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Stanley Fischer reveals: Who has the Influence behind the Scenes in the Israeli Market

22:35 10.6.2009 Guy Rolnik, Rotem Streckman and Moti Bassok

So why, Mr. Governor, did you dismiss Danny Dankner?

"I had reasons. We decided not to commence formal proceedings. Our aim was to maintain the stability of the Bank and not cause damage to people. We decided and acted, and I hope we succeeded."

I asked why you dismissed him and you did not answer the question.

"I am not interested in getting into details. In discussions with Bank Hapoalim we explained it to them."

Did you give them an incomplete explanation too?

"They got enough".

But not everything?

"No".

Doesn't the public need to know?

"No, the public does not need to know".

"You can carry on asking I have no problem listening and looking for a book at the same time" says Prof. Stanley Fischer dryly in the middle of the interview gets up from this seat and goes to the book case in this office. He pulls out the September 2005 edition of "Journal of Economic Literature", sits down and leafs through the pages until he reaches the article he was looking for, and starts reading out loud and in a slow pace sections that he highlighted for himself in yellow.

"Outside the United States and the United Kingdom, large Corporations usually have controlling owners, who are usually very wealthy families. Pyramidal control structures let such families control corporations without making their own capital investment. Through these Pyramidal control structures, a single holdings company controls several public companies that control more public companies and so on. The family members are usually appointed to senior roles in the organization. The structure enables some wealthy families to control a large part of the private sector in the country.

"To preserve their unique position, those families increase their political influence beyond the size of their capital, through investment in political connections. The implications of such steps on the economy can be very severe: a low rate of innovation, resource misallocation, low growth, economic fixation, capital markets that do not function efficiently and that have limited entry possibilities."

Do you want to tell us that this is how you see the State of Israel?

"This is an article that describes small countries."

How did this article suddenly come to your mind? You have plenty of books here after all.

"Already when I arrived in Israel I knew what was happening here. There were some who talked about 18 families and some who talked about 20 families, all sorts of things like that. I was aware of it and thought it was interesting, because the article is about Israel without referring to Israel."

I see it is already highlighted, when did you highlight the sections you have read out to us?

"I highlighted them when I read it myself a short while after I arrived in Israel. Since I arrived here I have not read it. Actually, maybe I read it once, when there was a conference here about banking controlling groups."

Even if he did not say so expressly, the article Fischer referred to was some kind of a personal summary of his and lesson learning from the Bank Hapoalim affair and the difficulties he encounters in his struggle to dismiss Danny Dankner from the position of chairman. Does he imply that influential factors acted in this affair who tried to lead to different consequences? Was pressure exerted on him?

"No", he says, "and in response to your next question - no political pressure was exerted either".

Mr. Governor, what did you learn from this affair about the oligarchy and the businessmen club in Israel?

"I didn't learn much, because I had already understood more or less how the market operates'

How?

"Like any other market in the world. There are interests and there are those who try to maintain them in various ways".

Simon Johnson, who was the chief economist of the International Monetary Fund, where you served as vice CEO, and whom you know, has also made similar claims. In his article "The Quiet Revolution" he wrote that most markets in the world are captive in the hands of tycoons who determine the economic policy more than the official policy setters.

"Yes, I worked with the Russian Government in the 90s."

And you saw it there?

"Yes, undoubtedly".

"All sorts of Rumours"

Are there hidden and sophisticated forces in Israel too, that have more influence than they should have?

"Like anywhere else in the world, there are influential people in the business sector who want to influence the economic policy for their own benefit. Sometimes it operates to the benefit of the market and sometimes it does not. The role of the government is to decide what to do. The Government is under pressure from different directions, not only from business people but also from trade unions for example. It has to formulate a position with regard to what is important to the market, and take into account everybody's interests. There are also different governments of a different nature, such as left wing and right wing governments. That's life."

Who in your opinion controls Bank Hapoalim: the management, the Board of Directors, Sheri Arison or factors external to the Bank?

"On day to day matters it is the management that has control. When it comes to electing the chairman, it is the controller and she also has influence through the directors that she suggested for the role. There is a Board of Directors in Bank Hapoalim and one of our aims

"There is a tendency in Israel to think that everything is measured against the Dollar. If you ask an Israeli about the exchange rate, he knows you mean the Dollar. But we need to refer to all of the exchange

was to contribute to the quality of its corporate governance. Therefore we asked it to operate as it was required to in electing the new CEO, we were seeking to help them take the right place in the management of the Bank."

rates of our foreign trade partners. I always present also the currency basket rate in which the Euro has a greater weight."

Various sources have argued that your real struggle is not against Sheri Arison but against factors external to the Bank.

"I have heard that, but in Israel as well as in the world, there are all sorts of rumors. I reach the conclusion that one must not act on the basis of what X thinks. There are many stories in all sorts of directions. That one is in X's pocket that one is in Y's pocket - these are things you cannot know without investigation. We need to act in accordance with what we see. People tend to jump to conclusions without enough information, and I try not to do that."

Did you try to gather information?

"We tried to gather information about proceedings within the Bank and whether they were in order."

And you reached the conclusion that they were not?

"You must have heard the story about the Lebanese who entered a police station in Beirut and complained: "a Swiss person has stolen my Syrian watch"

'You mean' said the duty officer at the station, 'a Syrian has stolen you Swiss watch'.

'You said that', answered the Lebanese."

Did you feel throughout the struggle that you were losing your prestige and status?

"I didn't notice that, but you never know these things. When I go out to the beach, for example, people usually come up to me to complain, but this is obviously not a statistical sample. At the Monetary Fund I used to work with a manager whom I always quote: at difficult times I would ask him 'what are we going to do now?' and he would answer: 'We have to do our work'".

Do you think that Bank Hapoalim and its management are going to conduct themselves in a professional and independent manner from now on, or are there still disturbing signs about the way the Bank is

being conducted? Do you foresee corporate governance problems with this Bank?

"We have approved the appointment of the new Chairman, Yair Sarusi, and we have trust in him. We have approved the process of finding a new Chairman and we expect the locating committee shall conduct it in a professional manner. We hope they succeed in running the bank in a professional and orderly manner."

Why doesn't Sarusi sit on the CEO locating committee?

"I don't know. I, for example, do not sit on the locating committees of the Bank of Israel."

Market leaders, prominent business people, who give interviews in the press, say that you have no explanation for the question of why Danny Dankner was dismissed.

"Of course that's what they say. If we were to publish all the details, they would have said 'why did you do that, there was no need to'".

So why, Mr. Governor, did you dismiss Danny Dankner?

"I had reasons. We decided not to commence formal proceedings. Our aim was to maintain the stability of the Bank and not cause damage to people. We decided and acted, and I hope we succeeded."

Perhaps I didn't hear the beginning of your answer, but I asked why you dismissed him and you did not answer the question.

"I am not interested in getting into details. In discussions with Bank Hapoalim we explained it to them."

Did you give them an incomplete explanation too?

"They got enough".

But not everything?

"No".

Bank Hapolaïm has a 300 Milliard Shekel balance sheet. Doesn't the public need to know?

"No, the public does not need to know. There is supervision; the Bank Supervisor knows what's happening at the Bank. Our aim is to maintain the stability of the Bank and to do it quietly. I have no idea why the public should receive explanations about everything. It has nothing to do with the stability of the Bank today and it does not affect the future of the Bank. The public does

not have a right to know everything that the Bank of Israel does - as long as we protect the public deposits the financial stability of the system, as well as the shareholders of Bank Hapoalim."

Did you feel during the last struggle in the Bank Hapoalim affair that your public status and your prestige were harmed due to the waste and corruption at the central bank? Do your critics use it in order to attack you?

"Not at all. I think that the public has a lot of appreciation for the decisions of the Bank of Israel, the monetary policy and the other professional decisions that the bank adopts."

When you arrived in Israel, you convened a meeting of newspaper editors and senior reporters and told us that we have an excellent economic press here. Do you still think so when you see the press coverage of the Bank Hapoalim and Bank of Israel affairs?

"That is a more general issue and I don't want to refer to it. There are excellent reporters in Israel, I knew that before and I still think so. But the need to issue at least four financial papers each day in a small market sometimes leads to 'news manufacturing'. It is too often that I read things that are incorrect - and it bothers me. Now you are going to ask for details."

Outside the United States and the United Kingdom, large corporations usually have controlling owners, who are usually very wealthy families. Pyramidal control structures, cross shareholding, and super-voting rights let such families control corporations without making a commensurate capital investment. In many countries, a few such families end up controlling considerable proportions of their countries' economies. Three points emerge. First, at the firm level, these ownership structures, because they vest dominant control rights with families who often have little real capital invested, permit a range of agency problems and hence resource misallocation. If a few families control large swaths of an economy, such corporate governance problems can attain macroeconomic importance—affecting rates of innovation, economic resource allocation, and economic growth. If political influence depends on what one controls, rather than what one owns, the controlling owners of pyramids have greatly amplified political influence relative to their actual wealth. This influence can distort public policy regarding property rights protection, capital markets, and other institutions. We denote this phenomenon economic entrenchment, and posit a relationship between the distribution of corporate control and institutional development that generates and preserves economic entrenchment as one possible equilibrium. The literature suggests key determinants of economic entrenchment, but has many gaps where further work exploring the political economy importance of the distribution of corporate control is needed.

1. Introduction

A growing body of work indicates that economic growth depends on the distribution of control over capital assets. Two vast literatures, already surveyed in the

Journal of Economic Literature, are relevant as points of departure. The first, reviewed by Philippe Aghion, Eve Caroli, and Cecilia Garcia-Penalosa (1999), discusses reasons why economic inequality might impede growth. The second, surveyed by Ross Levine (1997), discusses the functional role of capital markets in stimulating growth. We build on these insightful contributions by reviewing recent research relating the distribution of corporate control with the workings of capital markets and showing how these interactions affect economic growth.

* Morck: University of Alberta and National Bureau of Economic Research. Wolfenzon: Stern School of Business, New York University, and National Bureau of Economic Research. Yeung: Stern School of Business, New York University. We gratefully acknowledge helpful suggestions from Mark Casson, Ron Daniels, Mara Faccio, Roger Gordon, Henry Hansmann, Campbell Harvey, Diana Knizhneva, Bruce Kogut, Ross Levine, Enrico Perotti, Andrei Shleifer, René Stulz, Paul Vaaler, Belén Villalonga, Marina Whitman, and the referees.

No, I will not ask for details. But do you think that the press is influenced by those who control it?

"I don't read enough to know. I read four-five articles a day, and the rest of what I read is just headlines, therefore I can't decide about the quality of the newspapers. Each reporter has his own conscience and his own perspective on the world; I don't try to get into the question of why he writes the way he does. Some have a very well known perspective and there are articles that, when I read their headlines, I already know what the content will be. On the other hand, there are reporters whose texts I read, because they are really trying to prove something."

"The Asian Currencies will become Important"

When he is not facing strong forces in the Bank Hapoalim affair, Fischer struggles with the strengthening of the Shekel against the US Dollar, a strengthening that can cause the situation of export companies deteriorate even more and have an adverse effect on Israel's economy. In a surprising step, which at first seemed very dangerous, Fischer decided a year ago to enter the foreign currency market and purchase US Dollars. At the first stage, the entry of the Bank of Israel into the market was hesitant and disorganized, but after a short while the business became stable and powerful and the entire market got used to the fact that the Bank of Israel purchases 100 million US Dollars every day.

Fischer's purchase policy, combined with "tail wind" that he received from the international market, contributed to the recovery of the US Dollar at a rate of 30%, from an exchange rate of NIS 3.2 in July 2008 to more than NIS 4 at the beginning of 2009. This move was a success but the purchases lead to an increase in the foreign currency balance of the Bank of Israel, which this week has reached a record of nearly 48 million US Dollars. At the same time, and as if to spite, the US Dollar began to weaken and from an exchange rate of NIS 4.25 to the Dollar at the end of April, it declined in the past few weeks to under NIS 4. Now many are observing the Bank of Israel to see if it can carry on sustaining the Dollar, or whether it is going to surrender to the markets. If Fischer's move succeeds, it will be studied at universities, but if it fails - perhaps it is best not to know what will happen if it fails.

Are you not taking a risk of a war against the international foreign currency market? Historically, most central banks in the world that tried to influence the exchange rate failed.

"We wanted to influence the Dollar with Shekels. We said - let's try to raise the exchange rate and we did that through increasing the demand. We were a substantial factor in the market. From the beginning we were not ready to carry on purchasing endlessly. I, of course, do not think that we can do what the Chinese did - reach foreign currency balances of 2 trillion Dollars. When the time is right we will start to change our way and eventually we will be out of the market. We will choose the time. I do not think it is possible to influence the exchange rate trends for a very long time."

There is a feeling in the market that you have a certain goal for the Dollar exchange rate, but we know that in an open market that doesn't work.

"There is a feeling, yes, but we do not have a goal. There are people who claim that they cannot live with such an exchange rate and others speak

about a different rate, and then try to turn that number into our goal. We will not set a goal for the Dollar, because we will lose in the end."

The Dollar collapsed in the world against the Euro. What can you do?

"We do not expect to be able to influence the exchange rate of the Dollar against the Euro. We tried to influence the Shekel. There is a tendency in Israel to think that everything is measured against the Dollar. If you ask an Israeli about the exchange rate, he knows you mean the Dollar. But we need to refer to all of the exchange rates of our foreign trade partners. I always present also the currency basket rate in which the Euro has a greater weight."

Meaning you are trying to influence the basket and not the Dollar?

"We have had a discussion about the need to stress that more. Our objective is to assist export, and what influences export are the Dollar and the Euro. But other currencies will also become important in future, we must not forget that. For example, the Asian currencies. It is likely that in the coming year the Dollar will weaken against the Chinese and Indian currencies, as there will be an increase in imports from Asian countries. They are growing fast and a revaluation is to be expected there."

"The recession has not been stopped yet"

In recent months the financial world has been more optimistic: the fear of a horrible financial collapse has expired and the stock exchanges around the world are rising again. The realistic data also show the rate of deterioration is slowing down, but many economists ask themselves whether the change is real.

Do you think that the economic policy in the US really works? Are we seeing a real recovery or is it the result of injecting more drugs, i.e. a low interest rate and high liquidity (Quantitative easing)?

"We need only look back 7 months, when Lehman Brothers collapsed and the entire world was paralyzed. There were markets, in particular the commercial paper markets, which simply stopped operating. The problem is that companies that were funded through those markets were unable to receive funding and this is evident from the world export data. We did not see phenomena like that in the past. It was not entirely clear whether we had the tools to handle a situation like that.

"The recession has not been stopped yet. By the end of the year we will reach a low, but the recovery will not be so quick. It is possible that by the end of the year, perhaps at the beginning of next year, we will renew our growth, but until then we have to take into account the fact that unemployment is a phenomenon that is behind

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2010"**

"And then the American central bank charged in and within two months infused 1/4 trillion Dollars into the market and increased the US balance 2.5 times. That is an enormous amount, equal to the gross domestic product of a month and a half. We have not seen things at this level. And yet for several months the risk premium remained high, 3%, simply nothing worked. Now it already works. I have no doubt that if they had not acted, the situation would have been much harsher. It took us out of the more critical aspect of the crisis - the financial collapse. They saved us from a situation much harder than the current situation. There is no doubt that it was a mistake to let Lehman Brothers collapse. No one knew if the cure would succeed, but it did in the end. Now everyone can complain that it was exaggerated. Anyone who survived has the confidence to criticize the central banks.

Are we seeing now the end of the recession?

"We see that we have not reached a low, but it is impossible to know if anything else may happen. I remember the Mexican crisis that started in December 1994. As soon as 6 months later, the Mexicans went back into the markets and were able to raise funds. To many it seemed as if they recovered from the crisis, but at the end of the year the government submitted an unconvincing budget, and Mexico went back into crisis. The signs we see now, at least the expectations, are that the market will start to grow in the second half of the year. This is a big change."

In January 2009 you were one of the only ones who were more optimistic at the World Economic Forum meeting in Davos. You said that if there was wall to wall pessimism, maybe one had to be optimistic.

"I saw small buds in Davos and they continued to grow. I think that the American market is on its way to growth, but this forecast is not entirely clear."

And what about Israel? Has the recession been stopped? Is it possible to renew growth within two-three quarters?

"The recession has not been stopped yet. We are a little bit behind in Israel compared to the rest of the world. By the end of the year we will reach a low, but the recovery will not be so quick. It is possible that by the end of the year, perhaps at the beginning of next year, we will renew our growth, but until then we have to take into account the fact that unemployment is a phenomenon that is behind the gross domestic product and it may continue to increase at

the beginning of 2010, even after growth is renewed. But the harm to Israel should be smaller compared to the harm to the United States. Over there they expect a jump in unemployment from 4% to 10% and in Israel the increase in unemployment is from 6% to 8.5%."

All over the world interest rates are very low, almost zero rate. Also in Israel. Is zero interest rate not a recipe for the creation of more bubbles?

"If central banks continue to maintain a zero interest rate for years, it will cause bubbles. The question is whether we will know when to stop and whether we will be determined enough to do it. Everybody learnt what happened in the 2003- 2007 rise and I hope that they do not make the same mistake."

What in your opinion is the economic meaning of Obama's entry into the White House?

"There is no doubt that the fiscal change is important, because the government is much more active, there is no question about that. But the central bank was independent before and the governor, Ben Bernanke, was appointed by the Bush administration, so there is no great change."

What are the two most important reforms that need to be made in the post crisis market?

"We need to reform the land management system and reform many centers of inefficiency in the market".

In the last package deal, was the public sector overblown compared to the private sector?

"I don't think that that was what happened. There was a temporary increase in the government expenditure, but I don't expect it to continue."

Is the regulation of the financial markets in Israel appropriate, or are 2 trillion shekels worth of financial assets abandoned to company owners, the banks and the brokers?

"It is possible to improve the general supervision system over the financial markets and the management of the financial institutions, but it does not mean that in the present situation there is no efficient supervision or that there is lawlessness."

How do you explain your lack of success in managing the Bank of Israel itself (the employees, the salaries, the bonuses etc.) compared to your success in your role as a senior economic consultant to the market and the government?

"I think we made a revolution in the management of the Bank of Israel: we signed a new, historical wages agreement, which for the first time in the public sector reduces to a considerable extent the wages of employees and over time will move the bank into a more appropriate wage structure. We also reorganized the bank comprehensively, and that made the bank more efficient, professional and modern and contributed to our ability to handle the current financial crisis. To that we should add comprehensive changes in the senior management that runs the bank in a professional and dedicated manner. I think that the implications of these positive changes will manifest themselves in the coming years."

Are you interested in another tem in office?

"One of my teachers told me: 'do not answer an offer that you have not yet received,'"

Stanley Fischer

Age: 65

Marital status: married +3

Lives in: Herzliya

Former roles: vice CEO of the International Monetary Fund, vice chairman of the City Group

Something else: likes jogging, jogs on the beach in Herzliya.