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THE ROLE OF CENTRAL BANKING IN A DEMOCRATIC REGIME

Moshe Sanbar

After prolonged discussions, and a delay of about two and one-half months beyond the appointed time, the Bank of Israel has finally gotten a new head. Dr. Moshe Mandelbaum, a respected economist of wide practical experience, has been appointed as the central bank's fourth Governor. There is no doubt as to Dr. Mandelbaum's suitability for this high position, as his achievements in earlier roles as Director-General of the Ministry of Commerce and Industry, Deputy Chairman of the Bank for Industrial Development, and senior lecturer in economics at Bar-Ilan University have proved.

During his inauguration ceremony at the residence of the President of Israel, the new Governor declared his intention to continue in the path marked by his three predecessors, and faithfully guard the independence of the central bank. At the very same ceremony, the Minister of Finance, Mr. Yoram Aridor, interlaced his congratulatory remarks to the new Governor with certain statements concerning what he regards as the indicated lines of cooperation between the Finance Ministry and the Bank of Israel, and their respective heads.

In his allusion to the shaky relations which prevailed between him and the previous Governor, Arnon Gafni, the Finance Minister claimed that "the theory that the Minister of Finance and the Governor of the Bank of Israel must act in opposite directions is senseless; it is unworkable, and liable to endanger the achievement of the economic policy upon which the Government has decided."

This conception is of course correct; but it is nevertheless desirable to examine it more closely and to clarify it, for after deeper consideration it becomes clear that its obscurity overwhelms its apparent truth. For example: why did the Minister so need to emphasize the fact that it is the Government which decides upon economic policy, since that is self-evident, even being explicitly specified in the Law of the Bank of Israel of 1954? And why did the Minister feel the need to fight against a senseless theory which has never been adduced by any of the previous Governors, or by a single serious person who was at home in this subject? Why was there any need to set up a straw man? The suspicion slowly creeps into the mind of the attentive observer that the matter is not so innocent and simple as first strikes the eye.

The Finance Minister's declared approach consistently emphasizes the importance of "the expectations of the public" in the planning and execution of economic

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12 Moshe Hess St., Jerusalem. Tel: (02) 225874

policy. It was not so long ago that Mr. Aridor held Mr. Gafni's critical declarations against him, claiming that they damaged the Government's policy (read: Aridor's policy), undermining the positive expectations of the public, and thereby weakening his policy's chances of success. In other words, anybody who criticizes the policies and optimistic estimates of the Minister, particularly if the critic is the Governor of the central bank, hurts the Government and the national economy alike.

The fact that the criticism is for the most part directed not at the economic policy but at the means of its execution changes nothing at all, according to this approach, as in both cases the "expectations of the public" are influenced negatively, and any damage to them falls into the category of substantive damage to the economy. If we take this simple and so-called "logical" approach, we also obviate any practical possibility of desirable, constructive public criticism. Whenever he wishes, the Minister of Finance would be able to deviate from the declared policy of the Government and of himself. Nobody would be authorized to direct the attention of the public to such deviation from the agreed principles, or to the resultant contradiction between the stated principles and reality.

The Governor would be authorized to repeat the claims of the Finance Minister to others, but not to say a word on subjects reserved to the Minister. An identification similar to that required of Finance Ministry functionaries would be demanded of him. It was not by chance that the Finance Minister gave credit to the new Governor by expressing satisfaction with his public call for a cut in the budget for 1982 "as is presently warranted by the state of the economy." But what will his opinion be should the Governor contend, in all professional probity and frankness, that the social and economic situation obligates a cut not necessarily in public demand, but rather in private demand, which during Mr. Aridor's period in office has reached heights which the State of Israel has never before known? This opinion, for example, would not be in opposition to the declared principles of the Government's policy, and would even be supported by most of the Ministers, in spite of its not being in accord with the Treasury's view.

Mr. Aridor's approach utterly contradicts the famous saying of Voltaire, "I do not agree with a word you say, but I would defend to death your right to say them." Freedom of expression--without consideration of the convenience of the words to the political establishment--is one of the most vital foundations of democracy, and also constitutes the correct intellectual basis for the formulation of intelligent economic policy.

Another comment was also voiced at the Governor's inauguration ceremony, according to which policy is a matter for chosen representatives alone, for Ministers and Members of Knesset; that it is they who are responsible to the public, for good or ill, and that this fact is the basis of democracy. The Governor, whose position is appointive and not elective, must ever bear this in mind, and act and behave accordingly. This conception does not distinguish between the Governor and any other official who serves in public office. But the Governor is not a bureaucrat. His legal status is equal to that of the Ministers, and the Bank of Israel Law stresses in various ways the Governor's independence of the Government, in contradistinction to the Finance Minister. A notable example of this is the Law's requirement that the Governor, like judges, be appointed by the President. The obligations and privileges which the Law imposes and bestows upon the Governor are of an entirely different nature from those applying to other public positions.

The raison d'etre of the Bank of Israel is, to the best of my understanding, to serve as an objective, independent, and non-political decision-maker. Only the welfare of the economy should dictate its actions; its positions ought to be taken using the most reliable information which it is possible to obtain, and according to the best independent economic analysis which can be attained. It is the Governor's mission to carry out these missions with probity and impartiality, despite the unpleasantness which is involved when the estimates of the Bank of Israel differ from those of the Government, particularly in politically sensitive matters.

David Horowitz, the first Governor of the Bank of Israel, who served in this capacity for seventeen years, said in this connection that the Governor must be haMatzpen vahaMatzpoon--the compass and the conscience-- of the economy: a compass in order to sketch and determine as objectively as possible what the policy planning ought to do and a conscience in order to sound the alarm when the Government, for political or other reasons, finds it convenient or imperative to stray from declared policy, and there is danger that the goals of the policy might not be achieved.

I am in full agreement with this approach, so much so that I believe it to be not merely the Governor's right, but his clear duty, to publicly express his opinions. The Governor should not be prevented from freely expressing himself with regard to the areas which are entrusted to him, namely general economic policy and monetary policy in its widest sense. On the contrary, he should be required to speak his mind on every matter which his conscience and intellectual honesty obligate him to confront. This is not to say that the Government must accept the Governor's opinion on economic policy, for in the final analysis it is the Government's task to take into consideration factors which go beyond purely economic matters. Still, like any sea-captain, the economy's navigators must take a look at the compass.

The Prime Minister is responsible for all aspects of governmental policy, and economic policy is no exception, though he does not, and need not, involve himself in its details. In order for the Prime Minister to be able to determine his stand on economic policy, so that he and the Government can make their position firm, he would do wisely if, before bringing matters to formal deliberation, he were to invite the Governor to present his estimates and perceptions, in addition to those of the Minister of Finance. Solutions are generally not unambiguous. Discussions deepened by the estimates and recommendations of two independent but reliable sources, whether or not they agree, must increase the chances of the Prime Minister and the Government to reach the best decision. Such consultation with the Governor in no way curtails his right of free expression at a later date.

In a democratic state, public opinion exercises an influence upon the regime and the regime on its part governs the nation not by laws and decrees--and certainly not by police coercion--but by fostering normal relations with the public. According to the rules of the parliamentary game, the Opposition in a democratic regime always tries to underscore what it regards as negative aspects of the Government's policy. In contrast, the Government strives to hang the label of political or personal interest even on the Opposition's most considered criticisms. For these and other reasons, it is of supreme importance to guard the public status and prestige of all the non-political arms of the government, such as the courts, the State Comptroller, the army and the central bank. These institutions must do every thing to ensure that their objective, non-political nature is obvious and clear to all. On its behalf, the Government ought to do all it can to assure the independence of these bodies from political influence.

It is a supreme value that the public should believe in, and be utterly convinced of, the objectivity and independence of these bodies. Indeed, until now the State of Israel has done all it could to secure this public confidence.

The status of the Bank of Israel is different from that of all the other institutions which we have cited:

- The State Comptroller is an arm of the legislative branch of the democratic regime, and criticizes the actions of the Government in the name of the Knesset.
- The courts constitute the judicial branch of the regime.
- In contrast, the Bank of Israel belongs to the executive branch, for which the Government is responsible.
- The Israel Defense Forces and the Government's Legal Advisor are both integral elements of the executive branch: to an extent their status resembles that of the central bank. But there is nonetheless a great difference between them. The I.D.F. is entrusted with the execution of the Government's policy in a very narrowly defined area. The Legal Advisor of the Government is responsible for the interpretation of laws and the shaping of the policy of the Prosecutor General.

The central bank is the only organ in the executive branch empowered and expected to hold independent position in a prominent field, such as inclusive economic (macroeconomic) policy. This also explains why the personality of the Governor exerts so much more influence upon the policy of the Bank of Israel than does that of the Government's Legal Advisor on the legal positions of his agency. In most democratic states, the central bank is the single organ of the executive branch which is required to serve as a check and a balance to the Government.

Such complicated relations between the Government, which is responsible for all areas of policy, and the independent central bank, which in theory and in practice is still subordinated to the Government, exist in most states. However, in Israel things are more complicated still, seeing that according to the Law of the Bank of Israel, the Governor is simultaneously the Government's Economic Advisor.

Israeli Prime Ministers (including Mr. Begin) have more than once argued that, though the Governor/Advisor is authorized to criticize the budget and economic policy in general, he nonetheless ought to limit his criticism to internal Government deliberations and refrain from public dissent, for it would be unacceptable for an office-holder publicly to criticize an organization to which he is connected, and with which he actively cooperates in the shaping of its policy. Consequently there arises the pointed question of whether it is desirable to continue with the present arrangement, wherein the Governor legally serves also as Economic Advisor to the Government. As Governor, he must publicly voice his economic opinions, while as Advisor it would be preferable that he avoid this. This complication has more than once excessively strained the Governor's relations with the Prime Minister or the Minister of Finance. The incident between Messrs. Gafni and Aridor was not the first of its kind; it was distinguished only by the latter's unique style of attack and his general attitude to the Bank of Israel.

The Law of the Bank of Israel differs from the laws determining the roles and competencies of most other countries' central banks in other areas as well. According to the Law, the Bank of Israel is responsible for monetary policy, although it requires the Government's prior approval before it may utilize the major monetary instruments, such as setting the interest rates for deposits, loans, and so

forth. In contrast, most of the world's central banks are free to decide and act in these areas. They are authorized to make decisions concerning the nature and extent to which they make use of the instruments of monetary policy at their disposal, and need do no more than coordinate their activities with their treasury or Finance Ministry. In any case, theirs is the final decision.

The Law of the Bank of Israel was enacted in 1954, and many of its clauses require amendment. In my opinion, on one hand, the Bank of Israel ought to be freed from the necessity of obtaining Government approval of its execution of monetary policy, and on the other, the Governor's role as Economic Advisor to the Government ought to be abolished. This change in the principle and character of the law would grant the Bank of Israel more independence, as well as enhanced responsibility. The Bank could be freer and more effective in its designated field, while the range of potential conflict between the Governor and the Finance Minister would be correspondingly narrowed.

One hopes and assumes that the revocation of the Governor's title as "Economic Advisor to the Government" would not prevent his being invited to important economic deliberations in sessions of Government and other forums, both formal and informal. It is likewise to be hoped that this change in the official status of the Governor will not lead to the cancellation of the periodic consultations between him and the Prime Minister, particularly when the Government is about to make important economic decisions. Consultations with an advisor, in any field whatever, are called for when he is valued and his opinions are taken into consideration, and not when he and his advice are imposed on the Government by the force of law, custom, or binding agreement. Therefore, the Governor's effectiveness as advisor depends above all on his professional knowledge and judgment though his personal relations with the Finance Minister, and their mutual respect, are also of great importance.

The abolition of the title of "Advisor" would prevent, or at least reduce, misunderstandings about the nature of the Governor's role on the part of both sides, and is likely to improve relations between them. At the same time, the Governor would be able to continue to express his opinions, estimates, and recommendations on subjects pertaining to economic matters to the public whenever he considers this advisable. At the same time, the Government should refrain from appointing any economic advisor in addition to the Governor, for he is ever the "compass and the conscience" of economic policy, and such a role demands that he be the foremost advisor.

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Moshe Sanbar, a Fellow of the Jerusalem Institute of Federal Studies, is a former Governor of the Bank of Israel. This Viewpoints was prepared by him as part of the current project studying Israel's political economy, conducted in association with the American Enterprise Institute for Public Policy Research.