CHAPTER III

PRICES

1. MAIN DEVELOPMENTS

Inflation slowed in 1981 according to most price indexes. The consumer price index, the most conventional measure, went up 101 percent after rising 132 percent in 1980. Thus the steady advance of prices, which got underway in 1978 and reached its peak in 1980, was checked in the year reviewed.

This was accompanied by the swelling of the government demand surplus, which was directly connected with the anti-inflationary policy followed in 1981. The government took direct action to moderate the rise of prices by deferring the hiking of controlled prices (thereby subsidizing them more heavily) and by cutting indirect taxes on a large number of products. These measures initially led to an immediate retarding of inflation, together with the absorption of liquidity from the public. In other words, there was an increased collection of indirect taxes on goods whose purchase was advanced in anticipation of a renewed stiffening of the imposts. Subsequently this policy caused the government's demand surplus to bulge, which in turn generated a much larger liquidity injection. While the accelerated spiraling of prices was stemmed, the heavier injection did not make it possible to persist in this policy for very long without causing a marked aggravation of inflation or a deterioration in the balance of payments, and so in the second half of the year the government began to partially adjust the prices of controlled goods and services while gradually scaling down the subsidies. The increased injection engendered by the government's demand surplus hardly affected the inflation rate during the year reviewed, since part of the extra liquidity was absorbed through the growth of financial saving, which was encouraged by the government, and a smaller part was siphoned out through private sector purchases of foreign currency.

The effect of this policy on the prices of goods and services not subject to control is unclear. These items (which are included in the consumer price index) became 113 percent dearer during 1981, compared with 128 percent the year before. However, indirect imposts on many of these items were reduced in the year reviewed, and so their prices were influenced by the government's direct tax policy. It is therefore hard to quantify the effect of this policy in 1981.

Table III-1
SELECTED PRICE INDEXES, 1968-81
(Percent annual average increase)

	Average 1968-1970	Average 1971-1973	Average 1974-1977	1978	1979	1980	1981
Consumer price index	3	15	36	51	78	131	117
Wholesale price index of industrial ouput[a]	4	14	40	53	79	136	123
Index of agricultural input prices[b]	5	14	41	51	78	146	118
Index of housing construction input prices	6	18	34	57	87	128	132
Index of road construction input prices	6	15	40	75	92	145	146
Exchange rate against the dollar[c]	5	6	26	67	46	102	123

[a] Excluding printing and publishing.
[b] Excluding 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.

The index of uncontrolled prices was also influenced by the changes in import prices (in foreign currency terms) and in the official rate of exchange. Imported consumer goods became 91 percent dearer during the year reviewed (at the official rate of exchange), compared with 132 percent the year before; hence import prices also contributed to the toning down of inflation in 1981.

The change in the implicit price deflator for GNP at factor cost[1] points to stability in the rate of inflation. In the case of the business sector product the deflator rose 136 percent in 1981, about the same rate as in the previous year.

Nominal wages in the business sector went up 132 percent in 1981; this too was similar to the 1980 figure, but less than the increase in the GNP deflator.

2. THE INFLATIONARY PROCESS, 1970-80

During the 1970s inflation in Israel steadily gathered momentum, reaching its peak in 1980. From 1970 to 1980[2] prices rose by a factor of 49, or an annual average of 42 percent.

There is no unanimity about the reasons for this process—with respect to either the qualitative relationship between different economic variables or their quantitative effect. The various explanations offered have emphasized

[1] The change in this index relates to the annual average level. No data are available on the movement of the index in the course of the year, and so there is no way of knowing the trend.
[2] December 1969 to December 1980.

separate aspects of the process, whose influence varied during different subperiods. The difficulty arises from the complex economic background against which inflation steadily escalated.

Throughout most of the decade there was no real unemployment in the economy, but neither was there full employment. The terms of trade fluctuated sharply (especially in the wake of the oil and raw materials price shocks), and this grew worse as the decade wore on; public consumption rose and the government demand surplus hit a record high following the Yom Kippur War (both have since retreated, but not to their previous level). In the wake of these developments tough measures were introduced, inspired *inter alia* by the persistent fear of a balance of payments crisis. These measures focused primarily on the steady devaluation of the official (or effective) exchange rate while attempting to dampen private consumption by stiffening taxes and eroding real wages, and for part of the period on the cutting back of investment. Policy was frequently revised sharply rather than gradually, and without allowing sufficient time for adjustment; sometimes there was even an abrupt change of direction.

The second half of the decade witnessed a growing tendency to link financial assets and the creation of new financial assets representing a good substitute for money, particularly after the liberalization of the exchange rate at the end of 1978. The public adjusted its inflationary expectations to reality more quickly than in the past; for this reason, and because of the new money substitutes, the short-term elasticity of demand for money apparently increased.

Until the raw materials crisis, inflation was thought to be largely of the demand variety, a result of pressures originating in both the commodity and labor markets. But after the global price shocks of 1973–74, the chief causes were assumed to be on the costs side; subsequently the blame was placed on a combination of imported inflation and demand pressures engendered by an enormously larger government spending. In the second half of the decade the wage-price spiral was cited as the main factor, and toward the end of the 1970s the stress shifted to self-fulfilling inflationary expectations.

It should be pointed out that the tailing off of economic growth after 1973 was in itself a cause of inflation, as it dampened the public's demand for increasing its real liquid asset holdings, with a consequent contraction of the real resources that the government could absorb from the public in exchange for supplying liquidity.[3]

[3] In a period of rising economic activity the private sector increases its real liquid assets at a rate roughly matching the rate of economic growth. Thus, for example, at the beginning of 1980 the public's net liquid asset holdings amounted to IS144 billion; it follows that an additional percentage point of growth would have enabled the government to pump IS1.4 billion into the economy in 1981 without affecting the price level or the balance of payments.

An increase in the public sector's real demand surplus implies an increase in the inflation tax the government collects from the public. Under such taxation the exchange rate has to be adjusted in order to prevent a real revaluation, the shrinkage of foreign exchange reserves, and the expansion of the import surplus. In view of the bulging government deficit and the slackening of economic growth, the exchange rate was adjusted more frequently and more automatically.

The repeated adjustment of the exchange rate, prompted by excessive anxiety over an expansion of the import surplus and the desire to prevent it, apparently led in several instances to the devaluation of the currency by more than was necessary to ensure a balance between the inflation tax and the government injection. However, reducing the import surplus and thereby improving the balance of payments through an overcollection of the inflation tax (i.e. greater than the government deficit) is not an immediate process, and in the meantime the monetary system must strive to prevent an increase in the quantity of money caused other than by the contraction of the import surplus. This condition did not exist in Israel, both because of the desire to prevent unemployment, as reflected in a deliberate policy of monetary expansion (as in 1974) and the provision of aid to sectors experiencing difficulties, and because of the existence of such automatic mechanisms as the directed credit arrangements, which make more credit available to certain sectors with a nominal increase in the value of their production. The main outcome of the overdevaluations was thus to speed up inflation.

3. THE INFLATIONARY PROCESS IN 1981

The inflationary process in 1981 was characterized by two seemingly mutually opposed features: a drop in the rate of inflation and the bulging of the government domestic demand surplus. These conflicting developments existed side by side and were even interrelated: the increase in the demand surplus stemmed from the cutting of indirect taxes and a heavier subsidization, which directly helped to depress commodity prices and the rate of inflation. As a result of this policy, the government injection in 1981 was much larger than it would have been had the indirect tax and subsidy rates in force in 1979 and 1980[4] not been changed, and it reached a record high relative to the amount of money in the economy. In 1981 the injection was 2.5 times greater than the money supply at the beginning of the year, whereas in 1974, for example, it amounted to 40 percent of the money supply. It should be added that this reflected not only the growth of the goverment deficit but also the shrinkage of the money supply because of the higher rate of inflation;

[4] In these years net indirect taxes amounted to 10–11 percent of GNP at market prices, while in 1981 they amounted to only 5 percent.

nevertheless, this ratio serves as an indicator of the degree of inflationary pressure latent in the government injection.

When the government runs as excessively large real deficit due to reasons other than a deliberate expansionary policy, the central bank is supposed to act to moderate the inflationary impact of the deficit. But in view of the tough squeeze measures adopted by the Bank of Israel in 1979 and 1980, it could not further tighten them without harming real economic activity. Hence the steps taken in 1981 were similar to those the year before, with the result that monetary policy did not counter the government injection.

The indexes of controlled and uncontrolled prices (see Figure III-3) clearly show that the marked deceleration of controlled prices was mainly responsible for the cooling of inflation, as reflected by the consumer price index: controlled items became 65 percent dearer this year, as opposed to 150 percent in 1980. Uncontrolled prices also went up at a more laggard rate. Two contributory factors were undoubtedly the reduction of indirect taxes and this year's much milder rise of imported consumer goods prices (at the official rate of exchange). The increase here came to only 91 percent in contrast to 123 percent the year before, mainly because of the decline in the dollar prices of these products (see Table III-3). In the light of these data it is difficult to determine whether or not there was an additional effect, produced by the ebbing of inflationary expectations.

There is no way to measure inflationary expectations directly, and certainly not their influence on the pricing policy of firms. The changes in the circulation velocity of money and in nominal interest rates are generally taken to be indicators of inflationary expectations. The velocity of circulation accelerated in 1981, which suggested a sharpening of such expectations; on the other hand, nominal interest rates declined, signalling a moderation of expectations.[5] It should be noted in this context that a faster circulation velocity may also reflect other phenomena, such as a more efficient use of money substitutes; hence we can only conclude that the indicators point to a curtailment of mounting expectations.

The flagging of inflationary expectations and a connsequent milder hiking of prices by firms should be reflected in the factor-cost price level of goods. In the absence of direct information on these prices we can examine indexes in which the direct effect of subsidies is relatively weak. While these indexes do not point to a slowing of inflation, they do show that it did not grow worse in 1981. Uncontrolled prices included in the consumer price index (which are not subsidized) rose less rapidly this year, the residential and road construction input price indexes moved up at roughly the same pace as in 1980, while the implicit deflator for the product at factor cost does not show any tapering off of the price advance.

[5] See Tables VIII-4 and VIII-5.

Figure III-1
QUARTERLY MOVEMENT OF CONSUMER PRICES, 1974-81
(Percent monthly change)

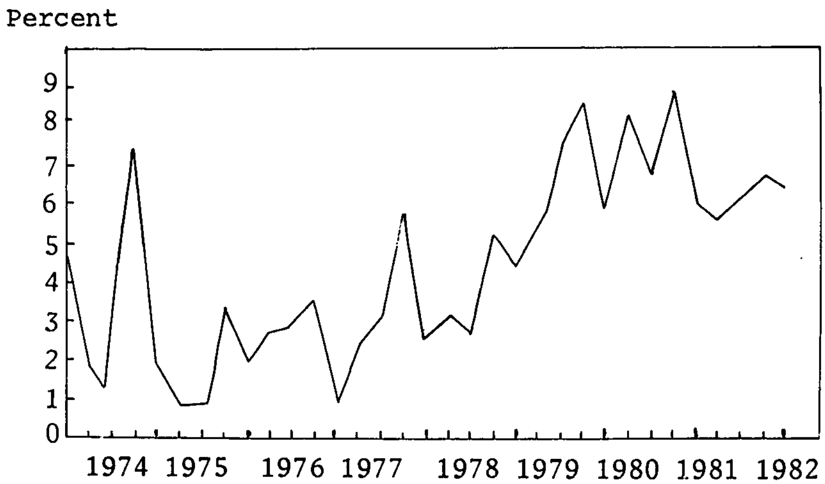
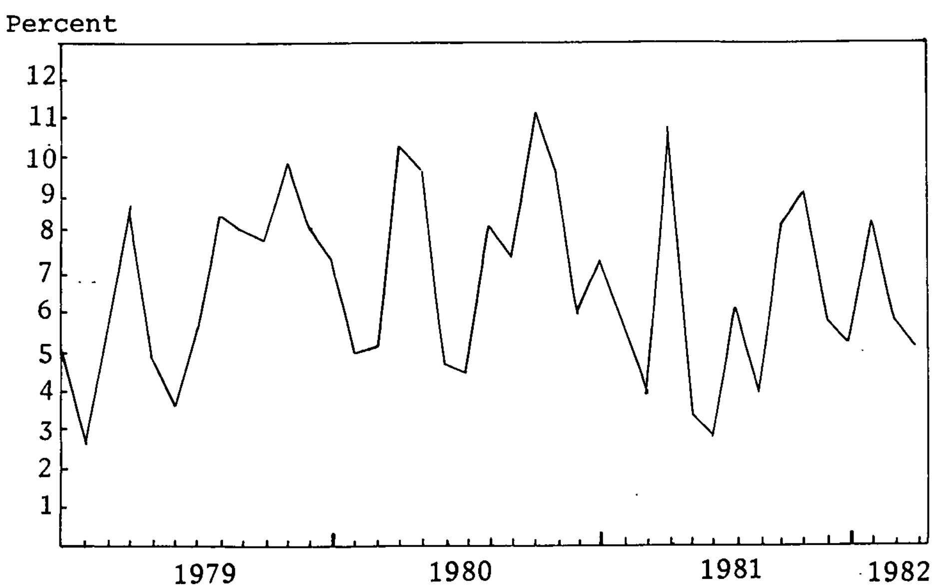


Figure III-2
MONTHLY CHANGE IN CONSUMER PRICE INDEX, 1978-81
(Percentages)



IMPLICIT DEFLATOR FOR BUSINESS SECTOR PRODUCT AT MARKET PRICES AND FACTOR COST, 1979-81

(Percent annual average increase)

	Gross domestic business sector product	
	At market prices	At factor cost
1979	73	74
1980	138	136
1981	121	136

As to the question of the time-gap between the reduction of prices because of an increased subsidization and the appearance of inflationary pressures generated by the resulting government injection, no clearcut answer can be given. There were two elements in the indirect tax reduction policy: the lowering of indirect imposts on highly taxed goods and a heavier subsidization of certain items. The tax cuts sparked a buying spree in such goods (i.e. the advancing of purchases), since the public suspected that this was a temporary measure.[6] As a result, the tax cuts were accompanied by the absorption of money from the public at the beginning of the year. It should be stressed, however, that such a situation cannot last very long; it will reverse itself and produce a relative growth in the quantity of money as soon as the buying spree fizzles out.[7] The second policy ingredient—a heavier subsidization by refraining from adjusting the market prices of the items for a rise in their factor cost—had an immediate expansionary effect on the government injection, though the increase was gradual and at the beginning of the year hardly significant.

As mentioned, most of the money pumped into the economy by the government served to swell the public's financial assets portfolio. The expansion of the portfolio by more than can be normally attributed to economic growth gives reason to believe that the impact of the government injection on prices and the balance of payments has yet to be felt, though this cannot be said for certain. In 1981 the public's financial asset holdings[8] rose 15 percent, after a 20 percent increase in the previous year, while the average growth rate for the last three years was similar to the 1976-78 level. But there was a striking difference between the two periods: in the past, financial assets expanded more or less in tandem with physical assets; in the last three years, however, financial assets averaged 10 percent higher per annum, as against 6 percent for

[6] In retrospect, it became clear that the policymakers intended to keep on lowering these taxes in conformity with long-term economic aims.

[7] Excluding, of course, goods with a high demand elasticity, where the reduction of taxes increases sales and consequently total tax receipts each year.

[8] For an estimate of the private nonfinancial sector's wealth see Table VIII-9.

physical assets.[9] This accumulation of financial assets may suggest a certain disequilibrium in the assets market, i.e. the public had not yet managed to turn to the goods and services markets. This was not the sole reason, and there may be other valid explanations. For one, the public probably did not regard the pruning of indirect taxes as representing a permanent addition to its income, and expected them to be raised again; hence, instead of stepping up its spending, it placed its extra income in linked assets that preserve their value, in order to spread the consumption of this one-time income over a number of years. For this reason no rapid flight from financial assets to goods and services must perforce be expected, nor do they constitute an inflationary timebomb. It is also conceivable that the growth of financial assets did not deviate widely from the desirable long-term trend, and that part of the growth compensated for the shrinkage of the portfolio in the past. Another reason for the accumulation of financial assets was the deliberate increasing of their return under the government's policy (see Chapter VIII). These assumptions are supported by the fact that most of the financial asset growth took place in the savings schemes, but only the new ones featuring a two-year maturity period. In the light of all this, it cannot be said for certain that the reduction of indirect taxes merely deferred the acceleration of inflation to some future date.

The toning down of the price advance despite the larger government injection can also be reconciled with the explanation of the inflationary process presented in the previous section. Every government injection can potentially engender a rise in prices that will equate the inflation tax on the money supply with the magnitude of the injection, thus eroding any injection-related increment to liquidity and income. It may have happened in the past that the devaluation-induced inflation far exceeded the rates that eroded the government injection. The money supply accommodated itself to the level of inflation, thereby making it possible for the government to pump more money into the economy while inflation could slow down without affecting the balance of payments.

4. PRICE INDEXES

(a) Consumer Price Index

The consumer price index moved up more slowly than in 1980, with the usual fluctuations around the trend. Both the monthly and quarterly measurements (see Figures III-1 and III-3) show an acceleration at the end of 1981 and beginning of 1982 in comparison with the beginning of 1981. The

[9] The estimate of physical assets is not exact and does not include, of course, human capital. Nevertheless, there is clearly a difference in the rate of increase of the two types of assets as defined here.

Table III-2
SELECTED PRICE INDEXES, 1977-81
(Percent increase, at annual rates)

						1980				1981				1982
	1977	1978	1979	1980	1981	I	II	III	IV	I	II	III	IV	I
1. Consumer price index														
General index	42	48	111	133	101	96	154	116	174	98	91	102	116	109
Housing	29	57	159	107	132	78	129	81	149	117	145	138	129	155
Food [a]	50	39	136	152	62	137	153	159	161	83	29	65	75	154
2. Wholesale price index of industrial output	50	47	114	138	104	116	141	129	169	124	95	101	101	131
3. Official exchange rate														
Against the dollar	76	24	86	113	107	98	96	106	178	102	178	74	82	124
Against the basket of currencies [b]	94	40	94	106	81	61	136	105	119	68	102	73	112	87
4. Index of input prices														
Housing construction	40	58	117	134	109	89	197	109	155	140	138	129	47	132
Road construction	61	66	124	152	122	97	156	151	209	153	109	156	80	125
Agriculture	45	46	115	150	96	135	178	121	170	111	94	76	105	158

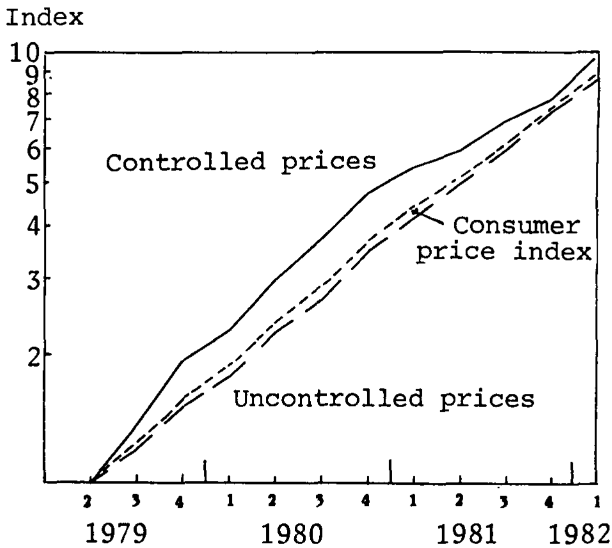
[a] Excludes fruit and vegetables.
[b] Basket of 15 currencies, weighted according to the percentage of imports from these countries.
SOURCE: Central Bureau of Statistics and Bank of Israel calculations.

advance of controlled prices slackened at the beginning of 1981, but picked up steam toward year's end. This component of the index was still higher at the end of 1981 than uncontrolled prices (base level: beginning of 1979), owing to the scrapping of most of the subsidies. Food went up at a very sluggish 62 percent rate because of the restoration of its price support.

Figure III-3

CHANGES IN CONSUMER PRICES: GENERAL INDEX, CONTROLLED PRICES,[a] AND UNCONTROLLED PRICES, 1979-81

(June 1979=1)



Semilogarithmic scale.

[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, fuel for domestic use, school fees (kingergarten, elementary, and secondary), cigarettes and other tobacco products, urban and interurban public transport, and postal services. The weight of these items in the consumer price index (with base 1980=100) is approximately 24 percent.

(b) Wholesale Prices of Industrial Output for the Domestic Market

As with the consumer price index, here too there was a significant slowdown, which was directly connected with the subsidization policy. No acceleration was apparent toward the end of the year, but in the first quarter of 1982 the index moved up faster, in annual terms, than at the beginning of 1981 (see Table III-4).

Table III-3

INDICATORS OF THE EFFECT OF THE SUBSIDY AND INDIRECT TAX POLICY ON THE CONSUMER PRICE INDEX, 1979-81

(Percent annual increase)

	Controlled prices [a]	Uncontrolled prices	Consumer price index	Imported consumer goods prices, in dollars [b]	Exchange rate of the sheqel against the dollar [b]	Imported consumer goods prices at official exchange rate
1979	153	101	114	7	71	83
1980	150	128	133	9	111	132
1981	64	113	101	-11[c]	115	91

[a] See the note to Figure III-3.

[b] The change between the average indexes for the last quarter of the year.

[c] Data for the last quarter of 1981 are provisional.

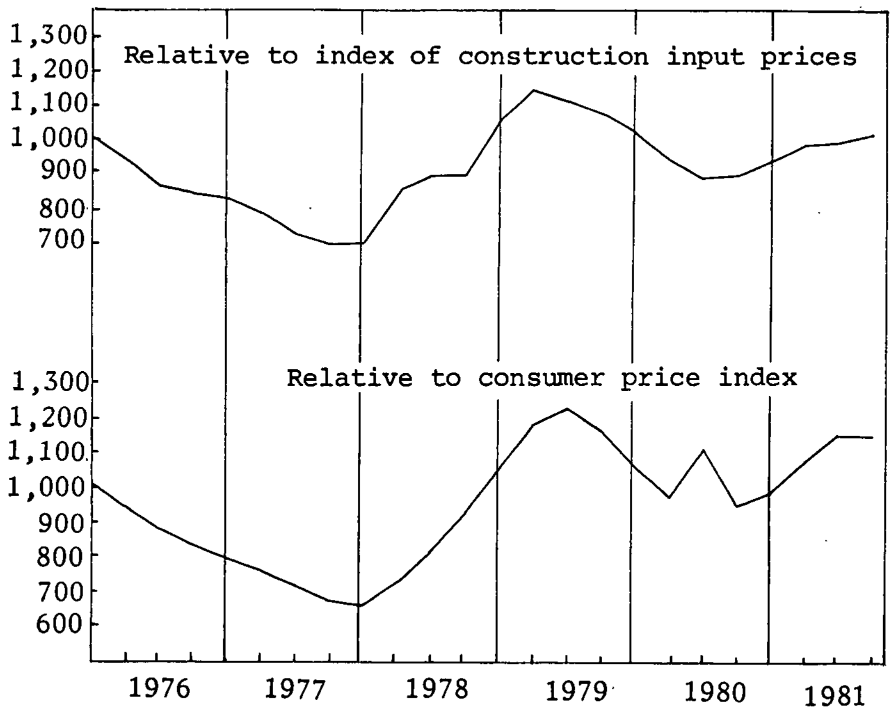
(c) Input Prices

Input prices rose less rapidly in 1981, especially in agriculture, apparently because of feed subsidies. All the indexes show an acceleration in the first quarter of 1982 compared with the 1981 average (see Table III-4).

(d) Housing Prices

Changes in this index were examined in relation to the consumer price index and the index of construction input prices. In 1981 housing prices went up in real terms, after declining in 1980. This signified some recovery of the housing market, though the rise may have stemmed partly from a decrease in supply rather than an increase in demand. The picture holds true for both the aforementioned indexes.

Figure III-4
INDEX OF DWELLING PRICES,[a] 1976-81



[a] See the note to Table III-4.

Table III-4

INDEX OF DWELLING PRICES, 1976-81[a]

(Average October 1975 to March 1976=100)

Year and month	Index of dwelling prices	Relative to consumer price index[a]	Relative to index of construction input prices[a]
1976 January	100.0	1.000	1.000
April	101.4	.944	.942
July	102.7	.879	.867
October	105.7	.832	.845
1977 January	107.6	.794	.830
April	108.6	.760	.788
July	110.0	.718	.727
October	116.2	.673	.696
1978 January	129.3	.662	.700
April	156.1	.725	.853
July	191.3	.817	.897
October	240.5	.926	.900
1979 January	313.0	1.058	1.057
April	403.7	1.175	1.144
July	497.4	1.220	1.116
October	587.4	1.166	1.077
1980 January	663.8	1.059	1.019
April	753.4	.972	.942
July	896.6	1.108	.891
October	1,118.0	.946	.898
1981 January	1,456.8	.990	.937
April	1,905.4	1.077	.982
July	2,387.5	1.151	.997
October	2,848.3	1.152	1.018

[a] This index is measured as six-month averages. The first column gives the midpoint of each six-month period covered in the survey of dwelling prices. For comparative purposes the consumer price index and the index of construction input prices are presented for the same periods.

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