Deception through Credible Commitment: Secret Inflationary Finance in Israel's War of Independence

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Abstract

Israel's War of Independence was largely financed by secret loans from the Anglo-Palestine Bank, the private bank of the Zionist movement. The government and the bank made a credible commitment not to increase *currency* too much, while secretly and illegally increasing the other component of the money supply – accounts. The credible commitment was part of a sophisticated campaign of secrecy and deception, which kept both population and enemies from knowing the desperate fiscal situation. Newspaper articles and gold prices indicate that the public was fooled as planned. The public was baffled about the inevitable inflation, while the government played innocent.

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In cunning ways you shall make war.

- Proverbs 24:6.

1. Introduction

Inflationary finance of wars and revolutions is a standard theme in monetary history. Inflation in the era of precious metal coinage involved a clandestine change in the purity and weight of the coins to produce more coins from the given quantity of metal. Modern warfare introduced paper money, which can be manipulated for the same purpose by changing its quantity at little cost. Even if the quantity of money is kept secret during a war because of the budgetary implications, in democracies that quantity is still supposed to be regulated by the public's representatives in parliament. In the American and French Revolutions and the American Civil War the parliaments even enacted the exact amounts of money to be printed.

This paper shows a case – Israel's War of Independence – in which, as in coinage-era wars, the outstanding amount of money was not known in real time to almost anyone. Moreover, the government did not simply keep the quantity of money a secret – it actively deceived the public about it. Ironically, the deception was conducted mostly by what we now call a credible commitment:[1] The parliament passed laws regulating the issue of paper money and treasury bills, with admirably prudent restrictions on quantities, exceptional transparency, and tight parliamentary supervision. But reality was far different from that: The government had secretly and illegally sold treasury bills to an important bank for months before the authorizing legislation was enacted and did not even receive paper money for them. While deliberately focusing the

[1] North and Weingast (1989).

attention of a partially financially illiterate population on the quantity of *currency* alone, the government had its account in the bank's books increased by the stroke of a pen. The bank's currency reserves, and the manipulated public trust in both the government and the bank, were large enough to sustain this operation for a few critical months. It is doubtful if the newborn state would have survived 1948 without this brilliant trick.

The story shows two problems with credible commitments. First, a cunning government can secretly get around them. If the secret is well kept and everyone involved collaborates, then the commitment is not going to be enforced by anyone – either parliament, courts of law, or the population. It has been long known that monetary and financial innovation is often motivated by profit-maximizing activity of economic agents who try to get around regulation.[2] In previous studies, the agents concerned were colonial governments in an empire or state governments in a federation, defying the wishes of the superior government. We could add the recent accounting creativity by European Union candidates and member states which fooled the new European federation. The peculiar thing in the current story is that the government got around regulation enacted by a parliament at its own level. Moreover, the government itself submitted that regulation to the parliament's approval. By creating credible commitment and getting around it, the government managed to have its cake and eat it too.

A second problem with credible commitments is that they are not just obstacles to get around, but can be advantageously used as a red herring, attracting attention in one direction to enable secret activity in another. These two "problems" are only for the concept of credible commitment; in the story told here, this abuse of credible commitment probably saved a nation.

[2] E.g., Hanson (1979), especially Sylla (1982), Goldberg (2009, 2023).

There are further implications for the narrower issue of inflation. The government not only cheated about the current quantity of money but also used the credible commitment to manipulate the public's expectations about the future growth of the money supply. These variables – the real-time quantity of money and expectations on future quantities – are key economic variables in the short run. An unknown increase in the money supply can increase output, while reducing expectations of money growth can reduce inflation today.[3] Empirical studies of inflationary episodes should therefore consider not only the quantities of money published ex post and available for historians, but also what was known in real time and what was expected to happen.

In standard economic histories of Israel, data and research begin in earnest only from the last day of 1948.[4] The main year of warfare – 1948 – was too chaotic for standard economic analysis, with huge changes in government, population, area, production, consumption, and trade. The statistical measurement of economic variables was also severely hampered by the war. The war therefore got far less attention by economists than later years. This paper, in contrast, intentionally dives into the economic fog of war and focuses on 1948. In the seminal work on the beginning of paper money in Israel, Ephraim Kleiman noted that there was inflationary finance: In August 1948 the chairman of the Anglo-Palestine Bank told the Prime Minister that the war was being financed only by treasury bills sold to the bank. Kleiman also mentioned that the bank used new paper money to buy such bills only from late November.[5] Kleiman did not explain how the bank paid for bills from August to November, and did not mention that the process was secret, deceitful, and even illegal. Kleiman did not have the benefit of some key sources published after his research – protocols of government meetings and the war diary of Prime Minister David Ben

[3] Lucas (1972), Obstfeld and Rogoff (1996), respectively.
[4] E.g., Patinkin (1965), Halevi and Klinov-Malul (1968), Gross (1990).
[5] Kleiman (1977), p. 242-243.

Gurion. Neither did he have at his disposal the Historical Jewish Press online database. Itzhak Greenberg stated that 55% of the war's local expenses (in the period May 1948-March 1949) were financed by loans from the Anglo-Palestine Bank, but he too said nothing of secrecy, deception, and illegality.[6] As for the history of economic deception in the context of war, there is an opposite example in which an aggressor state played weak: Ahead of the 1973 Yom Kippur war, "A flood of communiqués and reports on Egypt's economic instability and its inability to afford another war were made public."[7]

The rest of the paper is organized as follows. Section 2 provides basic information about Israel's War of Independence and its initial financial situation. Section 3 relies on contemporary Israeli newspapers to find out what the public knew about war finance. Section 4 uses sources which were secret in real time, such as government protocols, bank records, and Ben Gurion's diary, to reveal the awful truth of war finance. Section 5 documents the secrecy imposed on financial matters, and the active deception practiced by the government to manipulate information on, and expectations of, money creation. The newspapers seem to imply that the secrecy and deception were successful, but the newspapers were subject to strict censorship. Section 6 therefore analyzes the Tel Aviv gold exchange to examine indirectly the effectiveness of the secrecy and deception. Section 7 discusses the rise of inflation and the ironic appointment of no other than the bank's chairman to fight it. Section 8 concludes.

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[6] Greenberg (1988, 2017), also cited in Gross (1990). Local expenses were for soldiers' wages, food, and equipment. There was also a very large expense outside Israel for buying military equipment, but Ben Gurion insisted that all that expense be financed exclusively by external sources, namely donations of world Jewry. There was therefore a separation in principle between the two types of expenditure. E.g., Ben Gurion (1982), p. 540, 587. Naor (2006, 2009) discussed other revenue sources, mostly loans from the public early in the war, with an emphasis on their social implications.

[7] Aboul-Enein (2003), p. 53.

2. Background: The War and pre-independence finances

The war lasted from November 30, 1947, to July 20, 1949. The decisive events, however, were in 1948. The war started one day after the United Nations General Assembly voted to end the British Mandate for Palestine and create a Jewish state and an Arab state. The local Arabs rejected the plan and launched a civil war which lasted until the Mandate ended on May 14, 1948. The Jewish leadership then designated itself the Provisional Council of State (henceforth 'the Council') and declared the independence of the State of Israel. As fully anticipated, the next day Israel's four neighbors, together with Saudi Arabia and Iraq, invaded the new state.

As modern wars of independence go, Israel's was unusually consequential for the newly-independent population in its entirety – not just its soldiers and political leaders. Three years after the end of the Holocaust, Ben Gurion had no doubt that this was "war for life and death for us" and that "the rulers of Egypt, Syria, Iraq" would "do in Palestine what Hitler did in Europe."[8] To avoid such a fate, all means justified the end. Creative minds were incentivized to think hard how to survive. As Plato stated, necessity is the mother of invention. And here was one big necessity.

The Council's first legislative act was the Law and Administration Ordinance of May 19 (henceforth all dates refer to 1948 unless noted otherwise). The ordinance allocated executive powers to a subset of the Council which became the Provisional Government. The ordinance continued all Mandate laws, except for those giving any authority to the British or discriminating against Jews.[9] The government immediately declared an official state of emergency.[10] After heavy fighting, a one-month ceasefire was ordered by the United Nations Security Council and took

[8] Ben Gurion (1982), 525, 620.
[9] *Official Gazette* 2 (addendum A), May 21, p. 1-5.
[10] *Official Gazette* 2, May 21, p. 6.

effect on June 11. At that point it was clear that the immediate invasion failed but the situation was still very precarious. After the Ten Days' Battles in the middle of July, the existence of the State of Israel became an undisputable fact. A second UN ceasefire was then imposed without an expiration date. It was punctuated by two brief periods of battles in October and one in December-January. The last shots were fired on January 9, 1949. In March, the last operation involved Israel Defense Forces riding to the Red Sea and taking over the Negev desert without resistance. Armistice agreements were signed with Egypt, Lebanon, Jordan, and Syria from February to July 1949.[11]

The monetary and financial situation inherited by Israel from the Mandate was that of a semi-developed economy. Many residents did not have bank accounts, and there was no monetary policy to speak of, but the land already experienced bank runs, inflation, and government borrowing. The Palestine Currency Board issued the Palestine pound since 1927. Every note and coin were issued only after an identical amount of pounds sterling was deposited with the Board. The Palestine pound was part of the sterling area, in which all regional currencies of the British Empire were legally treated as sterling in the context of foreign exchange regulations.[12] Ordinary wages were paid in cash, because most laborers and all Arab peasants were not banked.[13] By far the largest bank was the Anglo-Palestine Bank which registered in the United Kingdom in 1902. Nearly all its voting stocks and almost half of the share capital were owned by the Jewish Colonial Trust, whose directors were appointed by the World Zionist Organization.[14] Upon Independence, 40% of the value of checking accounts was held at that bank.[15] The only other large bank was a

[11] Ben Gurion (1982), p. xvi.
[12] Ottensooser (1955), p. .
[13] Ottensooser (1955), p. 46, 61.
[14] Ottensooser (1955), p. 58.
[15] *Haaretz*, May 12.

branch of the British Barclays Bank, which was the banker of the Mandate government and the agent of the Currency Board.[16] There were also dozens of smaller banks and credit cooperative societies, some of which were associated with political parties or ethnic groups.

As international security crumbled from 1935, the economy started experiencing occasional bank runs. Due to the absence of a central bank, the banks were in the habit of maintaining unusually high levels of reserves to ensure their survival in such times. In 1945 the banks had 72 million pounds (henceforth MP) in deposits and 54% of that was covered by cash and similar assets.[17] The war itself brought high inflation: The cost-of-living index rose threefold during the war, mainly because of a huge increase in British military spending in Palestine for war-related products, which increased the currency fourfold. Another reason cited was import restrictions.[18]

The Mandate government borrowed from the population a few times.[19] Most relevant here, a 1944 Mandate ordinance, amended in 1945, authorized the British High Commissioner to instruct the Mandate's Treasurer to issue treasury bills, expiring within one year, in multiples of 10,000 pounds.[20] These war bonds were issued at a total value of 1MP, and were redeemed, in 1945-1946.[21]

In late 1947, the Anglo-Palestine Bank anticipated the troubles ahead and hoarded millions of pounds of currency notes in advance.[22] In March 1948 the amount of currency outstanding was

[16] Ottensooser (1955), 57.
[17] Ottensooser (1955), 52, 54, 63, 65-68.
[18] Ottensooser (1955), 54-55.
[19] Ottensooser (1955), 70-72.
[20] Palestine Treasury Bills Ordinance, no. 25 (1944), *Palestine Official Gazette* 1352 (add. A), p. 50-51, August 12, 1944; Palestine Treasury Bills Ordinance (Amendment), no. 13 (1945), *Palestine Official Gazette* 1400 (add. A), p. 53, April 2, 1945.
[21] *Palestine Official Gazette*, government's financial reports, various issues.
[22] Ottensooser (1955), 109.

53MP, 97% of that in notes and the rest in coins.[23] For comparison, the budget of the Mandate government for 1947 was 25MP.[24] In February 1948 the United Kingdom unilaterally excluded Palestine from the sterling area, a move that was recognized by historians as part of a deliberate attempt to sow chaos that would sabotage the creation of the Jewish state and its finances. It meant that foreign exchange regulations on residents would apply for sterling and other sterling area currencies throughout the British Empire. Also, all the assets of Palestine's banks in London were frozen.[25] Two months later, the chaos policy continued with the withdrawal of the Palestine Currency Board office to Britain.[26]

Upon Independence, Israel adopted the Palestine pound as part of the wholesale adoption of the Mandate's laws. It was a peculiar situation: The issuer of Israel's currency was a "neutral" (in fact, hostile) party, while the local Arabs and the invaders from Trans-Jordan (the eastern part of Palestine) also used that currency.[27]

3. War finance: What did the public know?

The only systematic, well-documented evidence of what the public knew in real time is newspapers, which were subject however to military censorship. Most newspapers belonged to political parties: *Davar* (labor), *Al Hamishmar* (labor-communist), *Kol Haam* (communist), *Haboker* (General Zionists, really capitalists), *Hazofe* (national-religious), and *Hamashkif* and later *Herut* (national). *Haaretz* was unaffiliated, as was the only Jerusalem-based, English newspaper – *Palestine Post* (soon changed to *Jerusalem Post*). The discussion of public knowledge of war finance and related issues is split here to three parts. First, the size of the budget and its

[23] Ottensooser (1955): In general – Part I; the laws and balances – p. 147-157.
[24] *Haaretz*, February 19, 22, Barkai (1990), p. 21, 25.
[25] Ottensooser (1955), 56.
[26] Ottensooser (1955), 108.
[27] Ottensooser (1955), 109.

components. Second, the launching of a new currency with a potential for inflationary finance. Third, the laws and issue of treasury bills.

3.1. The budget

On May 11, three days before Independence, the Jewish Agency began subscription to a National Loan to finance the defensive effort against the anticipated invasion. The amount planned by Agency Treasurer and incoming Minister of Finance Eliezer Kaplan was 5MP.[28] On May 15, he said that the state's *daily* budget was 0.1MP, justifying his request that people subscribe to the loan.[29] By May 20, half of the Loan had been subscribed, but then subscriptions slowed down.[30] Kaplan said the loan "was only a small part of the emergency budget of the state but this small part is the one that gives us the possibility to hang on until we take the high road."[31] The government also solicited donations in kind – blankets, clothes, bags, binoculars, canteens, compasses, and eating utensils – to equip the many new recruits as soon as possible.[32] The state drafted 40,000 men out of a total population of 600,000.[33] It was reported that invaders' tanks and armored vehicles were fought with Molotov cocktails – a poor soldier's weapon.[34] The days-old state still did not have any tanks or airplanes.

In late May, David Horowitz, general manager of the Ministry of Finance, said that the war budget was largely covered by the government's domestic income, and that two thirds of that income financed the war.[35] The military's general staff motivated the public to subscribe to the

[28] *Haboker*, April 7, *Haaretz* May 10.
[29] *Haboker*, May 16.
[30] *Haaretz*, May 24, *Hamashkif*, May 26.
[31] *Haboker*, May 24.
[32] *Davar*, July 20, 24.
[33] Barkai (1990), p. 23-24.
[34] E.g., *Haboker*, May 27.
[35] *Haaretz, Davar*, May 28, *Al Hamishmar*, June 2.

National Loan by stating that the June budget would be 4MP.[36] To remind, the last budget of the entire Mandate government was 2MP a month.[37] That was the last piece of precise numerical data given on the entire military budget by officials in 1948, and some of it was recycled by the press in August.[38] Unreferenced numbers appeared in the press in June and July: a monthly budget (civilian and military) of 3.5MP; or a monthly military budget of 2.5-3.5MP, funded "from special sources."[39] The press published the Lebanese radio's opinion that "the Jewish Agency would not be able to bear for long the war expenses."[40] An intensive marketing campaign led to the completion of the National Loan of 5MP in late July (Figure 1).[41]

Figure 1: The National Loan – public information

[36] *Al Hamishmar*, May 31, *Haaretz, Davar, Hamashkif, Hazofe, Kol Haam*, June 9.
[37] *Haaretz*, February 19.
[38] *Haaretz*, August 16, 23, *Al Hamishmar*, August 16, 24.
[39] *Haaretz*, June 23, July 7.
[40] *Al Hamishmar*, June 23.
[41] *Hamashkif*, July 5, *Hazofe*, August 1.

Kaplan said on August 11: "The first National Loan gave us the possibility to finance the war until June, and maybe a small part of July."[42] This was consistent with the military's estimate of 4MP a month. Talks about a new domestic loan, voluntary or forced, began immediately, but dragged on for months.[43] By comparison, the published civilian budget and ordinary government income were 0.6-0.7MP per month.[44] Ben Gurion's speech to the Council was reported: "The financial burden is heavy. A problem such as financing the war is not an easy one. … There were some serious cases of breach of discipline and the commanders knew the reason – there was hunger in the soldier's family."[45] Support for soldiers' families alone was reported to be almost 1MP a month.[46]

In late August, Kaplan told leaders of American Jewry of breaking records in war spending, and one of them said: "We could not understand how Mr. Kaplan hangs on and how he manages to balance the budget."[47] In September Kaplan told the Council of the "terrible pressure" of "the enormous war budget," reported rumors of state bankruptcy, and asked to raise taxes to recruit 10-12MP for the war.[48] In October the Council enacted an "ordinary" budget of 7.8MP for the second half of 1948, a fifth of which was openly given to the war effort.[49]

In December, five months after the end of the National Loan, three new loans were enacted: a Popular Loan similar to the National Loan, and two "voluntary" loans extorted from the rich and middle class who agreed to them to avoid forced loans: One from financial institutions and another

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[42] *Haaretz*, August 11, 1948.
[43] *Hamashkif*, August 1, *Haboker*, August 12.
[44] Budget Ordinance (July 1948), *Official Gazette* 10 (add. A), July 21, Budget Ordinance (August 1948), *Official Gazette* 13 (add. A), August 4, *Haboker*, July 7, *Haaretz*, July 7, 25.
[45] *Haaretz*, August 6.
[46] *Haaretz*, August 8.
[47] *Haaretz*, August 24, 25, also October 31.
[48] *Haaretz*, September 3, 10, 17, October 1.
[49] Budget Ordinance (July-December 1948), No. 2 of 5709-1948, *Official Gazette* 28 (add. A).

from members of economic organizations and associations. According to the Explanatory Note of these statutes, funding the war was the leading use of the 13.5MP to be collected.[50]

From all this scattered data in the newspapers the public could have concluded that the war cost a few millions of pounds every month, and that the regular government income was not enough to pay for that (it barely paid for the much smaller civilian, ordinary budget). The public knew that much information was withheld from it for security reasons. Already in May, David Horowitz designated the military budget "a military secret" and politicians followed this line.[51] It was public information that the published, civilian ordinary budget that was enacted was only part of the picture and that there was an unpublished military budget that was decided by the Council's Finance Committee behind closed doors.[52]

3.2. The banknotes

The replacement of paper money had been anticipated for two months when on August 16 the Council passed the Bank Notes Ordinance and the Currency Ordinance.[53] The event was celebrated as the most significant act of sovereignty since Independence.[54] Together with a treaty signed between the government and the Anglo-Palestine Bank, the two ordinances replaced the Mandate currency notes with new banknotes issued by the bank. These banknotes were declared legal tender and the currency unit was changed to the Israeli pound, equal in value to the former currency. The

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[50] *Haaretz*, December 3, *Hazofe*, December 15, *Official Gazette* 38 (add. A), December 17, p. 76-81.
[51] *Haaretz, Davar*, May 28, *Al Hamishmar*, June 2, *Haaretz*, August 6, September 10.
[52] Budget Ordinance (July 1948), *Official Gazette* 10 (add. A), July 21; Budget Ordinance (August 1948), *Official Gazette* 13 (add. A), August 4, *Haboker*, July 7, *Haaretz*, July 25, Treasury Bills Ordinance, 5709-1948, *Official Gazette* 27 (add. A), October 15.
[53] *Official Gazette* 15 (add. A), August 17.
[54] All newspapers, August 17.

public was given one month to change the Mandate notes to the Israeli notes, while Mandate coinage remained.

By the time the ordinances were enacted, there was speculation in the press – with great alarm – about the government using the new printing press to finance the war.[55] There was already significant inflation due to the severe disruptions of the war – higher consumption by an increasing number of drafted soldiers, and lower production because more and more workers were drafted, and property was destroyed. This inflation should have been expected, based on Keynes's then-famous book *How to Pay for the War*.[56] From the beginning of the war the cost-of-living index increased by 25% (47% in annual terms). The wholesale price index behaved similarly.[57] The inflationary finance seen so often in Europe since 1914, and especially the hyperinflation in Germany, were traumatic, living memories for most adults.[58] Israelis also knew about the contemporary wartime hyperinflation in the collapsing Republic of China.[59]

Therefore, there was emphasis in the ordinances, an accompanying Explanatory Note, a press conference, and speeches, that there were assurances against high inflation. First, a regulated private bank – rather than the government – controlled the printing press. Second, this bank was chosen partly "for psychological reasons," "by a desire to increase the trust among the public," it being "the Zionist bank that has existed and operated for 50 years." Third, the banknotes were managed by a newly established Issue Department at the bank which was separated from all the other bank's businesses – from then on called the Banking Department. Fourth, while foreign experts recommended against covering the currency with cash reserves, such cover was included

[55] E.g., *Haaretz*, June 23.
[56] Keynes (1940), p. 9.
[57] Central Bureau of Statistics (1949), p. xxv, 59.
[58] *Haaretz*, July 18.
[59] *Haboker*, June 22.

"for a psychological reason." No banknotes were to be issued without assets covering them and dedicated for this purpose only. Fifth, the assets would be at least 60% in reliable assets – gold, foreign currency, and Mandate currency – limiting the unreliable assets – treasury bills and private debts such as bills of exchange – to no more than 40% of the total issue.[60] Fifth, the Issue Department would publish its balance sheet every week "so that the public could always follow the Issue Department's actions" and this would "strengthen the public's trust in the new currency." Sixth, a bank committee would manage the Issue Department, while the Minister of Finance could appoint two people to attend the committee's meetings without voting rights. The independence of the committee was ambiguously qualified: "On those matters that the Minister of Finance and the committee acknowledge to be matters of principle, the committee will be guided by the government's opinion, which will be determined after consultation between the Minister of Finance and the committee." Those matters of principle were listed: "fighting the cost of living, expanding credit or contracting it." Council members agreed that the proposed structure of the management "would increase the public's trust in the new currency." Kaplan promised in conclusion: "the currency must serve the economy and for this reason we must preserve its value. And I repeat and announce that we would like to preserve the currency's stability more than the Palestine currency's stability was preserved."[61]

The press mentioned that the Bank of England was also split into a Banking Department and an Issue Department, and that the Bank of England published weekly reports.[62] So soon after

[60] The law said 50-50 but Kaplan committed in public for 60-40.
[61] Bank Notes Ordinance, No. 18 of 5708-1948, *Official Gazette* 15, (add. A), August 17, p. 34-37, 85-86, *Haaretz, Davar, Haboker, Hamashkif*, August 17.
[62] *Hazofe*, July 14, August 17, *Haaretz*, September 8.

the end of the hated Mandate, nobody was comfortable stating the obvious fact that the Bank of England was the inspiration for the new financial structure of Israel.

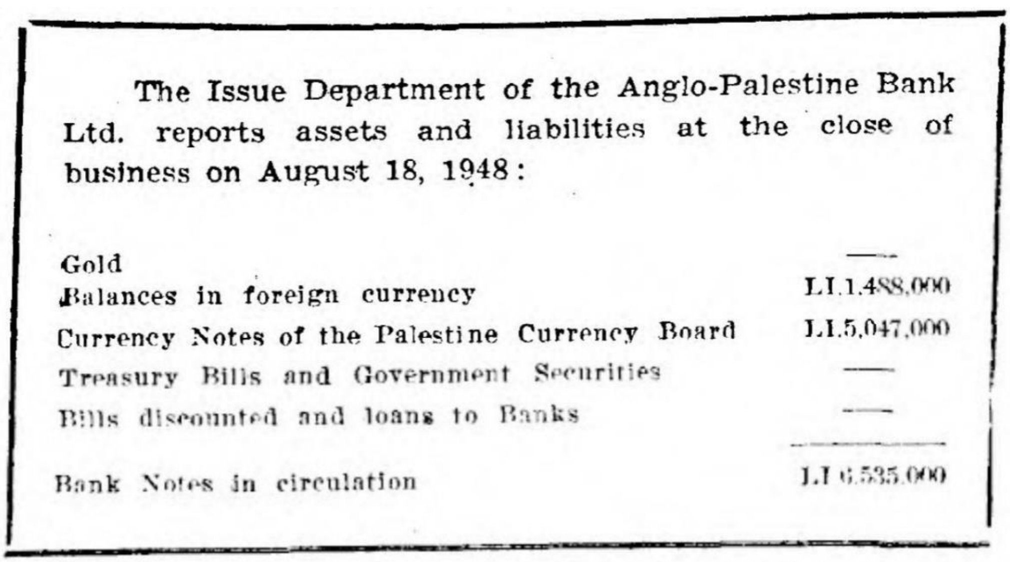
The currency swap began on August 17. The public happily converted the Mandate's paper money into the Israeli banknotes and accepted the new notes in market transactions.[63] The press was generally supportive and content with the anti-inflation measures. *Haboker* reported that the greatest popular concern was "the question how the new currency will affect the price level and the cost of living." Stating that the 40% upper bound on backing with government securities was "a very severe constraint, much more severe than imposed on other governments *in peacetime*," it concluded: "*Our currency is covered and secured against inflation in the most severe way*." It referred to the Anglo-Palestine Bank as "the national bank (de jure) and the central bank (de facto)."[64] *Davar*, affiliated with Kaplan's party, wrote: "From experience we know that the Minister of Finance excels in careful financial policy … hence the certainty" that he will approach the Issue Department only for "urgent economic needs," so "we are far from the danger of inflation. On the contrary, independence in regulating the currency adds to the state an efficient weapon in its war against the cost of living."[65] *Al Hamishmar* noted that the government could pressure the bank to print money, but with the expected higher tax revenues "the odds of balancing the budget are pretty good." It ended with a warning that the bank's de jure independence was not enough: "As we learned from the period of inflation after World War I, everywhere those interested managed to use measures that enabled inflation while not contradicting the formality of law."[66] Robert Ottensooser, a civil servant and a scholar, who wrote about the monetary history of the period in 1955, agreed: "The general confidence in the Anglo-Palestine Bank fully warranted the

[63] *Haboker*, *Al Hamishmar*, August 18.
[64] *Haboker*, August 17, 18.
[65] *Davar*, August 17, September 10.
[66] *Al Hamishmar*, August 18.

decision to bestow on it the note privilege," and the regulation regarding the cover of note issues was "extremely conservative."[67]

The next day the Issue Department made its first report. It showed conversion of just over 5MP to the new banknotes, and the bank also printed 1.5MP covered by dollars. The most significant entries in the report were empty: gold and treasury bills (Figure 2).[68] While the conversion continued, Kaplan promised the Council that the government would not balance the regular civilian budget by printing money.[69]

Figure 2: The first report of the Issue Department (Palestine Post, August 19)



The Issue Department of the Anglo-Palestine Bank Ltd. reports assets and liabilities at the close of business on August 18, 1948:

Gold	—
Balances in foreign currency	LI.1,488,000
Currency Notes of the Palestine Currency Board	LI.5,047,000
Treasury Bills and Government Securities	—
Bills discounted and loans to Banks	—
Bank Notes in circulation	LI.6,535,000

[67] Ottensooser (1955), 111-112.
[68] *Official Gazette* 16, p. 93, August 18.
[69] *Haaretz*, September 10.

The first report of the Issue Department after the (extended) deadline for note conversion passed – September 30 – stated that the bank exchanged 26.5MP (as expected).[70] The published amounts of gold and treasury bills were still zero. A gradual conversion of Mandate paper money for sterling was then handled by the bank and the Currency Board,[71] but the amount of new banknotes remained stable for a while.

3.3. Treasury bills

While the Bank Notes Ordinance mentioned "treasury bills," nobody is on record mentioning that the Mandate's Treasury Bills Ordinance was in force. According to Israel's Law and Administration Ordinance of May 1948 the Treasury Bills Ordinance, like all Mandate laws, continued in force, but all the High Commissioner's authorities passed to the Provisional Government.[72] In June that government divided responsibilities among its members but apparently forgot to grant responsibility for issuing treasury bills, while assigning bills of exchange to the Minister of Justice and banknotes to the Minister of Finance.[73] The authority to instruct the Minister of Finance to issue treasury bills therefore remained with the entire government.

A prospective treasury bills ordinance was first reported in the press in early October, and its use for war finance was immediately understood by the press.[74] The ordinance and its regulations permitted the Minister of Finance to issue freely assignable treasury bills of 10,000 pounds each, maturing within a year. The total amount would be limited by Council decisions. The

[70] *Official Gazette* 26, p. 6, October 8. Extension: *Haaretz*, September 20. Kaplan: *Haaretz*, August 17.
[71] Ottensooser (1955), p. 113.
[72] Law and Administration Ordinance, no. 2, 1948, *Official Gazette* 2 (add.), sections 14(a), 2(d), May 21.
[73] *Official Gazette* 5, p. 24, June 16.
[74] *Haboker*, October 8, *Hamashkif*, October 11, *Haboker*, October 12; *Al Hamishmar*, October 15, Treasury Bills Ordinance, 5709-1948, *Official Gazette* 27 (add. A), October 15.

forgotten Mandate order was not explicitly abolished, but the new ordinance implicitly voided it according to the amended Law and Administration Ordinance.[75]

With Kaplan promising that the treasury bills will not amount to more than 40% of banknotes, and given the 28MP issued thus far, *Haaretz* calculated that no more than 19MP could be printed for treasury bills ($\frac{19}{28+19} = 0.4$).[76] The bureaucratic apparatus was quickly put in place, with the Issue Department serving as the government's agent.[77] On November 10 the press reported that three-months bills were for the first time sold the previous day to banks, but no further information was given.[78]

November 25 was a turning point: The Issue Department's weekly balances showed for the first time 2MP of "treasury bills and bills of obligation of the government." The government openly practiced inflationary war finance and the press was alarmed: "It must not be forgotten that our currency is still young; it must also not be forgotten that the country suffers from an *inflation complex.*" Therefore, the Minister of Finance "should use this legal authority carefully – for *psychological* reasons," and the Council's Finance Committee "should follow these developments very carefully."[79] Due to this "*way of inflation* … a governmental explanation campaign is necessary. Government's spokesmen repeatedly promised that in no way will they practice the way of inflation. Now the public waits for an explanation of what seems to be a deviation from these promises."[80]

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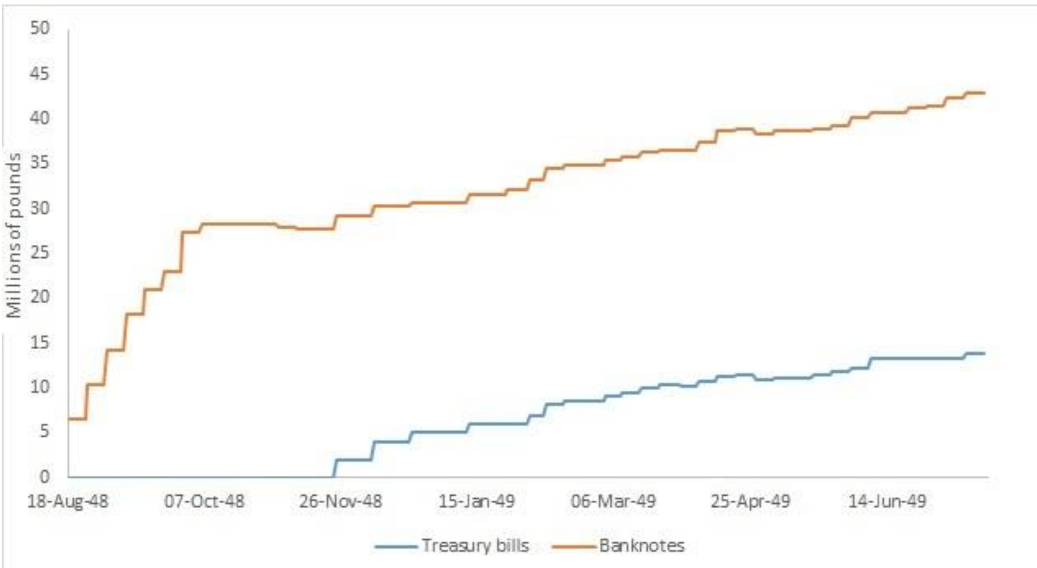
[75] Law and Administration Ordinance (Additional Instructions), No. 13, 5708-1948, *Official Gazette* 8 (add. A), July 7, p. 21-22.
[76] *Haaretz*, October 15, also *Hazofe*, October 21.
[77] Treasury Bills Regulations, 5709-1948, *Official Gazette* 28 (add. B), p. 15-16, October 22, *Haboker, Herut, Hazofe*, October 31, *Official Gazette* 29, October 29, p. 34, *Al Hamishmar*, November 3.
[78] *Haboker*, November 10.
[79] *Haaretz*, November 30, December 8.
[80] *Haboker*, December 7, *Kol Haam*, December 29.

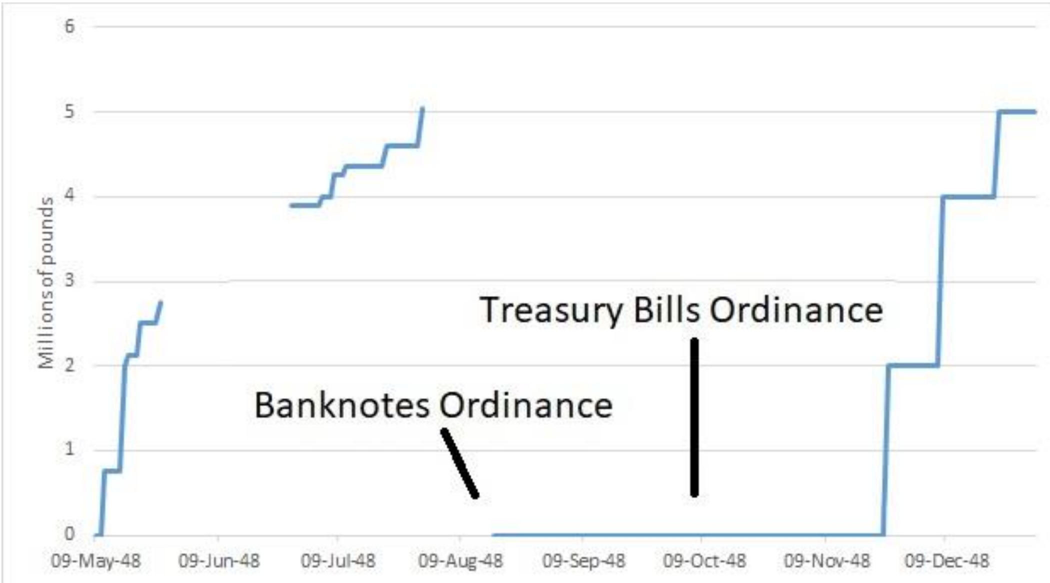
Nevertheless, inflationary finance it was. The Issue Department held 5MP in the last report for 1948, and by the end of the war on July 20, 1949, it held almost 14MP. This closely corresponded with an increase in banknotes (Figure 3). At the peak, treasury bills at the Issue Department amounted to 33% of banknotes, *not* violating the 40% upper bound.

Figure 3: Treasury bills and banknotes – public information



December 31 is a convenient point to halt the main analysis. Open inflationary finance was well under way; this date was only 10 days away from the end of combat operations; the three new statutory loans were about to begin; and published balance sheets of commercial banks referred to that date (the relevance of that is revealed below). As of that date, Figure 4 shows the publicly available information on state loans: 5MP of the National Loan from May to July, and another 5MP by treasury bills from late November to the end of December. The figure also shows the dates of enacting the relevant ordinances.

Figure 4: Public information on state loans in 1948



As with the military budget, the budget knew that some of the information was withheld from it. Uri Yadin, Head of the Legislation Department at the Ministry of Justice, explained on radio: "In this emergency period, while the enemy listens, it would be unwise to disclose in public all of the financial operations."[81] Treasury Bills Regulation 7(a) committed the Minister of Finance to publish every week the total amounts of treasury bills – outstanding at the beginning of the present fiscal year (April 1), issued since then, redeemed since then, and currently outstanding. However, Regulation 7(b) stated that this obligation of weekly publications "would become effective on the day the Minister of Finance will determine by an announcement in the Official Gazette." The negligent press only reported without qualification that the Minister "must publish every *week*" these amounts.[82] Kaplan never bothered to announce Regulation 7(a) effective, and

[81] *Davar*, November 10.
[82] *Haboker*, *Herut*, *Hazofe*, October 31.

Haaretz argued this was "for the duration of the emergency" "according to the British example."[83] The actual disclosure of so few facts about the sale of treasury bills led the press to declare that it was "top secret" and that "we will not find out as long as the war continues and the government will define important economic relations and statistical facts as secrets of war." [84]

Overall, while the public knew that important information was concealed across the board on all matters of war finance – both expenses and incomes – it was told that everything was supervised by the Council's Finance Committee.

4. The awful truth of war finance

Ben Gurion's war diary is replete with reports of shortages in the military: Weapons, ammunition, vehicles, fortifications, equipment, fuel, food, clothes, etc.[85] Some of the missing objects could be produced locally and had to be purchased or pressed.[86] During the first ceasefire, Ben Gurion heard from one third of senior military commanders about a crisis of morale because families were unpaid.[87] Most able-bodied men aged 18-35 were drafted, leaving their families without providers. As noted above, Ben Gurion told the Council and the public about this problem only a month and a half later and he mentioned isolated incidents rather than a general problem.

With National Loan funds running low in late June, a joint committee of the Ministries of Defense and Finance planned to continue spending 1MP a week. The committee was charged with "recruiting funds for the defense budget."[88] On June 24, the Ministry of Finance sent the Anglo-Palestine Bank three bills of a total value of 0.25MP. Their text was: "The Ministry of Finance is

[83] *Haaretz*, November 30, December 8.
[84] *Haboker*, December 7, *Haaretz*, November 30, December 8.
[85] Ben Gurion (1982), *passim*.
[86] Lack of funds is specifically mentioned in Ben Gurion (1982), e.g., 551, 556, 594, 613.
[87] Ben Gurion (1982), pp. 528-529.
[88] Ben Gurion (1982), p. 539-540.

obligated according to this writing to pay the Anglo-Palestine Bank Ltd. or to its order an amount of _______ Eretz Israel pounds on the __ day of the month of ___ 1948." An accompanying letter asked the bank: "Please transfer this sum to the Ministry of Finance's account at the bank and inform us."[89]

This is the first known instance of issuing treasury bills in Israeli history. To remind, this was two months *before* treasury bills were first mentioned in Israeli legislation (the Bank Notes Ordinance) and four months *before* the Israeli Treasury Bills Ordinance was enacted. The record of government meetings up to that date is silent on this issue, even though, as explained above, the Mandate-era authority to order the issue of treasury bills was held by the entire government.

If the treasury bills were sold to the bank two months before the Bank Notes Ordinance, how did the bank pay for them? Not in currency but with a stroke of a pen: The bank added 0.25MP in treasury bills to its assets and added 0.25MP to the Ministry's account at the liabilities part of its balance sheet. There was no need for currency to be involved, neither the Mandate currency nor a new Israeli currency. It was all on the bank's books. With fractional reserve banking this was both possible and legal, but it did pose an increasing stress on the bank's reserves. There was an increase in the amount of currency that all account owners taken together could withdraw, without any increase in the amount of currency in the bank's safes.

There was an urgent need for these new funds, for two days later Ben Gurion wrote: "There is no discipline in the military because the families don't receive salaries."[90] On July 2 the bank submitted to a government committee a proposal for the issue of banknotes, which had already

[89] Israel State Archive, G-5617/3, p. 586-589 [page numbers are according to the PDF file].
[90] Ben Gurion (1982), p. 557.

been printed by a private American printer and were on their way to Israel.[91] On July 4, the bank's chairman Eliezer Hoofien told Ben Gurion and Kaplan that with the banknotes "it will be possible … to solve the currency and credit problem that now burdens the state and the government." However, "as much as the solution will be faster and more complete it will expedite and increase the danger of the increase in prices." This was a "severe and urgent problem," said Hoofien and continued: "The government surely knows that lately we feel a considerable increase [in prices] … the fact of its existence is clear. When the market is in this mood already and shows such a tendency, the supervision and restraint while expanding the purchasing power is doubly important."[92] Ben Gurion was more disturbed that day by news that entire battalions "mutinied,"[93] surely for lack of funds. Kaplan immediately issued treasury bills at the total amount of 0.45MP.

Thus, it was with a total debt of 0.7MP to the bank in bills, that the government met on July 8 to discuss "the question of the currency" for the first time. Kaplan opened:

> I'll tell you why I'm pressing you on the question of the currency. The budget is also on the agenda today and with it you will get proposals on the taxes, but the situation is such that we "ate" all the reserves and used all the financial opportunities. The only way to recruit means to finance the war and immigration is by solving the question of the currency. If we don't end this question formally, I won't have the possibility tomorrow to give a certain amount, some tens of thousands of pounds for current expenses. I made sure today to recruit 500,000 pounds for security needs.[94]

Not a word was said by any minister on the desirability of inflationary finance. Nobody asked how come the minister somehow managed to obtain on his own such a huge amount, almost equal to the state's monthly civilian budget. The next day he indeed recruited that amount – by selling

[91] Israel State Archive, G-5617/7, p. 373.
[92] Israel State Archive, G-5617/7, p. 325, 370, 371.
[93] Ben Gurion (1982), 574.
[94] Israeli government protocols, July 8, 1948.

treasury bills to the Anglo-Palestine Bank. That day the first ceasefire expired, and the war resumed, leading to another sale of 0.75MP in bills. Overall, within nine days in the first half of July, the government borrowed 1.7MP from the bank. With the resources of the National Loan fully exploited just as warfare resumed, there was no other way. At the same time, Ben Gurion listed income sources for the July budget. Anticipating a quick passage of the Bank Notes Ordinance, he listed "the rest from printing currency."

As the second UN ceasefire began, without an expiration date, Ben Gurion felt that Israel walked into a financial trap. The UN General Assembly would only convene two months later and could spend another two months debating the situation. He wrote: "Maintaining the military all this time might choke us financially and economically" because of "the huge financial burden sitting on us."[95] Ben Gurion wrote: "Kaplan thinks the currency can give us 10-15 million for the war." Kaplan meant that the currency ordinance and treaty with the bank would allow the Issue Department to buy only an additional amount of treasury bills of 10-15MP. That was hardly good enough: Given that the military spent 4MP a month, 15MP would barely keep the military going until November, and there was no certainty that the UN would end the war by then. Kaplan added more bad news: "no chance to recruit large means in the next few months,"[96] meaning new tax proceeds or loans. The next day, July 20, the Ministry of Finance sold 1MP worth of bills to the bank, and the same happened a week later. That was exactly the military cost and there was no other source to provide the funds.

On August 1 the government convened, with "the state's currency and finance" leading the agenda. Hoofien was invited to inform the government about the war finance options with the new

[95] Ben Gurion (1982), p. 602, see also p. 631, fn. 1.
[96] Ben Gurion (1982), p. 603.

currency about to be introduced. The bank had bought by then 4MP worth of bills, almost all of which had not yet matured. Hoofien said:

> I have no doubt that members of the government asked themselves, and I suppose they also received an answer for the question – how did the Minister of Finance finance the war in the past few months, especially in the past few weeks? The answer is that the Minister of Finance began issuing treasury bills … and the bank purchased these treasury bills.[97]

Nobody commented on it. As for the future, Hoofien detailed the depressing calculations. The bank itself will transfer from the Banking Department to the Issue Department 14MP in Mandate paper money (the bank had hoarded long in advance 20% of the cash in the Jewish areas), together with pounds sterling and dollars.[98] The most optimistic estimate was that the public would convert 13MP of Mandate notes. According to the 40% rule agreed with the bank, this would allow the bank to issue additional 18MP for treasury bills and private debts ($\frac{18}{18+13+14} = 0.4$). Of that, Hoofien expected there to be 2MP in private debts and 16MP in treasury bills. The stock of bills currently held by the bank and expected to be purchased by it before the currency legislation passed was 6MP. Deducting this and another 1MP for pessimism from the 16MP, Hoofien told the government that a reasonably optimistic scenario would allow the issue of 9MP more in treasury bills and that's that. Given that the military spent 1MP a week, the new currency scheme will finance the war for 9 weeks after legislation passes. Given Hoofien's estimated timetable, from mid-October the state would need to find other sources.

After Hoofien left the meeting, Fritz Bernstein, Minister of Trade and Industry, was in favor of setting a deadline for the ceasefire because there's no way to collect enough taxes to pay

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[97] Israeli government protocols, August 1, 1948.
[98] Barkai (1990), p. 21, 25.

for the war: “I don’t know how we will fill the gap. If we need tricks, it means that after a short while we will face unlimited inflation.”[99] Hoofien soon wrote to Ben Gurion that 9MP was an optimistic estimate, and it could be as low as 6MP.[100] To Kaplan he wrote: “I do not see in the state a more urgent and more important problem than this one.”[101]

Hoofien took it for granted in these calculations that the 6MP worth of bills to be owned by the bank by the time legislation passes would be transferred to the Issue Department. That’s why he deducted it from the 15MP that the Issue Department could print. As of August 3, then, the treasury bills already purchased and all those that would be purchased were supposed to belong to the Issue Department. Inflationary finance would be out in the open for everyone to see, but very limited by law – also for everyone to see.

By the time legislation passed on August 16 the bank indeed held 5.87MP in bills and the next day it bought another 1MP. According to what Hoofien said to the government, the Issue Department’s first published report, dated August 18, should have included all these bills, and the same amount in new banknotes. It also should have included the Banking Department’s 14MP in Mandate notes, pounds sterling, and dollars. The ratio of bills to banknotes should have been ($\frac{6.87}{14+6.87} = 0.33$), which was legal but already precariously close to the 40% upper bound.

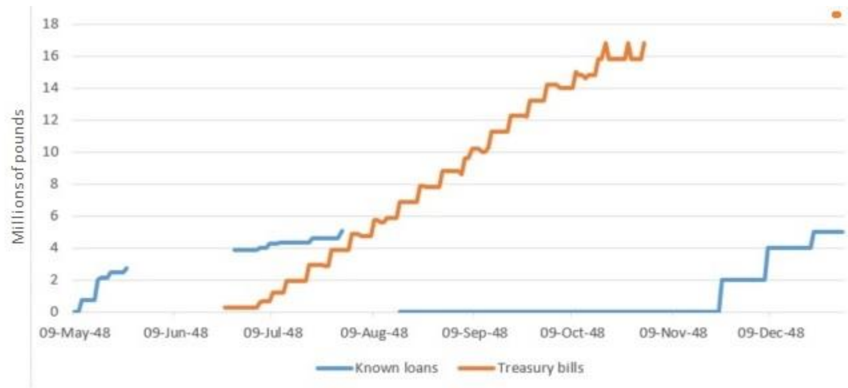
But as seen in Section 3, the reports – all the way to late November – showed zero treasury bills held by the Issue Department. This is the turning point of the story. This is where secrecy evolved into deception. Someone decided that the bills held by the Banking Department before the new legislation would remain there. Someone thought it would not be good for the public to know

[99] Ibid, p. 20-21, also p. 37.
[100] ISA, p. 291, Ben Gurion (1982), p. 632.
[101] ISA, p. 290.

that so many bills had been issued already, or someone thought it would be unwise to start with one third of the bills lacking cover in gold and foreign currency. What would that do to the population's trust in the government and the bank? Most importantly, Hoofien's method could support no more than nine weeks of war, but secretly continuing to issue treasury bills to the Banking Department could last for much longer. Indeed, the routine weekly sale of 1MP of treasury bills from the Ministry of Finance to the Banking Department, which began on July 20, continued, and, as before, as a complete secret. Government officials repeatedly professed that they would not resort to inflationary finance and pointed to the zero bills held by the Issue Department. There was not yet even an Israeli ordinance regarding the issue of treasury bills. The secret issue of bills to the Banking Department – a private institution with no duty to report its balance sheet every week – continued.

The procedure with 1MP a week was unchanged even as the Treasury Bills Ordinance became law in October. Bills started maturing before that and were usually paid by issuing new bills. The state never defaulted. On October 31, as the Ministry of Finance was about to execute the Treasury Bills Ordinance, the net government debt to the Banking Department by treasury bills reached 16.85MP and the total issue of such bills reached 20.3MP. The Banking Department could have sold all these bills to the Issue Department for new cash without crossing the 40% bound ($\frac{16.85}{28.275+16.85} = 0.37$) but again this would have revealed the extent of inflationary finance and that it was about to reach the upper bound. Figure 5 shows the value of bills held by the Banking Department until October 31. Exact data about treasury bill purchases after October 31 is not available, but the Banking Department's financial statement for December 31 (published much later) reported 18.19MP.

Figure 5: Secret net debt of the government to the Banking Department and publicly known loans



It can be presumed that the secret sales to the Banking Department ceased once the Issue Department started openly buying bills. As far as the censored newspapers reveal, everybody was fooled. As shown in Figure 5, the secret issue of bills swamped the other public loans of that year. It was this illegal, top-secret operation that kept the IDF from dissolving for lack of funds from early July until the Issue Department started openly buying treasury bills in the second half of November. It saved the state.

The funding of the war by the bank was kept secret for good reasons. First, the invading Arab states would have been emboldened by knowing that young Israel had no resources to pay for the war. They might have attacked with stronger determination or tried to extend the war indefinitely. Second, the same information might have despaired the Israeli population, and low morale could have doomed the war effort. Third, the public might have initiated a bank run on the Anglo-Palestine Bank had it known how the bank financed the war for treasury bills – increasing credit on the government’s account without increasing its cash reserve. Bank runs had been living memory for the locals, as they happened during the Second Italo-Ethiopian War (1935) and at the outbreak of World War II. There were substantial fears earlier in 1948 about such a run.[102] Such a bank run would have doomed the Israeli economy and war effort, and thus the state itself. Fourth, knowing the increase in the quantity of money would have increased inflationary expectations, and thus would have increased inflation itself.

5. Deception

There is no explicit statement in the surviving records that there was a deception of the kind described here. It is conjectured from the clear contradiction between two parallel financial universes – one of the laws and newspapers and one of the Ministry of Finance and Anglo-Palestine Bank records of actual financial activity. More direct and indirect evidence of deception is detailed here.

First, the secrecy of the military budget was not just government silence. The military censorship actively prevented publication of war secrets and other state secrets. Ben Gurion was aware of the importance of secrecy and censorship, particularly regarding the war budget.[103] On August 17, the day the currency swap began, he wrote:

> I invited the military censor and ordered him to toughen the prevention of news that can harm and damage the war effort. In the last few days there were published things that should not have been published: The building of the Burma Road, war expenses, youth draft, etc.[104]

The Burma Road was a top secret, strategically critical, makeshift road that bypassed Arab positions on the Tel Aviv–Jerusalem highway and enabled Jewish forces to continue communication with besieged Jerusalem. The "youth draft" was a debate on whether to draft 17-

[102] Barkai (1990), p. 24.
[103] Ben Gurion (1982), p. 464, 465, 467, 475, 534, 550, 583, 589, 590, 598.
[104] Ben Gurion (1982), p. 651.

year-olds to the military, joining the one-sixth of the population already drafted. It was a measure of desperation. Lumping these two existential issues with "war expenses" puts the latter in the right context in terms of its strategic importance – and its required secrecy.

Second, details of the deception emerged in 1949, when balance sheets of banks as of December 31 began to be published. In the first half of 1949, Hapoalim Bank and Discount Bank reported 1MP each in treasury bills, while smaller banks had smaller amounts (Yefet Bank, 0.17MP, Elern Bank, 0.05MP) or none at all (Apothecary Bank, Mercantile Bank, Kupat Am Bank).[105] The balance sheet of the Anglo-Palestine Bank was published in August, just after the war formally ended, instead of in May as usual. To everyone's amazement the Banking Department held on December 31 the huge amount of treasury bills to the value of 18.19MP.[106] It was far beyond the bank's share in the banking sector. Commentators could not understand how the bank bought so much in less than two months. They had no idea that purchases had begun five months beforehand.

The bank explained the delay in publishing the balance sheet by the fact that it was registered in England, and this raised issues of double taxation of dividends.[107] But *Haartez* wrote that there was "statistical blackout in the areas of the economy and finance." There was "criticism of the delay in publishing the balance. Many circles saw the non-publishing of the balance sheet as part of the blackout operation that was stubbornly performed by the government over many months." The newspaper concluded: "The Anglo-Palestine Bank acted here as a funding institution of the state," resulting in "a significant drop in the bank's liquidity." Adding those 18MP to the

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[105] All dates in 1949: *Davar*, January 27, *Herut*, February 9, *Haaretz*, March 23, June 28, *Al Hamishmar*, April 25, *Haboker*, July 13, August 9.
[106] *Haboker*, August 23, *Hazofe*, August 24, 1949.
[107] *Davar*, September 14, 1949.

5MP of the Issue Department and the other sums bought by other banks, the truth was now revealed: “The purchase of treasury bills by the bank shows to what extent the government needed finance outside its ordinary incomes.”[108] *Davar*, affiliated with the government, wrote that “we would not be blamed of exaggerated heresy if we assume there were additional considerations” regarding the delay, and “to the extent that the statistical blackout was part of the measures of defending the country – this was a just delay.”

Third, David Horowitz’s 1975 memoir includes this: “To a large extent the costs of the military were financed by local currency through inflation … even though we knew the destructive meaning of inflationary phenomena.” He elaborated:

> Indeed, in the tragic and hopeless race between means and needs we could obtain the resources we needed daily only by conscious inflation. The money printing by the Treasury was called of course in various diverse names and was made as jokingly said then, “with the help of *Hashem*” [meaning both ‘the name’ and ‘God’]. “Treasury bills and land bills,” meaning fictitious assets, whose values declined daily with the decline in the value of money, were used for “backing the currency.” Of course, we knew well that backing the currency has no importance and that the inflationary process and decline in the value of money are not consequences of lack of “backing,” but of imbalance between the money supply and the supply of goods and services in the economy.[109]

Land bills were issued only from August 1949, and treasury bills were known to be issued only from November 1948, so Horowitz’s statement – at age 76, 27 years after the event – is not directly about the secret finance of June-November 1948. Nevertheless, this testimony does serve as evidence of the spirit of the cunning ways – chiefly including treasury bills – in which the state was financed both during and after the war.

[108] *Haaretz*, August 19 and 24, 1949.
[109] Horowitz (1975), p. 16, 28.

6. Back to the public: The gold exchange

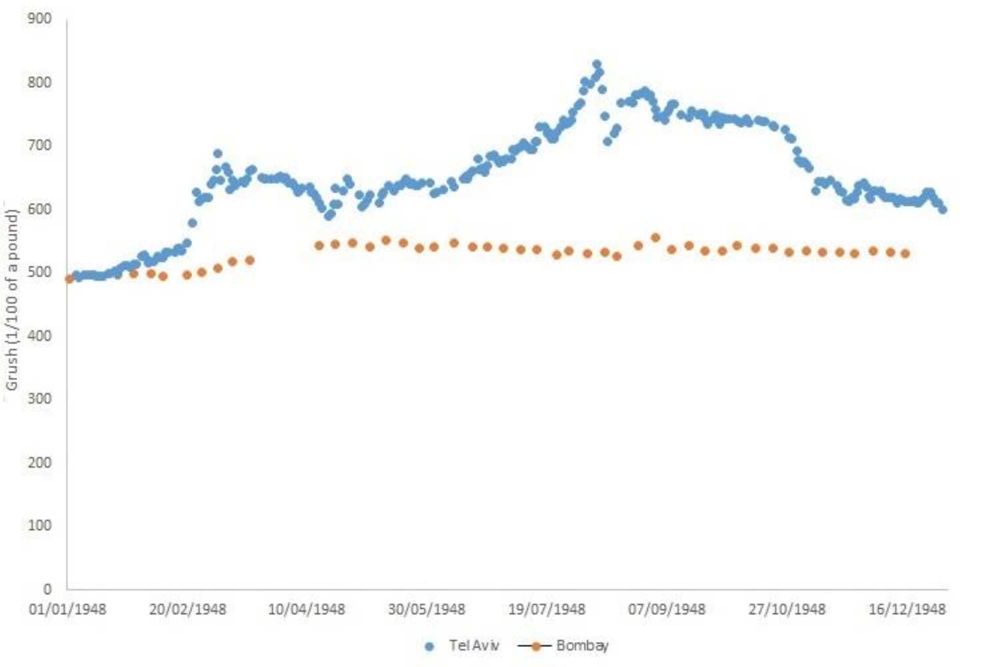
There is a problem with relying on newspapers as an indicator of the public's sentiment because they were all subject to military censorship. Is it possible that everyone knew about the secret operation but because of censorship there is no trace of that in the records? A unique real-time indicator not subject to censorship was the illegal gold exchange, held at the yard of a former coffee house in Tel Aviv's financial district.[110] Gold was as always the hedge against paper money inflation.[111] An increase in price can be interpreted (with caution) that inflation is more likely, or – in the circumstances of 1948 – even that a collapse of the entire regime is more likely.

The capitalist *Haboker* documented on a regular basis the selling and buying prices of the 'sovereign' – a golden British coin. Figure 6 shows the data available for 1948, compared with data of the price of an identical weight of uncoined gold traded in Bombay. That was the only market price regularly reported in *The Economist* because most of the world prohibited free gold markets in the Bretton Woods era. It is apparent that most of the volatility observed in Israel was domestic.

As Figure 7 shows, political and military events cannot explain any turning point, except perhaps for the sharp drop in late October which coincided with some victories (point #7). The earlier turn in the tide in Israel's favor with the first ceasefire (#4), and especially the Ten Days' Battles (#5), coincides, counter-intuitively, with an *increase* in gold price.

[110] *Hamedina*, July 14.
[111] *Al Hamishmar*, July 14.

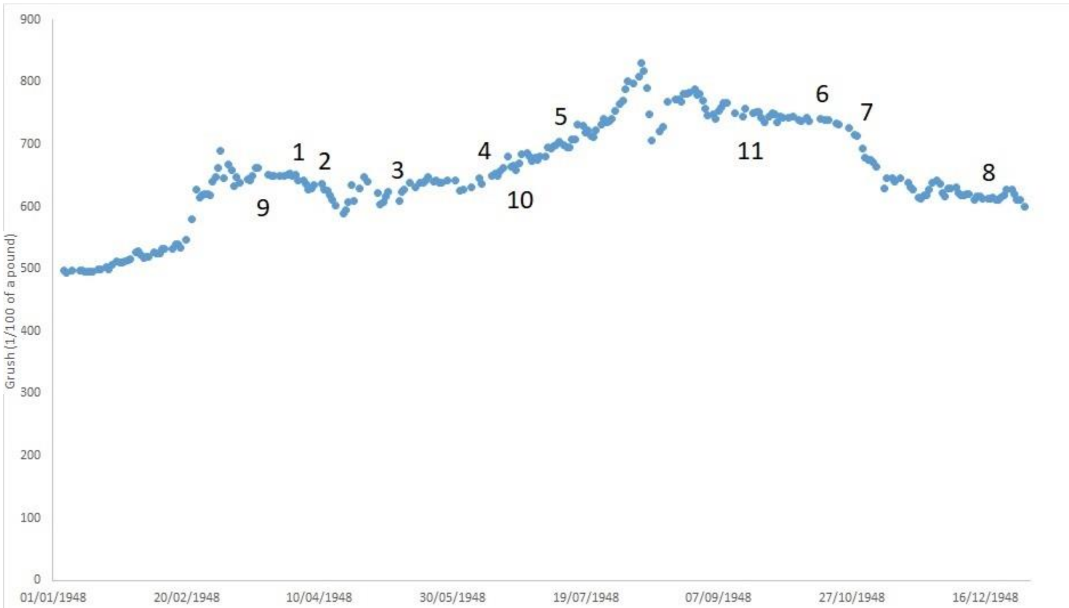
Figure 6: Gold prices in Tel Aviv and Bombay in 1948



Sources: 1. *Haboker*: daily issues, selling price of a gold sovereign coin in grush (1/100 of a Palestine/Israel pound). 2. *The Economist*, Thursday issues available at Internet Archive, price in rupee and its fraction anna (1/16 of a rupee) of gold weighing 1 tola. With 18 pence = 1 rupee, 1 tola = 3/8 ounce, and a gold sovereign including 0.2354 ounces of gold,[112] the price of gold in a sovereign coin in terms of grush is 0.2354*(8/3)*0.075*100 (=4.708) times the rupee price.

[112] Simha (1970), p. 328 (anna), 333 (tola), 605 (rupee); The Royal Mint (2023) for sovereign.

Figure 7: Tel Aviv sovereign price with political and military events



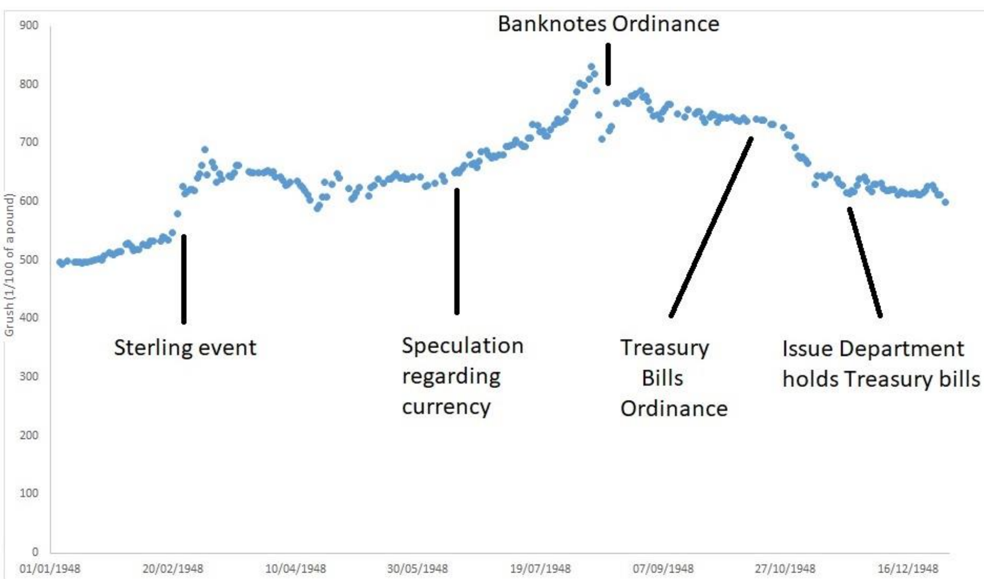
Note: Points above the graph indicate positive events from the Israeli perspective: 1. Nachshon Operation. 2. Arabs begin leaving the country. 3. Declaration of Independence. 4. First ceasefire. 5. Ten Days' Battles. 6. Yoav Operation. 7. Hiram Operation. 8. Horev Operation. Points below the graph indicate negative events: 9. The US decides against partition of the land. 10. The Altalena Affair, briefly on the verge of intra-Jewish civil war. 11. Assassination of UN mediator Count Folke Bernadotte by a Jewish militia was a diplomatic setback.

Monetary events seem to be more relevant (Figure 8). The first period of high volatility and jump in the level was in late February when the UK unilaterally kicked the Mandate out of the sterling area and froze all funds held by Mandate entities in London. There was a small, brief run on the banks, and the press explained that this was the reason for the jump in the level and volatility of the gold price.[113] The next interesting period began in early June. The gold price started increasing exponentially and culminated in huge volatility in the first half of August. This was

[113] *Maariv*, February 23, *Al Hamishmar*, February 24.

universally attributed in real time to nervousness about the new currency, which began with the first speculation about it in the press.[114] Commentators noted that other gold markets in the world had an opposite trend at the same time, consistent with the Bombay evidence.[115] Arbitrage with other gold markets was extremely difficult because the war sealed off much of the borders and anyone arriving to Israeli ports was subject to search (and seizure if importing gold illegally).[116] From that point the gold price declined, getting close to the level it had before February's sterling event. Publicly known milestones regarding treasury bills were not cited in the press as having any impact on gold and no such effect is apparent in Figure 8.

Figure 8: Tel Aviv sovereign price with monetary events



[114] *Davar*, July 16, 28, *Hazofe*, June 9, *Haaretz*, June 10, July 16, 18, 27, August 5, *Al Hamishmar*, July 18, *Haboker*, July 10, 13, *Hazofe*, July 16, *Kol Haam*, July 7, 19, *Maariv*, July 27.
[115] *Davar*, July 1, *Kol Haam*, July 7.
[116] *Haaretz*, July 8.

What can be concluded from gold prices about the deception? It seems that the passage of the Banknotes Ordinance calmed the market. The market did not suspect that the new monetary structure would create high inflation, nor did the secret leak out of the government and the bank. The extreme possibility that the public saw through the currency laws and knew what was really going on but the press was censored and couldn't tell it, seems unlikely. It is remarkable that during all this time actual inflation remained and according to public outcry got even worse. And yet, the gold price went down, presumably because the public believed the government that it would not create high inflation, because of the slow arbitrage of gold imports drawn by the high price, and because gold was legally imported by many immigrants.[117]

7. Inflation and chutzpah

During the five months of secret finance, from June to November, the wholesale price index rose by 11% (27% in annual terms) and the cost-of-living index rose by 6% (14% in annual terms).[118] Both indices, however, were considered unreliable, based as they were on antiquated formulas of household consumption dating back to the very different economy of 1939. The indices included many controlled prices of basic goods (including almost all food items[119]), while a significant part of the population bought these goods on the black market at much higher prices. These indices, complained contemporaries, severely understated the inflation's magnitude. Sellers raised prices of non-controlled goods which were not in the index. Other goods were rationed. Historians called this entire administrative regime "repressed inflation."[120]

[117] *Haaretz*, November 2, 10, *Davar*, November 16.
[118] Central Bureau of Statistics (1949), p. xxv, 59.
[119] Order of Food Supervision (Supervised goods), July 12, *Official Gazette* 10 (add. A).
[120] Ottensooser (1955), p. 117, 120.

Public outcry led the government to create a Cost-of-Living Committee of five ministers. In October the committee met with Ben Gurion and Hoofien. Kaplan emphasized the enormous dislocations of war: Since September 1947 “consumption grew by 50%, production and imports decreased by 25%.” Horowitz, the committee’s secretary, explained: “consumption rose – because monetary means increased.”[121] The government decided to solve the problem by appointing what would be called today an inflation czar, to coordinate actions of ministries in fighting the inflation. The government chose for this important job the man with the highest prestige and credibility on financial affairs – Eliezer Hoofien, chairman of the Anglo-Palestine Bank.[122] The chutzpah is remarkable. With his right hand Hoofien secretly fueled inflation by giving more and more credit to the government, while with his left hand he publicly fought the resulting inflation.

8. Conclusion

Three thousand years before Ben Gurion took office as head of a Jewish state, one of his predecessors, King Solomon, reputedly said: “In cunning ways you shall make war.” This was true for young Israel, but it can be true even for a land-grabbing empire fighting on a faraway land. A less famous recommendation by the same source, and one more befitting Israel, is this: “With no cunning ways a nation will fall.”[123] It is currently the motto of the Mossad. Without the cunning ways of war finance practiced in 1948, the state of Israel would not have funds for a critical four-months period and might not have survived its first year.

Where did the idea come from? A leading candidate is Germany, which had at least three similar episodes since 1914. In all these German cases, special, nominally private companies

[121] Ben Gurion (1982), p. 744.
[122] *Haboker*, October 23.
[123] Proverbs 24:6, 11:14, author’s translations. The Hebrew word *tachbula* there is commonly translated in English bibles as “wise council” but it is incorrect and it misses the point. I translate it instead as “cunning ways,” which is consistent with Hebrew dictionaries and current usage among Israelis.

received funds from the public by issuing special bills, and then spent the funds at the government's request for public purposes without affecting the publicly observable government budget and central bank balance sheet. The first case was of "Loan Funds," used to help financing World War I, that issued their own currency (cited by *Haaretz* on July 7, 1948).[124] The second case was of Oeffa bills during the Great Depression.[125] People involved in these two cases may have immigrated to Palestine and brought this knowledge. Immigrants from Germany quickly took over the primitive Tel Aviv financial sector. The third case was of Mefo bills during the Nazi era.[126] It is not likely that Jews were involved with that episode, but the matter was documented later and publicized at the Nuremberg Trials, in which the Nazi Minister of Finance Hjalmar Schacht was acquitted.[127]

The case of the Anglo-Palestine Bank is formally different from the German precedents because it was not a separate company established for that purpose. However, the inspiration from the Bank of England did create an artificial separation of an institution committed to the state into one part with a public face and another part with a private face. This situation easily lent itself to adopting the German method of secretly using a private company to fund the government.

This work has several implications. First, credible commitments may not help the public restrain the government and might even be abused to distract the public. In the case reviewed here, the public overall benefitted from being misled. The government and the bank cheated the public not for their private gain but to save the public itself. Probably this is why the secret was not leaked. Every employee at the Ministry of Finance and the bank who knew about it, understood that

[124] Bendix (1915).
[125] O. L. L. (1934), Der Spiegel (1995).
[126] Tooze (2006), p. 54-55, 62. I am grateful to Joel Mokyr for the reference.
[127] Office of United States Chief of Counsel for Prosecution of Axis Criminals (1946), vol. II, p. 742-743.

indirectly he would be risking his own life and the life of everyone he knew if the secret got out. So credible commitment, at the end of the day, was used to help the public, although through an unusual mechanism. Second, analysis of inflationary episodes should consider what the public knew in real time, and researchers should watch out for all sorts of tricks as the one revealed here. Unfortunately, the Israeli case does not easily lend itself to quantitative analysis. Data on the money supply and price changes is so partial and distorted, that any result would be very questionable. Finally, financial illiteracy is a hot topic today. In this episode, the government took advantage of the public's relative financial illiteracy: Everyone focused on currency as the determinant of the quantity of money and thus inflation, rather than on bank accounts. This had significant consequences. A more financially literate population would not have been fooled so easily.

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