Chapter 3
Prices

In 1994 the inflation rate departed slightly from the 10–12 percent level evident in the last two years. During the year the Consumer Price Index (CPI) rose by 14.5 percent, although the annual target was 8 percent. The acceleration of price increases in 1994 should be seen in the context of the expansion of demand in the second half of 1993 and the beginning of 1994. This expansion, due inter alia to expansionary fiscal and monetary policies, caused the import surplus to grow and inflation to accelerate. Most of the latter occurred in the second quarter, moderating somewhat at the end of the year. Price increases were particularly marked in housing and fruit and vegetables. In the housing market, demand rose partly as a result of portfolio adjustment, while in the fruit and vegetables market prices accelerated due to the contraction of supply.

1. MAIN DEVELOPMENTS

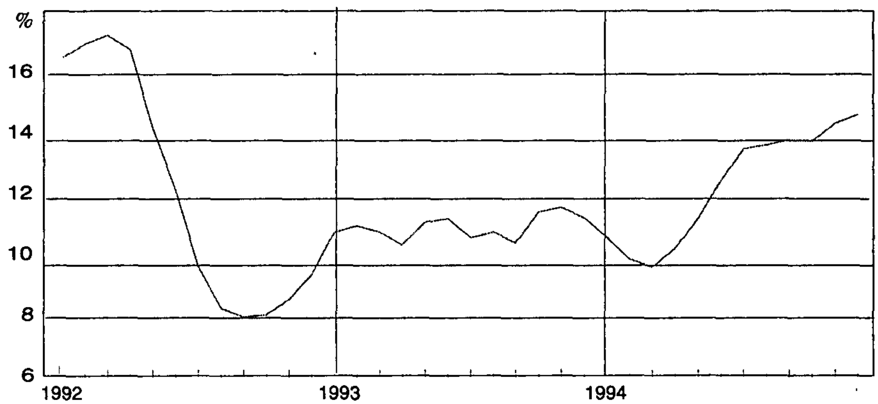
Prices rose faster in 1994 than in the preceding two years. The CPI rose by 14.5 percent during the year, after increases of 11.2 and 9.4 percent in 1993 and 1992 respectively, with other price indices rising, too. The acceleration of prices in 1994 occurred in the context of the rapid expansion of demand, which outstripped GDP, creating pressure for real appreciation and causing the CPI to rise beyond the target rate. Price increases were particularly prominent in housing, due *inter alia* to demand pressure connected with portfolio adjustment, and in fruit and vegetables, because of supply difficulties.

In 1992 and 1993 the CPI went up at an annual average rate of 10–12 percent, compared with an annual increase of some 18 percent in 1986–91. From 1992 background factors, including the sharp rise in the unemployment rate—with a subsequent slowing of the increase in nominal labor costs—and the lower rise in Israel's foreign trade prices, made it possible for prices to rise at a slower rate. Policy-makers also made an important contribution in the last few years. They helped to reduce the rate of inflation and increase economic stability by imposing fiscal restraint and adopting the Budget Deficit Reduction Law, announcing annual targets for inflation and the domestic budget deficit, and by introducing the crawling band exchange-rate regime.

The slowing of the rate at which prices rose in 1992 and the first half of 1993 created expectations that this trend would persist. In this context, an 8 percent target for the 1994 CPI was set in July 1993, and the slope of the exchange-rate band was reduced from 8 to 6 percent (and the midpoint rate raised by 2 percentage points). In the second half of

1993 and the first half of 1994, however, economic conditions caused domestic demand to expand rapidly. These conditions included the acceleration of domestic public consumption (excluding direct defense imports), from a 1 percent increase in 1993 to 4 percent in 1994 (Table 3.5). Fiscal expansion was reflected by wage agreements—which raised average public-sector wages by 23.7 percent (in nominal terms) in 1994—and by the appreciable expansion of employment in this sector. Demand also grew due to the decline in the interest rate and rise in the quantity of money in the second half of 1993, and to expectations that rapid economic growth would continue, among other things because of progress in the peace process (see Chapter 2). Although GDP increased substantially in 1994, alongside a decline in unemployment, demand increased faster. Thus, prices accelerated and the rise in the CPI considerably exceeded the target rate, despite the slowing of both the rate at which the exchange rate was adjusted and the rise in local-currency prices of imports and exports, and even though there was no significant pressure on prices from nominal production costs.

Figure 3.1
Rate of Change of CPI, 1992-94[a]



[a]Rate of change in last twelve months.
SOURCE: Based on Central Bureau of Statistics data.

Part of the 14.5 percent rise in the CPI during 1994 was due to temporary factors. According to several other price indices, however, even though inflation accelerated by 2–3 percentage points, it deviated only slightly from the 10–12 percent rate prevailing since 1992 (see Tables 3.2 and 3.3). Thus, just as the temporary moderation of housing prices in 1992 helped to bring the rise in the CPI down to a single-digit level, their exceptional increase in 1994, together with a temporary shortfall in the supply of fruit and vegetables, contributed to its acceleration.

The expansionary monetary policy adopted in mid-1993 served to increase demand at the end of the year and the beginning of 1994, and was introduced after price increases had moderated in June–August 1993 to a level lower than usual for these months.

Consequently, and in view of some slowing in economic activity at the beginning of 1993, it was assumed that the annual inflation rate had also moderated. An inflation target of 8 percent for 1994 was thus announced in July 1993, the slope of the exchange-rate band was lowered by 2 percentage points to 6 percent (and the midpoint rate was adjusted), and interest rates were reduced in July–November to bring them into line with the inflation target and stimulate economic activity. Developments in the second half of 1993 were not consistent with the announced target, however; an expansionary fiscal policy was adopted, expressed in exceptional public-services wage-agreements, and towards the end of the year housing prices accelerated again (after moderating in the second and third quarters of 1993). Declining interest rates in 1994 helped to expand demand, especially that arising from investment considerations (housing, consumer durables, machinery and equipment, etc.), which are more sensitive to alternative yields. During 1994, in order to moderate the acceleration of prices, interest rates were raised, but this apparently had a contractionary effect only towards the end of the year.

Table 3.1
Selected Price Indices, 1990–94

(annual change, percent)

		Implicit price index of		
	CPI	Domestic use of resources[a]	GDP	Wholesale prices
Change during period[b]				
1990	17.6	16.1	14.8	12.6
1991	18.0	15.2	20.4	14.6
1992	9.4	10.9	11.4	9.1
1993	11.2	9.3	9.7	7.2
1994	14.5	15.4[c]	15.0[c]	9.7
Average change				
1990	17.2	16.0	15.6	11.6
1991	19.0	17.7	20.8	16.0
1992	11.9	10.9	11.5	10.2
1993	10.9	10.5	11.3	8.2
1994	12.3	12.7	13.0	7.9

[a] Net of direct defense imports.
[b] CPI and wholesale price figures based on monthly data; GDP and resource use, quarterly.
[c] The steep rise in prices of GDP and resource use during the year is due to exceptional wage increases in the public services.

Goods can be classified as tradables (i.e., those that are exposed to international trade) and nontradables (i.e., those that are not, either because of their nature or because of restrictions imposed on them). Prices of tradables are affected directly by changes in the exchange rate and world trade, while prices of nontradables are affected by prices of tradables as well as by supply and demand. In this way, the exchange rate plays a vital—

Table 3.2

Prices of Tradables and Nontradables, 1990–94

(annual change, percent)

	CPI				Implicit price indices					
	Nontradables									
	Total	Excl. housing	Excl. fruit & veg. and housing	Tradables	Domestic resource use[a]	Narrow domestic resource use[b]	GDP	Business product	Imports[c]	Non-diamond exports
Change during period[d]										
1990	20.8	15.9	17.3	12.3	16.1	13.2	14.8	11.0	15.0	9.3
1991	20.2	16.2	16.3	14.0	15.2	13.4	20.4	20.4	3.4	15.1
1992	9.7	12.1	11.8	8.8	10.9	10.0	11.4	10.5	9.6	10.0
1993	13.7	8.3	9.5	6.5	9.3	8.4	9.7	8.8	6.7	6.7
1994	18.0	15.2	10.5	9.0	15.4	11.8	15.0	10.6	8.1	5.1
Average change										
1990	20.6	14.9	16.9	11.6	16.0	12.9	15.6	12.1	11.9	9.4
1991	22.2	17.7	18.3	13.3	17.7	15.1	20.8	19.1	8.6	14.8
1992	12.5	13.2	12.7	10.9	10.9	10.6	11.5	11.4	6.7	7.5
1993	12.8	9.4	10.4	7.3	10.5	9.0	11.3	9.9	9.8	9.7
1994	15.1	10.9	9.6	7.8	12.7	9.4	13.0	9.0	7.3	5.9
Weight in CPI (1994)	(619.6)	(411.9)	(375.0)	(380.4)						

[a] Excluding direct defense imports.
[b] Excluding direct defense imports, public services wages, nonprofit institutions, and housing services.
[c] Excluding direct defense imports and diamonds.
[d] Rates of change during period of CPI are based on monthly data, and of implicit price indices on quarterly data.

Table 3.3

Main Components of Consumer Price Index, 1990–94

(annual change, percent)

	Weight in CPI (1994)[a]	Change during period[b] 1990	1991	1992	1993	1994	Average change 1990	1991	1992	1993	1994
Total	(1000.0)	17.6	18.0	9.4	11.2	14.5	17.2	19.0	11.9	10.9	12.3
Housing	(207.7)	31.6	28.1	5.4	23.7	23.6	34.2	31.6	11.2	19.3	23.6
Fruit and vegetables	(42.3)	4.9	14.3	14.2	-1.2	56.1	0.9	12.2	16.9	0.6	21.4
Clothing and footwear	(59.5)	4.3	12.8	6.6	4.3	7.7	3.1	8.2	9.2	6.3	4.5
Controlled goods[c]	(155.4)	19.2	22.1	15.7	9.9	12.0	18.7	22.7	16.4	12.2	10.9
Total excl. housing	(792.3)	14.3	15.2	10.6	7.6	12.2	13.4	15.7	12.2	8.5	9.4
Total excl. fruit and vegetables	(957.7)	18.4	18.2	9.2	11.9	12.7	18.2	19.4	11.7	11.5	11.9
Total excl. controlled goods	(844.6)	17.3	17.4	8.3	11.5	14.9	16.8	18.4	11.2	10.7	12.6
Total excl. controlled goods and housing	(636.9)	12.6	13.7	9.5	7.0	12.3	11.6	14.2	11.2	7.6	9.0
Total excl. controlled goods, fruit and vegetables and housing	(750.0)	14.9	15.3	10.4	8.1	9.8	14.3	15.9	11.9	9.0	8.7
Total excl. controlled goods, etc.[d]	(535.1)	14.4	13.7	9.3	7.9	9.3	13.8	14.9	10.9	8.3	8.6

[a] The weights of the groups were changed in 1994.

[b] End-quarter or end-year data.

[c] Controlled goods include subsidized essentials, and goods and services supplied by public authorities, government enterprises, or supported corporations. New definitions were introduced at the beginning of 1991.

[d] Total excluding controlled goods, fruit and vegetables, housing, and clothing and footwear.

though not exclusive—role in determining prices. In addition, prices are affected by inelasticities such as those of wages, as well as by expectations. Hence, when the increase in demand exceeds that of GDP, the import surplus/GDP ratio rises, causing real appreciation, i.e., prices of nontradables rise relative to those of tradables.

Prices of tradables accelerated from an annual 6.5 percent during 1993 to 9.0 percent in 1994, even though in local-currency terms the rate at which prices of imports and exports rose moderated (Table 3.2).[1] The expansion of demand, which caused a 2.5 percentage point rise in the import surplus/GDP ratio may have prevented the dampening of the rate at which these prices increased. (The rise in the prices of tradables over and beyond that in foreign trade prices was made possible by monopoly power and such nontradable components of tradables as domestic marketing.) Prices of nontradables accelerated, from an annual rate of 13.7 percent during 1993 to 18.0 percent in 1994.

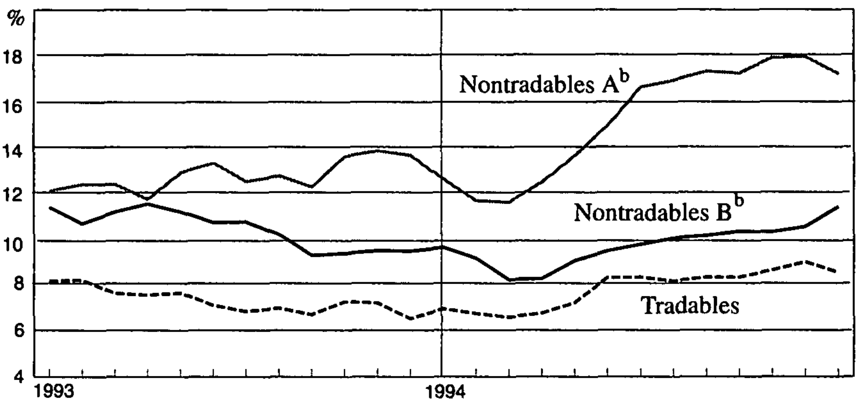
In nontradables, there was a marked increase in the prices of goods usually characterized by supply inelasticity in the short term—housing, and fruit and vegetables.[2] As stated, demand for housing expanded over and beyond the general increase in demand, partly for investment reasons. Part of this increase in demand derived from the absorption of immigrants, who brought their portfolio into line with that of the established population, part from the decline in interest in the second half of 1993, and part from further progress in the peace process, which affected investment considerations. Prices of fruit and vegetables accelerated primarily toward the end of the year, because of a drastic reduction in supply. In other nontradables, especially services, supply responded quickly to the rise in demand. Nonetheless, during 1994 there was an acceleration in the rate at which the index of prices of nontradables excluding housing and fruit and vegetables rose (Table 3.2, Figure 3.2). These developments also reflected real appreciation in 1994 (Figure 3.3). This is apparent in the gap between the prices of tradables and nontradables in the CPI, although when the prices of nontradables excluding housing and fruit and vegetables are compared with those of tradables the effect of real appreciation is significantly weaker. (A similar picture emerges when national accounts prices are compared with foreign trade prices, see Chapter 2.)

The rate at which the CPI rose accelerated from the last quarter of 1993, principally because of the increase in housing prices (Table 3.3). The other price indices began to accelerate only from the second quarter of 1994, however (Figure 3.4). Because of the timing of the changes, the acceleration of prices was not fully expressed in average rates of change, some of which even moderated in 1994. The acceleration of most indices was checked in the second half of 1994, and they slowed at the end of the year, as the increase in demand moderated.

[1] National accounts figures show that prices of tradables in the CPI rose faster during 1994 than those of imports and exports, while average prices rose at a similar rate to those of imports and faster than those of exports.

[2] In Israel, fruit and vegetables are nontradable because of administrative import restrictions, but in many other countries they are defined as tradable.

Figure 3.2
Price Indices of Tradables and Nontradables, 1993-94[a]



[a] Rates of change in last twelve months.

[b] Variant A, all CPI items; Variant B, excluding fruit and vegetables and housing.

SOURCE: Based on Central Bureau of Statistics data.

The development of prices in 1994 raises fears that the departure from the inflation plateau evident in 1992 and 1993 is not temporary. Even if the factors causing prices to accelerate are temporary, they might gather momentum and become permanent as a result of the undermining of confidence in the inflation target following deviation from it, the deterioration in the balance of payments, and continuous real appreciation (the last two could create pressure for exchange-rate adjustments), and the increase in the cost-of-living allowance (COLA) and other indexation payments, with the ensuing rise in inflation expectations. In addition, further wage increases in the public services in the wake of the agreements signed in 1994 raise fears of a higher inflation rate, since the marked decline in the unemployment rate reinforces expectations that they will spill over to the business sector. Nonetheless, price trends in the last quarter of 1994 do not indicate an increase in the inflation rate, and at present it looks as if the rise in the CPI in this period was due mainly to the temporary rise in fruit and vegetable prices, while the rate of increase of the other items moderated somewhat.

2. DETERMINANTS OF PRICES

In Israel, the exchange rate constitutes the basis of the process by which prices are determined; changes in it have a direct effect on domestic prices of tradable goods because of the close connection between these prices and the local-currency prices of imports and exports, which are determined by their prices abroad, exchange rates, and trade tariffs. The effect of the exchange rate on nontradables is less direct.

The influence of changes in supply and demand on prices of tradables depends to a great extent on the sensitivity of the exchange rate to such changes. In a regime with a fixed exchange rate such changes will be reflected primarily by changes in the volume of imports and exports, while in one with a floating exchange rate they will be reflected largely by price changes.[3] In Israel the regime is a combination of the two, with the exchange rate moving within a crawling band whose slope has been preset. In this situation, the exchange rate is affected both by changes in the supply of and demand for goods and by capital flows and central bank activity. Changes in the various markets will hence affect the volume of foreign trade in tradables as well as their prices.

The real exchange rate, which is the ratio between prices of tradables and nontradables, reflects changes in the supply of and demand for tradables relative to nontradables. Prices of nontradables are affected by exchange-rate changes, but to a lesser extent than are prices of tradables. Various rigidities—including nominal wage agreements and expectations—also influence the way in which prices are determined, sometimes preventing full adjustment between all the nominal elements.

The exchange-rate regime, as well as monetary and fiscal policies and the interaction between them, have a considerable effect on the process of determining prices. Economic policy can directly influence the prices of goods or their supply and demand, or indirectly affect capital flows, the exchange rate, expectations, etc. (see Chapter 7).

The following sections describe the development of factors affecting prices, though any attempt to separate them undoubtedly impairs the analysis, since it is their combined action and interaction that determines prices.

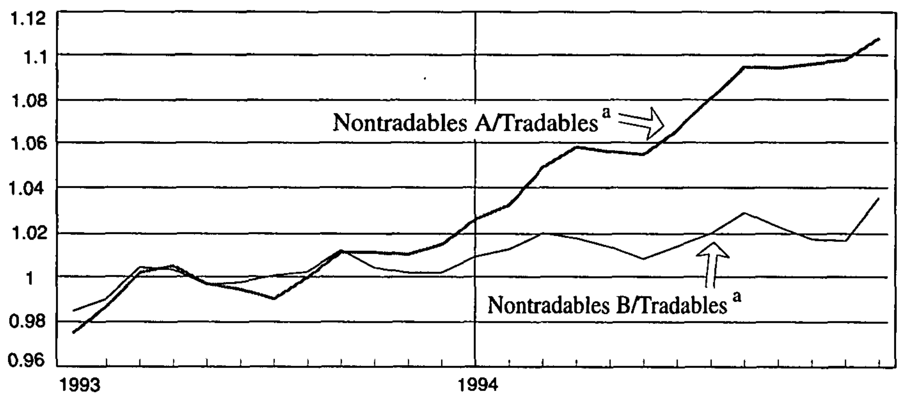
The exchange rate and prices of tradables and nontradables

Since December 1991 the exchange-rate regime has consisted of a midpoint rate within a crawling band with a preset slope. Alongside the policy of gradually reducing the slope of the band, in accordance with the declining path of the inflation target, the rate of adjustment of the effective exchange rate has moderated. Thus, during 1992 the exchange rate of the NIS against the basket of currencies rose by 14.9 percent, and in 1993 by 8.0 percent. In July 1993, with the moderation of many price-indices, the inflation rate appeared to have slowed. Consequently, a target rise in the CPI of 8 percent was set for 1994, and the slope of the exchange-rate band was reduced to 6 percent. The actual rise in the NIS/currency-basket exchange rate was 5.4 percent in 1994.

In September 1991, together with continued government activity intended to increase competition and reduce tariffs and restrictions on imports and exports, a process of trade liberalization was begun, the object being to permit the entry of competing imports, thereby reducing prices and increasing efficiency. In the context of the world recession of 1990–92 and the slower rise of foreign trade prices in dollar terms, this led to a

[3] Prices of tradables are also affected by supply and demand pressures because of a lack of competition between Israel and international markets, and because of the existence of some monopoly power and a nontradable component of tradable goods.

Figure 3.3
Real Appreciation: Relative Prices of Tradables and Nontradables, 1993-94



[a] Variant A, all CPI items; Variant B, excluding fruit and vegetables and housing.
SOURCE: Based on Central Bureau of Statistics data.

slowing of the rate at which prices of tradables rose—from about 12 percent in 1990–92 to 8 percent in 1993–94 (annual average rates, Table 3.2).

As is the case in many industrial countries, the long-term trend in Israel is towards real appreciation. This trend has intensified since the beginning of the decade, following the rapid rise in demand due to the influx of immigrants. In this period, use of resources increased faster than GDP (Table 3.5), with demand pressure, particularly on housing. Thus, in 1990 and 1991 prices of nontradables rose by an annual average of 20 percent. Demand pressure (particularly on housing) moderated slightly in 1992, enabling the increase in prices of nontradables to slow to 9.7 percent, and in the CPI to 9.4 percent.

Market rigidities have a marked effect on prices, especially on those of nontradables, which are labor intensive. Their influence seems to have lessened in the last few years, because of the rise in the labor force due to the influx of immigrants from the former USSR, and the weakness of the labor market at the beginning of the decade following the recession of the late 1980s. These factors caused the unemployment rate to rise to an unprecedented 11.2 in 1992 and the increase in the wage per employee post to moderate by an annual 2 percentage points, so that price increases eased, too. Fiscal policy, the announcement of inflation and budget deficit targets, and the crawling band exchange-rate regime also helped to moderate inflexibilities and dampen price increases *inter alia* because of the reduction of uncertainty and the demonstration of policy-makers' commitment to reducing inflation (see below).

The moderation of price increases persisted in the first nine months of 1993 but reversed in the last quarter, mainly because of the accelerated increase in housing prices, so that the CPI rose more rapidly. Thus, in 1993 the CPI rose at a slightly faster rate than it had in 1992—11.2 and 9.4 percent respectively—though the rate at which many price indices rose continued to slow.

Starting from mid-1993, demand grew significantly, following the contraction of unemployment, the exceptional wage increases granted in the public services in 1993 and 1994, and monetary expansion. As a result, starting from the second quarter of 1994, most price indices rose. Prices of tradables went up by 9 percent in 1994, a higher rate than in 1993 (6.5 percent), even though there was no acceleration of foreign trade prices in local-currency terms in Israel (Table 3.2), and the rate at which nontradables prices rose accelerated from 13.7 percent in 1993 to 18.0 percent in 1994. Prices rose particularly steeply in two nontradable markets—housing, and fruit and vegetables. This resulted from the expansion of demand in the former, partly for investment considerations, while supply contracted sharply in the latter.

Policy factors

Monetary and fiscal policy had a great effect on prices in 1994. Fiscal policy was primarily expansionary throughout the year, while monetary policy was expansionary at the beginning, and gradually became more contractionary.

Table 3.4
Prices and Exchange Rates: Target and Actual Rates, 1991–94

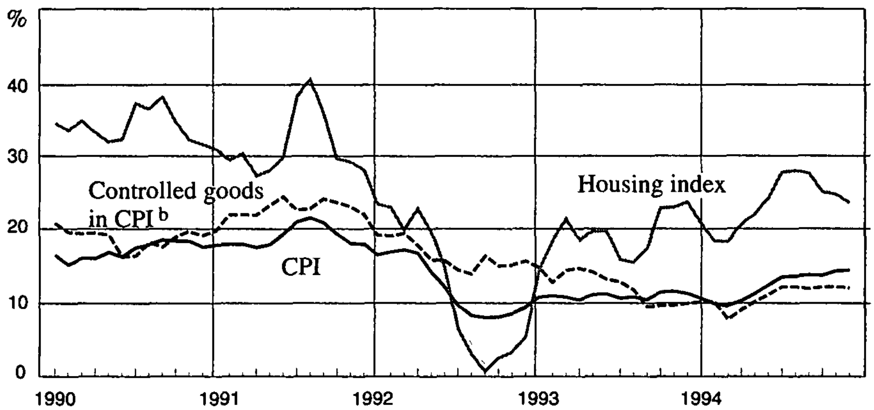
(rate of change during year, percent)

	Target				Actual	
		Rise in	Exchange-rate band[a]		Rise in	Exchange
Announcement	Date	CPI	Slope	Deviation	CPI	rate
1991					18.0	11.6
1992	Dec. 1991	Up to 14–15	9	3	9.4	14.9
1993	Nov. 1992	Up to 10	8	3	11.2	8.0
1994	Jul. 1993	Up to 8	6	2	14.5	5.4
1995	Sep. 1994	8–11	6	–		

[a] Against basket of currencies.

After adopting an expansionary monetary policy in the second half of 1993, the Bank of Israel raised the interest on the monetary (discount window) loan seven times during 1994. In the first half of the year the interest rate was raised by small amounts, while in the second half it was raised more significantly. In addition, statements were made repeatedly about the importance the authorities attached to reducing inflation and adhering to the target. But prices accelerated—as apparently did expectations that this

Figure 3.4
Rates of Change of Various Indices, 1990-94 [a]



[a] Rate of change in last twelve months.
[b] New definitions were introduced in 1991.
SOURCE: Based on Central Bureau of Statistics.

trend would continue—alongside the moderate interest-rate increases at the beginning of the year, so that real interest did not rise. The large interest-rate hikes at the end of the year, however, appear to have had a moderating effect (see Chapter 7).

Despite the reduction of the domestic deficit in 1994—the third successive year that it was below the target level—fiscal policy was on the whole expansionary. High wage increases and the marked expansion of public-services employment caused both public and private consumption to rise as wage income expanded. The wage increases also pushed up the price of public services (health, education, etc.), raising doubts as to the extent to which the government was willing and able to adhere to the inflation target.

In 1994 the government introduced several measures to reduce the inflation rate. In May 1994 it implemented a land sales campaign with the object of bringing down housing prices, which had accelerated at the end of 1993 and the beginning of 1994. This may have contributed to the easing of the rate at which housing prices rose at the end of 1994 (see Chapter 2). Steps were also taken to slow the increase in prices of fruit and vegetables. Import permits were issued, but high purchase prices and transport costs prevented imports from bringing prices down. The government also acted to reduce prices by lowering indirect taxes. In September, amid growing fears that inflation was accelerating, the government approved the 1995 expenditure budget in nominal terms, thereby signaling its commitment to reducing inflation. The approval of a supplementary budget towards the end of the fiscal year undermined the credibility of this message, however (see Chapter 5).

Table 3.5
Price Developments: Related Indicators, 1990–94

(annual change, percent)

	Average						During period[a]				
	1987–89	1990	1991	1992	1993	1994	1990	1991	1992	1993	1994
Price changes											
Imports											
Intermediates[b,c]	16.6	7.3	8.0	4.4	9.0	9.1	14.3	5.2	20.6	9.4	4.6
Consumer goods[c]	10.7	12.1	9.4	10.7	14.0	7.0	7.6	4.8	13.6	4.9	10.8
Producer durables[d]	11.8	8.5	15.0	10.6	9.4	5.2	4.9	15.3	12.8	5.8	–6.4
Exports (excl. diamonds)[d]	16.1	8.4	11.1	8.2	8.8	4.5	8.6	12.1	10.6	5.4	3.8
Real change in GDP and use of resources											
GDP[d]	3.5	5.9	6.2	6.7	3.4	6.5	9.8	8.5	0.1	10.1	2.4
Domestic use of resources[d,e]	3.3	8.1	12.2	6.9	5.2	8.0	12.6	15.2	0.3	10.1	4.0
Exports (excl. diamonds)[d]	4.0	5.9	1.3	14.4	12.5	8.8	3.1	13.5	4.4	14.6	8.7
Unit labor costs	0.6	–2.5	–5.9	0.2	1.9	2.5					
Nominal change in labor costs											
Public-sector wages per employee post	25.2	17.4	20.9	11.5	12.2	23.7	18.6	18.6	11.1	12.6	27.7
Business-sector wages											
Wage per employee post	22.7	15.5	12.8	14.0	11.2	12.1	20.3	11.8	14.3	10.3	8.4
Wage per employee post excl. COLA[f]	17.3	9.7	6.9	11.9	8.3	8.4					
Wage per man-hour	47.4	15.0	13.3	11.3	10.9	9.8					
Unit labor costs	21.6	8.4	12.1	10.9	12.5	10.8					

General government deficit (percent of GNP)											
Total	–2.7	–4.2	–4.3	–2.9	–2.8	–1.0					
Domestic	–4.2	–7.1	–7.3	–6.2	–4.4	–2.1					
Monetary indicators											
Change in M1	40.6	28.3	26.7	22.4	25.9	19.6	31.0	13.8	33.6	28.4	7.8
Change in M2	39.5	26.1	33.6	24.3	29.7	43.2	43.0	25.8	21.7	41.3	34.6
Interest rate											
Bank credit	41.8	26.4	26.4	19.9	16.4	16.9					
SROs	47.5	13.2	12.9	10.3	9.7	10.8					
Long term[g]	3.4	1.2	2.1	2.3	2.8	2.9					
Unemployment rate	7.1	9.6	10.6	11.2	10.0	7.8					
Change in exchange rates											
Currency basket	10.3	10.6	12.3	10.2	12.1	7.8	11.1	11.6	14.9	8.0	5.4
Dollar	9.1	5.2	13.0	7.9	15.1	6.4	3.7	13.7	16.9	10.1	1.8

[a] Change from fourth quarter of preceding year to fourth quarter of current year.
[b] Excluding fuel and diamonds.
[c] Foreign trade data at effective exchange rate, including tariffs.
[d] National accounts data.
[e] Excluding direct defense imports.
[f] Nominal wage increase not due to increase in prices. COLA = Cost of Living Allowance.
[g] Real gross yield to maturity on 5-year government bonds.
SOURCE: Based on Central Bureau of Statistics data.

Annual inflation and budget deficit targets have been announced by the Bank of Israel and the Ministry of Finance since 1992. The advantages of the system are that it increases certainty and stabilizes inflation expectations, providing consumers and producers with a long-term planning horizon and reducing rigidities. It also reinforces the policy-makers' commitment to attaining the targets, since their credibility is at stake. If the targets are not attained, the ensuing economic cost is expressed by the gap between expectations and actual developments as well as by policy-makers' impaired credibility.

The inflation target for 1992 was set at 14–15 percent, and the slope of the exchange-rate band at 9 percent (Table 3.4). The actual rate at which prices rose in 1992 was a surprisingly low 9.4 percent. The decline from the 18 percent inflation rate that had prevailed from 1986 to 1991, when the crawling exchange-rate band and the target rates were first employed, may have reinforced the credibility of the system, even though in 1992 the rise in the CPI was less than had been announced, and this was influenced by other important factors (the slower rate of increases in wages and foreign trade prices). In November 1992 a 10 percent inflation target was announced for 1993, but during the year the actual rate rose by more—11.2 percent. Even though the inflation target was not attained, the deviation does not seem to have been perceived by the public as significant, possibly because the budget deficit target was met, the annual rate of depreciation was in accordance with the slope of the exchange-rate band, and the actual divergence from the target was quite small.

In July 1993 an 8 percent inflation target for 1994 was announced, in the context of the moderation of the rate at which prices rose and the nonfinancial economic activity of the preceding months. It was accompanied by the announcement of a low budget deficit target, with a reduction in the slope of the exchange-rate band (and also an adjustment of the midpoint rate) and in the nominal interest rate. In the last quarter of 1993 prices accelerated, giving rise to fears early in 1994 that the inflation target for the year would not be met. As demand increased and many price indices accelerated from the second quarter of 1994, these fears were realized, and a further acceleration of inflation appeared imminent.

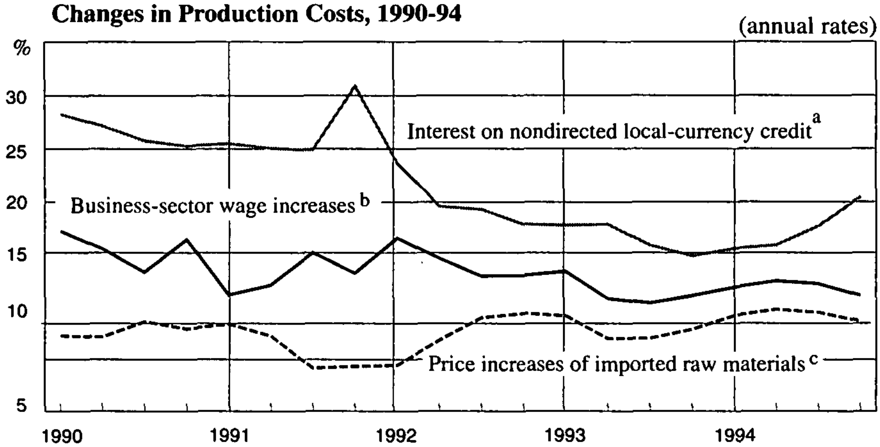
In the context of wage developments in the public services, the monetary expansion of 1993, and the faster increase in the CPI than the target, the adaptation of the economic variables to the 8 percent inflation target in the second half of 1993, and especially the reduction of the slope of the exchange-rate band to 6 percent, created an imbalance in the nominal system, thereby helping to reinforce real appreciation. During 1994 inflation expectations grew, together with the level of uncertainty.

In September 1994 the Ministry of Finance and the Bank of Israel announced an 8–11 percent inflation target for 1995, indicating both their commitment to bringing the inflation rate down by adopting the appropriate policy and their acknowledgment that the acceleration of the CPI in 1994 reflected only a temporary divergence from the downward inflation trend. Nonetheless, even though the policy-makers' determination to adhere to the inflation target appears to have strengthened in 1994, together with the public's awareness of the target, developments during 1994 and the departure from the target raised doubts as to the extent to which the latter could be attained. Thus, while many price indices eased in the last quarter of 1994, reflected by the public's lower expectations, at the end of 1994 these expectations were higher than the 1995 target.

Cost variables

Nominal unit labor costs in the business sector reflect changes in nominal wages, man-hours, and productivity, and hence provide a good estimate of labor costs. These rose by 10.8 percent in 1994, down from 12.5 percent in 1993 (Table 3.5). The change in business-sector labor costs in 1994 reflects a moderation of the increase in wages per man-hour—which rose by 9.8 percent, compared with 10.9 percent in 1993—and in output per man-hour, which rose by 7.8 percent, compared with 8.9 percent in 1993.

Figure 3.5
Changes in Production Costs, 1990-94



[a] Quarterly averages in annual terms.
[b] Rate of change of quarterly averages in annual terms.
[c] Excluding fuel and diamonds. Rate of change of four-month moving average.
SOURCE: Based on Central Bureau of Statistics data.

The rate at which the average wage per employee post rose accelerated from 11.5 percent in 1993 to 15.2 percent in 1994. Most of this derives from high wage increases in the public services in 1994 (23.7 percent), while in the business sector there was no significant change in the rate of increase, the average wage rising by less than the CPI—11.8 percent, after an increase of 11.2 percent in 1993. The expansion of employment appears to have increased the proportion of employees earning low wages, thus moderating the average wage rise in the business sector. It may also be due to the large number of wage contracts signed in the business sector in 1992 which covered several years (see

Chapter 4). Although there was no actual acceleration of wages in the business sector, there was upward pressure on prices of goods in 1994, because producers expected that in view of the considerable decline in unemployment, wage rises in the public sector would spill over to the business sector.

Wages rose steeply in construction, agriculture, and the public services. Wages in construction and agriculture were affected by the closures imposed on the administered areas in 1993 and 1994, and by the steep rise in the proportion of Israeli employees in those industries. Public services wages rose as a result of wage agreements, contributing to the 14.9 percent increase in the price of these services.

Local-currency prices of imported intermediates excluding fuel and diamonds rose by 9.1 percent on average in 1994 (9.0 percent in 1993) (Table 3.5), while fuel prices rose by 4.1 percent (2.1 percent in 1993), due to the rise in world oil prices and despite the lowering of import tariffs during the year.

Alongside the acceleration of price increases, average nominal interest on local-currency credit rose from 14.7 percent at the end of 1993 to 20.3 percent at the end of 1994. This means that firms' financing costs rose significantly, exerting pressure for a one-off increase in prices (while inflation had a dampening effect on demand). However, since the marked interest-rate hikes occurred mainly towards the end of the year, they did not exert upward pressure on production costs throughout the year.

3. THE DEVELOPMENT OF PRICES

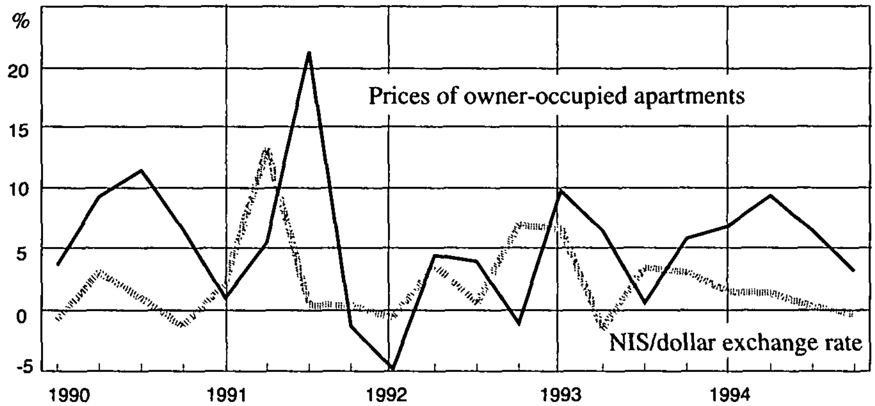
Housing

The index of housing prices rose by 23.6 percent during 1994, similar to the 1993 rate. Prices of owner-occupied housing (sales) rose particularly steeply—by 27.8 percent, while rents rose by only 4.4 percent.

The relative price of housing has been rising since the end of the 1980s, due to the influx of immigrants—primarily from the former USSR—and the addition of large cohorts of 24–30 year-olds to those requiring housing. In recent years demand for housing has also been affected by the public's investment considerations (see section on construction in Chapter 2). In 1990–92 government involvement in construction expanded appreciably, but this did not lead to a significant reduction of housing prices, *inter alia* because construction took place in outlying areas, where demand was low.

The rate at which prices of housing rose moderated in 1992, and its relative price fell by 5.5 percent. In 1992 and 1993 the government reduced its involvement in construction, and this together with the labor shortage arising from the closure of the administered areas in March 1993 served to reduce supply. Demand pressures increased because immigrants began to establish themselves and monetary policy was expansionary, so that the relative price of housing rose by 12.9 percent in 1993.

Figure 3.6
Housing Prices, 1990-94[a]



[a] Rates of change of quarterly averages.
SOURCE: Based on Central Bureau of Statistics data.

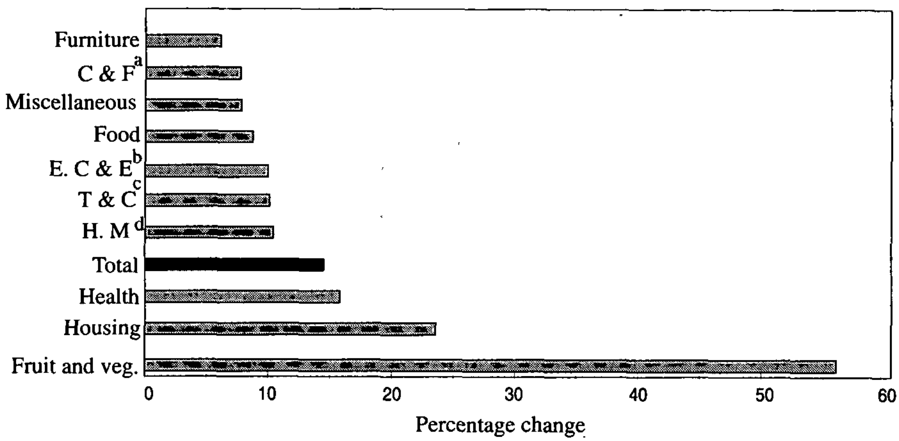
The forces operating on aggregate demand in 1994 also applied to the housing market, and the trends evident in 1993 persisted in the first half of 1994. As stated, the public's portfolio adjustment—in the wake of the decline in real interest at the end of 1993, the immigrants' integration and the adaptation of their portfolio to that of the established population, and progress in the peace process—also affected the housing market. The fall in share prices on the stock market did not necessarily depress housing prices, because although the decline in the public's assets should reduce the demand for housing, real estate can serve as an alternative to shares as a channel of investment. In May 1994 the government began to implement a program intended to moderate the rate at which housing prices rose. While the effects of the program on the extent of construction and supply of apartments should be evident in the next few years, expectations appear to have led to some moderation of the rate at which housing prices rose by the second half of 1994 (Figure 3.6), so that their relative price rose by 11.6 percent in 1994.

Because of the way the CPI is constructed, it is difficult to estimate the net value of housing services. The more moderate increase in rents than in prices of owner-occupied housing indicates that the demand for housing is affected to a great extent by investment considerations, which appear to have contributed to the surge in this item in 1994.

Other items

Apart from the steep rise in the price of housing relative to the CPI, there was also a marked increase in the relative price of fruit and vegetables, which rose at an annual average rate of 8.1 percent. This accelerated, mainly in the second half of the year, so that their average nominal price rose by 21.4 percent in 1994, after rising by 0.6 percent in 1993 (during 1994 prices of fruit and vegetables rose by 56.1 percent, after declining by 1.2 percent in 1993). This item is characterized by wide annual and monthly variance. The fluctuations in these prices derive from the inelasticity of demand, as well as of supply in the short run, partly because of import restrictions. Prices of fruit and vegetables rose in 1994 due to supply-side factors—weather conditions and the deliberate contraction of crops produced by farmers. In order to moderate the rate at which fruit and vegetables prices were rising, imports were permitted towards the end of the year, but because of the high purchase prices and transport costs, prices did not fall (see section on agriculture in Chapter 2).

Figure 3.7
Annual Rates of Change of Main Components of the CPI during 1994



[a] Clothing and footwear.
[b] Education, culture and entertainment.
[c] Transport and communications.
[d] Household maintenance.
SOURCE: Based on Central Bureau of Statistics data.

The lower inflation rate in 1992–94 than in 1986–91 is reflected by lower monthly and annual variance, as well as by the lower variance of other economic variables, such as the exchange rate and business-sector wages. Although price rises accelerated in 1994, their monthly variance declined. On the face of it, this result is surprising, but is due to the relative stability of the rate at which housing prices increased, while the variance of the CPI excluding housing rose slightly, as did that of the relative prices of main groups of consumer goods. Despite the lower variance of the monthly changes in prices in

1994, during the year economic instability and uncertainty, which are among the chief ills of inflation, increased. It is to be hoped that the acceleration of inflation in 1994 was merely temporary, and that Israel will soon return to a declining trend of inflation, approaching the level of the industrialized west.