

# Legal, Actual and Desirable Independence: A Case Study of the Bank of Israel<sup>1</sup>

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## 1. Main Lessons

1. There can be substantial changes in actual independence without any noticeable changes in legal independence.

2. Although both the actual and the legal independence of the BI were higher in the post 1985 era than prior to it, the increase in the former was much more dramatic than that of the latter,

3. Till roughly the mid nineties actual independence has generally been lower than legal independence. Since the mid nineties actual independence is found to be higher than legal independence.

4. Though high by domestic historical standards, the actual independence of the BI after the mid nineties is not as high as the current legal independence of the central banks of the twenty six countries that are either current or prospective members of the Economic and Monetary Union (EMU).

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<sup>1</sup> Forthcoming under the title: "De Jure, De Facto and Desired Independence: The Bank of Israel as a Case Study" in Liviatan N. and H. Barkai (eds.) The Bank of Israel, Vol. II: Selected Topics in Israel's Monetary Policy.

## **2. Main components of the index**

1. Allocation of authority over monetary policy and procedures for resolution of conflicts between the CB and government.
2. Relative importance of price stability in CB objectives as stated in the law.
3. Seriousness of limitations on lending by the CB to government.
4. Procedures for the appointment and dismissal of the governor of the CB.

**Table 1: The legal independence of the Bank of Israel before and after the "no printing" amendment - A comparison to developed economies during the eighties**

<b>Country</b>	<b>LVAW</b>	<b>Country</b>	<b>LVAW</b>	<b>Country</b>	<b>LVAW</b>
Israel - 1954	0.39	Ireland	0.44	New Zealand	0.24
Israel - 1985	0.46	Netherlands	0.42	France	0.24
Israel - 1998/9 (Levin C.)	0.61	Australia	0.36	Spain	0.23
W. Germany	0.69	Iceland	0.34	Japan	0.18
Switzerland	0.64	Luxemburg	0.33	Norway	0.17
Austria	0.61	Sweden	0.29	Belgium	0.17
Denmark	0.50	Finland	0.28		
US	0.48	UK	0.27		
Canada	0.45	Italy	0.25		

**Table 2: Over time evolution of the actual independence of the Bank of Israel**

Year	AVAW (actual)	Memo: LVAW (legal)	Year	AVAW-Actual	Memo: LVAW (legal)
Pre 1985	<b>0.13</b>	<b>0.39</b>	1994	0.51	0.46
Post 1985 -Average	<b>0.52</b>	<b>0.46</b>	1995	0.55	0.46
1986	0.50	0.46	1996	0.52	0.46
1987	0.44	0.46	1997	0.57	0.46
1988	0.39	0.46	1998	0.64	0.46
1989	0.32	0.46	1999	0.64	0.46
1990	0.39	0.46	2000	0.69	0.46
1991	0.44	0.46	2001	0.66	0.46
1992	0.43	0.46	2002	0.66	0.46
1993	0.46	0.46	2003	0.64	0.46

## **5. Codification of actual independence in the post 1985 era**

The post 1985 period is characterized by sustained processes of institutional change many of which had non negligible consequences for the actual independence of the BI. The most important of those are

1. A gradual reduction, mostly through attrition, of DC; a gradual increase in ceilings on the total stock of short term treasury bills (Makam) until their complete elimination at the end of 2001.
2. A gradual process of desegmentation of credit markets.
3. A gradual process of lifting of various controls on capital flows.
4. Gradual flexibilization of the exchange rate and the introduction of inflation targets in December 1991.
5. A substantial increase in the short term interest rate set by the Bank, starting in the mid nineties, points to an increase in the relative emphasis on price stability.