

Banking Privatization in Israel, 1983-1994: A Case Study in Political Economy*

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1. Introduction

Economists view economic efficiency as at least one and perhaps the most significant objective of both privatization and economic liberalization. And although these two concepts are distinct, they achieve their goal best when they are pursued jointly. Liberalization removes impediments to competition, and thus allows the more efficient suppliers to prevail in the competitive battle. Privatization substitutes entrepreneurs for bureaucrats, and thus the profit motive for a more passive attitude to the marketplace.¹ However, both liberalization and privatization upset the *status quo ante*, and thus transform, perhaps radically, the distribution of economic rewards. The powerful forces of the past cannot be expected to yield gracefully to the likely masters of the new economic environment. Their resistance can take a variety of forms, not the least of which is to subvert the rules of the new regime to serve the desires of the old guard.

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¹ Clearly, this is a very stylized view, which is examined more carefully in Prager (1992). Vickers and Yarrow (1988, Chs 2 and 3) remains an excellent summary of the relationship between efficiency, ownership, and competitiveness.

The present case study of privatization focuses on the political economy of the process, but deals with an unusual coalition of political players. Privatization policies are typically resisted by the managers and workers of to-be-privatized state-owned entities – rightly fearing the unemployment that normally accompanies privatization – and government ministers and bureaucrats, who lose patronage and control opportunities. The conflicts in the Israeli banking episode revolved less about whether the banks should be privatized than whether the privatization program should also be directed at radically modifying the structure of the banking industry. Hence, the banking community, managers and employees alike, and the Finance Ministry establishment supported privatization. The delay was partly a consequence of trying to satisfy the major interest groups and partly caused by central bank resistance.

The senior echelons of the Bank of Israel saw in the privatization process an opportunity to increase the competitiveness of the Israeli financial system. At the same time, the issue of the new owners of the banks came to the fore. Should each bank be sold to a nucleus group of owners, who possessed the capital and experience to operate the privatized institution, or should each bank be sold through a public offering on the stock market, and hence let the market decide ownership and control? This article argues that the answers to the interrelated issues of competition and ownership were made on political, not economic or financial, grounds. The attempt to revert to the *status quo* prior to the takeover of the banks by the government effectively squandered an opportunity to open the banking system to more competition.

The next section describes the structure of Israeli banking in both the banking and capital markets. Section 3 focuses on the stock market panic in 1983 caused by a potential meltdown in bank equities and the subsequent takeover of the nation's four leading banks by the government. The pseudo-nationalization of the banks was accomplished in a most oblique way, for the political leadership was obsessed with avoiding even the appearance of government ownership. Moreover, even after obtaining *de jure* ownership over the banks, the government refused to control or operate the banks.

My hypothesis, also spelled out and supported in Section 3, argues that the political and banking communities would jointly benefit from preserving the mechanism that had evolved over three and a half decades of Israeli statehood. It was more than inertia that underlay the attempt to restore the *status quo ante*. Real advantages in

the form of profits and political rewards had accrued the cadre of leading financial and political persona. The players appeared to believe that once this temporary fracture had been repaired, the system would continue to reward its past beneficiaries. That, in turn, meant that the structure of the banking industry should not be tampered with. It was not until reorganization proved inescapable that reforms were introduced.

Section IV turns to the issues and the parties involved in a proposed banking industry restructuring. It further highlights the political economy of privatization during the years between 1983 and 1993, and completes the historical record to late 1994. The final section summarizes.

A study such as the one undertaken here typically suffers from a lack of direct evidence. We can infer from parties' actions; rarely can we know from the written record or the oral testimony of the conspirators. Fortunately, some basis for the assertions made in this paper are backed by evidence gathered by a judicial investigatory commission of the bank stock crisis and government comptroller general audits of the privatization process. It should also be noted that the 1983-94 period covers a number of different governments, both right and left wing. But despite government turnovers – because they did not alter fundamental political relationships – the Israeli governments' policies toward the banks remained unchanged.

2. The Israeli banking system

Historically, the Israeli banking system differed little from banking systems in the non-communist world. Although socialist governments ran the major political institutions and although many of the nation's leading industrial firms were state-owned, not all the banks were public sector companies. Some banks, such as Israel Discount, Ellern, and Feuchtwanger, were owner-operated. A family – usually that of the founder – not only owned substantial shares, but also exercised its ownership rights by managing the institution. In others, widespread ownership meant that the typical equity owner did not and was not really interested in exercising control (e.g., United Mizrahi Bank). Instead, the banks were run by a self-perpetuating management group often allied to a political party. A network of credit cooperatives also provided key banking services, much along

the lines of credit unions in the US. However, they were never significant quantitatively, and by the late 1960s were no more than a handful. Indeed, they disappeared from the published banking records after Israel's basic banking act was revised in 1981.² Table 1 summarizes the historical development of Israeli banks and credit cooperatives by number and size for selected years.

TABLE 1
NUMBER AND ASSETS OF ISRAELI BANKING INSTITUTIONS, 1950-1992

	1950	1956	1961	1966	1972	1976	1981	1987	1992
Number of banking institutions	108	118	53	45	37	37	26	29	28
Commercial banks	23	25	26	27	24	21			
Credit cooperatives	85	93	27	18	13	6			
Total assets*	215	702	1,833	5,284	29,143	172,924	676.8	97.2	223.2
Commercial banks	181	564	1,733						
Credit cooperatives	34	138	155						

* The currency changes that characterized the inflation that began in the late 1970s are reflected as follows: 1950-1976 values are denominated in millions of Israeli lira; 1981 are in billions of Israeli sheqels; 1987 and 1992 are in millions of New Israeli sheqels.

Sources: Number: 1950-1961: Heth (1966), p. 40; 1966: Bank of Israel, *Annual Report* (henceforth, BIAR), 1966, p. 397, Table XV-16; 1972: BIAR 1973, p. 478, Table XVI-14; 1976: BIAR 1977, p. 565, Table XXI-8; 1981: BIAR 1983 (Hebrew), p. 316, Table IX-10; 1987: Bank of Israel, *Israel's Banking System: Annual Survey 1991* (henceforth, BIIBS), p. 47, Table 13; 1992: BIIBS 1992, p. 101, Table D-1. Assets: 1950-1961: Heth (1966), pp. 111-112; 1966: BIAR 1966, p. 396, Table XV-15; 1972: BIAR 1972, p. 360, Table XIII-18; 1976: BIAR 1977, p. 431, Table XVIII-10; 1981: BIIBS 1981, p. 25, Table B-3; 1987: BIIBS 1987, p. 7, Table 3; 1992: BIIBS 1992, p. 32, Table B-1.

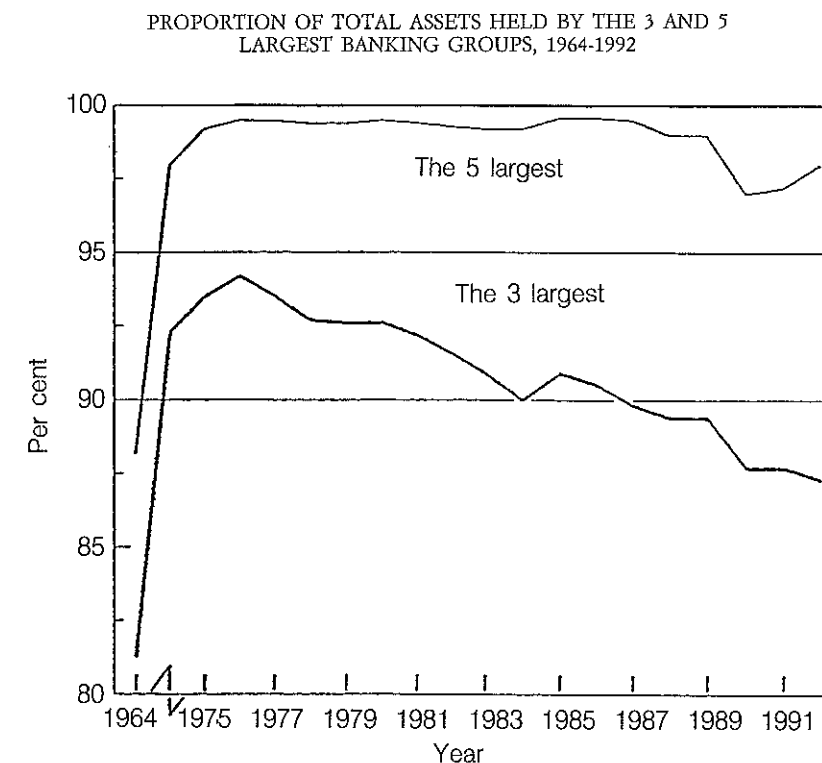
But although the number of banking institutions was large for a small country, a few giant banking conglomerates³ held a disproportionately large share of the nation's deposits and banking assets. Figure 1 depicts the share of total assets held by the 3 and 5 largest banking groups.⁴

² Heth (1994, II, pp. 10-11) documents and explains the decline of the credit cooperatives.

³ A definitional comment is in order. An Israeli banking conglomerate consists of a banking group and unconsolidated financial and non-financial concerns. The group comprises banking corporations registered in Israel, banks abroad, and consolidated financial and non-financial affiliates. The banking corporations themselves comprise ordinary banking institutions and specialized banking institutions, with the former consisting of commercial and merchant banks and the latter such affiliates as mortgage and investment finance banks. See Bank of Israel, *Israel's Banking System: Annual Survey 1984*, Appendix I-C, pp. 27-28. This paper uses the generic term "banks" in the belief that context will make sufficiently clear the appropriate form.

⁴ Heth's (1966, pp. 67 and 69) data for 1950, 1956, and 1961 show that the 3 largest banks held 62, 58, and 67%, respectively of total banking assets. Figure 1 may

FIGURE 1



Source: Bank of Israel, *The Banking System in Israel: Annual Survey*, 1992, p. 22.

The large commercial banks catered not only to the deposit and credit needs of their customers, but to the broader financial needs of the economy. Although they had been founded during the pre-state period under the British mandate and could have been expected to replicate the banking model of Great Britain, they embraced instead the German universal bank archetype. Consequently, the banks became stock and bond market brokers, new security underwriters, managers of mutual and provident funds, and investment advisers, an

understate banking concentration, since the banking groups include not only banking institutions in the narrow sense but also other affiliated financial institutions. For 1992, for example, the share of the big 3 in the narrower concept of banking organizations that excludes non-bank financial intermediaries came to 86.3% as opposed to the 81.6% share in the broader concept (see Bank of Israel, *The Banking System in Israel: Annual Survey 1992*, pp. 18-25 - Hebrew).

exclusive position they held well into the 1980s. Finally, not unlike their German counterparts, they directly and through investment funds actively control non-financial enterprises. Because the policy issues concerning narrow banking issues differ from those involving security market and industry control activities, I first survey the banking functions and then turn to the role of the banks in the capital market.

The banking market. As just noted, the Israeli banking system is highly concentrated, with the big 3 – Bank Leumi Le-Israel (BLL), Bank Hapoalim (BH, the Workers' Bank), and the Israel Discount Bank (IDB) – at the helm of banking groups. These institutions are holding companies, and control affiliates in the narrow banking sector as well as in the broader financial services industries. Moreover, they hold controlling shares in non-financial affiliates as well.⁵ The banks' domestic position is complemented by their prominence on the international scene, with both BH and BLL ranked among the world's 200 largest banks.⁶ In terms of relative size in 1992, BH held 37.1% of total Israeli banking group assets; BLL, 30.3%; IDB, 14.2%; United Mizrahi Bank (UMB), 9.2%; First International Bank of Israel (FIBI), 5.4%, leaving the remaining 11 institutions to share the final 3.8%. Notwithstanding the downward trend of Figure 1, the big 3 have from the onset of statehood accounted for more than half of the banking industry's assets and liabilities.

Yet, it would be wrong to infer that an oligopolistic market structure meant that the leading banks dominated the market or possessed substantial market power. As in most nations, the Israeli banking system operated in a heavily regulated environment, so that banks' freedom of manoeuvre was severely circumscribed. The Bank of Israel imposed a broad range of controls that extended beyond

⁵ A brief survey of the activities permitted Israeli banks and the historical reasons for their universal mode may be found in Heth (1991).

IDB is organizationally less complex than are the others, which are essentially bank holding companies with extensive financial and non-financial affiliates. Prior to 1991, IDB was a fully-controlled subsidiary of IDB Holdings, a holding company that also controlled IDB Development. The non-banking constituents of IDB Holdings were held in IDB Development, so that IDB was strictly a financial corporation.

⁶ In terms of assets, BH, with \$ 40.3 billion, and BLL, with \$ 34.4 billion, ranked 153 and 163, respectively, in *The Banker's* list of the top 1000 international banks in 1994. See *The Banker* (1995).

insuring bank solvency and banking system stability. In the early years, the Bank's macroeconomic objectives, especially the containment of inflation, led the authorities to constrain bank credit, first by imposing monetary limits on bank lending and later by using more indirect methods such as high reserve requirements.⁷ During much of the period between 1948 and 1985 regulations dictated the banks' fee structure (including interest rates) and their credit allocation. Furthermore, giving the banks free rein ran counter to sating the voracious appetite of a deficit-ridden government, which had resulted in the Treasury's stranglehold on the capital market.⁸ Thus, the Treasury found a captive financier in the bank-operated provident funds, who were forced to invest virtually their entire asset portfolio in government securities. Moreover, the government dominated the flow of investments as well, so that bank freedom to lend was similarly circumscribed. Indeed, to a not insignificant degree,⁹ the banks became administrators of the national development budget, as the government channelled the funds captured from the banks back to the banking system, but designated the borrowers and the credit terms.¹⁰ The agency role of the banks was even more evident in foreign exchange transactions; it would not be an exaggeration to claim that the banks were merely the channel through which the central bank captured foreign exchange inflows. To be sure, the banks retained a degree of independence in the short-end of the market even in the early days of the state, and the tight hold on the reins was slackened as time went on and the economy prospered. Nevertheless,

⁷ The effectiveness of these measures are questioned in Prager (1975).

⁸ Treasury approval was required for all bond and equity issues. The authors of a study of the capital market during the 1960s record that the Treasury's New Issues Committee "does not permit industrial and commercial firms to issue bonds, reserving this right almost solely for the Government and financial institutions. The decisions of the latter are subject to considerable Government control". Stock issues were less controlled, but "in most years [viz., to the mid-1960s, the volume of equity issues was] quite insignificant" (Ben-Shahar 1971, p. 390). The Treasury in 1987 waived exclusivity over all bond and stock offerings, but maintained the option to revoke its waiver. See also Heth (1994, I, p. 42) on banks' inability to function as independent suppliers of linked bonds. Indeed, this acute observer of the Israeli banking scene labels the Israeli capital market until the 1985 liberalization as "virtually nationalized" (*ibid.*, p. 121; author's translation).

⁹ For example, Heth (1966, p. 201, Table 62) lists the respective percentages of loans to the public coming from earmarked sources in 1952, 1956, and 1961 as 26.3, 36.7, and 36.7.

¹⁰ Estimates of government control over bank credit differ, but the range for most of Israel's existence exceeds 50%. The exception is Heth (1966, p. 202). But he under-

the power of the state was manifest in the banking industry even prior to the 1983 "takeover" of the banks. The difference was control by regulation instead of control through ownership.¹¹

Israeli banks in the market for long-term capital. Bank stocks have always constituted a substantial share of the equity market in Israel, which is a major reason for the banks' dominance of the capital market. Furthermore, as noted earlier, the commercial banks also acted as investment bankers and brokers, bringing to the public and marketing virtually all non-government issues. And, as in the banking market, the largest banks hold disproportionate influence in the capital market.

The demand for long-term capital in the early years of the Israel economy came primarily from the government, which in addition to running large deficits in its general budget, took upon itself primary responsibility for managing economic development. Acquiring capital equipment for and operating state-owned, money-draining enterprises and subsidizing recipients of its Development Budget largesse so increased the government's demand for funds that the capital market became synonymous with the government bond market. The financial needs of the government were met both by a captive audience of bond purchasers – primarily assorted financial institutions that required long-term assets to match their long-term funding needs – and the non-institutional public who were lured by attractive terms. After

estimates. His Table 63, headed "Partial Estimate of the Share of Banking Institution Credit Controlled by the Bank of Israel or the Ministry of Finance", finds controlled credit ranging from 20 to 33% for the 1956-1961 period. However, Heth's numerator is too small, while the denominator, which includes credit cooperatives in the definition of banking institutions, is too large. As Table 1 showed, credit cooperatives were never really significant and became even less so over time, and hence are not included in the data used here. On the other hand, Ben-Shahar, Bronfeld, and Cukierman (1971, p. 378) overestimate, since their data, which found that the government "controlled" 60-67% of financial system assets during 1960-1967, include insurance companies and funds from banks' own resources. Plessner (1994, p. 279) cites Bank of Israel data that show government controlled credit granted by the banking system to be 85% in 1985, although the figure declined to 52% in 1991. But he, too, overestimates, since he includes direct bank credit to the government. By 1985, credit actually allocated by government directive had fallen to 67% and by 1991 to about a quarter.

¹¹ Plessner (1994) surveys the overwhelmingly interventionist role of the government in Israel's economy. But he admits that Israel is moving in tandem with the rest of the world in reducing the scope of government intervention. See also Razin and Sadka (1993).

1955, the government regularly offered inflation-proof Treasury securities to a public that had experienced significant inflation (Figure 2a)¹² and who feared the government's inability or unwillingness to stabilize the price level.¹³ But such bonds, having principal and interest linked to the domestic price level and/or foreign currency, compounded the difficulty of private sector borrowers. Should a corporation have succeeded in obtaining the approval of the Treasury's New Issues Committee, its bonds would also have to offer comparable inflation-proof yields. Few firms could successfully meet that challenge.¹⁴

The equity market was less subject to government domination. Common stock issues before 1959 were few in number and small in size, but a sea change occurred thereafter. Some IL 400 million of new equities were sold to the Israeli public between 1959 and 1963, which Sarnat attributes to new government stimuli to equity-issuance as well as to new measures to enhance the attractiveness of equity to potential buyers.¹⁵ Two-thirds of the new issues went to the banks and their subsidiaries.

The boom collapsed in 1964 and the market remained anemic until the early 1970s. But as the equity market recovered by the middle of that decade – a recovery that extended into the early years of the 1980s – the banks entered in force once again. In the slack year of 1974, for example, the banks issued a sizeable IS 2 billion in equity, which constituted 93% of all new equity issues.¹⁶ They had discovered the magic of stock price stabilization.

¹² Inflation in this figure is measured by average changes in the consumer price index, which is the accepted measure in Israel. Note, however, that it is inaccurate insofar as during some periods prices were controlled.

¹³ Although prices rose at a far slower pace after 1955, Sarnat (1966, p. 43) documents that linked government bonds constituted 97% of all long-term capital market issues between 1955 and 1961.

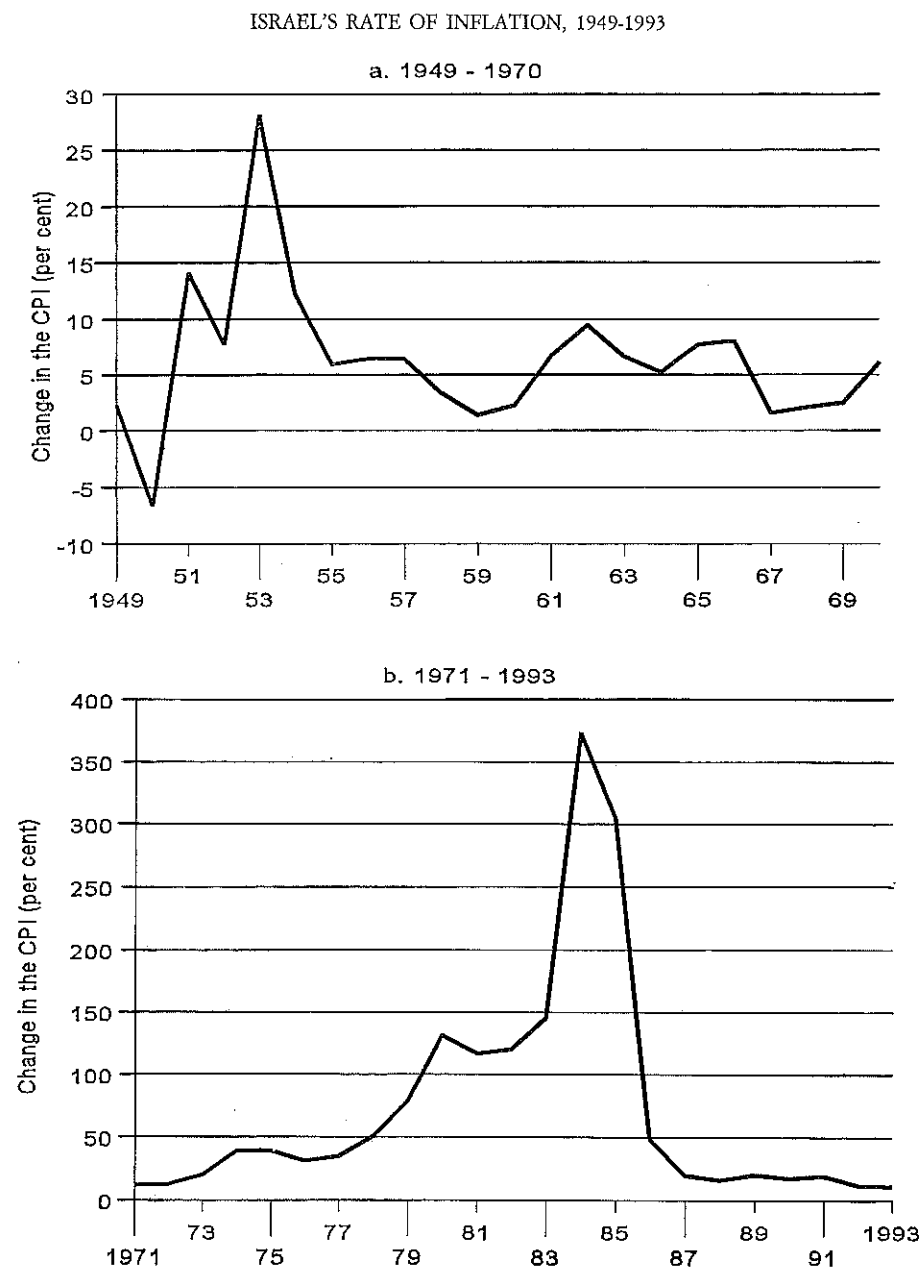
¹⁴ The Bank of Israel (*Annual Report 1974*, p. 482) notes that "the government has in effect prevented the development of a capital market worthy of its name ... – one that can compete in raising funds from domestic sources". The Bank emphasized the government's extensive intervention in the savings-investment process.

It is probable that the government could more easily afford linkage than could an individual firm. A steel mill's revenues, for example, rise only with the state of the steel market, while a government's revenues rise with its tax receipts, which are closely tied to general economic developments. Hence, a private corporation offering a bond linked to the overall cost of living would have to compensate the buyer for the additional risk that steel revenues would not accurately track the general economy.

¹⁵ Sarnat (1966), pp. 108-109.

¹⁶ The Bejski Report – officially, *Report of the Commission of Enquiry into the Intervention in the Trading of Bank Shares* (1986), p. 16 and Appendix Table 6, p. III-11 (12/83 prices).

FIGURE 2



The economic reasoning was compelling. The banks sorely needed additional funds not only to preserve their eroding capital base as inflation intensified during the late 1970s (see Figure 2b) but also to expand their operations.¹⁷ They could attract stock buyers only if bank securities were more appealing than competitive issues, especially riskless linked government securities.¹⁸ That, in turn, implied the stocks would have to provide not only a higher yield, but a virtual capital gains guarantee. And the bankers had – or at least thought they had – the capability of maintaining such a guarantee on their own stocks. Their success is quite evident in Figure 3. Bank stocks outperformed the equity market in general between 1970 and 1976, but yielded slightly less than linked government securities. How dramatically different was the period between 1977 and October 1983. Figure 3 shows an average real return on linked government securities of –2.8% and on non-bank equities of 6.6%. During those same years, bank stocks yielded 21.9%. Moreover, bank stock volatility was considerably lower than that of the alternatives, suggesting that bank stocks were also less risky.¹⁹ The public soon realized that bank stocks were quite atypical; they were more akin to liquid assets than to equities.²⁰ And they responded appropriately, switching into higher-yielding liquid bank stocks and out of lower-yielding bank deposits.²¹

¹⁷ Halperin (1983, p. 4); Brenner and Ruthenberg (1989). Although inflation is generally beneficial to banks in increasing demand for their services, the banks contended that both accounting conventions and tax statutes that did not permit them to adjust for inflation reduced their profits and shrunk their capital. While Heth (1994, II, pp. 276-279) supports this analysis, he rejects it as a justification for stock price stabilization.

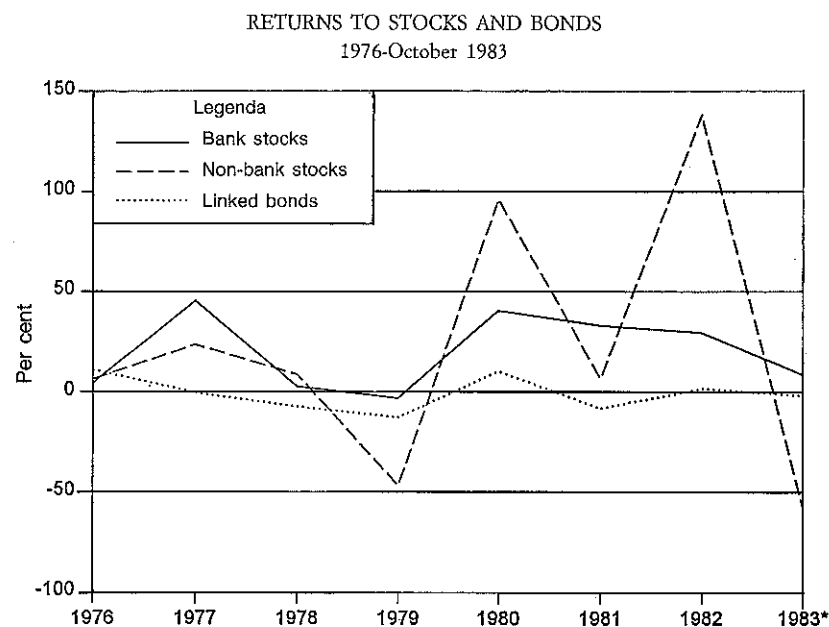
¹⁸ Bejski Report (1986), p. 22: "The banks' approach viewed the stock market as a permanent source for obtaining resources and thus it was imperative to assure over the long-term the value of the [bank] equity and its ability to compete with government bonds" (author's translation).

¹⁹ Brenner and Ruthenberg (1989) demonstrate that the banks achieved their objectives, namely, "to ensure that their shares should be preferred to alternative financial assets, that is, to achieve positive real yields at minimum cost" (p. 62).

²⁰ So did official documents. For example, the Bejski Report (1986; appendix Table 5, p. III-10) lists bank stocks along with money supply as liquid assets. The central bank recognized this even earlier. Its 1980 *Annual Report* (p. 259) mentions that bank shares "have become highly liquid because of the banks' intervention to stabilize their prices".

²¹ Bejski Report (1986, appendix Table 5, p. III-10) noted that between 1976 and 1983, the public's portfolio of financial assets shifted from 8% money and 3% bank stocks to 8% bank stocks and 2% money. Furthermore, the State Comptroller (1984, Table 1.2, p. 18) reported that bank stocks as a proportion of the public's total stocks and bonds rose from 7.6% in 1976 to 33.6% in September 1983.

FIGURE 3



The mechanism adopted by the banks to manipulate the bank stock market was a straightforward application of their market power.²² As long as natural forces brought the market up, the banks sold more stock and obtained their needed capital. But when the market turned down – and even rising markets experience occasional downturns – the banks used their networks to minimize the impact on the security prices. Thus, in addition to their own funds, the banks used the monies housed in affiliated provident and investment funds to buy back their own equities. And their retail investment advisers recommended bank stocks to their clients, often providing the loans that financed the acquisitions.²³

²² While the public may benefit from intervention designed to mitigate random fluctuations around a trend, the benefits of orchestrating the trend itself are likely to be captured by the manipulators. The State Comptroller (1984, p. 22) claimed that the banks were pursuing the latter policy. Brenner and Ruthenberg (1989) conclude that manipulation was limited to the period between February 1981 and October 1983. See also Heth (1994, II, p. 274).

²³ Bejski Report (1986, pp. 20-21). The advisers' conflict of interest between allegiance to their employers and providing objective advice to their clients is quite apparent.

Yet, as market manipulators have often discovered, even deep pockets have a bottom. During the fall of 1983, the public began to anticipate a devaluation of the sheqel, which induced them to buy assets denominated in foreign currency. They financed their acquisitions by selling bank stocks, a trickle that soon became a tide. The banks used their extensive resources to buy back their stocks and so support bank stock prices, but ultimately perceived that their efforts would be in vain. The government moved in October 1983 to shut down the Tel Aviv Stock Exchange temporarily, before the market in bank equities collapsed. During the two-week closure, the authorities and the bankers devised the plan that would ultimately lead to the government takeover of Israel's leading banking institutions.

3. The bank shares "Arrangement"

The bail out that became known as "the Arrangement" was an unusual concoction. Typically when governments step in to rescue banks – as did the Spanish government in the 1993 takeover of Banesto or Venezuela's acquisition of Banco de Venezuela in 1994 – they acquire the failing banks at the liquidation price, which entails significant equity losses for the former owners. Moreover, they replace the managers with their own appointees. Finally, they try to restore the bank to the private sector as soon as feasible. After all, the purpose of the takeover was preventative: to assure that the failure of one or a few banks did not snowball into system-wide bankruptcies. And because governments in market-oriented economies are rarely in the banking business nor do they wish to be encumbered with the day-to-day operations of commercial banks, they move rapidly to rid themselves of the banks.

The Israeli banks, however, were not insolvent; their balance sheets were healthy. Their failure to fulfill their unwritten commitment to their shareholders, to preserve the price of bank equities, did not mandate government intervention. The government could have remained aloof, permitted bank stock prices to plummet, and left existing stockholders holding the bag, poorer but wiser. The economic costs might have been bearable: a temporary loss of confidence in the banks and the stock market, a diminution of private wealth

with possible distributional impacts,²⁴ and a flawed international public image.²⁵ But the political costs apparently were not tolerable. After all, the stockholders were not a small circle of affluent residents, but a broad swath of the citizenry, rich and poor alike, who had trusted not only the banks, but who had taken as an implicit promise the government's inaction in the previous five years.²⁶

Thus, in late October 1983, the five largest banking organizations²⁷ and the government signed an agreement that rescued most of the banks' stockholders, preserved the *status quo* of the banks, revitalized the Tel Aviv Stock Exchange, and, most significantly, did not immediately nationalize the banks. For though the stocks were to be bought from their private holders, they were not to be acquired by the government. Instead, new subsidiaries of the Arrangement banks known as "trust companies" were to buy the estimated \$ 6 billion of bank shares held by the public. They would be funded from the resources of a government corporation, M.I. Holdings, with the bank stocks serving as the loan collateral. Hence, technically, the government would neither directly nor indirectly own the bank shares, although it was financing the entire purchase. The banks would revert to government ownership only if the trust companies would prove unable to pay off the loan.

The Arrangement appeared to be a win-win solution. The political leadership defused the public outrage that would have erupted from government inaction. And although the financial price that the government paid was to transfer assets from the general taxpayers to bank stockholders, the widespread nature of the bank stock owner-

²⁴ In fact, the fall in the public's wealth would have been beneficial. The consequent reduction in spending would have eased pressure on the domestic economy and hence moderated the inflation, which in 1983 was approaching 200% annually.

²⁵ The Beijski Report (1986, p. 53) notes that the Finance Minister feared foreign deposit outflows in the absence of government action, but criticizes his panicky reaction, which was not based on any serious investigation.

²⁶ The Finance Ministry, which included the securities regulators, and the central bank had tacitly agreed to the stock price stabilization policy. The Beijski committee censured a number of high government and central bank officials for this implicit support. See also Heth (1994, II, pp. 292-293).

²⁷ Although both IDB Holdings and IDB stock prices were "stabilized", it was only the former - the holding company that controlled the bank - and not the bank directly that signed the Arrangement. The complex organizational structure of the IDB group led to some interesting permutations of market intervention. For instance, IDB lent its funds to sister affiliates that they used to intervene in the market for both IDB Holdings and IDB stock. See Beijski Report (1986, pp. 90-92).

ship meant fundamentally a transfer from taxpayers to themselves.²⁸ The Arrangement preserved the credibility of the stock market and the banking system. Not the least, the bankers survived intact with their banks.

The Arrangement and related legislation also contained an incentive structure designed to induce the stockholders to defer immediate exchange of their bank equities. Because the government feared that the public would spend rather than save its receipts from stock conversion, which would put further pressure on an economy already experiencing triple-digit inflation, it was willing to pay more favourable yields to the stockholders who would commit themselves to sterilizing their exchanges for periods up to 6 years.²⁹

Yet, a number of puzzles remain. To be sure, political realities dictated that the government could not remain passive. But, first, why did the government, which was being asked to bail out the banks, accept a one-sided agreement, in which it bore all the downside financial risk and renounced the potential for gain? Were the banks to demonstrate strong profits, the general public could retain its shares instead of converting them into cash. Alternatively, under the Arrangement, the trust companies would borrow the funds from M.I. Holdings to acquire bank stocks, sell them profitably in a rising market, and use the proceeds to repay the loan to the government corporation. In either event, the banks would operate as before the bank stock crisis, perhaps with different private stockholders but with

²⁸ There was some redistribution, for not everyone had purchased the bank stock at the same time nor held onto it for identical periods. This redistribution was exacerbated by the apparent generosity of the payout, as evident by the following citation: "Today, it is evident to all that the Arrangement was generous to bank stockholders. They did not lose their investment, neither absolutely nor relative to other investments. Moreover, those bank stockholders who had acquired their stocks between 1978-82 and continued to hold them until redemption profited more than investors in most other investments in the Israel economy during that period. The loser was the Treasury or, in other words, the taxpayer. All agree to this". Author's translation from "Comments and Replies" (1987, p. 3). See also Heth (1994, II, p. 293).

²⁹ A special dispensation was provided to senior citizens, who were permitted to cash in their shares as early as two years from the date of the Arrangement. Bank stockholders who agreed to sterilize their holdings for at least four years would be eligible to exchange the stocks at a total indexed rate of 12%, but could increase their yield to 34% by sterilizing their accounts for an additional two years. On the other hand, stockholders who opted not to sterilize their equities could sell them to their respective trust companies in October 1988 for a guaranteed indexed return of only 4%. By early 1987, of the \$ 6.9 billion in eligible bank stocks, M.I. Holdings had acquired \$ 2 billion, \$ 1.2 billion were sterilized, and \$ 3.7 billion waited in the wings for 1988. See Droti (1987, p. 66).

fundamentally the same management. On the other hand, were bank profits to be anemic over the next decade, were future prospects to augur no better, and were the public to respond by bailing out of the banks, the government would take over banks with poor profitability and weak potential. For then, the bank trust companies would not repay their loans from M.I. Holdings, and by 1993 M.I. Holdings would be the repository of low value bank equities. A straightforward government takeover right at the start at least would have balanced the risk of loss with the possibility of gain.

The quandary is compounded by the government's passive attitude towards managing its potential loss. The Arrangement called for the bank trust companies to consult with the government prior to the banks' undertaking any major policy changes, presumably so that the government could protect its stake.³⁰ In fact, the government did not intervene.³¹

The final puzzle concerns the disparate treatment of the owner-operators of taken-over banks in Israel and elsewhere. In no other nation did those who were responsible for a banking crisis and the subsequent bank nationalization remain in charge of their institutions. In Israel, the small cadre of stockholders – the controlling interests³² – whose shares held voting rights and who effectively controlled the banks and appointed the managing board and the chief executives, remained in power. Indeed, it was ironic that a seemingly sensible and just provision of the Arrangement would actually strengthen their domination over their institutions. The agreement excluded these "interested parties",³³ so as not to reward those ultimately responsible for the policy that led to the bank stock debacle in the first place.³⁴

³⁰ See Bank Leumi Le-Israel, *Prospectus* (1993, p. III-7, para. b).

³¹ "Today, the majority of bank capital is in fact in the hands of the government. But they [i.e., the banks] remain in the control of the original controllers [i.e., the original majority voting share holders]" (Weissbrod 1991, p. 106; author's translation). As late as 1993 the BLL *Prospectus* (1993, p. III-2) declared forthrightly: "The government of Israel never [intervened] nor at present intervenes in the management of the bank or its affairs" (author's translation). This conclusion conflicts sharply with the implicit belief of Blass and Grossman (1994, pp. 23-24), who calculate the "inefficiencies resulting from the banks being run for a decade by the government" at NIS 6 billion.

³² The concept of "controlling interest" is not unique to Israel. For Mexico, see Welch and Gruben (1993, p. 8).

³³ The determination of "interested parties" itself was open to negotiation. Some apparent anomalies are documented in State Comptroller (1993, pp. 8-10).

³⁴ The State Comptroller (1984, pp. 71-72) points out the incompatible incentives between the controlling interests who retained power and the Treasury. It is interesting

But this meant that the controlling shareholders, who could not trade in their shares, would retain their voices in future bank decisions. Simply put, why did not the government insist that voting rights either shift over to the government or be based on a straight majority of shareholder votes, with each share representing a single vote?

A number of explanations for the asymmetric nature of the Arrangement have been advanced. Perhaps the most popular is the government's fear of a massive outflow of funds that would immediately follow outright nationalization.³⁵ Israeli banks have over the decades attracted a large number of foreign depositors. Despite the occasional flare-ups interrupting a long-standing cease-fire with most of its neighbours, Israel is politically stable, the threat of expropriation of foreign holdings appears totally unjustified, access to the money centres of the world is virtually instantaneous, and its banks offer competitive yields as well as deposits linked to a choice of foreign currencies.³⁶ Yet, even in a worst case scenario, with all foreign short-term deposits turning into hot money and emigrating suddenly, Israel's official foreign currency reserves would have been more than adequate to cover the outflow.³⁷ Even more important, nationalization would hardly have presaged a change in Israeli banking policy. As noted earlier, while the banks were not owned by the government and hence were nominally independent of the state, they have been so regulated by the Treasury and the central bank that nationalization could only have been an anticlimax. It is difficult to fathom why nationalization would have made a difference to foreign depositors.³⁸

to note that the bank stocks bought by the banks during their futile attempt to stabilize stock values were eligible to participate in the Arrangement. Thus, these owners benefited indirectly.

³⁵ Plessner (1994, pp. 262-263), State Comptroller (1993, pp. 13-14); Heth (1994, I, p. 96). This point was also emphasized in a personal interview with Mr Moshe Sanbar, chairman of BLL, during the summer of 1993.

³⁶ According to Bank of Israel, *Annual Report 1983* (Hebrew, Table VII-22, p. 198), total deposits of foreigners in Israeli banks equalled \$ 6.3 billion and \$ 6.6 billion at the end of 1992 and 1993, respectively. The accounts were denominated in foreign currency and thus protected against devaluations in Israel currency.

³⁷ Foreign depositors held \$ 811 million in short-term bank deposits in September 1983, while Israeli official foreign currency reserves stood at \$ 3.77 billion (*ibid.*, Table VII-24, p. 201). Moreover, total Israeli short-term foreign assets exceeded short-term liabilities by \$ 9 million in 1982 and \$ 3 million in 1983 (*ibid.*, Table VII-21, p. 196). The *Report* comments (p. 196) about the unusual international financial situation of Israel, which then had no net foreign short-term debt.

³⁸ As opposed to foreign bank stockholders. A similar point was made by Ophir in "A roundtable on bank stocks" (1989, pp. 96-97).

Finally, the fear presumes that foreign depositors were unsophisticated and possessed no more than a surface comprehension of the Israeli political and financial system.

The intense linkage between Israel's banking and political elites predates statehood. The two largest banks, Bank Leumi Le-Israel and Bank Hapoalim, were never truly private entities, despite their corporate structure and widespread private sector equity ownership. BLL and BH were accurately described by Heth as "banks controlled by public bodies",³⁹ and were never motivated solely by the bottom line. The World Zionist Movement that established BLL in 1903 as the Anglo-Palestine Bank formed the nucleus of the post-state Labor government. The primacy of Labor government coalitions for most of Israel's existence assured the intimate alliance of BLL and Israel's predominant political party.

Bank Hapoalim's connection with the political establishment followed a different path. BH is a creature of the Histadrut, the national labor federation. Founded in 1921, BH is the financial subsidiary of the Histadrut's industrial holding company, *Hevrat Ovdim* (The Workers' Corporation), whose *raison d'être* was to serve the agricultural cooperatives and Histadrut economic enterprises.⁴⁰ The Histadrut's leaders run and are elected on the basis of party affiliation, not personal popularity, and hence owe their allegiance to the party.⁴¹ From the start, the labor federation and its subsidiaries have been dominated by the Labor party.⁴² (A similar relationship existed for UMB and the National Religious party, a critical partner in most government coalitions into the 1970s.) Only the latecomer, IDB, founded in 1935, is unaffiliated with a political organization. It is a family-run financial institution, whose growth is attributed to the

³⁹ Heth (1966, p. 32). Also see Shalev (1992, p. 303).

⁴⁰ See Onn (1964, p. 48); Heth (1994, II, pp. 170-171). Currently, BH's clientele spans the domestic economy and indeed the world.

⁴¹ The 1994 election of Chaim Ramon, who broke with Labor and campaigned against its candidate, was a repudiation of the past and may set a repeatable precedent.

⁴² Personal relationships are very close, which is hardly surprising in a small country with an even smaller leadership cadre. More relevant is the revolving door that characterized the personnel flow, especially at the highest levels, between the Labor party and the Histadrut. Halevi and Klinov-Malul cite an observation of Professor Abba Lerner, which they claim was made only "half in jest": "The workers have a Histadrut, and the Histadrut has a government". They comment that the interrelationship is more complex and not unidirectional. See Halevi and Klinov-Malul (1968, pp.46-47). Halevi, commenting on an earlier version of this article, also pointed out the revolving door between senior Treasury and central bank officials and the big banks.

"energetic activities" of the entrepreneurial Recanati family.⁴³ Nevertheless, the Recanatis are an integral component of the Israeli establishment.

These long-standing banking-political associations should have buttressed depositor confidence rather than weakened it. Why should nationalization, which for the most part would only formalize the *status quo*, represent such a danger?

The political linkages and the revolving door relationships between the political and financial elites demolish another reason advanced for avoiding nationalization: the desire to prevent political intervention and political appointees from running the banks.⁴⁴ Equally unsatisfactory is another argument that relies on the adverse consequences of nationalization on Israeli banks abroad.⁴⁵ Transactions between US bank affiliates of Israeli banks – and BLL, BH, IDB, and UMB all own affiliates in the US – and their nationalized parents in Israel would be subject to US regulatory constraints that would not apply were the parents not state-owned institutions.⁴⁶ The problem here lies in the presence of US subsidiaries of nationalized banks of other countries such as France, Italy, and Spain, which appear to have functioned in the US without undue regulatory restraint.⁴⁷

I suggest a simpler explanation that is based on the symbiotic relationships between the banks and the government and that is

⁴³ Michaelis (1984, p. 90).

⁴⁴ State Comptroller (1993, p. 14).

⁴⁵ This issue first arose in 1988 after the US federal banking authorities reinterpreted provisions of the International Banking Act of 1978. I am most grateful to Mr Sanbar and Ms Jennifer Janes of BLL for pointing out this issue and for providing me with a memorandum prepared for BLL by Shaw, Pittman, Potts & Trowbridge, a Washington, D.C. law firm.

⁴⁶ The US bank affiliates would be prohibited from undertaking transactions that exceeded 20% of the US bank's capital and surplus. The memorandum implies that such constraints would mean substantial hardships, although it is not clear whether that would be to BLL, the Israeli government, or both.

⁴⁷ The Maor Report (Bank of Israel, *Report of the Team to Investigate the Major Issues of the Banking System* (1986, p. 45; author's translation. Ms Maor was then the Examiner of Banks) mentions a fiscal argument in passing. Since government acquisition of bank stocks would be paid for by issuing more government debt, the government's financing costs would increase. But while the government's debt would rise, it would be receiving earning assets – bank stocks – in exchange. The balance sheet impact of this transaction should be a wash. At the same time, the income impact would depend on whether the earnings on the bank stock exceeded or fell below the interest payable on the additional debt. Moreover, the government stood to gain capital appreciation were the banks to be run profitably, and thus actually reduce the net cost of the takeover.

grounded in historical linkages and mutual benefits. The evolution of the banking system until 1983 had satisfied the needs of both the financial and political communities. And although the leading banks chafed under government regulation, they could tally identifiable benefits as well. First, the leading banks maintained and even strengthened their oligopoly domination of the banking industry. Figure 1 vividly demonstrates that even after the downward trend in asset concentration between 1975 and 1983, the big 3 still were far better positioned than they were in 1964. If the government did not actively support this intensification of banking industry concentration, neither did it inhibit it. Second, although the banks were often passive suppliers of finance, serving as lending agents for the government, they also faced none of the risks of default, belated, or partial payment. The banks' profits were fattened by stable and secure government payments essentially on a cost-plus basis. Finally, because the men and women who headed the financial and government communities formed a mutually-reinforcing elite – and this statement is meant to encompass the 1983 majority party Likud leadership as well – the relationship between these two groups were far more complex. It is wrong to believe that the government imposed its will on the banking industry. Influence flowed in both directions.⁴⁸ That should not be surprising for BLL and Hapoalim, with their close ties to the Labor party, nor for the UMB, linked to the National Religious Party. It is most probably true for IDB, although here the influence relies more on personal than institutional relationships. In short, a stable and mutually satisfactory *modus vivendi* had been reached between the banks and the government in the past, and neither stood to gain from upsetting it in 1983.

The banking sector is an exception to the government's massive ownership role over Israel's industries. The socialist ideology that pervaded Israel's prestate history and that found expression in most of the Labor-party controlled socialist governments has led to an economy characterized by dominant state-owned industries. Thus, virtually none of the nation's agricultural land is privately-owned.⁴⁹ Moreover, as late as 1991, when privatization had begun to take hold,

⁴⁸ White (1991) suggests a fundamentally similar analysis in his study of Mexican bank nationalization.

⁴⁹ See Plessner (1994, pp. 66-70), on the ideological and historical roots of Israeli land policy.

it was still true that five of Israel's 10 largest industrial enterprises, with sales accounting for almost two-thirds of the total, were state-owned. Similarly, three of the 10 largest non-industrial companies, accounting for 40% of total sales, were government enterprises.⁵⁰ And, if we add the non-private sector Histadrut firms to those owned by government, then their numbers and sales rise to 7 and 84% for the 10 largest industrials and 6 and 67% for the non-industrials.⁵¹

This atypical treatment of the banking sector lends credence to, even if it does not prove, the validity of my hypothesis: the government never sought formal ownership of the large banks simply because it and the bankers had found a mutually satisfactory relationship. And in 1983, when the big banks began to hemorrhage dangerously, the government physicians stepped in with a transfusion that would restore the patient to his previous condition.

The transfusion did not take. The banks were never able to repay the loans they were forced to take from M.I. Holdings. By the end of 1991, M.I. Holdings had paid out \$ 9.2 billion of the Treasury's money and held virtually all the stocks of the Arrangement banks.⁵² Whether it wanted to or not, the government was forced to devise privatization strategies and policies.

4. Bank privatization

De jure, then, by late 1993, the Arrangement banks were state-owned, if not state-controlled. But the government prevaricated, and at least part of the saga since 1993 relates to the state avoiding even the semblance of control. Bank nationalization, even though it was passive, was sufficiently painful to the state's political leadership, not to speak of the controlling interests of the banks. The further step

⁵⁰ Dun and Bradstreet cited in Eckstein *et al.* (1993b, Table 13.5 and 13.6, pp. 240-241). The reader interested in a general survey of the privatization process in Israel in recent years should consult this work as well as Eckstein (1993a).

⁵¹ *Ibid.* Note that some Histadrut industries were partly owned by the government, making this distinction even less meaningful.

⁵² State Comptroller (1993, Table 1, p. 12). The Comptroller estimated that the Arrangement would increase the internal national debt by approximately 25% (p. 69).

of the government's actually managing the banks that they now owned was even more reprehensible. Hence, a two-phase agenda emerged: (1) interim management arrangements and (2) privatization. Privatization, however, brought to the fore a player that had remained on the sidelines for most of the decade since 1983 – the Bank of Israel. While the Bank was sympathetic with the joint banker-government objective of restoring bank ownership to the private sector, it also viewed privatization as a heaven-sent opportunity to restructure the banking industry.

Reducing the economic power of the big banks required two interrelated initiatives. First, the narrowly-defined commercial banking system had to become more competitive, which could be accomplished only by destroying the banking oligopoly. Second, the broader financial market place had to become more competitive, which could be accomplished only by breaking the banks' domination of the capital market. Stockholder equity also surfaced, and, although this was a tangential issue from an economic point of view, it merits a few comments.

Bank shares' voting rights and bank activity restructuring. Shareholder rights was not an issue until the impending takeover of the banks. Israeli stockholders were concerned with current returns and capital appreciation rather than with corporate governance. They appeared ambivalent about control as long as their financial returns were satisfactory. In BLL, for example, the few shareholders who owned less than 2% of the bank's capital held 75% of the voting power. The UMB structure represented even tighter minority control, for owners of only 0.03% of the equity held 50.02% of the voting power.⁵³ The equity issue could no longer be ignored once the government owned the majority shares and was committed to privatization. Who would invest the substantial capital needed to buy the bank shares from the government without also gaining control? In fact, the issue was resolved in 1990/91, when the banks, at the prodding, indeed, coercion of the government agreed to equalize voting rights. One-share, one-vote became the rule. The majority stockholders would henceforth command a majority of the power.

⁵³ Data are from State Comptroller (1993, Table 2, p. 13).

Surprisingly, a more open capital market also turned out to be a non-issue. A consensus emerged that the range of activities undertaken by the bank holding companies had to be curtailed. The conflicts of interests that became evident in the aftermath of the bank-share crisis raised the issue of fair market treatment of investors. Economic efficiency apparently played a minor role, if it entered into the deliberation at all.⁵⁴

Among the events that had shaped a new public attitude toward the capital market were the macroeconomic reforms of 1985. Although Israel's triple-digit inflation never quite reached the epic proportions of Latin America, it had escalated rapidly from 50% in 1978 to almost 200% in 1983 to 445% in 1984 (Figure 2b). The tight monetary and fiscal policies that led to its subjugation in short order – by 1986, consumer prices rose by only 20% – meant greater confidence in the domestic currency and domestic security markets.⁵⁵ At the same time, the tighter government budget made the government more receptive to greater market freedom, less captive to government fiscal requirements and more open to private long-term capital demands. But corporate financial needs could only be met by a greater flow of investment funds, and domestic, not to speak of foreign investors, would not be attracted to a capital market characterized by obvious or even perceived conflicts of interest. Finally, the authorities were willing to liberalize banking regulations in their new-found commitment to a market economy, which encouraged competing financial institutions to participate more actively in the capital market.⁵⁶

The reforms have already taken root. Although the banks have been able to retain ownership over their provident fund subsidiaries, their direct influence in investment decisions has been curtailed. Thus, bank management have become minority representatives on the

⁵⁴ On economic grounds, a broadening of bank options might have yielded economies of scope. Indeed, the narrowing of Israeli banks' options runs counter to the trend in most of the world, especially the US. See Prager (1988).

⁵⁵ Bruno, a former professor of economics at the Hebrew University who headed the Bank of Israel from 1986 to 1991, wrote (1993) an extensive analysis of these reforms. He played a central role in the attempt to restructure the banking system that is discussed below. Bruno's relationship with the Treasury on bank privatization is reflected in his pithy remarks in a footnote on p. 87.

⁵⁶ For details, see Ben-Bassat (1990), Razin and Sadka (1993, ch. 12), and the interesting summary historical tables in the appendix to Sarnat and Dilevsky (1991).

investment committees of the funds, which themselves have been restructured as subsidiaries of bank holding companies rather than as direct subsidiaries of the banks themselves. Moreover, conflicts of interests are to be prevented by the erection of "Chinese walls", whereby bank investment advisors are to be kept separate from other bank staff, thus blocking information flows in either direction. Finally, new legislation passed since 1986 requires that the funds recognize their primary responsibility to the welfare of their members and sets limits to fund investment or lending to a single bank or individual.⁵⁷ Anecdotal evidence, as manifested by bankers' vocal protests to these arrangements, suggests that the reforms are not meaningless, although it is difficult at this point to quantify their significance.

Competition in banking. Privatization provided an opportunity for ending the concentration in the narrowly-defined banking industry that was evident from Figure 1. The authorities could restructure the industry by splitting the major banks into competitive components as they sold the banks and their affiliates. And, because the banks were sufficiently large, the resulting components would still be able to capture economies of scale. Moreover, competition could flower in the more liberalized financial atmosphere following the 1985 reforms. The government had reduced its direct intervention in the banking industry and opted to rely more heavily on indirect monetary controls, leaving greater scope for private sector initiatives. On the other hand, a decision to sell the bank holding companies intact, which would preserve the oligopoly franchise, would also indicate that banking competition was not a high priority objective.⁵⁸ It would also coincide with my hypothesis of a government-banker

⁵⁷ Klein (1991, pp. 22-23) outlines bank holding company restructuring policies. The fundamental Israeli banking law was revised in 1981 and again in 1989, the latter focusing on bank holding company activities. See also Bahat (1993). Although a 1993 joint Treasury-Bank of Israel committee recommended limiting bank ownership to no more than 15% equity in a given non-bank enterprise, the Knesset, at the recommendation of the government, legislated a 25% ceiling. See Rosenfeld (1994). This ceiling fell to 20% in 1990.

This discussion of conflicts of interest as well as the following paragraphs dealing with banking industry reform relies heavily on the State Comptroller (1993, pp. 67-88).

⁵⁸ The impact on government revenue from the sales is unclear. On the one hand, the charter value of an oligopoly bank should exceed that of a bank operating in a more competitive environment. On the other hand, the greater number of bidders, including foreign bidders – which, perhaps surprisingly, were not feared – that could participate in an auction for smaller banking institutions would also lead to higher auction prices.

alliance that sought as much as possible to preserve the power of the major banks in general and the specific interests they represented in particular.

The Bank of Israel challenged the implicit government-banker alliance, although its power was quite limited.⁵⁹ The Bank's initial salvo in its campaign to intensify banking competition came as early as 1985, when it advocated that competition be an explicit policy objective in future bank privatizations.⁶⁰ That recommendation was rejected by the government, who ostensibly viewed structural reform as hindering the speedy sale of the banks.⁶¹

The government's abdication of responsibility for bank management while it remained an owner required an innovative restructuring of bank management. At the same time, this restructuring could not interfere with its ultimate objective of privatizing the banks intact, preferably to the old controlling interests in the first instance and to others by default.

The Bank Shares Arrangement (Temporary Provisions) Law (1993) was the key to the former strategy. The government was to appoint a 5-member "Public Committee", which in turn would appoint a 5-member "Committee for Bank Stocks" for each nationalized bank. The latter committees would vote the bank stocks, and also nominate public members who would be elected bank directors as well as the chairman of the board. These Committees for Bank Stocks are apparently thus isolated from the political process and ministerial control,⁶² and being public members, presumably view their roles

⁵⁹ For example, because the Bank is responsible for bank licensing it was able to condition approval of a banking license to the former controlling interest of IDB to divestiture of IDB's direct stake in the First International Bank as well its indirect stake in the General Bank. The entire episode with IDB is analyzed in State Comptroller (1993, pp. 44-66).

Prager (1975) demonstrates that the limited power of the central bank *vis-à-vis* the Treasury is institutionalized in Israel.

⁶⁰ It may have been a foregone conclusion even then that the government ultimately take over the banks. Swary (1987, p. 110) suggests that the trust companies would be best served by turning over the government the bank stocks immediately upon acquisition from the public. Present financial conditions and future profit prospects made borrowing from M.I. Holdings until 1993 a losing proposition. He also notes that this option might not be in the best interest of incumbent bank management.

⁶¹ My hypothesis is supported by the evidence presented in the State Comptroller's *post mortem* of the stock sale episode, which strongly implies a political decision had been made to return the banks to their former controlling interests and hence to prevent structural reform. Even the equalization of voting rights was manipulated to preserve the power of the former controlling interests, albeit in a diluted form.

⁶² *De facto*, all the individuals involved must be *persona grata* both to the Finance Minister and the Governor of the Bank of Israel.

as representing the public interest. At the same time, it seems to be understood that the Committees would act as caretakers, preserving the institutions as going concerns until a final resolution occurred, and not initiate major policy initiatives. Nothing to this date contradicts this view.

The act's objectives section confirms my contention of preserving the bankers' oligopoly. The three stated goals are: (1) to sell the stocks on terms deemed appropriate by the government, (2) to ensure that the government does not intervene in the banks' daily management, and (3) "to permit structural changes in the banking industry *in accordance with the policy of the government* and according to the law".⁶³ Note that this last provision does not specify the objectives of these structural changes; it surely is a weaker terminology than "to enhance banking competition". But even more revealing is the italicized phrase, which authorizes the government alone to define and approve structural changes in the banking system. The government has generally interpreted the permission given by the third objective as not requiring any positive action.

That is not to claim that no restructuring has taken place. Yet the splitting off of Union Bank from the BLL group can at best be considered minor.⁶⁴ A controlling interest of 26% of UMB was sold to an Israeli group at the end of 1994 with the approval of the Bank of Israel and the Finance Ministry, but this merely substituted one group of owners for another and did not affect the degree of banking concentration. It may be of interest that the political role of the UMB's former control group, the National Religious Party, has steadily diminished. Where once it was a pivotal member of early coalitions, it is now an outsider with marginal influence.

Restructuring IDB is an exception that fits in well with the banker-political elite hypothesis, for it came about not because of government volition but despite government resistance. In late 1990, after much back and forth pedaling, top-level bank management that had been singled out by the Beijski Report for their role in the bank stock manipulation episode were criminally indicted. Among them was Rafael Recanati, a principal of IDB Holdings, the conglomerate

⁶³ The Bank Shares Arrangement (Temporary Provisions) Law (1993, ch. 1, para. 2). Author's translation and emphasis.

⁶⁴ Klein (1993, p. 60) notes that BLL management was ambivalent about retaining ownership of Union. Heth, however, in personal conversation, disagreed. In any case, Union was sold to a group of Israeli entrepreneurs in May 1993. See Lipkis and Rosenfeld (1993).

with both financial and non-financial subsidiaries. Bruno, the governor of the Bank of Israel, would not approve ownership of a bank by a group headed by a potential felon, but was overruled by the government, which decided to proceed with an earlier commitment to sell IDB Holdings as a unit to the Recanati group. The government backed down only after its own legal adviser strongly supported Bruno. This ruling meant that the Recanatis could not acquire Israel Discount Bank, and hence not IDB Holdings as long as the bank was an affiliate of the holding company. The Recanatis, now fighting alone, had no choice but to agree to split IDB out of IDB Holdings.⁶⁵

The slow pace of bank privatization is not surprising given the government's decision to sell Israel's largest banking units whole, rather than decompose the banking conglomerate into entities that would be more digestible by the securities market. A further constraint derives from the government's decision to sell only to buyers who would take over control. While there is some validity to the contention that only individuals with proven bank management ability should be permitted to acquire control over banks so vital to the Israeli economy, the flaw in the argument is simple. The managers most capable of running these large financial institutions are the previous controlling interests.⁶⁶

Minority interest – 21% in a public offering and another 10% to employees – in Bank Hapoalim was sold in June 1993, but a further tranche, marketed in November, failed to attract much attention. Similarly, 23% of BLL was sold in 1993.⁶⁷ However, it is clear that by selling a minority of bank shares to a diverse public and by essentially maintaining an arm's length distance from the banks, the government cedes decision-making to the original controlling interests. By now that should hardly be surprising.

⁶⁵ A summary of the events may be found in Klein (1993). Incidentally, the Jerusalem District Court ruled against the bankers in early 1994 (see *Government of Israel v. Bank Leumi L'Israel et al.* 1994).

⁶⁶ "The Jewish Agency-affiliated Jewish Colonial Trust and the Histadrut's Hevrat Ha'ovdim, the banks' erstwhile owners, are determined to regain control ... for political reasons" (Rosenberg 1993, p. 31). Rosenberg (1994) reported that only one bidder each – presumably those mentioned in the previous sentence – had surfaced for BLL and Hapoalim.

⁶⁷ Rosenfeld (1993a, 1993b and 1994b).

5. Summary

Bank nationalization came to Israel not because of a socialist government's ideological commitment nor because of a loss of public confidence in the banking system. It was the inevitable outcome of the government's rescue of bank stockholders, who by 1983 constituted a large segment of the population. They had invested in a "sure thing", stocks whose values rode a rising trend and whose yields were highly competitive. That the trend had been artificial, manipulated by the nation's largest and most respected banking institutions, did not breed concern. After all, in addition to the promises of the bankers, the bank stocks had the implicit backing of the government, who stood passively by as the bubble grew ever larger. When the bubble burst in the fall of 1983, the government's earlier do-nothing attitude generated a pragmatic response to its implicit commitment to the public – the Treasury bailed out the banks' stockholders.

Rapid nationalization and government operation of the nationalized banks accompanied by replacement of existing management is the typical recipe in such circumstances. In Israel, nationalization was a protracted affair, as the government devised an elaborate strategy to stall the takeover. It indirectly lent the banks the monies to acquire bank stocks from the public, and acquired the banks only a decade later when the loans matured and the banks found themselves unable to repay them. Moreover, the government never controlled the banks, neither during the 1983-1993 period when its ownership was indirect, nor after the banks became state-owned institutions. Nor did it, as a policy decision, replace bank management. Finally, and again in contrast to bank takeover episodes in other countries where crisis-engendered nationalization is typically followed by speedy privatization, in Israel, denationalization has been prolonged as well.

This article has argued that the key to understanding the Israeli episode lies fundamentally in the long-standing cooperative relationship between the Israeli government and the banking community, especially the largest banks. Both parties had much to lose from upsetting the *status quo*, and both stood to gain from its early restoration. By delaying nationalization as long as possible, they both hoped that improved economic circumstances would enable the bankers to avert a government takeover. On the basis of a best-case scenario, the government would never nationalize the banks, and

consequently should not meddle in the internal operations of the banks, including personnel decisions even at the highest management levels.

When the best-case scenario did not materialize and government ownership became a fact, the government indeed sought speedy privatization. However, speed took second place to another priority: restoring the *status quo*. Hence, the government set privatization conditions that favoured the previous owners, which in three of the four instances were institutions controlled by national bodies rather than private individuals. Thus, despite a record of liberalizing economic measures taken since 1985 and a desire to expose the Israeli economy to more competition, the government treated the banking industry quite differently.

The government's policies of stall and obfuscation have proven a success when judged from its own priorities. And although the Israeli banking system remains technically in government hands, it does not lie in its control. The very same banking groups that dominated the financial system from the earliest days of the state continue to do so. *Plus ça change, plus c'est la même chose.*

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