hole lecture Fischer stated that central banks should "take any other action… deems necessary… under circumstances of special urgency" (Fischer 2009). In the discussions regarding the new BoI law, he explained to the Finance Committee that a central bank must have the responsibility for financial stability: The central bank is like a "a mother to which [banks] have to run when a financial crisis occurs" (Finance Committee, February 23, 2010).

In February 2009 his words put to a test when he faced long-term interest rate decline. In response, the bank announced a government bond purchasing program for an amount of $20 billion. The Annual Report explained that the program was designed "to support a decline in longer-term interest rates, and thereby alleviate credit terms in the economy and promote economic activity" (BoI 1997, 119). This scenario was very similar to that Frenkel faced in 1995-6, when the he refused to carry out an extensive bond purchasing program.[6]

[6] The Bank increased its holding of government bond holdings from 0.8 percent of total government bonds in 2008 to 5.5 percent in 2009. For comparison, Between December 1993 and December 1996, during the pension funds crisis, the

Fischer's concern with financial stability turned it into a guardian of the banking system. had an impact on the bank power resource. After the publication of Ba'char's report, commercial banks were exposed to a wave of legislations designed to tight regulation with the aim making the system more competitive and decentralized. Ficher used his clout and reputation to protect the banks from this legislation, dismissing the claim of overpriced banking serviced and and unjustifiabley high profitability. In the annual meeting of the Banks Association Fischer stated that "a strong and stable banking system is essential for the strength of the economy." The recent bill proposas, he argued, "could, sometimes, harm the banks" (Haaretz 2007B).

Exchange rate management

Fischer's most controversial policy decision was the purchase of foreign exchange reserves. The foreign exchange purchasing program started in 2007. Until 2013 the bank increased its foreign reserve from $28 billion to $80 billion.

The trigger for the decision was the strengthening of the shekel during 2006 and 2007. The US dollar price fell from 4.5 shekels in May 2006 to less than 4 in October 2007. Exporters and industrialists warned that "we will not have other choice but to let go hundreds of workers" (Koren 2007). Initially, the bank resisted the pressure, but in March 2008 it announced a plan to increase its foreign currency reserves from $10 billion to $40 billion. Within a year, the bank boosted the program declaring the purchasing of $100 million a day on the average. An Op-Ed at Haaretz stated that "for those who can read between the lines… this announcement is almost similar to 'we will do whatever we can to stop the dollar'"(Haaretz, 2008B). The bank justified the decision on the basis of the "needs of the economy" (Basuk 2008a). The Annual Report explained the "timing" of the programme on the basis of the "the large and continued appreciation of the shekel" (BoI 1997, 119–20). According to the press, capital market actors took seriously the bank decision and prepared themselves for a weakening of the shekel (Avrieli 2008).

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banks increased its total holding of bonds (private and government) from 2.5 percent to 4 percent (calculated from BoI Annual Report, 1996, Table Zein-Nun-8, p. 319).

Fischer's policy was brutally criticized by monetary hawks. David Klein warned that the bank policy undermined Israel's reputation and the independence of the bank (Gorodisher 2010). Leonardo Leiderman, the head of the Research Department under Frenkel, warned that the decision "does not really contribute to monetary credibility" (Haaretz 2008A).

The portrayal of the bank's policy as a politicization of thet bank is based on the Public Choice Theory, according to which any deviation from the rule of price stability targeting, is a sign of politicization. However, form the perspective of the Historidal Theory, Fischer's policy was guided by a different economic rationale. Already in 2001 he expressed the view that even in floating exchange rate regimes, "interventions [in foreign exchange market] can be useful in reducing the degree of volatility in exchange rate markets" (Fischer 2001, 14). Fischer also endorsed the increase of foreign currency reserve as "the first line of defense in dealing with capital flow reversals" (Fischer 1999). Fischer different perceptions oef the bank purpose, does not imply that the pressure from the exporters did not play a role in the bank's decision, however. It implies that the exporters' voice was an indicator that should have been taken into account by the bank, just as rising inflation.

Discussion and conclusion

This article challenged the rational choice and the sociological theories of central banking. Despite the different ontological foundations of the two theories and their distinct normative implication, both theories accept the premise that the monetary rules of price stability targeting is an essential features of central banks, which defines their independence and power. This article aimed at bringing history back into the theory of central banking. We did so by making the hypothesis that the purpose of central banks can change over time as well as their power resources. This historical approach implies that any study of the behavior of central banks must not *assume* that a deviation from the conventional policy rules is caused by politicization, but this causal claim has to be supported empirically.

The article provide strong evidence that the behavior of the BoI changed when Fischer entered into office, despite the fact that the law of the bank did change during Fischer's first term. The article rejected the explanation that during Fischer's period the bank was politicized, as Fischer policies were consistent with his perceptions of the central bank

purpose. Rather the opposite: we presented evidence that Frenkel needed the support of the prime minister, to handle opposition to its policy by senior economists within the bank. The article also dismissed the claim that central bankers operate as an epistemic community characterized by epistemic uniformity. Rather, we showed that throughout the period discussed in this article, central bankers were guided by different perceptions regarding the behavior of "good" central banks.

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