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The Politics of Institutional Reform: The 'Declaration of Independence' of the Israeli Central Bank

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Abstract

Over the last two decades, increasing numbers of central banks in both developed and developing countries have gained independence from political echelons and other state bureaucracies, becoming important actors in the political arena with the capacity to significantly affect the configuration and functioning of national economies. Through a detailed process-tracing analysis, this paper studies the institutional turning point in the position of the Israeli central bank within the state institutional configuration: namely, the amendment of the Bank of Israel Law in 1985 which prohibits the central bank from providing loans to the government to finance budgetary deficits. The analysis focuses on the conditions that facilitated the institutional change, as well as on the actors and mechanisms that were involved in the process.

This legislative amendment, which opened the path to the increasing independence of the Bank of Israel, was the result of the constitution of a new cross-national field of policy-making, comprised of both local and foreign political actors: the Israeli Ministry of Finance, the U.S. government and a cross-national network of Israeli and American academic economists. Within this field processes of both coercive and expert isomorphism operated and interacted with each other, producing synergetic effects that fostered the dynamic which led to central bank independence

Over the last two decades, increasing numbers of central banks in both developed and developing countries have gained independence from political echelons and other state bureaucracies, becoming important actors in the political arena with the capacity to significantly affect the configuration and functioning of national economies. This institutional transformation is an important component of the broader restructuring of the capitalist political-economy. This process, that characterized most capitalist societies following the re-globalization of finance, the unexpected coincidence of inflation and unemployment in the 1970s, and the decline of Keynesianism, constituted a regime shift from the interventionist state to the regulatory state and to neo-liberal policies.

While there is an extensive, and primarily prescriptive, literature that considers the macro-economic effects of central bank independence (CBI), mainly in terms of inflation levels (Alesina and Summers 1993; Cukierman 1992; Cukierman and Lippi 1999), studies that focus on CBI as a dependent variable are relatively scarce. Among these, several cross-national comparative studies have used static quantitative methods in search of variables that explain, or at least correlate, to central bank independence (Bernhard 1998; De Haan and Van 'T Hag 1995; Polillo and Guillen Forthcoming). This paper offers an alternative research strategy, arguing that detailed process-tracing case study is necessary to capture the dynamic, complex and multi-layered political and institutional processes that lead to the adoption of the institutional practice of independent central banks. This approach entails studying political actors who are involved in the process of institutional reform, their strategies and the specific mechanisms that lead to CBI. Moreover, in this paper we claim that studying institutional reforms that affect the ways in which states are involved in the economy require a frame of analysis that considers both domestic and external conditions for the adoption of reforms and the actions and interactions of local and foreign actors.

This framework is employed to analyze the first and crucial political step that would lead to the increasing independence and power of the Israeli central bank: the amendment of the Bank of Israel Law by the Knesset (Israeli parliament) in 1985, which prohibits the central bank from providing loans to the government to finance budgetary deficits. The significance of this legislative amendment for the study of CBI is twofold. First, legal limitations on monetary financing of fiscal deficits are considered a major dimension of central bank independence, as they protect central banks from political pressures to monetize the government deficit, and allow them to introduce anti-inflationary monetary policies. Therefore, the existence of such legal restrictions is one of the main components of conventional CBI indices (Alesina and Summers 1993; Cukierman 1992). Second, the legislative amendment represented an institutional turning point in the position of the Israeli central bank within the state configuration, basically altering its relationships with the government in general and with the Treasury in particular. Within the framework of the Israeli developmental state, the main roles of the central bank were the monetization of fiscal deficits and the allocation of subsidized credit, contributing in this way to key tasks of state-building: the financing of high military expenditure, absorption of massive immigration, rapid industrialization and full employment. By restraining one of these major historical roles – the monetization of fiscal deficits – the amendment was a first step to opening the path toward the emergence of an independent and powerful central bank with the institutional and political capacity to influence the economy and to be involved frequently in harsh conflicts with the Treasury. It can be asserted that without the amendment, the Israeli central bank would continue to be a mere agent of the Ministry of Finance, as it was since its establishment in 1954. For these two

reasons, the legislative amendment provides a fertile research site for an in-depth analysis of the political conditions and processes that lead to the adoption of CBI.

As we shall show in detail in the following sections, the legislative amendment was the result of the constitution of a cross-national field of policy-making and the combined actions of both local and foreign political actors within it. These actors include the Ministry of Finance, the U.S. government and a cross-national network of Israeli and American academic economists. Within this field processes of both coercive and expert isomorphism operated and interacted with each other. The most important condition that facilitated the institutional reform was the acute hyperinflation crisis that affected Israel during the first half of the eighties, which allowed these actors to promote their reform agenda. The perception of hyperinflation as a social and political crisis that threatened the stability of the Israeli regime, and the concomitant sense of urgency to find a radical solution for the maladies of Israeli economy, promoted the constitution of a new policy-making field and the repositioning within it of political actors, opening a window of opportunities for extraordinary policy-making (Keeler 1993).

The Politics of Central Bank Independence: Isomorphism, Actors and Conditions

Central banks are one of the major constitutive institutions of the nation-state, and after World War II they became an almost universal symbol of independent nationhood and "rational" statehood. During the period of the interventionist state and as part of Keynesian doctrine, monetary policy, which traditionally is the major function of central banks, was employed as a tool to promote economic growth and full employment, or at least it was subordinated to these goals (Goodman 1992). Within this context, the major roles of central banks in interventionist states were the facilitation of deficit spending by the governments and the allocation of subsidized credit to facilitate industrial development (Boylan 2001; Loriaux, Woo-Cumings, Calder, Maxfield, and Perez 1997). This institutional configuration and policy approach assured that central banks functioned under strong political influence from the governments, as was commonly practiced in most capitalist societies until the end of the 1980s (Cukierman 1998).

Starting in the early 1990s, a growing number of governments reduced their control over monetary policy by making their central banks legally independent, providing evidence for what could be called a global wave of central banking reform (Bernhard 2002; Carruthers, Babb, and Halliday 2001; Siklos 2002). For example, between 1990 and 2000, 17 countries in Eastern Europe and the post-Soviet region made statutory changes towards independence, as did 13 countries in Western Europe, 11 in Latin America, 9 in Africa and 3 in Asia (Polillo and Guillen Forthcoming). By reducing the discretionary power of governments over monetary policy-making and implementation, these reforms substantially altered the power relationships between different state agencies, as well as the mode of state intervention in the economy, especially the capacity of governments to affect economic conditions through traditional monetary means. Moreover, these institutional reforms reflect basic changes in the way in which the primary goal of macro-economic management was defined: from an emphasis on growth and full employment to giving primacy to price stability.

There are several possible explanations for the institutional change represented by the granting of independence to central banks. The broadly-accepted view among the community of central bankers, international financial institutions like the World Bank and the IMF, and the community of mainstream economic experts is that economies in countries with independent central banks function better, and as a result

many countries around the world adopt this organizational practice and grant their central banks independence (Alesina and Summers 1993; Cukierman 1998). Claiming that by insulating monetary policy from the short-term and shortsighted considerations of politicians, independent central banks can assure the rational and efficient functioning of the economy – i.e. lower inflation at a low price in terms of unemployment and loss of growth – this functionalist argument is more a prescription or a justification for CBI than an explanation of the political and institutional processes that lead to its adoption (Kirshner 2003b). Moreover, as we will elaborate later, the mobilization of this argument, and its presentation in the public arena as scientific truth serving the common good, play a crucial role in the politics of CBI (Grabel 2003).

A more institutional explanation for the diffusion of central bank independence can be offered by world-culture theory, which observes that nation-states imitate one another as part of their search for solutions to common problems, as a way of minimizing uncertainty, and especially as a tool to gaining legitimacy in the nation-state system (Meyer, Boli, Thomas, and Ramirez 1997). Moreover, this theory asserts that a shared transnational global culture has emerged that fosters an ongoing process of convergence in the institutional configuration of the nation-states. This explanation coincides with the mechanism of mimetic isomorphism as conceptualized by DiMaggio and Powell in their theory of organizational institutionalism (1991). However, institutional practices, such as central bank independence, do not magically fall from heaven or circulate and take hold by themselves; they require carriers with the interests and capacity to promote them in a new context. Hence, analyzing institutional reform requires relating to both conditions that encourage or allow their adoption, and to the concrete mechanisms through which change occurs (Campbell 2004).

An alternative explanation, which points to the specific actions of political actors, is that of coercive isomorphism. In this case, institutional reform results from direct political influence exercised by powerful actors (DiMaggio and Powell 1991). Political influence may result from internal as well as external actors. Babb (2001:19), for instance, notes that since 1982, governments of undeveloped countries adopted liberalizing reforms, including the adoption of the model of central bank independence, under the pressure of resource dependency, in order to gain access to resources controlled by powerful external actors such as the IMF, the World Bank and the U.S. government. Yet she emphasizes that coercive isomorphism is only part of the story of institutional reforms. Undoubtedly, the dependence of developing countries on external resources, especially during economic crises, is an important variable, yet how could one explain the adoption of central bank independence in developed countries? Moreover, even in the case of developing countries, comprehensive and realistic sociological analysis must take into account not only the role of foreign actors who impose neo-liberal reforms, but also the role played by local actors in this processes (McNamara 2002). Pressure exercised by external actors is always mediated and processed by local actors, as well as affected by specific local institutional and political conditions (Carruthers, Babb, and Halliday 2001).

Direct and visible political influence, as suggested earlier, can also stem from local actors. For instance, Stockdale (1999) asserts that central bank independence is constructed from within the banks themselves. In the cases of the United States and Britain in the twentieth century, central bank officials were able to deploy different political and institutional resources in order to play a decisive role in the construction of legal independence.[i] Hence, legislative changes leading to central bank independence may merely be the formalization of the political power already exercised by the central bank.

The final explanation is that of normative or, as put by Babb (2001), expert isomorphism. Organizations, and in the case studied in this article, nation-states, adopt similar institutional practices due to the influence of professionals that share common institutional and policy models. Babb (2001:19) for example, notes that local economists trained in the U.S. and working in state organizations – finance ministries and central banks – of developing countries have been instrumental in pursuing liberalizing institutional reforms in their respective countries, including granting independence to their central banks. These economists, who were trained in American universities, have been socialized into a common ideology and policy paradigm – neo-liberalism – which is also held by powerful foreign actors, both policymakers and international financiers. This cognitive common ground and the social ties with foreign policymakers and officials of multilateral organizations, which are often based on their graduate school days and on prior appointments within international organizations, function as a source of power for local experts, placing them in a pivotal position within the local policy-making field.

Grabel (2002) adds a complementary dimension of expert isomorphism, which relates to the legitimacy problem linked to coercive isomorphism and to the presence of alternative discourses, as suggested by discursive institutionalism (Campbell and Pederson 2001). The diffusion of the model of CBI in recent years stems from the widespread acceptance within the economic epistemic community of the theories of time inconsistency in monetary policy and policy credibility, and especially from their ability to impose these causal models within policy-making fields. These theories suggest that in order for a country and its monetary policy to be credible, and hence effective, its central bank should be freed from shortsighted political influence. Maxfield (1997) adds that, following these assumptions, politicians use central bank independence to try to signal their countries' creditworthiness to potential investors and global financial markets. Therefore, professional economists who claim universal scientific validity for their theories, and introduce CBI in the political-economic field as the only conceivable rational institutional arrangement for monetary policy-making and implementation, play a crucial role in diffusing and legitimizing central banking reforms (Grabel 2003; Kirshner 2003a). Hence the experts' claims about the rationality, or even necessity, of an "a-political" independent central bank, are in themselves a powerful political instrument in the struggle for institutional reform.

Following these neo-institutional explanations, this article asserts that central banks gain independence as a result of political processes whereby different actors in the economic-political field, foreign and local, are involved. As suggested by Fligstein following Bourdieu, interactions within institutional fields are games in which collective actors attempt to increase their power by reproducing or challenging the established system of domination. Hence, these interactions are "continuously conflictual and inherently political" (Fligstein 2001:15; see also Edelman and Stryker Forthcoming). We claim that processes of both coercive and expert isomorphism operate and interact within this field. As we shall show in our analysis, both processes not only operate simultaneously, but, what is more important theoretically, they interact with each other, producing a synergetic effect that strengthens the political dynamics leading to institutional reform.

Yet, the adoption of models of central bank independence originates not only from political interactions among cross-national networks of actors, but also depends on the opening of windows of opportunities for institutional reform, especially a national sense of crisis and political instability. Studies suggest that institutional reforms and the diffusion of new institutional practices are made possible by shocking disruptions in the ordinary state of affairs, that place doubt on the legitimacy

and efficiency of existing institutional arrangements (Djelic 2002; Hall 1992; Keeler 1993). Fourcade-Gourinchas and Babb (2002:538), for instance, claim that the adoption of neo-liberal reforms, including granting independence to the central bank, in all the four countries studied – Chile, Britain, Mexico and France – originated from economic crises. Moreover, the reforms followed intense political debates over the proper economic policy to resolve the crises, and sometimes experimentation with different policy alternatives. Political instability is an additional condition that can open a window of opportunities for the adoption of central bank independence. Cukierman (1998) asserts that under conditions of political polarization, high political instability encourages politicians to delegate more authority to the central bank. In a similar vein, Bagheri and Habibi (1998:200) claim that in both Western democracies and developing countries in advanced stages of democratization, political instability correlates to CBI.

Yet, the specific mechanisms that link crises and instability to institutional change very often remain theoretically vague. Our analysis specifies one central mechanism that links economic and political crises to processes of institutional reconfiguration of the state: the constitution of new policy-making fields and the repositioning within these of political actors. As a result of deep crises, actors who were marginal or did nor participate directly in the policy-making field prior to the crisis become key players with the capability to introduce new policy and institutional models on the agenda. As shall be seen, both conditions of economic and political crises operated in Israel to constitute a new cross-national field of policy-making, within which local and foreign actors had the interests and the necessary political capacity to pursue and accomplish their agenda of institutional reform regarding the position of the central bank within the state apparatus.

Political-Economic Crisis and the Constitution of a Cross-National Field of Policy-Making

The amendment of the Bank of Israel Law was not the result of an automatic process of diffusion of economic models, or the outcome of the decision-makers' discovery of the functional utility of such reform. Rather, it was the result of complex interactions among different external and local actors within a newly constituted policy-making field which emerged as a consequence of a deep political-economic crisis.

The most severe problems of the Israeli economy in the early 1980s included recurrent crises in the balance of payments and escalating inflation. The economic policy of different governments in office has been characterized by inconsistency since the late 1970, and different finance ministers proposed and tried to implement different solutions. Some suggested that economic policy should deal mainly with the improvement of current account of the balance of payments, while others emphasized the need to fight the escalating inflation. In any case, economic policy fluctuated between focusing on either the balance of payments or inflation problems and abandoning the other (Ben-Porath 1986:17-18).

Moreover, the political-economic field was characterized by a deep disagreement regarding the causes of the inflation and the appropriate measures for dealing with it. The first school, headed by Yoram Aridor, the Ministry of Finance between 1981 and 1983, and his economic advisor Professor Yakir Plessner, who also served as the Deputy Governor of the Bank of Israel, explained the accelerated inflation using the 'bubble theory', according to which the inflation process is merely driven by inertia of self-fulfilling expectations. To stop this inflationary vicious cycle, Aridor and Plessner proposed a dollarization plan in late 1983, according to which the U.S. dollar would become the exclusive legal tender in Israel. One of the implications of the dollarization plan was that the Israeli government would not be able to borrow

money from the central bank to refinance the government deficit. An additional consequence would be that the Bank of Israel would not be able to carry out one of is basic functions: the implementation of monetary policy. As the plan would imply completely relinquishing monetary sovereignty, it was received with strong opposition across the board, based on both political and economic considerations. As could be expected, the leading opponents were the Ministry of Finance and the central bank (Bruno and Fischer 1986).

The alternative and more orthodox school, led by Professor Michael Bruno, a well-known economist from the Hebrew University of Jerusalem, and supported by several macro-economists from Israeli and American academia, as well as by the professional apparatus in the Ministry of Finance and the Bank of Israel, argued that the sources of inflation are the large budget deficit and the loss of a monetary anchor. Specifically, a large government deficit persistently increased the internal and external debt and the loss of a monetary anchor caused an accommodation to inflation through the automatic supply of linked liquid assets and an almost automatic adjustment of the exchange rate (Bruno 1986:386; Fischer 1987:275). According to this monetarist approach, the lack of independence of the central bank led to an accommodative monetary policy that further exacerbated the inflationary pressures (Bruno 1993; Bruno and Piterman 1988; Bufman and Leiderman 1999; Djivre and Tsiddon 2001; Fischer 1987; Stein 1990). As we shall show later, this supply-side explanation of inflation, that emerged as dominant in mainstream macro-economics during the late seventies, would provide the concepts and causal model to define the character of the economic crisis as well as the appropriate and necessary measures to resolve it. In other words, this causal and prescriptive model would eventually serve as the cognitive base for building consensus in the political-economic field regarding the necessity to reconfigure the relationships between the central bank and the government in order to ensure fiscal and monetary discipline. Yet, in order to play such a role in the process of institutional change, it was necessary a reconstitution of the policy-making field that would permit the academic economists who carried the monetarist model to position themselves as institutional entrepreneurs (see Campbell 2004). The intensification of the inflation and balance of payments crises led to such a development.

Though the poor performance of Israeli economy dated from 1974, since 1983 hyperinflation became the most salient political-economic problem: while annual average inflation in the period 1979-1983 was 123%, in the period 1983-1985 it reached 389% (Bruno 1993:50). Under these conditions, an urgent sense of crisis developed among both the political elites and the public, creating a perception that the Israeli state was losing its control over the economy and society to a point that its very legitimacy was threatened (Grinberg 1991; Shalev 2000). As a result of the objective economic conditions and the political construction of the crisis, the situation was perceived as a fundamental threat to the established distribution of power in the Israeli polity. Furthermore, following the 1977 elections political polarization become a constant characteristic of the Israeli polity, and the continuous political instability led to the emergence of new actors in the policy-making field, or at least a significant re-allocation of power among old actors, opening the way for non-elected elites such as the judiciary, regulators and professionals to become important players in decision-making processes (Maman 2004).

Under these conditions of deep economic and political crisis, political elites started to rely on experts and professionals, especially from the academia, while looking for measures to deal with the economic problems. This allowed academic economists to introduce their causal and prescriptive models into the policy-making field, starting to play the role of institutional entrepreneurs. In addition, the

dependence of the Israeli state on American resources in general and to confront the economic crisis in particular, and the American geopolitical interest in the resolution of the economic crisis repositioned the American government within the policy-making field, significantly increasing its direct influence over the direction of the institutional and policy reforms. Hence, the conjunction of acute economic crisis and political instability led to the constitution of a cross-national policy-making field composed of the professional staff of the Ministry of Finance and the central bank, the U.S. administration, and Israeli and American academic economists, whose primary preoccupation was to formulate policy and institutional reforms to overcome the hyperinflation crisis. By promoting the constitution of this new policy-making field, the political-economic crisis opened a window of opportunities for the legislative amendment that would lead to central bank independence. The question to which we now turn is how the interaction between the different actors in the field served as base for the processes of coercive and expert isomorphism that led to the institutional turning point in the relations between the central bank and the government.

Political Actors, Isomorphism and Central Bank Independence

In contrast to the American and English cases, in which central bank officials played a pivotal role in promoting legal central bank independence (Stockdale 1999), the Bank of Israel was a relatively minor player in the political-economic field. Yet the central bank was eager to change its position within the state configuration, and to alter its relationships with the government. In January 1984, for example, the Governor of the Bank of Israel submitted the Money Supply Report to the government and the Knesset Finance Committee in which he urged them to adopt an economic policy appropriate for simultaneously dealing with the recurrent balance of payments crisis and escalated inflation. The Governor proposed that the government would not be allowed to finance the deficit by borrowing money from the central bank. The proposal reflects the central bank's view that there was a need for a radical change in the Israeli political-economic regime, and especially in the relationships between the government and the central bank that will grant independence to the latter. The government, and especially the Ministry of Finance, opposed the central bank's proposal, and in a cabinet meeting the Governor was condemned by the Deputy Prime Minister for putting it forward. In a newspaper interview, the Governor admitted that recommending the proposal "was a political mistake but not an economic mistake."[ii]

The institutional configuration of the Israeli developmental state placed the central bank in a marginal position within the policy-making field, functioning essentially as a "technical instrument of the government."[iii] This institutional feature prevented the possibility that the central bank would have the political and institutional resources required to play a prominent role in the process leading to its legal independence, as was the case in the Federal Reserve System and the Bank of England (Stockdale 1999). Moreover, the central bank's political and institutional weakness was further aggravated by two specific circumstances that damaged its public prestige: the failure to efficiently manage the hyperinflation crisis attributed to it, and its responsibility for the bank-stock collapse in 1983. Given this marginality, the involvement of the central bank in the process was restricted mainly to raising the issue of the need for the legislative amendment in decision–making circles.

A far more powerful actor in the cross-national policy-making field was the American administration. The continuous and severe economic crisis led the administration to increase its direct involvement in the management of the Israeli economy, as it was concerned that Israel would join the Latin American countries who were suffering from an acute debt crisis, and that the economic assistance would vanish with spiraling inflation. It is safe to assume that the American government was concerned about the negative repercussions of the potential destabilization of the

Israeli state due to the hyperinflation crisis on its own geopolitical interests. Hence, starting in 1982, before Congress approved the annual economic assistance, the American government initiated economic discussions with Israel in order to push forward substantial changes in the economic policy.

It is important to note that this increasing involvement occurred during the Reagan administration, when the neo-liberal economic doctrine became dominant and the administration adopted a new economic paradigm based on the principle of removing government intervention from the economy. The main policy tools and institutional means proposed to achieve low inflation and economic growth were government contraction, deregulation and increased fiscal and monetary discipline. Though not always strictly implemented in the U.S., this neo-liberal agenda was exported to less developed countries by multilateral and American government agencies such as the World Bank, the IMF and the U.S. Treasury, interacting with local actors, such as professional economists educated in American universities (Babb 2001).

In order to fulfill its active role within the Israeli policy-making field, the Administration adopted a new pattern of operation regarding the Israeli crisis. In the fall of 1983, Secretary of State George Shultz – who was Professor of Economics at the University of Chicago – nominated a team of four economists, headed by Professor Herbert Stein and including Professor Stanley Fischer from MIT[iv] to advise him on the Israeli economy, indicating the significance the Administration attributed to the economic crisis in Israel. Stein served previously as the Chairman of the Council of Economic Advisors under President Nixon and President Ford, and then as Professor of Economics at the University of Virginia and as senior fellow at the American Enterprise Institute, a well known conservative think thank. Furthermore, a series of conferences on the Israeli economy were held in Washington with the participation of economists from the Israeli state bureaucracy – Ministry of Finance and Bank of Israel – and from the U.S. government, in particular from the State Department. In addition, several professors of Economics from both Israel and the U.S. were invited to participate, providing the Administration with the opportunity to form its opinion of the Israeli economy and exercise its influence on policy-making through the authoritative voice of academic economists. The incorporation of academic economists in the policy-making field and their active participation in consultations were intended to create the impression that the U.S. government was not dictating policy to Israel, but rather suggesting measures based on their valuable professional expertise. Hence, the mechanism of expert isomorphism was mobilized as a tool to legitimize coercive isomorphism by concealing its power dimension. Thus, Samuel W. Lewis, the U.S. Ambassador to Israel, could claim that "no formal 'conditionality' was ever sought or imposed" (Lewis 1986). A similar claim was made by Herbert Stein:

> The relationship between the U.S government as adviser and the Israeli government as advisee was delicate and unusual. The Israelis were understandably sensitive to the idea of being dictated to about their economy policy, and the U.S. government did not want to prescribe policy for Israel (Stein 1990:15).

Given the position of the Federal Reserve System in the American political-economy, central bank independence was taken for granted by the American side. Moreover, the new economic paradigm held by the Reagan administration together with the monetaristic approach to inflation dominant among academic economists, gave the central bank a central role in the decision-making process, especially while attempting to resolve hyperinflation crises. Consequently, from the early phases of the consultations, the Americans suggested that Israel should amend the Bank of Israel

Law, prohibiting the government from borrowing money from the central bank, even before adopting a comprehensive stabilization program. For example, in December 1984 the *Ha'aretz* newspaper published a letter from Secretary Shultz to Prime Minister Peres, in which the former advised Israel to adopt "the old American proposal to grant independence to the central bank, which will limit printing money by the government and will help fighting the inflation."[v] Similarly, during a visit in Israel by the Chairman of the Senate Sub-Committee for Foreign Assistance Programs, Senator Robert Kasten (Republican), together with a member of the sub-committee, Senator Daniel Inouye (Democrat), discussions were held regarding the economic crisis and the new Israeli request for $1.5 billion in emergency aid in which they expressed their view that the central bank should be much more independent and influential and closer to the American model.[vi] It is clear that the coercive power of the American administration rested not only on Israel's general economic and political dependence on the U.S., but also on Israel's specific request for extra emergency aid of 1.5 billion dollars to overcome the crisis.

Thus, one of the major factors that led to the amendment of the law prohibiting the government from borrowing directly from the central bank was the pressure and coercive power exerted by the U.S government which was presented as "persuasion among friends" (Stein 1990:15). In fact, as stated by Michael Bruno, the architect of the 1985 stabilization program, in the Israeli case the U.S. government played the lending and monitoring role that the IMF plays in the cases of other less-developed countries (Bruno 1993:87).[vii] However, coercive isomorphism by a foreign actor was not the only mechanism that led to the reform. Local actors, especially academic economists, played a crucial role in promoting the amendment of the law and in mobilizing the American administration support to persuade both elected politicians and nominated state officials.

As previously stated, the continuous political-economic crisis led the way for the increased involvement of academic economists within the political-economic field, allowing them to promote the reform in the relationships between the government and central bank. From the early 1980s, prominent economists from the Hebrew University and Tel Aviv University, as well as American experts on the Israeli economy, held ongoing discussions with economists from the research department of the Bank of Israel, focusing on the factors that led to the economic crisis and the appropriate measures required for dealing with it. Among the participants were Michael Bruno, Don Patinkin and Nissan Liviatan from the Hebrew University, Eitan Berglas and Elhanan Elppman from Tel Aviv University, Stanley Fischer from MIT and Jacob Frenkel from the University of Chicago (Bruno 1993:88). These discussions resulted in different policy proposals. For example, Michael Bruno, who would be the architect of the stabilization program implemented in 1985 and Governor of the Bank of Israel between 1986 and 1991, published in 1981 a comprehensive "shock" program in which he asserted that inflation results from two sources: a large budgetary deficit and excessive flow of credit. The central bank was deemed as being largely responsible for the flow of credit, especially through the monetization of the government deficit. Hence, one of the solutions proposed was barring the government from borrowing from the Bank of Israel. This was conceived as a means of imposing both fiscal and monetary discipline (Bruno 1981). Similarly, in 1982 Jacob Frenkel, who would serve as Governor of the Bank of Israel between 1991 and 2000, and Stanley Fisher, who was recently appointed as the next Governor of the Bank of Israel, published a detailed proposal for a stabilization strategy involving fiscal and monetary reform along orthodox monetarist lines. The proposal stressed the need for a concentrated, rather than gradual, effort, and was based on a drastic reduction of the budgetary deficit and a rigorous restrictive

monetary policy that would require an independent central bank (Fischer and Frenkel 1982).

The direct involvement of academic economists illustrates how the political-economic crisis opened windows of opportunity for new players to enter into the policy-making field as well as the role played by expert isomorphism. In contrast to the previously customary pattern of economic policy-making in Israel, leading academic economists (Israeli and American) who claimed scientific expertise and apolitical objectivity started to assume an important role in the formulation of the appropriate and indispensable economic policy and institutional reforms to resolve the crisis. First, these economists were instrumental in introducing into the Israeli policy-making field the monetarist approach to inflation that began to predominate in the epistemic community of economists in the late seventies, providing a scientific and hence persuasive causal model to explain the hyperinflation. Second, they could offer a concrete and authoritative package of policy measures necessary to resolve the crisis, as stemming directly from their causal model. Hence, the process of change led by professionals as institutional entrepreneurs was one of adoption of macroeconomic models which support granting independence to central banks, and their application to the concrete conditions of the hyperinflation crisis in Israel.

The source of professional power was derived from their knowledge and expertise as well as their participation in the political game. Professional economists, both in academia and in the state bureaucracy succeeded in positioning themselves as professional natural and apolitical actors, and as monopolistic holders of the jurisdiction of the economic field (Abbot 1988). Moreover, within the context of the continuous economic crisis and the chronic failure to resolve it, the advice of professional economists was perceived as objective and as such served as a mechanism to mobilize legitimization for unpopular policy measures (Keren 1995). As suggested by Keren (1995), economists did not live in an ivory tower, but rather participated in a power game over symbolic and material resources. The political mobilization of members of the economic profession who took part in the policy-making process during the 1980s included three roles: alerting, advising and explaining. This mobilization originated from the fear that the economic crisis and the continuous unsuccessful attempts to overcome it would delegitimize the economic profession. Hence, the stabilization of the economy was aimed not only at preventing its continuous deterioration, but also at consolidating the position of economists within the economic policy-making field.

The participation of economists from academia in policy-making and the importance of the cross-national network built by Israeli and American professors are best illustrated by their direct involvement in the discussions on the stabilization program. The Joint American-Israeli Economic Development Group (JEDG) was established in late 1984 by an agreement between the American Secretary of State, George Schultz, and Israeli Prime Minister Shimon Peres, with the purpose of elaborating a concrete stabilization program as was demanded by the American administration as a condition for providing the extra financial assistance asked for by the Israeli government. The Israeli side was headed by Emmanuel Sharon, the Director-General of the Ministry of Finance. Other members of the team were Professor Bruno, Professor Berglas, Professor Liviatan (who participated part of the time) and Mordechai Frenkel, head of the Research Department at the Bank of Israel, who was an unofficial member since the central bank and its Governor were not formally involved in process (Bruno 1993:97). The American side of the committee included Professors Stanley Fischer and Herbert Stein, both well-known for their firm monetarist approach. The two American economists were sent to Israel in April 1985 in order “to see if we could firm up what needed to be done” (Fischer 2001). At the

end of the visit Stein unofficially submitted a list of ten measures that should be the essential components of the stabilization plan to Emmanuel Sharon, the Director-General of the Ministry of Finance. The list was leaked to the Israeli press and published as the "*Herb's* (Stein) *Ten Points"* (Stein 1990). Its fourth point stated that "The Bank of Israel Law (that prohibits the Central Bank lending money to the government) should be passed."[viii]

The influence of academics was not only exercised directly on local decision-makers. Using their professional and personal networks, they succeeded in mobilizing support from the American government in order to promote their reform agenda. The close relations of the American members of the team – Professors Stein and Fischer – with the Administration facilitated the mobilization of the American coercive power by the carriers of expert knowledge. This involvement of professionals in the bilateral relationships between the governments was criticized by politicians and high officials in the Israeli state bureaucracy, and the academic economists were even accused of persuading the American administration to refrain from approving the extra aid package unless Israel adopts a comprehensive stabilization program based on the ten measures presented by Herbert Stein. Prime Minister Peres argued that there was nothing of the sort,[ix] and yet Professor Bruno admitted that:

> "Actually, there was apprehension among private economists on either side that an extra package might be approved by the U.S. Senate before the adoption of a comprehensive programme and without adequate conditionality being attached" (Bruno 1993:100, note 33).

The economists' involvement in the policy-making process was not limited to convincing decision-makers in Israel and the U.S., but they also partipated in a well-orchestrated campaign to foster public support for the reform program. Through articles in daily newspapers and interviews in the electronic media, professional economists prepared the public for a new set of economic rules and convinced the public that difficult decisions would have to be made (Keren 1995). For instance, in an article published in the newspaper *Ha'aretz*, Bruno emphasized the need for monetary reform and a halt of money printing by the Bank of Israel to finance the budget deficit.[x] Similarly, in an interview published in the same newspaper, Professor Eytan Sheshinsky, an economist from the Hebrew University, quoted American pressure as an important reason for implementing the reforms. He asserted that if these measures were not to be implemented, "there will be anger in the administration, and this definitely could affect the American willingness to assist us in the future."[xi]

The interacting processes of coercive isomorphism – i.e. the political and economic pressures exercised by the U.S. government – and expert isomorphism – i.e. the diffusion of policy models based on scientific expertise by academic economists – were extremely instrumental in the adoption of the institutional practice of CBI through the amendment of the law. However, a necessary condition for the amendment was the willingness of the Ministry of Finance to adopt such a reform, which actually involved losing power to an actor that until that point had been a mere agent of the Ministry of Finance. Hence, it is important to consider the interests of this key actor in the policy-making field that conduced to its decision to tie its own hands by conceding a considerable level of legal independence to the central bank.

The spiraling inflation and the continuous failures of different governments to deal with the lasting economic crisis led the Ministry of Finance to realize that it has lost its pivotal position within the state bureaucracy, especially concerning fiscal policy. The Ministry of Finance failed to maintain fiscal discipline, since different governmental ministries, municipalities and other governmental and state organizations took advantage of the hyperinflation to expend their operations, increasing the deficit in turn. For example, the budget deficit reached 15 percent of

GDP in 1984 (Bruno 1993:115, Table 5.2) The growing deficits were financed largely by the creation of money by the Bank of Israel, and this led to accelerating inflation. This lack of control over fiscal policy is illustrated by the assertion of the Minister of Finance, Yitzhak Moda'i in a discussion in the Knesset Finance Committee: "The Budget Bill and the Budget Principles Law tie the hands of the Ministry of Finance and not of other governmental ministries."[xii]

The deficit problem became far more severe as a result of declining state revenues. For example, in 1984 there was a 14 percent drop in state revenues as a result of several factors, including the acceleration of inflation and the decrease in purchases of durable goods (Bank of Israel 1985). Moreover, businesses and independent income-earners took advantage of the high inflation rate delaying the remittance of their taxes, thus decreasing the real value of government tax receipts (Patinkin 1993:119). In order to reestablish its pivotal position within the state apparatus as the agency that command fiscal policy, in late 1984 the Ministry of Finance proposed some legislation amendments that would strengthen its power vis-à-vis other state agencies. Basically, the Ministry of Finance suggested two complementary measures. First, deviations from the budget by specific agencies would be addressed using one of two courses, according to the size of the deficit: in a case of minor deviations from the planned budget (a managerial deviation), the officials responsible would be charged in the Disciplinary Court for the Government Employees, whereas in cases of significant deviations from the planned budget, the administrators would be charged according to criminal law. The second proposal, based on the recommendations of the U.S. Administration and the academic economists, was to prohibit the government from borrowing from the Bank of Israel to finance the budget deficit. According to the proposal publicized by the Minister of Finance, Yitzhak Moda'i, the central bank would not be able to print money according to government demand, and hence would assume full responsibility for the monetary policy.[xiii]

As soon as the Ministry of Finance reached the conclusion, under the influence of the American Administration and the cross-national network of academic economists, that it would be in its political and organizational interests to restore its pivotal position within the state bureaucracy, and that to achieve this goal it needed to tie its own hands, the door was opened to amend the law. In other words, the processes of coercive and expert isomorphism brought about institutional reform through their effects on the way in which the key actor in the policy-making field formulated its interests and the appropriate means of pursuing them.

From the end of 1984 until mid-1985, the Ministry of Finance and the Bank of Israel negotiated several aspects of the law: which law would prohibit the government from borrowing money from the central bank; the length of the transitory period in which the government would be able to continue to borrow money; and the amounts of money that the government would be able to borrow in the transition period. In May 1985, following the end of the negotiations between the central bank and the Ministry of Finance, and before the decision on the Stabilization Program was made in early July, the government approved the amendment of the Bank of Israel Law that added an article which could henceforth only be changed by an absolute majority of Knesset members, prohibiting the central bank from lending to the government to monetarize its deficit.

When the amendment proposal was put before the Israeli Parliament, both the Ministry of Finance and the Bank of Israel urged the members of the Knesset Finance Committee to pass the amendment as soon as possible. To build the legitimacy of the reform, the Governor of the central bank appealed to the principle of learning from the experience of successful economies, arguing that it was necessary for the Israeli

economy to follow the model existent in other countries. He claimed: "In all countries around the world which achieve price stability, the government can not take loans from the central bank to finance its expenditure…"[xiv] Moreover, in order to strengthen their arguments, central bank officials resorted to the most prized model in the Israeli economic-political field, emphasizing that the legal restriction on the central bank to loan to the government exists in the U.S.[xv] In addition, attempting to mobilize legitimization from powerful external actors, the bank officials asserted that there is a consensus among the community of central banks, international financial institutions and the U.S. administration on the need for reform in the relationships between the government and central bank. This is illustrated by the argument of the Governor of the Bank of Israel in the Knesset Finance Committee:

> I just return from the annual meeting of the Governors of Central Banks in Basel and this (the amendment of the law which prohibits the government from borrowing from the central bank) was the only thing I could 'sell' them… In this terrible period of the State of Israel, I don't think we should undervalue the International Monetary Found and other organizations that think that this is the minimum we can do.[xvi]

Thus, despite its marginal position, the central bank officials made enormous efforts to legitimate the reform agenda through indicating that the Israeli economy, like other economies in the word, will benefit from it and by stressing the consensus among external actors over its necessity.

On July 29, 1985, the Knesset passed the amendment to the Bank of Israel Law that became known in Israel as the "law against money printing". The legislative amendment represents an institutional turning point in the relationships between the central bank and the government, especially the Ministry of Finance. While tying the hands of the Ministry of Finance, this statutory change opened the way for the Bank of Israel to significantly increase its actual independence from the political and bureaucratic echelons of the government (Cukierman 2004). During the discussion of the amendment in the Israeli parliament, MK Ramon foresaw the future by asserting the following:

> This amendment of the law is the declaration of independence of the Bank of Israel. It is not surprising that the Governor of the Bank fought tooth and nail on the amendment. The Governor believes that as soon as the new law is passed there will be no differences between the central bank and the Federal Reserve Bank.[xvii]

Though the legislative amendment was not formally part of the stabilization program, it certainly was a central component of the basic reform in the Israeli political-economy initiated in 1985 with the implementation of the emergency stabilization plan. While serving as Governor of the Bank of Israel, Michael Bruno stated:

> One of the most blessed decisions taken by the Knesset in the last decade, or in the last twenty years, is the 1985 decision on the law against money printing. If there is a thing that sets a limit, so that we have an inflation of 15-17-18 percent and not of 500 percent, this (the legislative amendment) is one of the components.[xviii]

As in the case of the legislative amendment, the Bank of Israel was not formally involved in the crystallization of the stabilization program, yet its successful implementation depended to a large extent on actions taken by the central bank. These actions were related to the program's two basic components: a significant decrease in government spending and hence in its deficit, and a restrictive monetary policy. Concerning the restrictive fiscal policy, the limit on government borrowing from the bank imposed by the amendment of the law functioned as an important factor that contributed to the reduction of the deficit. As for the monetary policy, the Bank of

Israel restricted the nominal size of bank credit and during the first months following the implementation of the program it produced extremely high real rates of interest (Patinkin 1993:119).

This central role in the new economic policy would serve the central bank as a resource upon which it would build its public prestige and institutional power as an apolitical agency, working on behalf of the common good according to scientific criteria, especially during the tenure of two prominent academic economists: Professor Michael Bruno (1986-1991) and Professor Jacob Frenkel (1991-2000). Hence, the amendment of the Bank of Israel Law and the stabilization program constitute a shift in the position of the central bank within the state apparatus in Israel, a watershed in the level of central bank independence. Since then, from being an agent of the Ministry of Finance within the framework of a developmental state, the Bank of Israel gradually emerged as a powerful actor in the political-economic field that very often would strongly confront the government around issues of current monetary and fiscal policy, as well as around the contested institutionalization of new rules of the game concerning the configuration and functioning of financial markets and the relationships between the central bank and the government.

Conclusions

The amendment of the Bank of Israel Law, prohibiting the central bank from lending money to the government to finance its deficit, marks a turning point in the position of the central bank within the state institutional configuration. While since its establishment in 1954 the Bank of Israel functioned under the effective control of the Ministry of Finance, playing a central role in the monetization of the fiscal deficit and allocation of cheap credit according to the development policy of the Israeli state, after 1985 it gradually became a central actor in the political-economic field, concerned mainly with price stability and liberalizing institutional reforms. As in many other countries (see for example Carruthers, Babb, and Halliday 2001; Loriaux et al. 1997), this shift in the position and functioning of the central bank is part and parcel of the general transformation of the interventionist state into a regulative state, which implies a basic change in the power relations between different state agencies (Maman 2004).

In this paper we examined the Bank of Israel's "declaration of independence" not as a process of functional adaptation to new conditions, such as the re-globalization of finance, based on social learning and automatic processes of adopting "rational" or "effective" institutional innovations (e.g. Siklos 2002), but as an inherently political process. Furthermore, the reform that led to higher levels of central bank independence in Israel was not the result of simple processes of imitation, as suggested by world-culture theory and some neo-institutional approaches (Polillo and Guillen Forthcoming), nor the consequence of politicians attempting to use central bank independence to signal their nations' creditworthiness to global financial markets (Maxfield 1997). In contrast to other cases of growing central bank independence (Stockdale 1999), due to the institutional configuration of the pre-1985 Israeli developmental state, the central bank did not play a decisive role in the institutional turning point that would lead to its behavioral independence.

We have focused our analysis on the complex relationships between different political actors within a newly-constituted, cross-national policy-making field. Local academic economists, who prior to 1985 were located at the margins of the decision-making field, became key players with the capacity to promote their agenda of institutional reform. Their success resulted both from their ability to formulate concrete and authoritative policy and institutional alternatives based on scientifically-accepted cognitive frames, and from a crucial resource held by local economists: their

close ties with leading American economists. The dense network of cross-national academic economists enabled them to gain access to both the Israeli decision-makers and the American administration, which used its coercive power to put pressure on the Israeli government to amend the Bank of Israel Law. Within the context of a deep political-economic crisis that threatened the established distribution of power between state and society and between different state agencies, the Ministry of Finance adopted the institutional changes proposed by the carriers of coercive and expert isomorphism as a means of restoring its dominant position within the state apparatus.

At a more theoretical level, we have shown that within the newly established cross-national policy-making field functioned processes of both coercive and expert isomorphism. These two mechanisms of institutional change are generally considered in the literature as alternative explanations for institutional reform (Babb 2001; Polillo and Guillen Forthcoming). In contrary to this assumption, our analysis suggests not only that coercive and expert isomorphism can operate simultaneously, but, more importantly, they can interact with each other in a way that reinforces the dynamics leading to institutional change. On one hand, the actor carrying the process of coercive isomorphism, the American administration, mobilized the scientific expertise of both American and Israeli academic economists in order to legitimize the pressure it placed on the Israeli government, precisely by concealing its coercive character. On the other hand, the actors carrying the process of expert isomorphism, the American and Israeli economists, mobilized the American coercive power in order to promote their reform agenda. The concerted actions of these actors had synergetic effects that fostered the dynamics leading to CBI, being instrumental in the formulation of the Ministry of Finance's own interest in granting independence to the central bank as a tool to restore its control over fiscal policy and hence its pivotal position within the state apparatus.

A second contribution of our study refers to the conditions that made the operation of these mechanisms of institutional change possible. Many studies have asserted that profound economic and political crises open windows of opportunities for institutional reform (e.g. Campbell 2004; Fourcade-Gourinchas and Babb 2002; Keeler 1993). In our analysis, we specified one central mechanism that connects political-economic crisis to institutional reform: the constitution of new policy-making fields and the repositioning of political actors within them. In our case, the crisis led to the constitution of a cross-national policy-making network in which the American administration played a far more intensive and direct role than before. Similarly, the crisis led to the emergence of academic economists, both local and foreign, as central actors in the process, proposing and legitimizing policy measures and institutional reforms. The appearance of these actors on the scene, who carried the processes of coercive and expert isomorphism, profoundly affected the ways in which the Ministry of Finance defined the tools to resolve the crisis while simultaneously advancing its political and organizational interests; namely, the adoption of an institutional reform which led to an increasingly independent central bank.

Notes

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[i]. Stockdale (1999) refers to four legislative events: the 1935 Banking Act and the 1980 Monetary Control Act in the U.S., and the 1946 Bank of England Act and the 1998 Bank of England Act in the U.K.

[ii]. Sharoni, Yehuda, "The Lost Honor of the Bonds", *Kesaphim*, Issue 191, February 20-26, 1984, p. 10 (in Hebrew).

[iii]. Sharoni, Yehuda, "The Lost Honor of the Bonds", *Kesaphim*, Issue 191, February 20-26, 1984, p. 6 (in Hebrew).

[iv]. In an unprecedented decision, Fischer, an American citizen, was recently appointed by the Israeli government to serve as Governor of the Bank of Israel.

[v]. Eldar, Akiva and Zvi Barel, "Secretary of State Shultz in a Letter to Peres", *Ha'aretz*, December 25, 1984, p.1 (in Hebrew).

[vi]. Maoz, Shlomo, "The Senators Come from the U.S.: Israel Should First Help Itself", *Ha'aretz*, December 17, 1984, p. 2 (in Hebrew).

[vii]. In contrast to other less-developed countries (see Babb 2003; Fourcade-Gourinchas and Babb 2002; Stiglitz 2002), in the Israeli case the IMF did not play a direct role in imposing neo-liberal reforms, including granting independence to the central bank. The reason is quite simple: the Israeli economy, even during the deep crisis, was not dependent on IMF resources. Counting on the geo-politically motivated generous support from the U.S. government, in 1984 Israel decided to continue the policy it had followed since 1978, and decided not to apply for financial aid from the IMF. The rationale of the Ministry of Finance was that Israel was not willing to consent to the conditions imposed by the IMF; i.e. adopting the comprehensive liberalization reforms that are a precondition for IMF loans (see Maoz,

Shlomo, "Israel will Continue this Year not Asking for Financial Aid from the IMF", *Ha'aretz*, March 4, 1984, p. 6 [in Hebrew]).

[viii]. *Ha'aretz*, "Herb's Ten Points", April 18, 1985, p.2.

[ix]. Maoz, Shlomo, "The Balance will Decline in 250 Million Dollars in June in the Event we do not Get Aid from the USA", *Ha'aretz*, June 13, 1985, p. 1 (in Hebrew).

[x]. Bruno, Michael, "How to Escape from the Inflation", Ha'aretz, January 20, 1984, p. 11 (in Hebrew).

[xi]. Eldar, Akiva, "Today's Conversation: With Professor Eytan Sheshinsky", *Ha'aretz*, May 1, 1985, p. 2 (in Hebrew).

[xii]. Knesset, Finance Committee, Protocol no. 150, June 25, 1985, p. 14 (in Hebrew).

[xiii]. Lavie, Arie, Yehudit Vinkler, and Sagy Hehud, "Moda'i Rejects the Dollarization and Patamization Plans for the Stabilization of the Market", *Ha'aretz*, December 28, 1984, pp. 1-2 (in Hebrew).

[xiv]. Governor of the Bank of Israel in the Knesset Finance Committee, Knesset, Finance Committee, Protocol no. 146, June 17, 1985, p. 8 (in Hebrew).

[xv]. Knesset, Finance Committee, Protocol no. 146, June 17, 1985, p. 8 (in Hebrew).

[xvi]. Knesset, Finance Committee, Protocol no. 146, June 17, 1985, p. 25 (in Hebrew).

[xvii]. Knesset Proceedings, Bank of Israel Law (Amendment 15), June 3, 1986, pp. 2720 (in Hebrew).

[xviii]. Knesset, Finance Committee, Protocol no. 344, December 26, 1990, p. 11-12 (in Hebrew).