Chapter III

PRICES

Inflation escalated to a disturbing extent in the year reviewed. In December 1984 the various price indexes were more than five times higher than in the previous December, with the increase in the consumer price index, the most conventional measure of inflation, reaching 445 percent.[1]

Price developments in 1984 were not all of a piece. Inflation actually began to accelerate in October 1983; at the beginning of 1984 it stabilized at a 13 percent average monthly rate, but in the third quarter it spurted so fast that there was a distinct danger of degeneration into hyperinflation. This trend was blunted toward the end of the year following the introduction of the first package deal between the government, Histadrut (Trade Union Federation), and employers (represented by the Coordination Bureau of the Economic Organizations), which provided *inter alia* for a price freeze (see Table III–1).

The principal relative prices in the economy fluctuated sharply in 1984, mainly because of frequent shifts in the government's subsidy, exchange rate, and wage policies. The aggravation of inflation heightened the prevailing uncertainty, which is undoubtedly one of the reasons for the productivity slowdown in recent years.

The more rapid spiraling of prices began, as stated, in the fourth quarter of 1983. In October of that year the government decided to change its priorities, placing the stress on mending the balance of payments, even at the cost of a worsening of inflation. To this end it adopted, even after the large devaluation and steep hiking of subsidized prices in October 1983, a policy of faster nominal depreciation of the sheqel and the pruning of subsidy outlays by sharply increasing the prices of controlled goods. This reversal of policy was not accompanied by a significant reduction of the government's real activity. Because of the flagging of domestic demands (see the analysis in Chapter II), the currency depreciated by several percent in real terms, but the government's attempt to achieve a larger real depreciation intensified the inflationary pressure. The switch in policy targets and in the instruments employed altered the public's inflationary expectations. Given the monetary structure of the Israeli economy, the combination of these factors caused prices to climb more rapidly.

[1] The average annual increase in the CPI was 374 percent, compared with 377 percent for the GNP deflator (see Tables III–2 and III–3).

Table

SELECTED PRICE

(Percent increase during

	1981	1982	1983	1984
1. Consumer price index				
General index	101	131	191	445
Controlled prices[b]	60	143	206	382
Uncontrolled prices	114	128	187	459
General index, excl. fruit and vegetables	101	132	194	438
Food (excl. fruit and vegetables)	62	153	209	424
Dwelling prices	155	122	156	462
2. Wholesale prices of industrial output	105	138	202	447
3. Index of input prices				
Residential construction	109	130	179	476
Road construction	122	133	188	418
Agriculture	96	141	205	424
4. Official exchange rate				
Against the dollar	107	116	220	493
Against a foreign currency basket[c]	82	100	194	436
5. Import prices[d] (excl. diamonds)				
In terms of foreign currency basket[c]	8	–1	3	9
In IS terms	102	99	190	504

[a] Data are for December 1984 and January 1985.
[b] The index of controlled prices comprises the following items: bread, flour, eggs, frozen beef 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.

Monetary developments in 1984 permitted inflation to continue unabated. As in the last few preceding years, the liquidity feeding this process originated in the virtually full indexation of the public's financial portfolio and the expansion of the asset base. In 1984 the latter was due primarily to the swelling of the government deficit (despite the contraction of public domestic consumption) following a sharp drop in tax receipts and a heavier subsidization. Another reason for the real growth of the portfolio this year was a switch to assets linked to the exchange rate[2] and a real depreciation of the sheqel.

[2] The official statistics on financial assets do not include the public's foreign currency holdings, which expanded in the year reviewed (see the discussion in Chapters VII and VIII).

III-1

INDEXES, 1981–85 I

the period, at annual rates)

1983				1984				First package deal[a]	1985
I	II	III	IV	I	II	III	IV		I
118	135	137	487	311	496	536	565	69	222
88	157	112	758	356	352	486	347	52	459
125	132	142	440	301	534	548	493	73	185
98	159	142	505	313	479	551	439	60	217
118	131	127	699	381	360	603	386	45	268
125	—	156	370	368	377	507	636	—	311
113	121	165	570	345	387	656	446	31	205
109	154	139	373	358	650	575	375	79	185
138	122	147	425	300	479	524	397	70	260
97	139	146	658	291	468	462	410	38	269
91	108	223	719	309	466	731	541	144	226
67	98	198	655	440	382	556	385	115	256
-9	-5	10	11	8	6	15	3	—	—
82	73	159	600	381	376	557	723		

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

[d] 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.

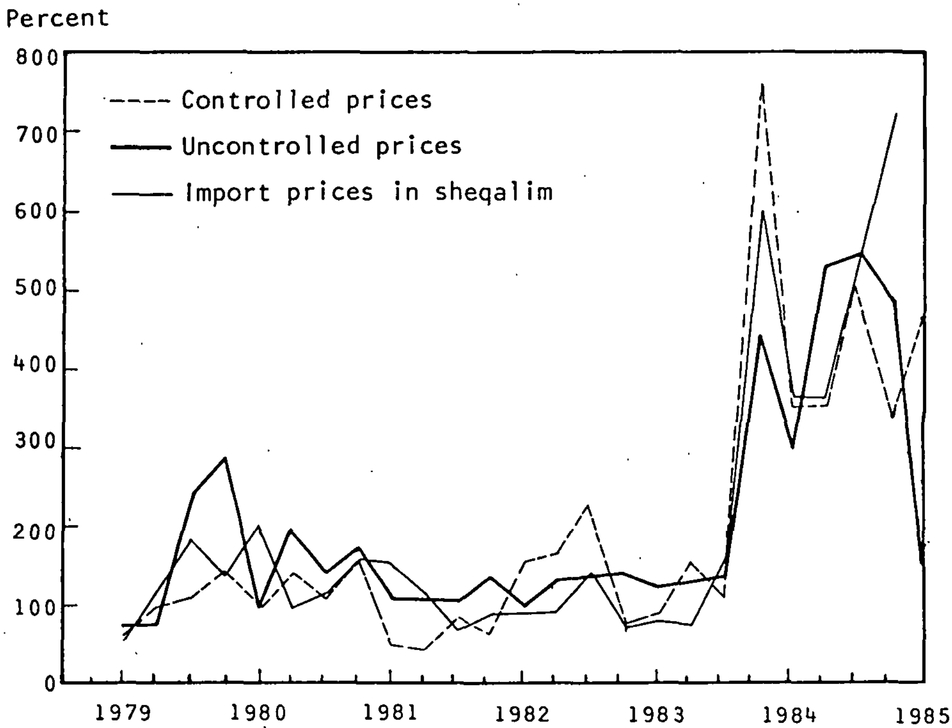
SOURCE: Central Bureau of Statistics and Bank of Israel calculations.

In the first quarter of 1984 inflation plateaued at a 13 percent average monthly rate (compared with 7 percent previously). Among the factors that helped to check the accelerated rise of prices at the end of 1983 were the stabilization of the nominal currency depreciation at a new level and the changed conditions in the real sphere after the weakening of demands, which permitted the preservation of the end-1983 real depreciation of the sheqel. Inflation remained relatively stable until July,[3] but a shift in the government's policy in April, in particular an increased subsidization and substantial wage awards, combined with a precipitate drop in tax receipts to generate a big fiscal expansion and a consequent growth

[3] Except for April, when prices always go up because of strong seasonal influences.

Figure III-1

CHANGES IN IMPORT PRICES (EXCL. DIAMONDS) IN SHEQALIM, UNCONTROLLED PRICES, AND CONSUMER PRICE INDEX, 1979–85



of liquidity. These developments formed the background to the postelection escalation of inflation.

After the elections a number of steps were taken to arrest the dwindling of foreign exchange reserves (see the discussion in Chapter VII): the sheqel was devalued by 9 percent (over and above the current adjustment of the exchange rate), administrative curbs were placed on imports, and the cutting of subsidies was resumed. These measures were accompanied by mounting expectations of a package deal, and consequently there was a strong tendency to raise prices before such an agreement should go into effect. These developments further fueled the inflationary fires, and in October the consumer price index soared 24.3 percent.

While the new government was taking shape, no overall economic plan was formulated and there was a danger of the situation deteriorating into hyperinflation. This prompted the Histadrut, employers, and the government to sign an agreement (the "package deal"), whose most salient provision was a total price freeze

Table III-2

SELECTED PRICE INDEXES, 1970–84

(Percent average annual increase)

	Average 1970–1973	1974–1978	1979–1983	1980	1981	1982	1983	1984
Consumer price index	13	39	118	131	117	120	146	374
Wholesale price index of industrial output[a]	11	43	122	135	123	126	145	397
Index of agricultural input prices[b]	13	43	122	144	119	128	140	391
Index of housing construction input prices	16	38	120	128	132	117	135	388
Index of road construction input prices	14	47	131	145	147	127	144	351
Exchange rate against the dollar[c]	5	34	103	102	123	112	132	421

[a] Until 1978 excludes printing and publishing.
[b] Excludes agricultural services.
[c] The official exchange rate of the sheqel until October 1977 and the representative rate thereafter.
SOURCE: Central Bureau of Statistics and Bank of Israel calculations.

Table III-3

CHANGES IN PRICE DEFLATORS FOR RESOURCES AND USES, 1970–84

(Percent average annual increase)

	Average 1970–1973	1974–1978	1979–1983	1980	1981	1982	1983	1984
Gross national product	14.0	39.7	120.0	126.8	126.4	122.6	150.9	380.8
Imports, excl. direct defense imports[a]	14.9	46.9	111.6	135.4	115.8	106.5	125.9	410.0
Private consumption	13.5	39.4	116.9	128.6	118.9	116.3	144.4	388.5
Public consumption, excl. direct defense imports	15.7	41.6	124.1	125.7	133.3	125.3	145.4	395.6
Gross domestic investment	16.4	43.3	119.6	132.6	134.0	118.4	132.3	383.1
Total domestic uses, excl. direct defense imports[a]	**14.7**	**40.6**	**119.0**	**128.8**	**125.0**	**118.8**	**141.8**	**389.8**
Exports, at domestic prices	13.2	46.4	13.1	128.7	118.4	107.8	134.6	396.5
Total uses, excl. direct defense imports[a]	**14.4**	**24.1**	**117.4**	**129.4**	**123.0**	**115.9**	**140.1**	**389.5**

[a] Until 1977 excludes ships and aircraft.
SOURCE: Central Bureau of Statistics.

for a three-month period beginning in November. The package deal greatly improved the picture on the inflation front: from the beginning of November until the end of January prices moved up at a relatively mild 3–5 percent rate (see Table III–1).

Table III–4

MONETARY INDICATORS OF INFLATION, 1974–84

	Percent increase during the year					
	Inflation	Liquid assets[a]	Money (M1)	Real money balances[b]	Weight of narrow monetary base[c]	Indicator of long-term inflationary pressure[d]
1974	56	44	18	100.0	27	100
1975	23	17	22	94.0	26	137
1976	38	20	27	84.4	26	180
1977	43	58	39	88.7	31	240
1978	48	58	42	80.1	21	330
1979	111	83	30	60.2	16	330
1980	133	148	100	44.2	12	393
1981	101	90	79	39.4	11	447
1982	131	132	111	35.8	11	567
1983	191	216	132	31.1	10	620
1984	445	448	352	21.4	7	533

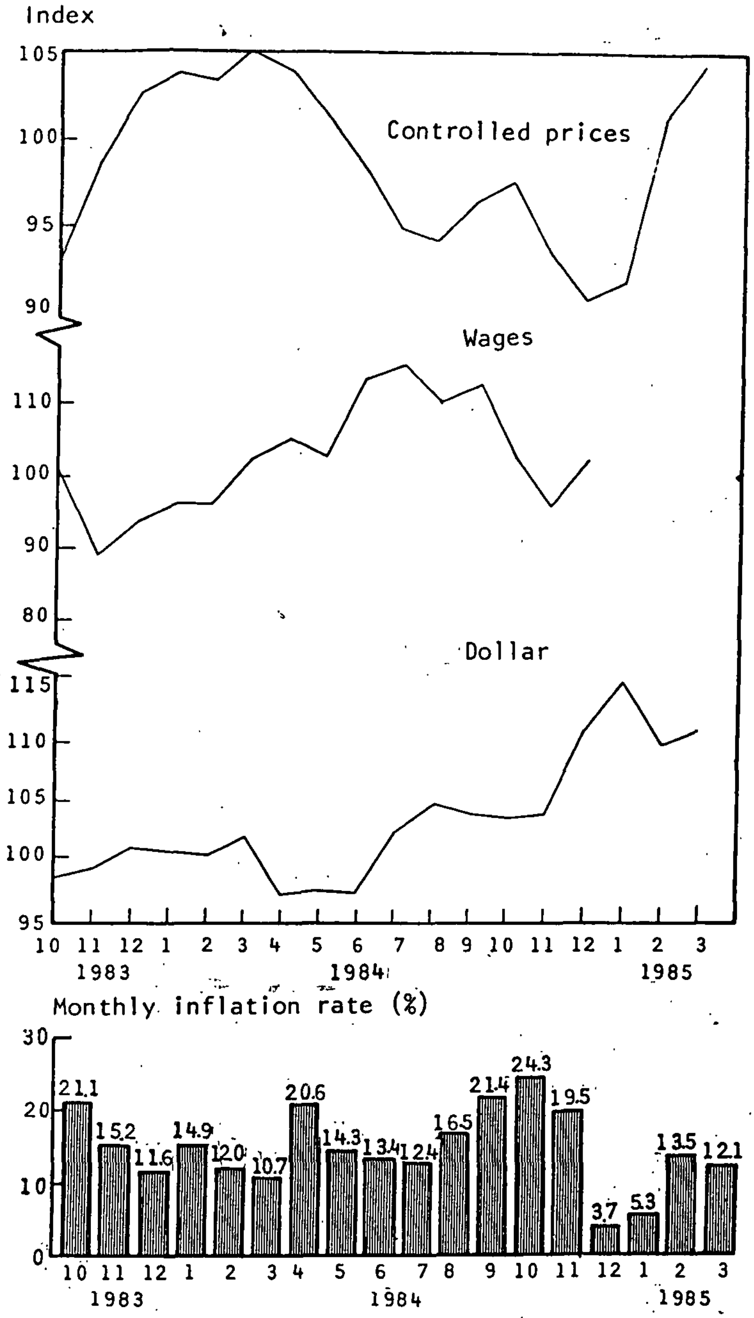
[a] Money (M1), time deposits, negotiable CDs, and tradable bonds and Patam (sheqel deposits denominated in foreign currency) held by the public.
[b] Base: 1974=100; annual average.
[c] The ratio between the narrow monetary base and the liquid asset base (annual average).
[d] The ratio between the net liquidity injection (as defined in Chapter VIII), less the injection warranted by the growth of the economy in relation to the narrow monetary base; calculated as a three-year moving average. Base: 1974=100.

The retrenchment of inflation was due to several factors. The most important was, of course, the tripartite agreement, which made it possible to control the principal relative prices (real wages, the exchange rate, and subsidized goods and services) while reducing the rate of inflation. In addition, the public understood that the rules of the game had changed, and its confidence in the new strategy[4] was reflected by a marked dampening of its inflationary expectations.[5]

[4] The public's cooperation contrasted glaringly with its attitude toward the "5 percent" policy adopted at the end of 1982, which aimed at bringing inflation down to a 5 percent average monthly rate.

[5] Drastic variations in inflationary expectations, such as occurred in October 1983 and November 1984, contradict the conception that expectations are formed on the basis of past inflation rates (adaptive expectations), and strengthen the assumption regarding rational expectations, which take into account all the relevant information, including that which is not purely economic.

Figure III-2
CHANGES IN AVERAGE MONTHLY RELATIVE PRICES, OCTOBER 1983 TO MARCH 1985
(Relative to CPI; average 1982 = 100)



The nominal developments were reinforced by the real performance of the private sector in 1984: a rise in the saving rate, the cutting back of investment, and an improvement in the external current account. As an interim measure prior to the implementation of the package deal, the government put a temporary freeze on new procurements by government departments, while the Bank of Israel conducted a monetary policy aimed at raising real interest rates and cooling demands (this was reflected by the growth of unemployment in the final quarter of 1984).

Despite the remarkable success of the first package deal in slowing the advance

Table III-5

UNCERTAINTY INDEXES OF INFLATION, 1970–85I

(Base: 1975–77 = 100)

Period	Average monthly change in CPI (%)	Index of change in CPI over time[a]	Index of change in relative prices[b]
1970–72	0.95	51	86
1975–78	2.52	100	100
1979–83	7.30	126	152
1974	3.84	161	135
1979	6.46	105	142
1980	7.32	107	152
1981	6.04	109	163
1982	7.26	78	135
1983	9.40	232	167
1984	15.30	257	173
1982 I	6.36	111	121
II	7.64	89	136
III	8.22	84	138
IV	6.81	78	143
1983 I	6.73	74	136
II	7.46	114	198
III	7.47	113	139
IV	15.95	232	186
1984 I	12.52	226	131
II	16.08	213	199
III	16.73	175	143
IV	15.87	258	205
1985 I	10.29	285	138

[a] Calculated as the standard deviation of the monthly rates of change in the consumer price index around the annual average rates of change.

[b] Calculated as the standard deviation of the monthly rates of change in the consumer price index items (according to their weights in the index) around the monthly rate of change in the index. The annual figure is an average of 12 monthly observations.

of prices, it created a number of problems which militated against the continuation of the disinflationary process. The fiscal burden, already very heavy on the eve of the freeze, increased still more. In addition, some major relative prices were distorted in the process: (1) The fairly rapid depreciation of the sheqel during the package deal period led to a widening gap between the prices of imported commodities and the prices frozen at the exchange rate in force when the deal went into effect. (2) The price freeze on subsidized items at a time of rising input prices increased the rate of subsidization, which was already unduly high on the eve of the freeze.

These distortions, together with the delaying of the economic measures the government had committed itself to implement, prompted the parties to the package deal to agree to some modifications even before its expiration. The second package deal, which went into effect at the beginning of February 1985, differed essentially from the first. The inflation targets were not met—in February and March prices went up 13 percent on a monthly average—and this induced the signatories to again modify the agreement. The third package deal provided for a 7 percent general price increase, to be followed by a total freeze for two months (from the beginning of April). In April the consumer price index soared 19.4 percent, casting doubt on the sustainability of a disinflationary policy based solely on package deals.

Despite the success of the first agreement and the attempt to leash prices through additional agreements, this strategy cannot serve as an alternative to an overall economic policy for healing the economy, which must put the emphasis on reducing the government's real expenditure while tightening its control over nominal developments. Without such a policy, there is a danger of a renewed burst of inflation once the goodwill generated by the success of the first package deal dissipates.