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***MUNIFICENT OBSESSION:  
THE RELUCTANT NATIONALIZATION  
AND THE  
PROTRACTED PRIVATIZATION OF  
THE ISRAELI BANKING SYSTEM***

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MUNIFICENT OBSESSION:  
THE RELUCTANT NATIONALIZATION AND THE PROTRACTED PRIVATIZATION  
OF THE ISRAELI BANKING SYSTEM

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ABSTRACT

Although Israel's major banks were bailed out by massive government loans in late 1983, they passed into the government's hands only a decade later. Even then, ownership but not control was transferred. Selling the public's stake, which began in late 1993, has proceeded slowly, despite the government's intense desire to return the banks to private ownership. This study in political economy argues that the government's reluctance to nationalize as well as its protracted privatization stems from the historic symbiotic relationship between the government and the leading banks. The partners' tactics of delay and obfuscation were designed to preserve the status quo ante. But when such maneuvers failed and reorganization became inevitable, minimalist reform was the preferred policy. It appears to have succeeded despite some internal resistance.

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I. Introduction

The present denationalization of the Israeli banking system is unique in the brief annals of financial institution privatization. Indeed, in the Israeli banking context, the terms "nationalization" and "privatization" are themselves technically inadequate -- although I shall use these terms for convenience -- for the banks were never really nationalized in the sense of owned and operated by the government and hence cannot be privatized. The pseudo-nationalization of the banks after 1983 is related to the very structure of the Israeli banking system and to the role the banks play in Israel's capital markets.

Hence, the outline of this paper. After some brief comments on the nature of the nationalization of the Israel banks and a statement of this paper's major hypothesis in this introductory section, the second section briefly describes the structure of Israeli banking in both the banking and capital markets. Bank intervention in the stock market that led to a near panic in 1983 as well as the subsequent nationalization of the five largest bank holding companies is the subject of the Section III. This section also seeks to answer the obvious question: Why not outright nationalization rather than the convoluted structure that emerged? Section IV examines the conflict over restructuring the banking industry, which further highlights the political economy of privatization during the years between 1983 and 1993, and brings us up to date. The final section summarizes and offers some general conclusions.

The point of this paper is simple and obvious, but all too often ignored: *Privatization is never merely an economic phenomenon*. It is always taken in a particular political context as this case study of nationalization-privatization emphasizes. It also implicitly accentuates the indispensable role of country-specific knowledge, especially concerning the nodes of political and economic power and the relative strengths of the parties involved in the privatization process.

**Nationalization and Privatization in Israeli banking.** The Israeli government played white knight, riding to the rescue of the major Israeli banks in October 1983. As public sales of bank stocks snowballed, the banks discovered themselves insufficiently liquid to persist with an equity buy-back policy that would prevent drastic stock price plunges. The government's bail-out, however, did not result in immediate nationalization. Rather, it took a most unusual round-about route that gave the banks a decade to restore the status quo ante. Only because the banks failed to act by the latter date did the Israel government take over formal ownership. Efforts to return the banks to full private ownership have accelerated since the 1993 takeover, but were evident much earlier.

In *de jure* terms, then, the banks have been nationalized for only a very brief time. The same can be said *de facto*, even though nationalization appears to have begun at the start. The agreements between the government and the banks contained a proviso that no ownership action -- such as voting at annual meetings or appointing directors and management -- could be taken without the explicit agreement of the government. However, the government never intervened. The fundamental puzzle that motivates this paper concerns the government's obsession against even the appearance of nationalization right from the start. Indeed, even after obtaining *de jure* ownership over the banks, the government has refused to control or operate the banks. Why?

My hypothesis posits the collective desire of the political and banking communities to preserve the mechanism that had evolved over 3 1/2 decades of Israeli statehood. It had worked sufficiently well in the past and, aside from this temporary lapse, would presumably function well in the future. Banking privatization in Israel, then, really meant little more than denationalization and a restoration of the status quo ante.

Two additional points are worth making at the outset. First, policy coordination between the banks and the government is never made explicit, but must be inferred from their actions. Second, government policy vis-a-vis banking nationalization remained fundamentally stable despite the changes in the makeup of the Israeli government over the period under discussion.

## II. The Israeli Banking System

Israeli banking conglomerates resemble the broad-ranging European universal banks rather than the narrower Anglo-Saxon banking model.<sup>1</sup> In addition to providing the typical depository and credit services, Israeli banks are active in financial markets as brokers, underwriters, managers of mutual and pension funds, investment advisers, and, not unlike German banks, directly and through investment funds actively control nonfinancial enterprises. I first briefly survey the relevant elements of the banking functions and then turn to the role of the banks in the capital market.

**The banking market.** The Israeli banking system from its inception has been composed of a small number of relatively large banks and a larger number of relatively small banks. The big 3 -- Bank Leumi Le-Israel (BLL), Bank Hapoalim (BH, the Workers' Bank), and the Israel Discount Bank (IDB) -- stand at the helm of banking groups, owning either directly or via a holding company structure some of the smaller banking institutions as well as a host of financial and nonfinancial affiliates.<sup>2</sup> Indeed, in 1992, both BH and BLL ranked among the world's 200 largest banks.<sup>3</sup> The international scope of these large banks is not surprising. The big 3 all own branches and affiliates outside Israel, which come in addition to the international financial correspondent network common to banks of all countries dependent upon international trade. Figure 1 depicts

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<sup>1</sup> A definitional comment is in order. An Israeli banking *conglomerate* consists of a banking *group* and unconsolidated financial and nonfinancial concerns. The group comprises *banking corporations registered in Israel*, banks abroad, and consolidated financial and nonfinancial 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 term generic term "banks" in the belief that context will make sufficiently clear the appropriate form.

<sup>2</sup> 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 nonfinancial affiliates. Prior to 1991, IDB was a fully-controlled subsidiary of IDB Holdings, a holding company that also controlled IDB Development. The nonbanking constituents of IDB Holdings were held in IDB Development, so that IDB was strictly a financial corporation.

<sup>3</sup> In terms of assets, BH, with \$34.1 billion, and BLL, with \$28.4 billion, ranked 159 and 193, respectively, in *The Banker's* list of the top 1000 international banks. See *The Banker* (1993).

the share of total assets held by the 3 and 5 largest banking groups,<sup>4</sup> the two additional groups being the much smaller United Mizrahi Bank (UMB) and the First International Bank of Israel (FIBI) and their subsidiaries. In terms of relative size in 1992, BH held 37.1 percentage of total Israeli banking group assets; BLL, 30.3 percent; IDB, 14.2 percent; UMB, 9.2 percent; and FIBI, 5.4 percent, leaving the remaining 11 institutions to share the final 3.8 percent. Notwithstanding the downward trend of Figure 1, the big 3 never controlled less than 80 percent of industry assets.

Despite the oligopolistic structure of the industry, the major banks never enjoyed the full benefits of market power. The hero or culprit was the intensely regulated environment that sorely limited the banks' initiative. They were subject to the entire gamut of controls aimed at assuring banking solvency and stability as well as more general macroeconomic objectives. During much of the period between 1948 and 1985, regulations dictated the banks' fee structure (including interest rates) and their credit allocation. Furthermore, the banks were constrained indirectly, a consequence of the Treasury's stranglehold on the capital market.<sup>5</sup> For example, bank-operated pension funds were mandated to invest virtually their entire receipts in government securities. Part of this savings flow found its way back to the banks as earmarked government deposits, which the government allocated to favored industries or activities (e.g., exporters, companies locating in development regions). The banks administered these loans -- which at times played a significant role in their portfolio<sup>6</sup> -- essentially serving as contractors for the government. Only in the short-end of the market did the banks exhibit some of the independence normally associated with

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<sup>4</sup> This may 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 nonbank financial intermediaries came to 86.3 percent as opposed to the 81.6 percent share of the broader concept. [See Bank of Israel, *The Israeli Banking System: Annual Survey, 1992* pp. 18 - 25 (Hebrew).]

<sup>5</sup> All bond and equity issues had to be approved by the Treasury's New Issues Committee. The authors of a study of the capital market during the 1960s record that this "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 are less controlled, but "in most years [viz., to the mid-1960s, the volume of equity issues was] quite insignificant." See Ben-Shahar, *et. al.*, p. 390. It was not until 1987 that the Treasury granted a general waiver for all bond and stock offerings, although it maintains the option to revert to a totally constrained environment.

<sup>6</sup> For example, in 1952, 1956, and 1961, the respective percentages of loans to the public coming from earmarked sources was 26.3, 36.7, and 36.7, respectively. See Heth (1966), Table 62, p. 201.

banking activities, subject, of course, to the typical central bank management.<sup>7</sup> Finally, foreign exchange transactions were extensively controlled, often to the point that banks were merely the channel through which the central bank captured foreign exchange inflows. In short, even before the 1983 "takeover" of the banks by the government, Israeli banks had seemingly met their match through the countervailing power of state institutions.<sup>8</sup>

**Israeli Banks in the Capital Market.** The largest banks have long dominated the capital markets as well, not only through their control over the flow of investible funds but also because bank stocks constitute a significant portion of the Israel equity market.

In general, the early years of the Israeli capital market were synonymous with the government bond market, both for financing general government operations and state-owned enterprises (Table 1). In addition to a captive audience of bond purchasers -- primarily assorted financial institutions that required long-term assets to match their long-term funding needs -- the Treasury succeeded in selling bonds with principal and interest linked to the domestic price level and/or foreign currency to inflation-shy private investors. Any successful private sector bond issuer would not only have to obtain government permission but compete on real yields with linked government bonds.<sup>9</sup>

Government regulation of the equity market was less intrusive. Although until 1959 common stock issues were few in number and small in size, between 1959 to 1963 some IL400

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<sup>7</sup> In Table 63, headed "Partial Estimate of the Share of Banking Institution Credit Controlled by the Bank of Israel or the Ministry of Finance," Heth's calculations range from a fifth to a third for the 1956 - 1961 period. He underestimates. The numerator is larger, as is evident from Heth's "partial estimate" title, while the denominator is smaller, since this table includes credit cooperatives in the definition of banking institutions. These intermediaries have been omitted from data used here. Ben-Shahar, Bronfeld, and Cukierman (1971) found that the government "controlled" 60 - 67 percent of financial system assets during 1960 - 1967. See Table 13-6, p. 378. Plessner (1994), p. 279, cites Bank of Israel data that show government controlled credit granted by the banking system to be 85 percent in 1985, although the figure declined to 52 percent in 1991.

<sup>8</sup> See Plessner for a survey of the overwhelmingly interventionist role of the government in Israel's economy. But he notes that liberalization is slowly penetrating Israel as it is the rest of the world. Also Razin and Sadka (1993).

<sup>9</sup> Linkage risks on government bonds are likely to be smaller than those facing any individual firm. Government revenues rise with the overall cost of living, while a firm's revenues rise only with the market success of its product line. Hence, a private corporation offering a linked bond would not only have to compensate the buyer for the additional credit risk but for the marginal linkage risk as well.

million of new equities were sold to the Israeli public. Sarnat attributes this sea change to both government push and pull: new inducements to stimulate firms to issue equity and new measures to enhance the attractiveness of equity to potential buyers.<sup>10</sup> The banks and their subsidiaries were major beneficiaries, accounting for two-thirds (by volume) of the new issues.

The brief boom burst in 1964 and the market did not recover until the early 1970s. Soon after, the banks discovered the magic of stock price stabilization. The Bejski Report notes, for example, that banks were able to sell over IS12 billion in the slump year of 1974, a sum that constituted 93 percent of all new equity issues.<sup>11</sup> Indeed, Table 1 indicates that bank dominance of the new issue market continued during the rest of the decade and into the next.

By 1977, with inflation intensifying -- see Figure 2 -- the banks found the real value of their capital base eroding while their capital needs grew.<sup>12</sup> The banks' policymakers were convinced that a financially-astute public would buy bank stocks if only they were offered more attractive terms than comparable government securities.<sup>13</sup> And so they embarked on a policy whose success is visible in Figure 3. In contrast with the 1970 - 1976 period, when bank stocks outperformed the equity market in general, but yielded slightly less than linked government securities, the years between 1977 and October 1983 saw dramatic change. While the real return on linked government securities averaged -2.8 percent and on nonbank equities 6.6 percent, the return to bank stocks came to 21.9 percent. And, as Figure 3 indicates, the fluctuations around the mean were considerably smaller than those of alternative assets.<sup>14</sup> The public responded to

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<sup>10</sup> Sarnat (1966), pp. 108 - 109.

<sup>11</sup> 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).

<sup>12</sup> Halperin (1983): 4; Brenner and Ruthenberg (1989).

<sup>13</sup> 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.)

<sup>14</sup> 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)

these higher-yielding, less-risky assets by treating bank stocks as liquid assets.<sup>15</sup> Between 1976 and 1983, the public's portfolio of financial assets shifted from 8 percent money and 3 percent bank stocks to 8 percent bank stocks and 2 percent money.<sup>16</sup>

The banks' position in the capital markets facilitated their stock price stabilization policy.<sup>17</sup> Not only could the banks use internal funds to buy back equities whenever stock prices turned down, but their holding company affiliated pension, provident, and investment funds could also indulge. Moreover, bank investment advisers recommended bank stocks to their clients, and in many cases financed the acquisition.<sup>18</sup>

Yet, however deep the banking organizations' pockets were, they were not bottomless. The end approached during the fall of 1983, when fears of sheqel devaluation led the Israeli public to dump bank stocks in order to hedge in foreign currency markets. The tide swept under the banks' vain efforts to support their stocks. Their admission of defeat in October 1983 led to the collapse of bank stock prices, to a temporary market shutdown, and ultimately to the intervention that saw the government become the predominant owner of Israel's leading banking institutions.

### III. Nationalization: The Bank Shares "Arrangement"

In late October 1983, five banking organizations<sup>19</sup> and the government of Israel initialed

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<sup>15</sup> 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...."

<sup>16</sup> Bejski Report (1986), appendix Table 5 (p. III-10). The State Comptroller's report (1984) notes 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 (Table 1.2, p. 18).

<sup>17</sup> The State Comptroller clearly distinguished between stabilization that aimed at reducing random fluctuations around a trend and manipulating the trend itself. The banks were pursuing the latter. See State Comptroller (1984), p. 22. Brenner and Rothenberg (1989) show that manipulation better describes the period between February 1981 and October 1983.

<sup>18</sup> Bejski Report (1986), pp. 20 - 21.

<sup>19</sup> IDB Holdings, the holding company that controlled IDB, rather than IDB directly, was party to the Arrangement; both IDB Holdings and IDB stock prices were "stabilized." To give some impression of the complexity of the manipulation, consider that IDB lent its funds to sister affiliates that the latter used to  
(continued...)

an agreement that bailed out the banks' public stockholders, guaranteed the continued functioning of the banks, and assured the survival of the Tel Aviv Stock Exchange. The most striking element of the Arrangement was the absence of overt bank nationalization. A convoluted procedure was devised instead. A government corporation, M.I. Holdings, was revitalized, and new bank subsidiaries -- "trust companies" of each bank specifically orchestrated for the Arrangement -- were created. Instead of direct Treasury purchases of the public's approximately \$6 billion worth of bank shares, the trust companies would buy the bank stocks from the public. These equities would then serve as the collateral for a loan from M.I. Holdings. Only if the trust companies did not pay off the debt would the government take over bank ownership. Furthermore, the public could not take advantage of this cash-for-stock exchange for at least 2 years and most holders had to wait at least 4 years.

The details of the Arrangement are relatively easy to explain. On the one hand, the government, having agreed to the bail-out, had to provide equivalent assets to the public. And, though in retrospect many deemed the government's offer benevolent to a fault,<sup>20</sup> the united front provided by the bankers, the government, the central bank, and the legislature averted a potential financial meltdown and an inevitable political reaction.<sup>21</sup> On the other hand, the government feared a massive spending spree and further inflationary pressure -- recall from Figure 2 that the 1983 rate of inflation was approaching 200 percent per annum -- if the public was permitted to cash in their stocks immediately, and so phased in the exchange over a 6-year period. Indeed, it designed an incentive structure in terms of guaranteed yields to induce the bulk of the public to

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<sup>19</sup>(...continued)  
intervene in the market for both IDB Holdings and IDB stock. See Bejski Report (1986), pp. 90 - 92.

<sup>20</sup> "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): 3.

<sup>21</sup> Bank support of their securities was tacitly agreed to by the authorities, including the central bank and the Finance Ministry, which included the securities regulators. The Bejski Report of the crash held both bankers and the authorities responsible.

wait the full 6 years.<sup>22</sup>

More difficult to explain is the government's consent to take an immense financial downside risk with no potential upside gain. Were the banks to be sufficiently profitable over the next years, they could expect the public to hold onto their stocks rather than convert. Were the banks inadequately profitable over the first five years, their future prospects not better, and the public cashed in their bank equities, the Arrangement procedure came into play. The bank trust companies could borrow from M.I. Holdings the funds to buy the stocks, repaying the loan should the banks prove to be sufficiently profitable during the next five years. Only if by 1993 the banks' capital did not suffice to pay off the loan -- which implied a string of weak profits -- or if it would make financial sense for the trust companies to default on their loans would the government obtain the bank equities. But clearly, then, the government and the taxpayer suffered the loss. Nationalization at least balanced the risk of loss with a potential for gain.

The hands-off attitude the government took towards managing its potential loss is even more startling. To be sure, the bank trust companies formally had to consult with the government for any major policy changes. In fact, the government did not intervene.<sup>23</sup> Most puzzling is the treatment of the banks' controlling shares. The bulk of the publicly-held stock carried limited voting rights; policy was made by minority stockholders who held the controlling shares. The bank shares Arrangement did not apply to these "interested parties,"<sup>24</sup> an apparently sensible and just policy. After all, why bail-out those who were ultimately responsible for the policy that led to

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<sup>22</sup> Only men over the age of 65 and women over 60 could cash in as early as 2 years. Bank stockholders who agreed to sterilize their holdings for at least 4 years would be eligible to exchange the stocks at an indexed rate of 12 percent (total, not per annum), but could increase their total indexed return to 34 percent by sterilizing their accounts for an additional 2 years. On the other hand, holders who opted to hold onto their equities rather than sterilize them could sell them to the trust companies in October 1988 for a guaranteed indexed return of only 4 percent. By early 1987, of the \$6.9 billion in eligible bank stocks, M.I. Holdings held \$2 billion (including the shares sold by pensioners to the trust companies), \$1.2 billion were sterilized, and \$3.7 billion waited in the wings for 1988. See Drori (1987): 66.

<sup>23</sup> "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 stock holders]." Weissbrod (1991): 106. (Author's translation.) As late as 1993 the BLL prospectus declared forthrightly: "The government of Israel never [intervened] nor at present intervenes in the management of the bank or its affairs." (p. III-2; author's translation)

<sup>24</sup> The determination of "interested parties" itself was open to negotiation. Some apparent anomalies are documented in State Comptroller (1993), pp. 8 - 10.

the bank stock crash in the first place?<sup>25</sup> But at the same time, the controlling shareholders were thus able to preserve their voices in future bank decisions.

Perhaps the most accepted among the proposed explanations in Israel relates to potential hot money outflows that were feared would inevitably follow outright nationalization.<sup>26</sup> The data might appear to support this argument. Israeli banks have over the decades attracted a large number of foreign depositors by offering a politically-stable economy, attractive yields, secure principal and interest, and easy access. By late 1992, foreign deposits in Israeli banks exceeded \$6 billion.<sup>27</sup>

This argument is less than fully convincing. First, foreign depositors held \$811 million in short-term bank deposits in September 1983, while Israeli official foreign currency reserves stood at \$3.77 billion.<sup>28</sup> A worst-case scenario would reduce reserves by 22 percent, which, while substantial, is hardly catastrophic. Second, as noted earlier, Israeli banks, while nominally independent of government, have always been subject to extensive government intervention; virtually no area of bank operation has been immune. Why should nationalization make a difference to foreign depositors?<sup>29</sup> Moreover, the banking and the political establishments have always been closely linked, a crucial element in the nationalization question.

The intensity of this association predates statehood. Bank Leumi Le-Israel and Bank

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<sup>25</sup> The State Comptroller (1984, pp. 71 - 72) points out the incompatible incentives between the controlling interests who retained power and the Treasury. Note also that these owners benefited indirectly, because bank stocks bought by the banks during their futile attempt to stabilize stock values were eligible to participate in the Arrangement.

<sup>26</sup> Plessner (1994), pp. 262- 263; State Comptroller (1993), pp. 13 - 14. This point was also emphasized in a personal interview with Mr. Moshe Sanbar, chairman of BLL, during the summer of 1993.

<sup>27</sup> 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.

<sup>28</sup> *Ibid.*, Table VII-24, p. 201. Note that even these deposits were not technically demand deposits.

<sup>29</sup> A similar point was made by Z. Ophir in "A Roundtable on Bank Stocks," (1989): 96 - 97.

Hapoalim are, in the words of Heth, "banks controlled by public bodies."<sup>30</sup> The former was established in 1903 as the Anglo-Palestine Bank by the World Zionist Executive, a headstart that the bank was able to capitalize in post-statehood years and does much to explain its leading role in the banking system. But its political connections are still more significant. The World Zionist Executive formed the nucleus of the post-state Labor government. And, Labor has led government coalitions for most of Israel's existence. Hence, BLL was and continues to be closely allied with Israel's predominant political party. Bank Hapoalim, founded in 1921, is the financial arm of the the nation's labor federation, the Histadrut. It is a subsidiary of the Histadrut's industrial holding company, *Hevrat Ovdim* (The Workers' Corporation), which oversees a huge agricultural, industrial, and service empire. BH, too, has a natural clientele that accounts for its place as the largest Israeli banking group. It was founded and continues to serve the agricultural cooperatives and Histadrut economic enterprises.<sup>31</sup> To complicate matters further, the Histadrut's leadership is chosen by its members from candidates affiliated with the national political parties, and has from the start been dominated by the Labor party.<sup>32</sup> (A similar relationship existed for UMB and the National Religious party, a critical partner in most government coalitions into the 1970s.) Of the 3 leading banks, only IDB, founded in 1935, is unaffiliated with a political organization and is a privately-run organization. Its growth is attributed to the "energetic activities" of the entrepreneurial Recanati family.<sup>33</sup>

In light of these well-known historical linkages, which may well have buttressed depositor confidence rather than weakened it, one may wonder why nationalization, which for the most part would only formalize the status quo, would represent such a danger.

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<sup>30</sup>M. Heth (1966), p. 32.

<sup>31</sup> See Onn (1964), p. 48.

<sup>32</sup> 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.

<sup>33</sup> Michaelis (1984): 90.

Preventing political intervention and appointments is another suggested reason as is the desire to limit government intervention in the economy.<sup>34</sup> These arguments seem disingenuous in light of the close links between politics and banking and in light of the government's extensive control over Israel's economic life. Equally problematic is the fiscal argument mentioned in passing in the Maor Report.<sup>35</sup> It asserts that increasing the government's internal debt by issuing additional obligations to pay for the bank stocks would adversely affect the terms of government bond refinancing. This issue, however, is one of limited magnitude. After all, the government would be receiving earning assets -- the banks -- in exchange, and those revenue flows could be used to pay off interest on the additional debt. It is only the difference between the earnings flow and the interest on the debt that would impact on government financing. Moreover, were the nationalized banks to be run profitably, the potential capital gain to be realized from ultimate privatization would reduce the government's debt.

Another argument -- which came to the fore in response to some intimations of an actual takeover of the banks in 1988 -- relies on the potential adverse impact of nationalization on Israeli banks abroad.<sup>36</sup> BLL owns and controls Bank Leumi Trust of New York (BLTNY), a U.S. affiliate subject to U.S. banking regulations, among them the International Banking Act of 1978. Regulatory constraints not imposed on BLTNY -- and the U.S. affiliates of Hapoalim, IDB, and UMB -- as a private entity might be imposed were the government to take over BLL. The major area of concern involves transactions between the bank affiliates and other affiliates of the Israel government, including those with nationalized parent banks in Israel.<sup>37</sup> That argument surely

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<sup>34</sup>State Comptroller (1993), p. 14.

<sup>35</sup> Officially, Bank of Israel, *Report of the Team to Investigate the Major Issues of the Banking System* (1986; author's translation), p. 45. Ms. Maor was the then Examiner of Banks.

<sup>36</sup> The content of this paragraph is based on a memorandum prepared by Shaw, Pittman, Potts & Trowbridge, a Washington, D.C. law firm, for BLL, for which I am most grateful to Mr. Sanbar and Ms. Jennifer Janes of BLL. It is clear from the memorandum itself (dated September 29, 1988) that this argument was irrelevant in 1983. The regulations and interpretations in effect in October 1983 were far more liberal and a 1978 precedent dealing with Bank Hapolim would have governed.

<sup>37</sup> The U.S. bank affiliates would be prohibited from undertaking transactions that exceeded 20 percent of the U.S. banks' capital and surplus. The memorandum implies that such constraints would mean substantial hardships, although it's not clear whether that would be to BLL, the Israeli government, or both.  
(continued...)

demands further elucidation. After all, are Israeli banks by nature different from nationalized banks in France, Italy, and Spain, which also do business in the U.S.?

I venture an alternative explanation that takes into account the historical linkage between the banks and the government. Clearly, the pre-1983 bank-government nexus satisfied the needs of both parties. The price the major banks paid for the status quo was government intervention. But they profited as well. First, the leading banks' oligopoly position was never really challenged, and the benefits, if muted by regulation, were nonetheless real. Second, the government buttressed bank profits by using the banking system as a channel for conducting many of its activities (such as loans from the development budget). Third, the nation's relatively few movers and shakers form a mutually-reinforcing elite. Hence, viewing the relationship between the banks and the government as unidirectional, with bankers on the receiving end of government dictates, does not do justice to a far more complex reality in which influence flows in both directions. That is clear in the case of BLL and Hapoalim, with their close ties to the Labor party. It's equally true for UMB, and I surmise it's true as well for IDB, although here the influence is more indirect.<sup>38</sup> 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.

Government ownership of Israel's productive resource base is extensive, which is not surprising given the socialist makeup of almost all of Israel's governments. For example, virtually none of the nation's agricultural land is privately-owned.<sup>39</sup> Again, as late as 1991, Dun and Bradstreet reported that 5 of Israel's 10 largest industrial firms were government enterprises, and their sales constituted almost two-thirds of the 10 largest. Three of the 10 largest non-industrial companies, accounting for 40 percent of total sales, were state-owned.<sup>40</sup> If one adds the

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<sup>37</sup>(...continued)

<sup>38</sup> Bank financing of election campaigns might give some evidence of the linkages. I have not yet been able to obtain data. But I have no doubt that the banks finance the parties to which they are affiliated.

<sup>39</sup> See Plessner (1994), pp. 66 - 70, on the ideological and historical roots of Israeli land policy.

<sup>40</sup> Cited in Eckstein *et. al.*, (1993b), Table 13.5 and 13.6, pp. 240 - 241. This and Eckstein (1993a), will provide the reader with an overall review of the privatization process in Israel during recent years.

Histadrut industries to those owned by government, then the numbers of nonprivate enterprises and their sales rise to 7 and 84 percent for the 10 largest industrials and 6 and 67 percent for the nonindustrials.<sup>41</sup>

The banking industry's exception to the rule is consistent with my hypothesis that Israel's governments never sought formal ownership of the large banks simply because they and the bankers had achieved a mutually advantageous relationship. They subscribed to the well-known aphorism: If it ain't broke, don't fix it! And in 1983, when it did break, they naturally tried restorative surgery.

Unfortunately for the banks and the government, the banks' profits never achieved levels adequate to avoid borrowing from M.I. Holdings. By the end of 1991, M.I. Holdings held virtually all the bank stocks (excluding those of the "interested parties") at a cost to the government of \$9.2 billion.<sup>42</sup> The government was forced to devise privatization strategies and policies.

#### IV. Bank Privatization

As the late 1993 nationalization of the leading banks became inevitable, the obsessive stance of the Israeli government confronted a painful reality. It could no longer deny the impending takeover, and with its becoming the majority owner of the banks, it could not disclaim the decisive voice it would acquire through its control over the voting rights. The solution: the government waffled.

The saga of bank privatization once the major players realized that *de jure* nationalization was a real possibility may be viewed as a political battle, albeit a most uneven one, between the bankers and the government on the one hand and the central bank on the other. The Bank of Israel saw the banks' predicament as a heaven-sent opportunity to restructure the banking industry. The theme of a more competitive financial system involved two distinct if related

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<sup>41</sup> *Ibid.* Note that some Histadrut industries were partly owned by the government, making this distinction even less meaningful.

<sup>42</sup> The State Comptroller (1993), Table 1, p. 12. The Comptroller estimated that the Arrangement would increase the internal national debt by approximately 25 percent (p. 69).

concerns: (i) undoing the tight oligopoly of the deposit-lending functions of banking, thereby increasing competition in this narrow banking market and (ii) restricting the scope of bank holding company activities, thereby opening the financial sector to more competition. A third issue involved stockholder rights, although equity rather than economics was the main concern.

**Bank shares' voting rights and bank activity restructuring.** In retrospect, neither activity constraints nor stockholder rights were really controversial once the takeover occurred and change became mandatory. As long as the government did not own and hence did not have to sell the bank stocks, it mattered little that stock ownership did not coincide with actual control. That the interested parties in BLL owned less than 2 percent of bank capital but held 75 percent of the voting power or that UMB's owners of only 0.03 percent of the equity held 50.02 percent of the voting power<sup>43</sup> became critical only when privatization strategies forced considering the possibility of new owners. What new owner would buy equity without control? This issue was resolved in 1990/91, when the banks and the government agreed to equalize voting rights. Henceforth, the one-share, one-vote rule guaranteed that those who owned a majority of the stock also commanded a majority of the power.

Similarly, a consensus grew that the range of activities undertaken by the bank holding companies had to be curtailed. The primary issue here was not efficiency, since a case might have been made for the presence of economies of scope in banking. Indeed, the narrowing of Israeli banks' options runs counter to the trend in most of the world, especially the U.S.<sup>44</sup> The prime mover here was perceived conflicts of interest. It was generally conceded that the stock market intervention engaged in by the banks and their affiliates during the pre-crash years most probably involved potential if not actual conflicts of interest. A thriving capital market could not tolerate even such perceptions if it expected to win the confidence of the nation's investors, not to speak of foreigners. Moreover, by 1985, a new economic attitude had swept Israel in the wake of a

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<sup>43</sup> Data are from *ibid.*, Table 2, p. 13.

<sup>44</sup> See Prager (1988).

successful macroeconomic stabilization policy.<sup>45</sup> Inflation was maintained at low double digits in the years following the reforms of 1985 (Figure 2). Freeing the capital market from many of its restraints became possible with the government's brightened fiscal picture. More liberal banking regulations, which also permitted greater access via competing financial institutions, demonstrated a greater commitment by the authorities to the market economy.<sup>46</sup>

A practical issue remained in the case of bank-owned and -managed pension and provident funds, which became more critical after the capital market reforms permitted the funds to allocate up to 50 percent of their assets in equities. Could the authorities prevent conflicts of interest without causing potential harm either to the banks or to the public? Or consider the following scenario: Bank-managed funds associated with a particular banking group could recapture control of their group by buying equities once the privatization process began. Would this be a legitimate use of fund assets?

No satisfactory resolution has yet occurred and, given the small size of the capital market, this tension can be expected to persist. Banks have not been obliged to divest themselves of their affiliated funds, although some "Chinese walls" have been erected to prevent conflicts of interest. Thus, bank conglomerates have been required to set up funds as holding company affiliates rather than direct subsidiaries of the banks, and have been forced to staff their investment committees with a majority of outside directors not responsible to bank management. Moreover, 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.<sup>47</sup>

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<sup>45</sup> For an extensive analysis of these reforms, see Bruno (1993). Bruno served as governor of the Bank of Israel from 1986 to 1991. His pithy remarks on Treasury - central bank relations in Israel may be found in a footnote on p. 87.

<sup>46</sup> For details, see Ben-Bassat (1990), Razin and Sadka (1993; ch. 12), and the interesting summary historical tables in the appendix to M. Sarnat and J. Dilevsky (1991).

<sup>47</sup> Bank holding company restructuring policies are outlined in Klein (1991): 22 - 23. The fundamental Israeli banking law was revised in 1981, with further revision in 1989 concerning 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 percent equity in a given non-bank enterprise, the banks have persuaded the Finance Minister to push for a 25 percent ceiling. See J. Rosenfeld (1994).

This discussion of conflicts of interest as well as the following paragraphs dealing with banking  
(continued...)

**Banking industry restructuring.** The area of greatest conflict lies in the area of banking competition, and revolved around 2 questions: (i) Was the Israeli banking industry too oligopolistic? and (ii) If so, should the impending privatization serve as the vehicle for exposing the banking industry to more competition? These issues became crucial after the government's decision in 1985 to reduce its direct intervention in banking and to limit as far as possible its direct instruments of monetary control.

Economists at the Bank of Israel, who like most economists view competition as indispensable for efficient resource allocation, answered yes to both questions. Their campaign to diminish concentration surfaced in 1985, with the report of an internal study committee that urged increasing banking competition be an explicit policy objective of future bank privatizations,<sup>48</sup> a view rejected by a joint Bank of Israel-Finance Ministry steering committee appointed in May 1988. The Bank took the unusual step of requesting from the Deputy Finance Minister that its own views be presented to the government. However, the government's agenda placed priority on the speedy sale of the banks, and saw structural reform as an unnecessary hindrance.

The government's policy stance coincides quite remarkably with my hypothesis of a government-banker alliance. Indeed, the State Comptroller's post-mortem of the stock sale saga suggests a conspiracy between the Treasury and the bankers. The evidence presented strongly implies that at the highest (read: "political") Treasury levels, policy decisions were made not only to return the banks to their former controlling interests but also to prevent structural reform. The resistance of the Bank of Israel mattered only in those areas subject to the exclusive control of the Bank.<sup>49</sup> Even the equalization of voting rights -- which surely corrected an obvious abuse -- was

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<sup>47</sup>(...continued)  
industry reform relies heavily on the State Comptroller (1993), pp. 67 - 88.

<sup>48</sup> It may have been a foregone conclusion even then that the government ultimately would take over the banks. Swari (1987, p. 110) suggests that the trust companies would be best served by turning over to 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 interests of incumbent bank management.

<sup>49</sup> For example, bank licensing. Hence, the Bank conditioned 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 their indirect stake in the General Bank. The entire episode with IDB is analyzed in *ibid.*, pp. 44 - 66.  
(continued...)

manipulated so that the power of the former controlling interests, albeit diluted, would not be destroyed.

Two strategies coalesced in this environment of self-limiting government options. First, an innovative management structure would have to be created that was simultaneously responsible to the government as bank owner and yet not controlled by government. Second, bank ownership would have to be restored to the private sector even in the absence of controlling interest buyers. Yet such sales would have to be restricted, so as not to preclude future sales of control.

The key to the former strategy was the Bank Shares Arrangement (Temporary Provisions) Law, 1993. The act provided for a government-appointed "Public Committee" to be comprised of 5 public members including a member of the judiciary as chair. The committee's primary purpose was to appoint a 5-member "Committee for Bank Stocks" for each nationalized bank, who would vote the bank stocks, and also to select public members who would be elected bank directors. In addition, these Committees for Bank Stocks would play a critical role in appointing the chairman of the board of directors and in dealing with sundry issues that required shareholder consent. At this point (May 1994), the committees have been appointed and have begun to perform their functions. Although it is clearly premature to comment on the efficacy of their activities, no change in banking policies is yet evident.

Perhaps the most surprising section of the act appears to contradict my earlier assertions. The act's objectives are: (1) to sell the stocks at 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.*"<sup>50</sup> It is this last citation that might imply the government's commitment to restructuring the banking system. Note, however, that the act does not specify the objectives of these structural changes. Moreover, the italicized terms authorize the government alone to define and approve structural changes in the banking system. At this point, little has happened to suggest

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<sup>49</sup>(...continued)

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

<sup>50</sup> Ch. 1, para. 2. Author's translation and emphasis.

that my hypothesis is being seriously threatened.

To be sure, there has been some minor restructuring. Two smaller banks have been split off from their larger banking groups: Union Bank from the BLL group<sup>51</sup> and Tefahot, a mortgage bank, from UMB. Sale of UMB itself fell through after the Bank of Israel refused to grant a banking license to the remaining bidder on grounds of unsuitability, although recently new bidders have come forth. IDB has undergone a major restructuring in ownership, but this has not changed the degree of banking system concentration.

Indeed, the IDB episode lends further support -- as the exception that proves the hypothesis -- to my supposition. IDB Holdings, the conglomerate with both financial and nonfinancial subsidiaries, had to divest itself of its majority stake in Israel Discount Bank before the authorities would permit the previous owners to acquire IDB Holdings, an action that would totally sever the conglomerate link between the two components. Serendipity, not conscious preplanned government policy, however, lay behind this surprising turn of events. Criminal action in connection with the bank share stabilization episode had been introduced in late 1990 against Rafael Recanati, a principal of IDB Holdings, as well as other major participants in that episode. An opinion from its legal advisor forced the government to reverse a previous commitment to sell IDB Holdings as a unit -- comprising both the financial and nonfinancial components -- to the Recanatis and their allies.<sup>52</sup>

At this writing the record of bank share sales is decidedly not encouraging. Certainly, the government's own decision that, with minor exceptions, the bank groups be sold whole (that is, with all their affiliated banks and their consolidated financial and nonfinancial affiliates) rather than as separable units, limited the number of likely buyers and precluded potentially intensified

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<sup>51</sup> Majority ownership in Union Bank was bought by a group of Israeli entrepreneurs in May 1993. See Lipkis and Rosenfeld (1993).

<sup>52</sup> 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.) The divestiture of the Union Bank from the BLL group is also noted in this article (p. 60); the reason was the apparent ambivalence of BLL over retaining Union.

banking competition.<sup>53</sup> Moreover, the government seemed committed to finding a buyer who would take over control, arguing not unreasonably that the banking organizations should be turned over to groups with proven bank management ability. Unfortunately, the only Israelis who fit that bill were the previous controlling interests.<sup>54</sup> Minority interest -- 21 percent in a public offering and another 10 percent to employees -- in Bank Hapoalim was sold in June 1993, but a further tranche, marketed in November, failed to attract much attention. Similarly, 23 percent of BLL was sold in 1993.<sup>55</sup> 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 leaves control in the hands of the original controlling interests. By now that should hardly be surprising.

## V. Conclusion

The objective of both privatization and of liberalization is economic efficiency. 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.<sup>56</sup> 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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<sup>53</sup> A possible economic rationale that hinged on economies of scale or scope has little empirical support from studies in other countries. However, one might argue that the government saw an externality in preserving banking groups of large absolute size, both for the importance to the national economy of trade financing and international capital flows. I have not seen such arguments made.

<sup>54</sup> "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).

<sup>55</sup> J. Rosenfeld (1993a), (1993b), and (1994b) .

<sup>56</sup> Clearly, this is a very stylized view, which is examined more carefully in Prager (1992).

I have argued that the nationalization of the major Israeli banking groups represents an unanticipated and undesired event imposed upon a banking system characterized by well-defined and long-standing roles played by the government and the bankers. The threat to this cooperative mechanism could not be ignored, but it could be managed. Two tactics served the system well: delay and obfuscation. By delaying the onset of nationalization, the powers that were hoped that time would make this step unnecessary. By attempting to limit the government's role should a formal takeover of the banks be unavoidable, they hoped to modify the form but retain the substance. Interpreting events in this light explains why the government tried its best not to nationalize the banks and why, when nationalization was inevitable, it was an active party to empowering previous bank management. Moreover, even its privatization efforts were designed to conserve the old rather than restructure the system, an alternative that would have buttressed its own liberalization activities. Thus, the Israeli banking system remains nationalized in name, but, by the government's own volition, lies beyond its direct control. The 3 big banking groups that dominated the economy since even before the founding of the state continue in their accustomed role. *Plus ca change, plus c'est la meme chose.*

**The lessons.** Certainly political intervention in the economic sphere is not unique to Israel. Nor need one emphasize the symbiotic relationship between political and economic interests for understanding economic policy either in Israel or elsewhere. The more significant lessons may lie in three less obvious points highlighted by this episode. First, the actors' role is ultimately defined by the script. And, as the script is rewritten, the actors are forced to adapt to new and occasionally less appealing characterizations. Or, to put it less obliquely, neither political nor economic interests operate in a vacuum, but must work within a dynamic framework. For example, however much the Israel government might have preferred to preserve the power of its old banking partners, it was faced by a massive debt overhang that could be reduced by selling off the banks, even if that meant curtailing banker independence. Cooperation turned at least partly into confrontation. Second, as circumstances change, bit players may perceive an opportunity to star. Thus, once banking system restructuring became possible, the Bank of Israel took a stance that challenged the political leadership and the bankers themselves. Third, information is power in a democracy provided it is widely disseminated. The free press plays a vital role in the Israeli

democracy, and extensive and continuing press coverage of the entire bank stock scandal issue prevented the silent interment of the highly critical State Comptroller's report.

In short, privatization initiatives require a catalyst. They will succeed to the extent that the status quo is shattered, new coalitions emerge, and the public can express tangible displeasure against a reform-resisting old guard. The mixed success of recent privatization programs the world over suggests that these conditions do not often coalesce.

TABLE 1 - CAPITAL MARKET ISSUES, SELECTED YEARS

Year	Bonds			Equities		
	Total	Gov't	Private	Total	Banks	Banks (% of total)
1950 <sup>1</sup>	11			0.7	0	0
1955	9			0		
1960 <sup>2</sup>	78.8	42.1	36.7	26	7.2	28
1965 <sup>3</sup>	116.8			9.2	4.5	48.9
1970 <sup>4</sup>	1,264.2	724.1	540.1	0		
1975 <sup>5</sup>	7.8	2.0	5.8	17.1	14.5	85
1977				48.5	34.4	71
1980 <sup>6</sup>	1.6			28.2	20.9	74
1983				26.8	6.8	25
1985 <sup>7</sup>	1,049.2			56	9	16
1990 <sup>8</sup>	2,218	1,013	1,025	723.5		
1992 <sup>9</sup>	3,622	3,296	326	4,222		

<sup>1</sup>Data for 1950 (gross issues) and 1955 (net issues) in IL millions from Sarnat, Table A-5, p. 127.

<sup>2</sup>IL millions. Data for bonds from Bank of Israel, *Annual Report 1960*, Table XXI-7, p. 385, and for stocks from Table XXI-10, p. 388.

<sup>3</sup>IL millions. Data for bonds from Bank of Israel, *Annual Report 1965*, Table XX-1, p. 427, and for stocks from Table XX-12, p. 445. Banks here include finance and insurance.

<sup>4</sup>IL millions. Data for bonds from Bank of Israel, *Annual Report 1970*, Table XVIII-1, p. 388, and for stocks from p. 393.

<sup>5</sup>IS billions (IS1 = IL1,000). Data on bonds from Bank of Israel, *Annual Report 1975*, Table XIX-2, p. 435. Equity data from 1975 - 1983 are in IS billions, December 1983 prices, from the Bejski Report, Table 6, Appendix p. III-11.

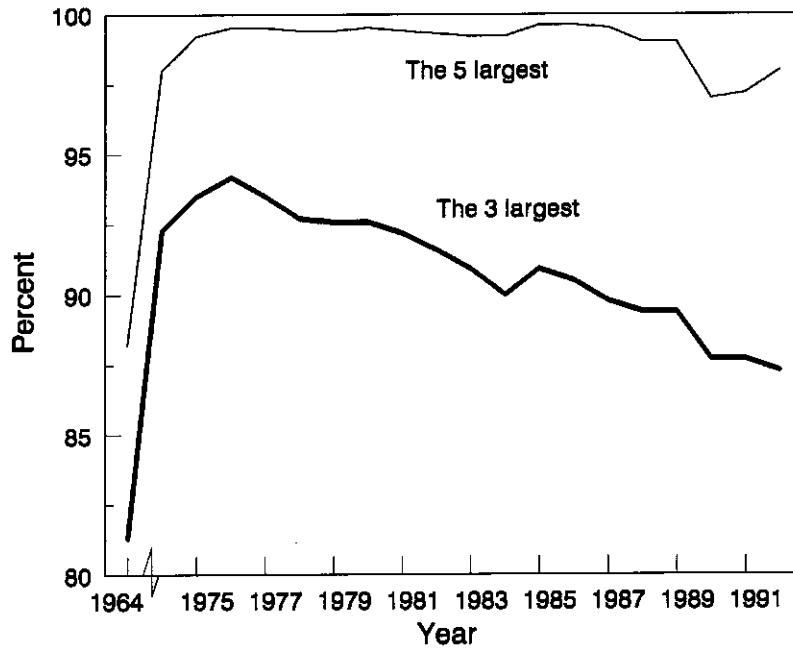
<sup>6</sup>IS billions. Data on bonds from Bank of Israel, *Annual Report 1980*, Table VIII-15, p. 274.

<sup>7</sup>Data for bonds from Bank of Israel, *Annual Report 1986*, Table VIII-B4, p. 224, and for stocks from Bank of Israel, *Annual Report 1985*, Table VIII-B1, p. 221; equities are in 1986 prices.

<sup>8</sup>NIS millions (NIS1 = IS100). Data for bonds from Bank of Israel, *Annual Report 1990*, Table 7.10, p. 185, and for stocks from Table 7.A16, p. 204. Bonds of public sector corporations are included as private.

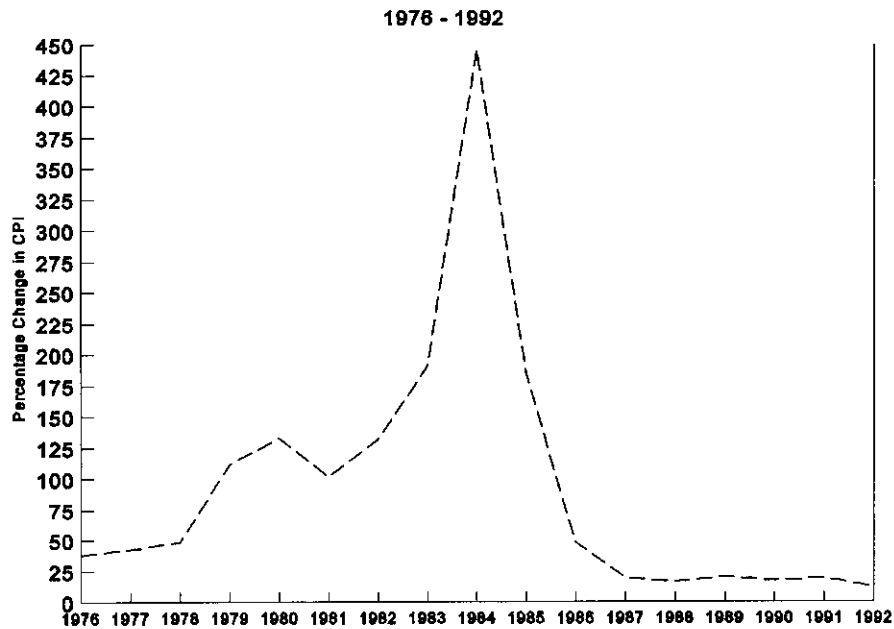
<sup>9</sup>Data for bonds from Bank of Israel, *Annual Report 1992*, Table 7.12, p. 164, and for stocks from Table 7.11, p. 162.

**FIGURE 1: PROPORTION OF TOTAL ASSETS HELD BY THE 3 AND 5 LARGEST BANKING GROUPS, 1964-1992**



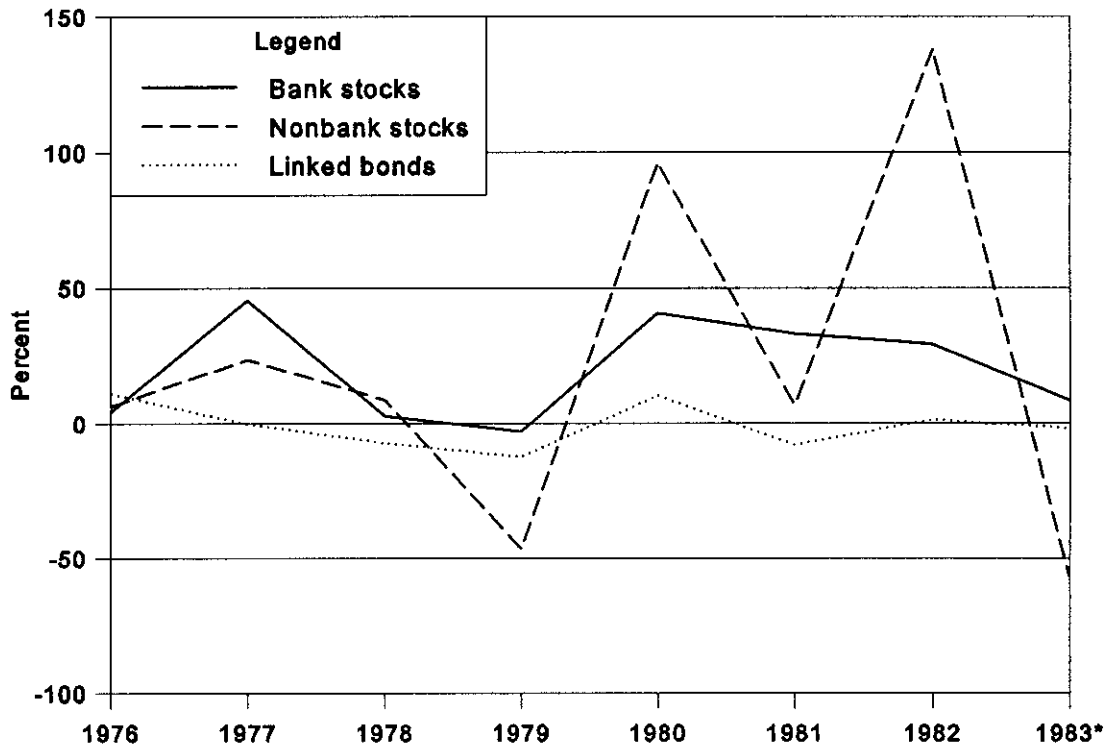
Source: Bank of Israel, *The Banking System in Israel: Annual Survey, 1992*, p. 22.

**Figure 2: INFLATION IN ISRAEL**



### Figure 3: RETURNS TO STOCKS AND BONDS

1976 - October 1983



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