CHAPTER III

PRICES

1. MAIN DEVELOPMENTS

The relatively low inflation rate attained in consequence of the 1985 stabilization program was maintained in 1987 for the second consecutive year, thus consolidating one principal achievement of the program. However, no real further progress was made in closing the gap between domestic price inflation and that prevailing in the Western economies.[1]

In the year under review, some slowdown was recorded in the rate of increase of prices of domestic uses, GDP and the Consumer Price Index. The rise of the latter slowed from 20 percent in 1986 to 16 percent in 1987, although when fruit and vegetables are excluded, the 1987 price rise was 18 percent—slightly above the preceding year's price increase. The price indexes of domestic resource uses and GDP climbed during the year by some 19 percent, as against 24 percent in the previous year. On average for the year, the principal price indexes rose at rates around 20 percent—less than half the rates of increase between 1985 and 1986.

In examining price movements it is appropriate to distinguish between the changes in the price of tradeables—import and export goods, and their close domestic substitutes—and the price of non-tradeables. During 1987 prices of tradeables went up by some 15 percent, a rate that reflects both the devaluation of the currency and price changes abroad. Prices of non-tradeables rose at a higher rate, so that the real exchange rate[2] fell, albeit more slowly than in the preceding year.

The real appreciation in the year under review continued a trend that had set in following the stabilization program, and was related to the rapid expansion of domestic demand while supply-side constraints impeded the expansion of GDP. In 1987 both of these factors lost much of their force, as the growth of domestic demand slowed and GDP supply increased, so that the gap between their relative growth rates closed. Still, some pressures were discernible for a real appreciation, which had their roots in the

[1] In 1987 the average rate of inflation in the industrialized Western economies rose by half a percentage point to 3 percent per annum, and the fall of their export and import prices, in terms of their respective currencies, was checked (see Appendix Tables VII–25 and VII–7).

[2] The real exchange rate is defined as the ratio of the price of tradeables to that of non-tradeables. A decline in this ratio is defined as a real appreciation.

disparate development of the composition of demand and the structure of production capacity. Thus, there are signs that the increment to domestic demand shifted towards non-tradeables, while the additional productive capacity was directed towards tradeables. The increase in exports could have resulted in a contraction of the resources allocated to production for the home market, including resources for the production of non-tradeables. As regards production costs, 1987 was conspicuous for the slower rise in wage costs relative to 1986, but the cost of imported intermediates increased, and so did the real cost of finance (although the rise in interest rates at the same time restrained demand expansion). During the year the government continued to raise the prices of services under its control at a relatively rapid rate.

In January 1987, the currency was devalued by 11 percent against the basket of currencies representing Israel's foreign trade, and a further 2 percent depreciation was recorded towards the end of the year. The January devaluation was accompanied by an accord between the government, the Histadrut (General Federation of Labor) and the employers' organizations, whereby the government reduced employers' national insurance contributions and undertook to freeze prices of part of the goods under price control; the Histadrut, for its part, agreed to postponing part of the cost-of-living allowance due to be paid. These measures, together with a temporary rise in interest rates, helped to moderate the response of prices to the devaluation in the short run.

The curbing of inflation began to make itself felt in the economy, and seems to have contributed to GDP growth this year, particularly by increasing certainty. Nonetheless, there are forces at work which tend to make inflation persist at this new rate rather than slow further.

The price controls imposed when the stabilization program was launched continued to be lifted in 1987, and by the end of the year controls remained in force only for goods and services that had also in the past been administered by the government.

The conspicuous changes in the various components of the CPI in 1987 were the fall in the price of fruit and vegetables and the continued rapid rise in prices of services. The wholesale price index of industrial output for domestic uses rose by 21 percent, as against 15 percent in the previous year. The rise in the price index of construction inputs was similar to that of the previous year, while input prices of road construction and agriculture went up more rapidly.

2. THE INFLATIONARY PROCESS AND ECONOMIC POLICY IN RECENT YEARS

During the 1970s and the first half of the 1980s, Israel's economy experienced high inflation, which ultimately accelerated to an annual rate of 400 percent (see Table III–1). Although several attempts were made during these years to halt inflation, the unbalanced nature and lack of credibility of the measures taken led to their eventual failure. Finally, in July 1985, a comprehensive and balanced stabilization program was adopted, which dealt at one and the same time with costs and demand, and created conditions for being accepted with greater confidence. Within a short time, the program resulted in a dramatic reduction of inflation, to an annual rate of 20 percent, and at the same time succeeded in improving the balance of payments position while impairing output and employment only relatively moderately.

Following the initial success of the stabilization program, the economic policy of the last two years was directed towards preventing, first, a renewed outbreak of high inflation, and in the second stage, the reduction of inflation to a one-digit rate, as prevails in Western economies.

Control of price movements over time requires two kinds of measures: First, there must be control over some nominal variable, such as the exchange rate or the money supply. The role of a control instrument of this kind (the 'nominal anchor') is to determine the path of price movements on a lasting basis, and to create a mechanism that will make deviations from it difficult. In Israel, as in most small and medium-size economies open to foreign trade, the exchange rate was chosen as the nominal anchor.

Table III–1
INFLATION RATE, 1970–87

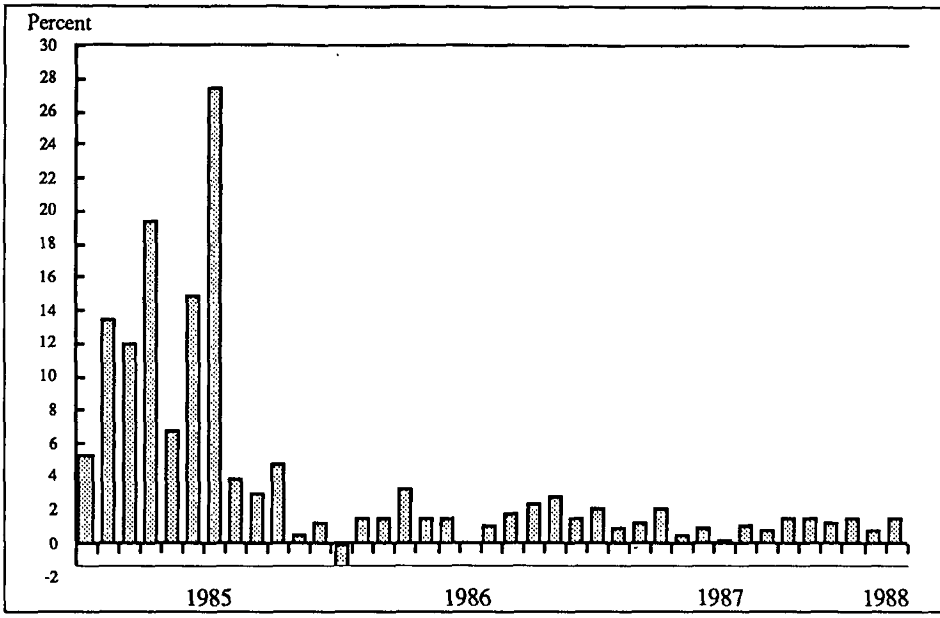
	1970–73	1974–78	1979–82	1983	1984	1985	1986	1987
Average annual price rise, percent								
CPI, annual average for period	15.4	41.2	118.9	190.7	444.9	185.2	19.7	16.1
CPI, over preceding period	12.7	38.8	110.6	145.6	373.8	304.6	48.2	19.9
GDP prices, over preceding period	14.2	39.7	113.1	149.7	391.8	256.8	50.7	20.3

SOURCE: Central Bureau of Statistics.

The fixing of the exchange rate constrains the movement of prices of imports and exports, thus affecting also the prices of other goods—subject to demand and supply forces which determine the relative prices of the various goods.

Second, appropriate background conditions must be assured for restraining, as far as possible, pressures for a deviation of the control instruments from the planned path, and to persuade the public that the government is able to persist in its policy over time. In Israel, where the exchange rate is the nominal instrument of control, the supplementary measures have the task of preventing pressure on the exchange rate through a drain on the foreign currency reserves, and the emergence of an excessive gap between prices of tradeables and non-tradeables. The central means for achieving this objective is to curb the budget deficit, especially by restraining the increase of public sector spending.

Figure III-1
MONTHLY INFLATION RATE (CONSUMER PRICE INDEX), 1985–88 I



SOURCE: Central Bureau of Statistics and Bank of Israel calculations.

Monetary policy, too, has an important role to play in this context.[3] Additional measures were wage policy and direct price controls. The emergency grant-in-aid provided by the U.S. also contributed to increasing the public's confidence in the stabilization program.

Since the introduction of the stabilization program until August 1986, the exchange rate against the dollar remained fixed. As the US dollar weakened against the other major currencies, this stability of the NIS/dollar exchange rate led to an unplanned depreciation of the sheqel against a wider basket of currencies. It was therefore decided in August 1986 to peg the sheqel to a basket of the five principal currencies in which Israel conducts its foreign trade. This was accompanied, since the end of 1985, by a gradual removal of the freezes imposed when the stabilization program was introduced. Thus, the wage freeze was lifted, and price controls began to be dismantled gradually, with price adjustments for goods that remained under control. Real interest

[3] Under a fixed exchange rate regime, monetary policy has a great direct influence on the foreign currency reserves, via the implications of the domestic interest rate for the composition of the public's asset portfolio. Monetary policy affects demand primarily where investment in fixed assets, stocks, and durables are concerned. These assets contain a large import component, so that the direct effect of monetary policy on the demand for GDP and prices of non-tradeables is more limited. Moreover, this influence is at least partly offset by the opposite effect of interest rates on the supply of GDP.

Table III–2
SELECTED PRICE INDEXES, 1985–88 I
(Percent change during period, annual rate)

	Weight in CPI[a]	1985	1986	1987	1986 I	1986 II	1986 III	1986 IV	1987 I	1987 II	1987 III	1987 IV	1988 I
Consumer prices													
Consumer Price Index	1,000.0	185	20	16	7	30	13	31	19	16	10	19	18
CPI, excl. fruit and vegetables	938.9	186	17	18	3	30	15	20	22	21	13	18	14
Food, excl. fruit and vegetables	186.1	189	17	14	15	48	7	4	23	12	8	12	21
Fruit and vegetables	61.1	179	65	–7	95	18	–7	249	–9	–24	–22	36	91
Housing prices	229.9	192	4	16	–26	13	2	35	18	14	15	15	21
Controlled prices[b]	228.0	249	15	15	8	36	12	8	22	14	16	9	13
Uncontrolled prices	772.0	171	21	16	7	28	13	38	18	17	9	22	18
Wholesale prices of industrial output		**153**	**15**	**21**	**16**	**22**	**11**	**12**	**32**	**14**	**18**	**20**	**17**
Input prices in:													
Residential construction		136	24	24	21	36	22	18	35	22	25	14	28
Road construction		151	18	24	18	25	19	11	39	21	26	12	13
Agriculture		167	6	18	17	1	11	–5	30	20	12	9	–98
Exchange rates													
NIS/$		145	0	4	0	2	–2	0	39	–4	–1	–11	5
NIS/currency basket[c]		163	7	14	13	5	7	1	60	–1	0	7	2
Business sector wages		155	48	27	157	0	9	71	0	55	9	53	

[a] Based on 1985 revision of family expenditure.

[b] The index of controlled prices comprises the following products covered by the CPI: Flour, eggs, frozen meat, frozen chicken, edible oil and margarine, milk and dairy products, local rates, electricity, water and gas for household use, fees for kindergarten, elementary and secondary schools, cigarettes and tobacco, urban and interurban bus fares, telephone and postal services, fuel, oil and driving licenses.

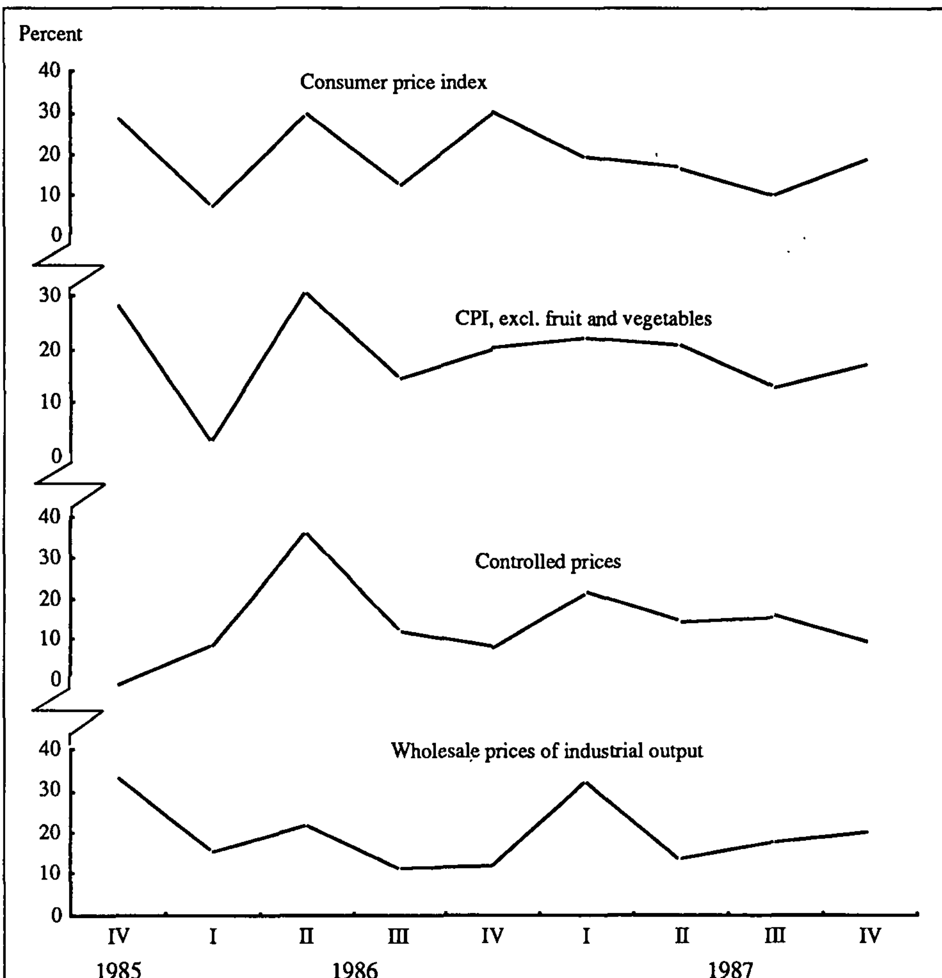
[c] The 5-currency basket comprises the US$, the DM, £, Ffr. and ¥.

SOURCE: Central Bureau of Statistics, National Insurance Institute and Bank of Israel.

rates, which had risen steeply when the stabilization program was launched, were also reduced. On the other hand, fiscal restraint was maintained, and the public sector deficit was further reduced.

This stage, in which restraints began to be removed in order to lead the economy back to normal functioning, was critical for the success of the stabilization program, since it exposed the economy to the risk of a renewed inflationary explosion and a backslide to balance of payments difficulties. These dangers did not materialize, thus laying the foundations for taking lasting advantage of the stabilization program.

Figure III-2
SELECTED PRICE INDEXES, 1985–87
(During quarters, annual rates)



SOURCE: Central Bureau of Statistics and Bank of Israel calculations.

However, no further progress was achieved in 1986 with further lowering inflation. Also, wages rose steeply, and prices of non-tradeables rose faster than export and import goods (see below). This background generated expectations that the government would devalue the currency, and these, in turn, gave rise to anticipations of future price rises. This increased the readiness of employers to yield to wage demands and that of consumers to pay relatively high prices. These responses, for their part, augmented the pressure for devaluation, particularly against the backdrop of difficulties encountered by some exporters who had been hurt by the changes in foreign cross rates and difficulties in particular export markets.

The 11 percent devaluation in January 1987 was based on the assumption that prices would not rise in step with a nominal devaluation, but that it would help to overcome price rigidities which impeded a transition to a more appropriate structure of relative prices and returns to capital and labor. In order to provide more time for this adjustment mechanism, the nominal devaluation was accompanied by an accord between the government, the employers, and the Histadrut (General Federation of Labor), which had the effect of dampening the response of wages to the devaluation. This was done by a 2.7 percent cut in employers' national insurance contributions and a postponement, at the same rate, of the cost-of-living allowance due for the price rises. It was also agreed to maintain price controls until March 1988, and to freeze prices of part of the subsidized goods until then (see below).

At the same time the Bank of Israel took steps to raise nominal interest rates, out of concern that price rises might accelerate. In the event, prices rose more moderately than had been expected, so that the real interest rate rose. In the second quarter of the year the Bank acted to bring down nominal interest rates, but a decline of the real interest rate materialized only in the last quarter of the year.

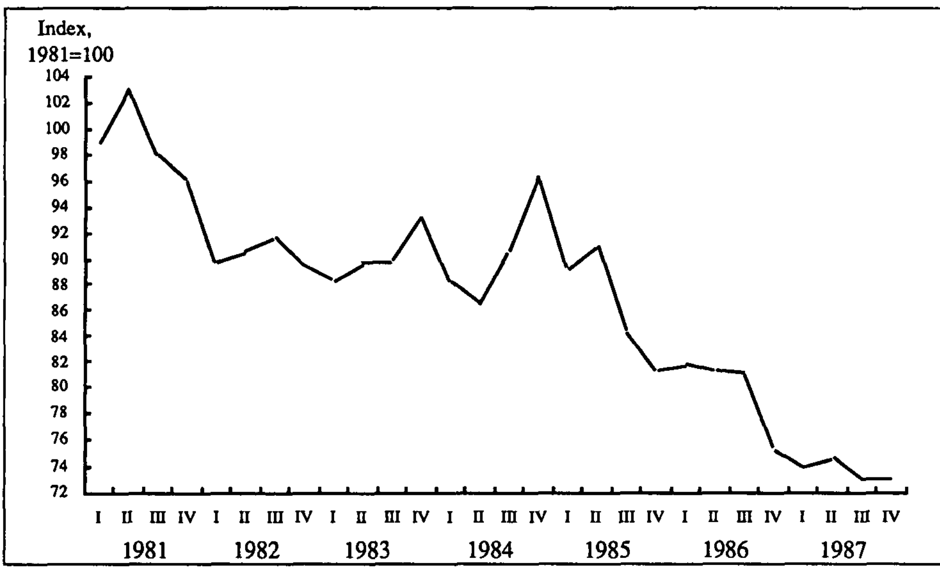
Fiscal restraint was eased in the course of 1987. In addition to the cuts in national insurance contributions, there were also income tax reductions. Price controls, as mentioned earlier, continued to be lifted.

3. PRICES OF TRADEABLES VERSUS NON-TRADEABLES

As already stated above, since the adoption of the stabilization program the principal instrument for guiding price movements has been the exchange rate. It is therefore appropriate to examine the price movement of the goods directly affected by the exchange rate, as compared with prices of other goods, and which factors were behind the differences in the price changes of the two groups of goods. Our examination will concentrate on final goods, since their prices are those covered by the principal indexes, such as the CPI and the price index of resource uses.

The exchange rate has a direct influence on the prices of tradeable goods, namely imports, exports and their domestic substitutes. These prices are, in addition, affected by price movements abroad, changes in indirect taxes, restrictions on foreign trade, price controls and domestic supply and demand conditions.[4] Table III–3 presents several indicators of the price movements of tradeables.[5] These include import and export prices of goods and services as estimated in the national accounts (excluding direct defense imports, fuel and diamonds), prices of manufactured goods covered by the CPI (a relatively tradeable group), and a more detailed, but provisional breakdown of the CPI items between tradeables and non-tradeables.[6] Despite the variation between the different indicators, it may be said that in 1987 the annual price rise of tradeables was around 15 percent. The data further show that these price rises were lower than those shown by the general indexes, such as the price index of resource uses, the implicit price index of the GDP, and the CPI—which went up at rates between 16 and 20 percent. Differently put: in the last two years the economy went through a

Figure III-3
RATIO OF PRICES OF TRADEABLE AND NON-TRADEABLE GOODS COVERED BY THE CONSUMER PRICE INDEX,*) 1981–87



*) As classified in Table III–3.

SOURCE: Central Bureau of Statistics and Bank of Israel calculations.

[4] Domestic supply and demand conditions affect both tradeables and non-tradeables. For goods actually traded in international markets these conditions influence trading margins, prices of ancillary services, etc..

[5] There is a certain degree of substitutability between most goods in the domestic market and goods actually traded in international markets, so that the definition of domestic substitutes for import and export goods is to some extent arbitrary.

[6] See note 4 to Table III–3.

process of real appreciation (see note 2). This process weakened in 1987 as compared to 1986; thus, the ratio of import prices to those of domestic uses as estimated in the national accounts fell by 6.5 percent between the last quarter of 1985 and the last quarter of 1986, but only by 3.5 percent between that quarter and the last quarter of 1987.

4. THE SOURCES OF THE REAL APPRECIATION [7]

We have seen that in the last two years prices of non-tradeables rose faster than those of tradeables, which are largely affected by the movements in the exchange rate and prices abroad. It follows that an examination of the general price level requires an analysis of the factors that caused prices of non-tradeables to increase more rapidly, i.e., the causes of the real appreciation. Since this process characterized not only the year under review, but also the previous year, we shall examine the factors behind it for both years.

1. Demand-side factors

When domestic demand expands more rapidly than GDP, pressure for a real appreciation is generated because demand increases also for non-tradeables. Greater production of the latter generally requires a rise in their prices relative to those of tradeables (while higher demand for tradeables is satisfied by increasing the import surplus).[8]

As may be seen from Table III–4, domestic uses (excluding direct defense imports) expanded in 1986 by 8.3 percent while GDP growth was only 3.3 percent, thus generating pressure for a real appreciation.[9] In contrast, in 1987 domestic demand and GDP increased at similar rates—5.8 and 5.2 percent, respectively—so that the gap between them did not widen in the year under survey, and no further pressure for real appreciation developed on this count. Data on developments during the year also indicate that such pressures have abated in 1987.[10] Nevertheless, the rapid GDP growth itself may have created supply bottlenecks, against the background of continuing change in the patterns of demand (see Chapters I, II and VI).

[7] See note 2.

[8] The relationship over time between the real exchange rate and the size of demand relative to GDP is illustrated in Fig. VII–2 of the Bank of Israel Annual Report for 1986.

[9] For the analysis of the factors that expanded domestic demand and the role of monetary developments, see Chapter II, Product and Domestic Demand, and Chapter VIII, Money and Capital Markets.

[10] According to quarterly data, GDP growth in 1987 was lower than during 1986. This picture, however, is highly influenced by quarterly fluctuations.

Table III-3

INDICATORS FOR THE FLUCTUATIONS IN THE CONSUMER PRICE INDEX, 1970–87

	Monthly price change, percent	Standard deviation of monthly price changes	Standard deviation of relative prices[a]
1970	0.8	1.2	1.9
1971	1.0	1.0	2.2
1972	1.0	1.1	2.9
1973	2.0	1.2	2.5
1974	3.8	3.5	3.5
1975	1.8	1.7	2.5
1976	2.8	1.8	3.0
1977	3.0	3.0	2.6
1978	3.4	1.6	3.1
1979	6.4	2.3	5.2
1980	7.4	2.3	3.8
1981	6.0	2.4	5.3
1982	7.2	1.7	3.2
1983	9.2	5.0	4.2
1984	15.2	5.6	3.4
1985	9.2	8.2	4.6
1986	1.6	1.2	2.7
1987	1.2	0.6	2.0

[a] Weighted average of the standard deviation of monthly relative prices of the ten principal product groups in the CPI. The relative price of each group is defined as the ratio of the index of the group to the general Consumer Price Index.

SOURCE: Bank of Israel calculations based on data of the Central Bureau of Statistics.

In 1987 two other processes may have contributed to the real appreciation, although their quantitative weight is difficult to determine: (a) rapid export growth which, to the extent that it was due to more favorable conditions abroad for Israeli exporters, or to an expansion of export-oriented production capacity, may have reduced the share of resources allocated to alternative production, and could have caused pressure on the prices of non-tradeables; and (b) a shift of demand towards non-tradeables, which is indicated by what happened in 1987 to incremental employment (see Chapter IV, Employment and Wages). It should also be observed that the composition of investment demand shifted in 1987 towards non-tradeables, reflecting itself in a larger share of construction and earthworks in total investment. The direction of change in the composition of consumption demand is more difficult to establish.

Table III–4
BACKGROUND DATA AND FACTORS AFFECTING PRICES, 1985–87
(Percent changes)

	Annual average			Last quarter of year[a]	
	1985	1986	1987	1986	1987
1. Change in import and export prices					
a. Civilian imports of goods and services[b]	305.3	39.5	17.0	15.5	15.3
b. Exports of goods and services[c]	270.0	30.0	15.9	6.9	15.5
c. Imports of raw materials[d]	248.9	31.8	14.1	5.0	17.9
2. Real change in GDP and resource use					
a. Gross domestic product	3.7	3.3	5.2	5.9	3.1
b. Domestic uses, excl. direct defense imports	–2.2	8.3	5.8	11.2	4.9
c. Exports of goods and services	6.2	2.3	9.2	–0.5	9.8
3. Nominal change in labor costs					
a. Wages in the business sector	154.8	47.8	27.0	46.7	27.8
b. Labor costs per unit of business sector product	245.0	56.3	21.6	–	–
4. Proportion of public sector deficit in GDP					
a. Total deficit (–) or surplus (+)[e]	–2.2	2.8	–0.1	–	–
b. Domestic deficit (–) or surplus (+)[f]	–8.8	–3.4	–2.8	–2.3	–5.1
5. Monetary developments					
a. Increase in money supply	351.5	169.4	60.2	116.2	58.8
b. Increase in M3	309.0	44.3	36.8	21.5	35.4
c. Real average rate of interest on bank credit	19.8	7.8	20.8	2.0[g]	8.2[g]

[a] Rates of change in items 1, 2, 3, 5a and 5b are over the corresponding period of the previous year. Items 4 and 5c are levels for last quarter.

[b] National accounts data, excluding direct defense imports, fuel and diamonds.

[c] National accounts data, excl. diamonds.

[d] Foreign Trade Statistics data, at official exchange rate; excludes fuel and diamonds.

[e] National accounts data; see Table VIII–3.

[f] Cash-based data, including interest payments; see Table VIII–3.

[g] In annual terms.

SOURCE: Central Bureau of Statistics, Bank of Israel and Bank of Israel calculations.

2. Supply-side factors

A real appreciation can also come from the supply side, such as a wage increase higher than that consistent with developments of demand, the government's price and tax policy, or production bottlenecks. Such factors may raise relative prices of non-tradeables even when such a rise is not supported by higher demand, but at the cost of restraining economic activity.

In 1986 wages rose very substantially, largely as a reaction to the overshooting of wage restraint in the initial stage of the stabilization program. The overall rate of the wage rise in 1986 was also due to the fact that, in line with their increase in prosperous industries, wage demands were pressed also in industries where demand had weakened. The readiness of employers to raise wages seems to have been influenced by the expectation that the government would offset the fall in profitability by devaluing the currency or by other policies accommodating the wage hikes. Also noticeable in 1986 were difficulties in the adjustment of the production system to the changes in economic conditions at home and abroad. These changes had their source in the slowing of inflation, the contraction of the government deficit, the development of exchange rates abroad and difficulties in some of Israel's export markets. These factors would seem to have outweighed the growth-supporting effects of the fall in real interest rates and the decline in prices of imported production inputs (see Table III–4). At the end of 1986 the supply of fresh farm produce also declined. Finally, the government raised the prices of the services under its control faster than the price rise of goods, in which tradeables weigh more heavily than in services.

In the course of 1987 there was a substantial easing in the supply-retarding factors which in 1986 had held back the response of GDP to the expansion of demand. On the one hand, the production system adjusted more promptly to the changes in demand conditions at home and abroad, and on the other—the effects of the stabilization program , and particularly the slowing of inflation, made themselves felt (see below). In addition, there was the influence of the cut in income taxes, the easing of some of the difficulties in export markets, and larger supplies of farm produce. The partial lifting of price controls also contributed to making economic activity more efficient, even though it removed barriers to some price increases.

Labor costs continued to rise in 1987, but at a slower pace than in 1986 (see Table III–4). Money wages per employee in the business sector rose 28 percent between the last quarter of 1986 and the last quarter of 1987. Taking into account the growth of productivity and the reduction of employers' national insurance contributions, nominal wage costs per unit of product went up by 20 percent. Institutional factors (such as the enactment of the minimum wage law) also had an impact on the wage increase in 1987, but it is difficult to say that the wage rise exceeded that of the contribution of labor to output.[11] It cannot therefore be said that in 1987 pressures for a real appreciation had their origin in wage increases.

As already noted, the real interest rate rose in 1987 above the previous year. Although this assisted a curbing, or postponement, of demand expansion, it also raised production costs, with relatively greater detriment to producers dependent on finance from the expensive categories of credit (particularly so in the industries of non-tradeables—see Chapter VI, The Principal Economic Sectors).

[11] In other words, it cannot be said that the rise of real wage costs to employers during the year exceeded the rise in the marginal product of labor.

Prices of imported production inputs, excluding fuel and diamonds, rose more rapidly than in 1986. Energy prices went up again in 1987, following their drop in the previous year, although in both years the price changes were not fully passed on by the government to domestic consumers.

To conclude: In 1986 a substantial expansion of demand combined with supply-side difficulties to exert considerable pressure for a real appreciation. These factors abated significantly in 1987, although some forces still acted in this direction. This expressed itself in a slowing of the rate of appreciation, i.e., the gap between the price rises of tradeables and those of other goods.

It should be noted that the fall in the real exchange rate (see note 2) in the last two years occurred against a tendency towards a steady appreciation over time, apart from the cyclical fluctuations due to short- and medium-term developments in supply and demand. Evidence for this trend may be found in the development of the ratio of prices of the tradeable components of the CPI to the non-tradeables, as illustrated in Fig. III–3, based on the provisional classification shown in Table III–3. The same trend appears in Fig. VII–2, which uses alternative indicators, showing that the trend of continued appreciation did not reflect a corresponding expansion of domestic demand relative to GDP growth, but would seem to be due to changes that took place over time in the structure of demand and output. Thus, if the increment to the economy's productive capacity was largely directed towards the production of tradeables, while demand did not change in this direction, a relative rise over time in the prices of non-tradeables was to be expected.

In early 1987 the response of prices to the January 1987 devaluation, including prices of tradeables, was conspicuously moderate. Prices continued to be adjusted to the devaluation in the second quarter of the year, whereas in the third quarter price increases slowed substantially. This slowdown, however, was temporary, and towards the end of 1987 and the beginning of 1988 price increases accelerated again. We have no full explanation for the quarterly movements of prices, but it would seem that price movements during the year were influenced by the quarterly development of wages, the small devaluation at year's end which was accompanied by expectations of a bigger devaluation to come subsequently, and by the movement of real interest rates. We also suppose that in many cases prices responded with a lag to the various factors affecting them.

The lags in the adjustment of prices in the last two years may have their explanation in two factors: the delaying of price increases for goods under price control and, as inflation slowed down, a tendency to change prices less frequently. If the stabilization program caused the lags in price adjustments to become greater, this may strengthen the persistence of the inflationary process. Other factors acting in the same direction may be the difficulty of adjusting relative prices by price reductions, and a stronger feeling that inflation is settling down to a new rate of around 20 percent per annum, after two years of inflation at this rate. This may lead to the assessment that the January devaluation checked the rise of real wages at least temporarily, and perhaps also moderated the real appreciation during the year.

5. DISINFLATION AND THE RENEWAL OF GROWTH

The accelerated inflation of the 1970s and the first half of the 1980s was closely connected with two other fundamental problems with which the economy struggled during that period: the financing of government expenditure and of the balance of payments, and the decline in the growth of output and productivity. The relationship between these and inflation was two-directional. On the one hand, inflation largely reflected the means by which economic policy attempted to cope in the short run with the two other problems; on the other hand, inflation aggravated them in the long run through its corrosive effects on the efficiency of production and resource allocation. The damage caused by inflation was due to the combination of three factors: (a) it increased the fluctuations of relative prices and of the general price level, thus causing uncertainty to mount; (b) the failure of efforts to adapt the system of taxes on the business sector to inflationary conditions; and (c) the difficulties of attaining full coordination between the different indexation schemes. In these conditions, the period of high inflation was accompanied by an increase in the resources allocated to financial and tax management, at the expense of resources devoted to managing production, and by economic decision-making on the basis of unreliable information and, in many cases, by giving preference to economic activities with a short repayment period. Inflation also had many implications for the distribution of wealth and income—not always in directions justifiable by considerations of either social equity or economic efficiency.

The stabilization program of July 1985 succeeded in simultaneously achieving a considerable relief of the financing problems and a sharp cut in the inflation rate, thereby contributing to creating the conditions for improved economic performance and renewal of growth. Appendix Table III–A1 presents the fluctuations of relative prices and the general price level—which are one of the major sources of uncertainty. The amplitude of the fluctuations, by both indexes, increased in parallel with the acceleration of inflation in the 1970s and 1980s (particularly so in years when the inflation rate changed sharply). In the last two years the fluctuations declined to a level even lower than in the early 1970s, even though the present rate of inflation is still higher than in that period.

Employment in the banking industry, which swelled during the high inflation years, has contracted in the last two years. It also appears that the slowing of inflation has contributed to GDP growth in 1987. It is nevertheless difficult to assess to what extent the economy has already adapted to taking full advantage of the benefits from slower inflation. The exploitation of some of these gains requires changes and investment in human resources and tangible capital. These necessarily need time, and their implementation depends on the confidence which the public accords to the new circumstances. In the money markets, where adjustments tend to be more prompt, developments also point to a gradual adjustment to conditions of low inflation, as reflected in the continued increase in demand for money and the gradual shift towards unindexed long-term sheqel deposits. Considering this background, the rapid growth of the monetary aggregates in the last two years (see Table III–4) should not be seen as evidence for pressures towards accelerated inflation (see also Chapter VIII).

Taking full advantage of the slowing of inflation and the cut in the government deficit would seem to depend largely on implementing complementary reforms, including greater perfection of the money and capital markets, and more liberalization of foreign trade. The latter will also contribute to increasing the share of tradeables in output and enhancing control over price movements through the exchange rate.

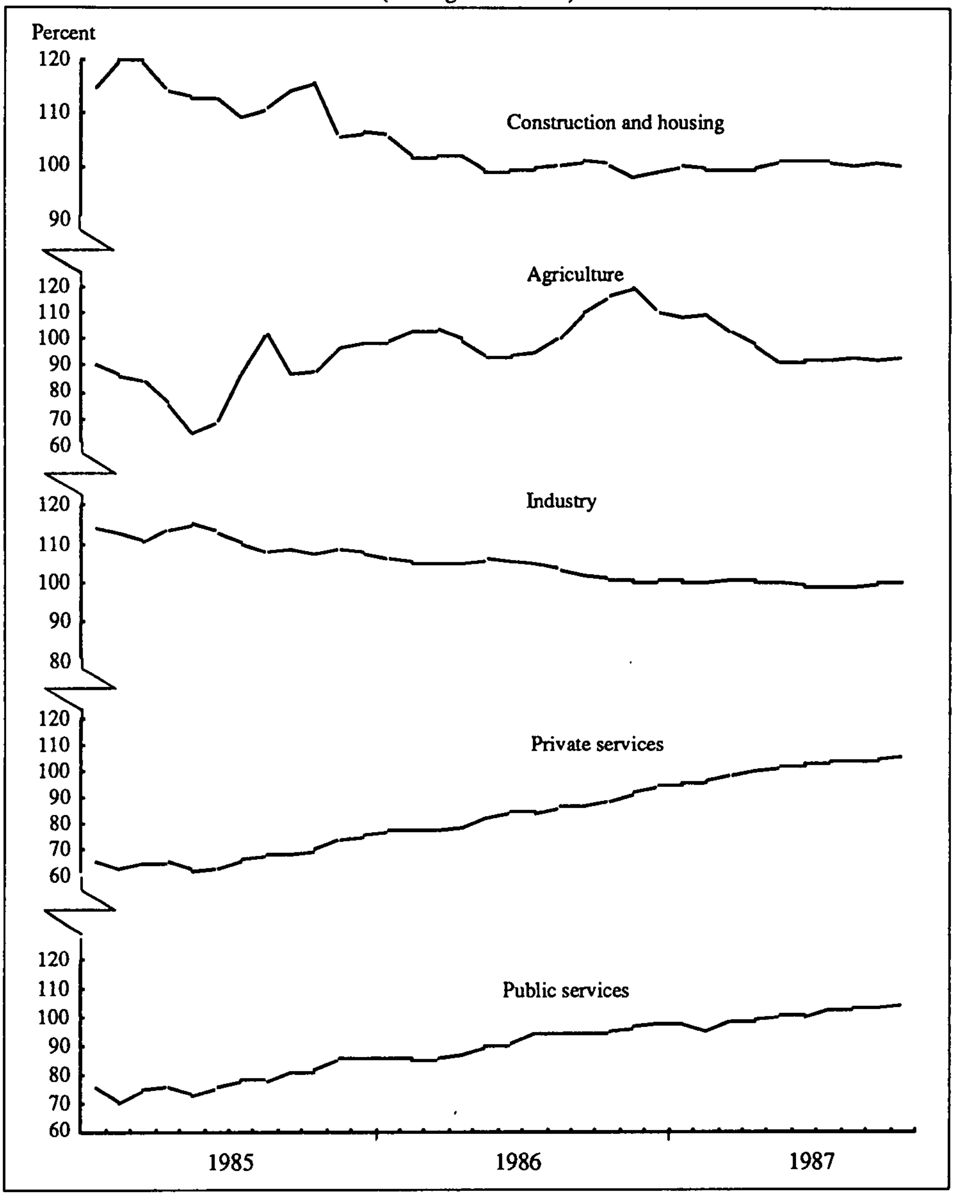
6. PRICE CONTROLS

The July 1985 stabilization program was included price controls on all goods and services, except fruit and vegetables, export goods and inputs for export production. The price controls no doubt helped to quickly curb price rises and dampen the inflationary expectations prevailing when the program was launched. This provided a breathing space for other measures included in the program to take effect.

The authorities adjusted controlled prices from time to time, in accordance with the development of production costs. The price control system was generally complied with; nevertheless, it was realized that price controls are largely a temporary expedient, since they impair efficiency, and their continuation is likely to increase attempts at circumvention of the controls. Beginning in early 1986, the controls were therefore progressively reduced, and until the end of the year the proportion of the goods under controls covered by the CPI declined to some 45 percent, as against 95 percent in the initial stage of the stabilization program. The lifting of price controls continued in 1987, and up to the end of that year only goods with a weight of about 25 percent in the CPI remained under control. These include products that had already in the past been subject to administrative control (mainly basic products and public sector services) and goods produced under non-competitive conditions, price increases of which required the posting of advance notice.

The price control law was prolonged twice; its date of expiry is now March 1989. The possibility of reimposing controls on goods from which they have been lifted is an indirect means of pressure on producers.

Figure III-4
PRICES OF PRODUCT GROUPS IN THE CPI RELATIVE TO TOTAL CPI, 1985–87
(Average 1987=100)



Source: Central Bureau of Statistics and Bank of Israel calculations.