CHAPTER III

PRICES

The year reviewed was characterized by the acceleration of inflation: the various price indexes rose 190–200 percent, with the consumer price index going up 190.7 percent—far greater than the 120 percent average increase in the four preceding years.[1] The escalation of inflation occurred in the final part of the year reviewed, reaching a 16 percent average monthly rate in the fourth quarter.

Prices did not move up at an even pace during 1983. In the first three quarters they did not rise more rapidly than in 1979–82. These three quarters in effect constituted a continuation of the fourth quarter of 1982, when a number of steps were taken with the intention of bringing inflation down to 5 percent a month.

In the fourth quarter, however, inflation accelerated strongly and reached a 487 percent annual rate. Developments in this quarter were decisively influenced by the measures adopted by the government from October 1983 onward, after the economic policy followed until then failed to achieve the objectives with respect to inflation, disrupted relative prices, and exacerbated the unfavorable current account and external debt trends.

The principal target of the policy introduced in October 1982 was to reduce the rate of inflation. The underlying conception of this policy was that inflation is caused primarily by the combination of cost push and self-fulfilling expectations.[2] An increase in the sheqel exchange rate pushes up prices, and vice versa; the raising of controlled prices drives up the general index, and this in turn leads to wage increases, aggravating the wage-price spiral. What is more, inflationary expectations adjust themselves and the inflationary process proceeds apace, since the bulk of the financial assets in Israel are value-linked (either to the consumer price index or to the exchange rate). The supply of liquidity is therefore largely endogenous, a fact that also helps to keep the inflationary spiral going.

Prompted by this conception, the government devalued the sheqel at a uniform 5 percent monthly rate and raised the controlled prices of basic goods and services to the same extent. It also modified the cost-of-living allowance arrangement,

[1] During this period inflation was fairly stable; the fluctuations were very slight and were due to special factors which directly affected specific prices. See the chapter on prices in the Bank of Israel Annual Report for these years.

[2] In retrospect, it turns out that inflation does not finance a significant part of the government budget deficit; the inflation tax amounts to only a few percent of GNP, and it may be that inflation even imposes an additional burden on the government budget (see Chapter VIII).

Table

SELECTED PRICE

(Percent increase during

	1980	1981	1982	1983
1. Consumer price index				
General index	133	101	131	191
Controlled prices[a]	150	60	143	206
Uncontrolled prices[b]	128	114	128	187
General index, excl. fruit and vegetables	131	101	132	194
Food (excl. fruit and vegetables)	152	62	153	209
Dwelling prices[c]	94	155	122	147
2. Wholesale prices of industrial output	138	105	138	202
3. Index of input prices				
Residential construction	134	109	130	179
Road construction	152	122	133	188
Agriculture	150	96	141	205
4. Official exchange rate				
Against the dollar	113	107	116	220
Against a foreign currency basket[d]	106	82	100	194
5. Import prices[e] (excl. diamonds)				
In terms of foreign currency basket[d]	12	8	-1	3
In IS terms	134	102	99	190

[a] The index of controlled prices comprises the following items: bread, flour, eggs, meat and poultry, edible oils and margarine, milk and milk products, property tax, municipal rates, electricity, water, gas for household use, school fees (kindergarten, elementary, and secondary), cigarettes and other tobacco products, public urban and interurban transport, and mail and telephone services. The weight of these items in the consumer price index is about 20 percent.

[b] The index of uncontrolled prices comprises all consumer items not listed in note a.

[c] The increase in dwelling prices is the average quarterly change. During 1983 the measurement of this item was revised; as a result, the datum for the third quarter of the year reflects the price

shortening the interval for compensating the public for rising prices. These steps were intended to bring inflation down fairly quickly to a 5 percent monthly rate (approximately an 80 percent annual rate).[3]

These measures were implemented, with hardly any deviations, from October 1982 to July 1983; nevertheless the consumer price index continued to climb at a 7

[3] According to this conception the interest rate is one of the costs whose reduction is supposed to help ease inflationary pressure from the costs side; the government therefore opposed any increase in the base interest rate. It should be noted, however, that the lowering of interest has an expansionary monetary effect.

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INDEXES, 1980–84l

the period, at annual rates)

Quarterly data								
1982				1983				1984
I	II	III	IV	I	II	III	IV	I
109	141	158	120	118	135	137	487	311
156	167	228	56	88	157	112	758	356
100	134	140	141	125	132	142	440	301
114	148	160	110	98	159	142	505	313
154	149	251	85	118	131	127	699	381
105	136	145	138	125	–	156	147	
131	148	184	97	113	121	165	570	345
132	151	152	92	109	154	139	373	358
125	132	184	99	138	122	147	425	300
149	163	142	109	97	139	146	658	291
128	149	112	80	91	108	223	719	309
86	132	96	90	67	98	198	655	440
6	–10	8	4	–3	–4	8	12	
95	97	123	82	77	87	164	707	

change over a period of four and a half months, and for this reason no figure is given for the second quarter of the year.

[d] A basket of five currencies: U.S. dollar, German mark, pound sterling, French franc, and Dutch guilder.

[e] The increase in import prices is a quarterly average; no data are available on the movement of import prices during the quarter. The annual change is the change in fourth-quarter levels.

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

percent average monthly rate (125 percent annual rate)—the same as in the four preceding years.[4] Implementation of this policy had grave implications for the balance of payments, capital market, and real demands, and it eventually induced the initiation of steps that led to the aggravation of inflation in the final part of the year.

Following are the principal factors that thwarted the government's policy:

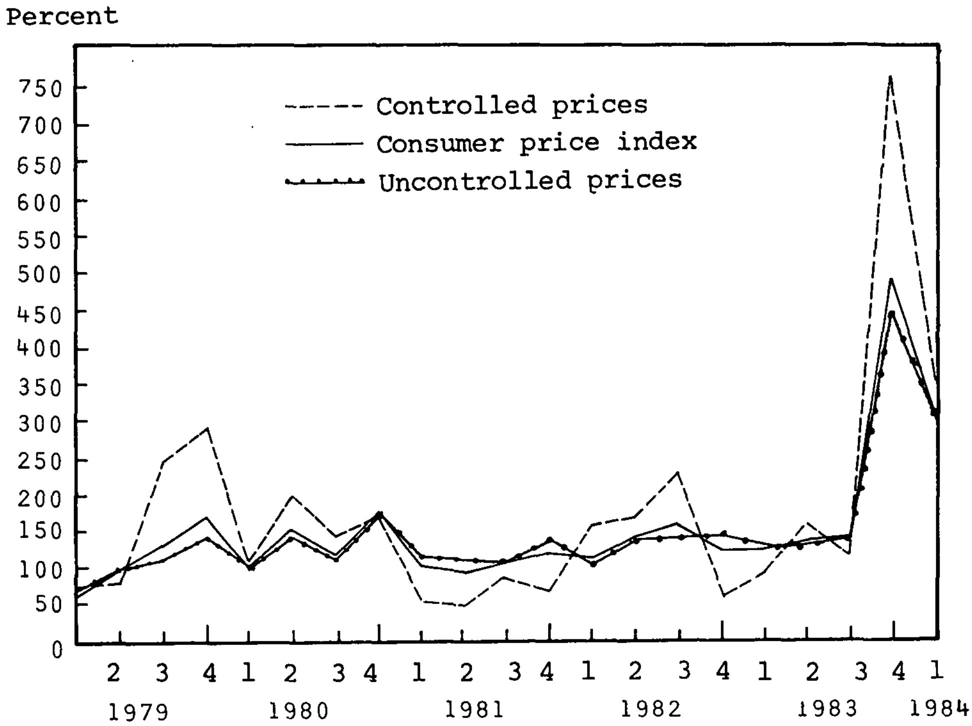
(a) The measures introduced were not accompanied by the dampening of

[4] Noncontrolled prices went up at a 7.2 percent average monthly rate during this period.

Figure III–1

MOVEMENT OF CONSUMER PRICES: GENERAL INDEX, CONTROLLED PRICES, AND UNCONTROLLED PRICES, 1979–83

(Percent quarterly increase, at annual rates)



government demand, and in fact defense spending even grew. Moreover, the rate of private saving was pulled down by the heavier taxation. Another inhibiting factor was the prevailing macroeconomic trends: a cumulative deterioration in the country's current account and the swelling of the public's financial wealth in recent years. The latter can be mainly attributed to the large public sector deficits in earlier years (especially 1981) and the continuing real rise in bank share prices, which in the case of most of the leading banking groups were supported by affiliated companies. These trends existed before the introduction of the government's policy, and their continuation exacerbated the balance of payments position and the drop in the private saving rate in 1983.

(b) The government did not coordinate the various price increases, especially wages;[5] moreover, it simultaneously took steps that counteracted the entire effort.

(c) The public doubted the government's ability to persist in these measures for long, especially as it had to retreat from a similar effort in 1981. The policy was not

[5] The noncoordination of price increases was particularly conspicuous in the case of the deviant growth of wages (discussed in Chapter IV).

presented to the public as one that required comprehensive cooperation on the part of the various sectors of the economy, but as a one-sided government action.

Let us elaborate. As in the previous year, domestic demands continued to expand in real terms (notably defense), with part of the incremental demand being diverted to imports (see Chapter II). But in contrast to 1982, some of the additional demand was this year diverted to the domestic market—a development reflected by a modest gain in the product and the reduction of the unemployment rate. In the first three quarters of the year real wages went up sharply, testifying to the nonsynchronization of the various price increases. The growth of wages is explained by institutional factors (the wage agreements in the public services, which were supposed to cover the year 1982 but were not signed until the final months, and the payment of retroactive increments at the beginning of 1983), as well as the recovery of domestic activity, which stimulated demand for labor, chiefly in the business sector. The wage hikes had an inflationary effect from both the costs side, which ran counter to the government's policy, and the demand side, as domestic demands continued to expand faster than the domestic product.

Restraining the rise of import prices should have moderated the rise of domestic prices, but this was thwarted *inter alia* by two opposing policy targets: maintenance of full employment and preservation of a given level of foreign exchange reserves. Exposing the economy to outside competition by lowering import prices creates difficulties for firms in the transition stage, and is liable to lead to the folding of less viable establishments and the loss of jobs. The steps taken by the government to protect local enterprises succeeded in maintaining full employment, but prevented the leashing of inflation. In addition, the attempt to retard inflation solely by slowing the depreciation of the sheqel clashes with the all-important endeavor to preserve the country's foreign reserves.

Because of the persistence of the previous rate of inflation, controlled goods and services were more heavily subsidized and exchange rate insurance payments stepped up, creating an onerous fiscal burden that could not be borne for long. In addition, the real appreciation of the sheqel and the decline in the relative price of imports intensified the deterioration in the balance of payments. As a consequence, in the first three quarters of 1983 the public's expectation of a change in policy, in particular the implementation of a large one-time devaluation, grew stronger and induced it to adjust its financial portfolio by shifting to assets linked to the exchange rate and shedding other assets, notably bank shares.[6]

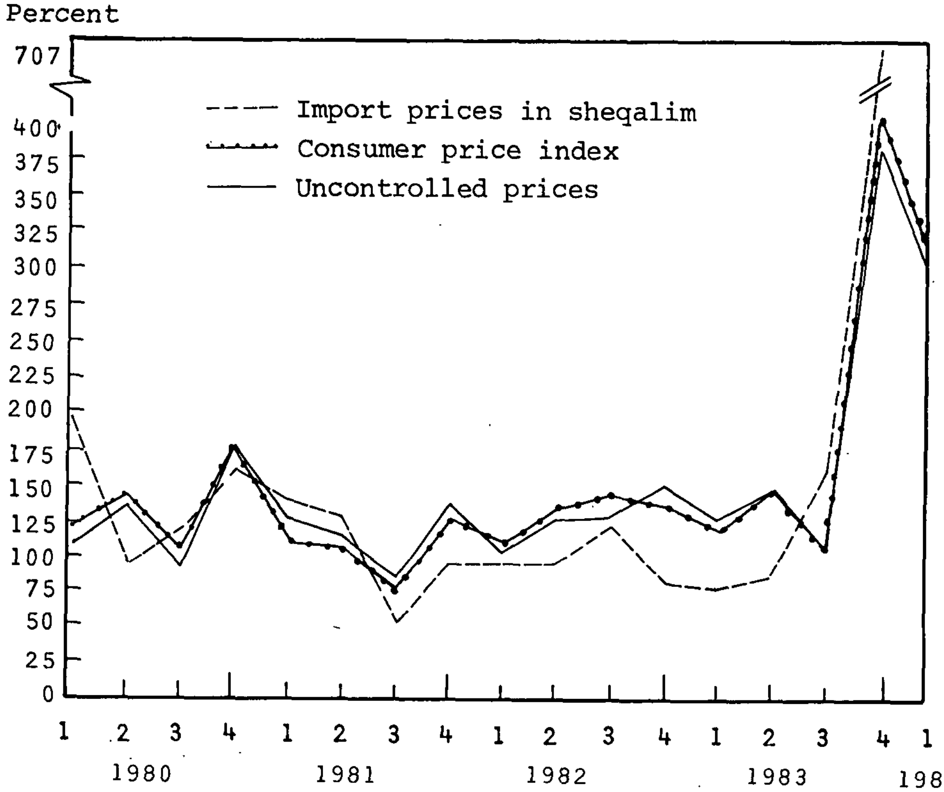
Since the public had no confidence in the government's ability to stick to its price policy, and because of developments in real economic activity, especially the further expansion of domestic uses and the diversion of most of the increment to imports, inflationary expectations continued to run high. These expectations were fed by the information available to the public from all the various sources, and in particular by all the government's policy measures. The public apparently foresaw

[6] This is explained in detail in Chapter VIII.

Figure III–2

CHANGES IN IMPORT PRICES (EXCL. DIAMONDS) IN SHEQALIM, UNCONTROLLED PRICES, AND CONSUMER PRICE INDEX, 1979–84I

(Percent average quarterly change, at annual rates)



the change of policy: its expectations influenced its behavior, and ultimately led to the abandonment of the policy. The government began to backtrack around mid-year: initially import exchange rate substitutes were introduced; then (in August) the sheqel was devalued by 7.5 percent at a stroke, and the prices of controlled goods and services were raised by 6.5 percent in August and 9.4 percent in September. These changes arrested the decline in the relative price of controlled goods and services and resulted in a small real devaluation.

Despite the partial abandonment of the price policy, the aforementioned trends in the balance of payments and especially the capital market continued unabated. This led to the adoption of further drastic countervailing action in October: termination of the supporting of bank share prices (which caused them to fall steeply), a big devaluation of the sheqel, the slashing of subsidies on basic goods and services, and a decision to cut the budget.

These measures were prompted by a change in emphasis in government policy—from fighting inflation, even at the price of a worsening of the balance of payments, to the reduction of the balance of payments deficit, even at the price of accelerating inflation. After the large October devaluation the government continued its attempt to maintain the real exchange rate through nominal adjustments, and it also continued to cut subsidies on basic items. In the past the structure of Israel's capital market, in which most of the public's assets are linked (to the price index or the exchange rate), and the buildup of financial asset holdings made it possible to pass on almost all of the cost-induced price increases without harming real activity. In the fourth quarter of 1983 the upward pressure was only partly reflected in prices, and from October 1983 to March 1984 the sheqel declined 7–8 percent in real terms,[7] accompanied by a drop in employment. This real depreciation stemmed from a real contraction of the public's financial portfolio (after the supporting of bank shares ceased), the erosion of real wages, a real credit squeeze, and the pruning of government spending. As a result, the average monthly inflation rate shot up to 16 percent in the last quarter of the year, while the average depreciation of the sheqel and the average advance of controlled prices reached 19 and 20 percent respectively. The attempt to preserve the real end-1983 devaluation and to reduce subsidies continued in the first quarter of 1984, driving up the consumer price index by 13 percent on a monthly average.

[7] The reference is to the exchange rate of the sheqel against the dollar (monthly average), compared with the consumer price index.