CHAPTER IX

PRICES

1. MAIN DEVELOPMENTS

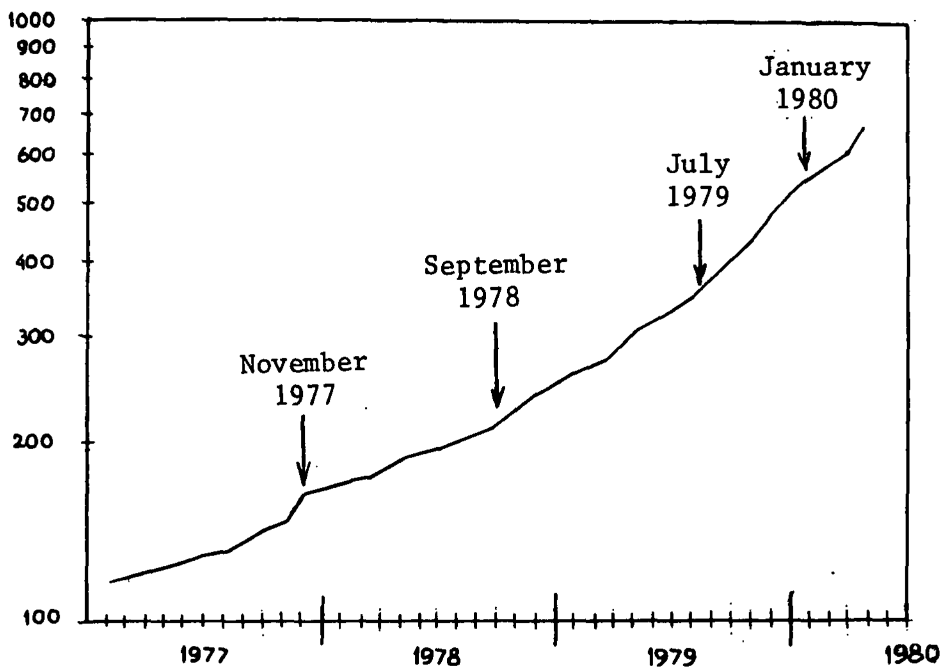
Prices in the Israeli economy increased at a record pace in 1979, with inflation exceeding 100 percent during the year. This high rate prevailed in all markets, both production inputs and final products: in the period between December 1978 and December 1979 consumer prices rose by 111.3 percent, wholesale prices of industrial output for the domestic market by 113.2 percent, and prices of inputs by 116.6 percent in agriculture, 116.5 percent in residential construction, and 123.8 percent in road construction.

These figures represent a new phase in the inflationary process that has plagued the Israeli economy in recent years. After 1973 inflation ran at a 30-40 percent annual rate—a development whose origins lay in the deterioration of the balance of payments following the oil crisis and the rise in defense spending in the aftermath of the Yom Kippur War. A policy of persistent devaluations and heavy taxation helped to improve the balance of payments, but it generated increases in prices, wages, and the exchange rates when the economy was relatively stagnant. When the recession ended in 1978, the growth of demand intensified the inflationary process and the spiral accelerated. A turnabout in residential construction at the end of 1977 played a major part in this development, stimulating demand and the advance of prices. The foreign currency reform in October 1977 included a substantial increase in the price of imports, which was immediately reflected in domestic price hikes. Furthermore, the reform contributed to the bulging of total demand by enlarging private wealth (through the appreciation of assets denominated in foreign currency) and, especially, by increasing the demand for local products, which were now relatively less expensive.

The rise in demand, which first appeared at the end of 1977 in the housing market, spread through the entire economy during the following year. The expansion of demand, along with import substitution, exerted upward pressure on domestic prices because of labor market constraints, which hindered the short-term growth of domestic output. Wages were also affected by the labor shortage: wage

Figure IX-1

CONSUMER PRICE INDEX, 1977-80
(1976 = 100)



earners were given full compensation for all price rises and a real increase as well, even though the formal agreements provided for only partial compensation. All these developments led to a doubling of the pace of inflation by the end of 1978 as compared with the start of the year and with several previous years.

The 1978 trend of economic activity and the expansion of demand carried over into the first half of 1979. At the beginning of the year an even faster rate of growth was anticipated, which did not materialize since a larger portion of domestic demand was diverted to imports. Continued economic growth against a background of protracted inflation and full employment fostered expectations of a further, rapid spiraling of prices, which did in fact take place: the average monthly inflation rate of 5 percent recorded in the fourth quarter of 1978 (80 percent on an annual basis) persisted through the first half of 1979. Prominent among the cost components was the rapid increase of wages at a rate in excess of inflation. This

Table IX-1

SELECTED PRICE INDEXES, 1976-79
(Percent change during the period, at annual rates)

					1978—quarterly				1979—quarterly			
	1976	1977	1978	1979	I	II	III	IV	I	II	III	IV
1. Consumer price index												
General index	38	42	48	111	35	44	36	82	66	93	133	168
Housing[a]	23	29	57	159	28	69	41	101	119	213	173	142
Food[a]	41	50	39	162	28	25	36	70	71	71	208	243
Electricity, water and fuel[a]	28	56	28	169	58	2	0	62	120	20	278	426
2. Wholesale price index of industrial output	39	50	47	114	33	47	42	68	62	110	132	165
3. Index of dwelling prices[b]	7	22	144	101	103	138	153	192	160	136	80	47
4. Official exchange rate												
Against the dollar	22	76	22	82	32	29	21	9	36	119	71	113
Against the basket of currencies[c]	23	94	40	89	71	26	59	11	38	118	63	169
5. Import prices in dollars[d]												
Total imports excluding diamonds	8	7	11	36	14	2	11	18	29	28	75	17
Consumer goods	6	10	13	19	20	-1	10	23	17	5	46	12
6. Index of input prices												
Housing construction	30	40	58	117	50	100	48	41	68	193	129	95
Housing construction, excluding wages	27	47	55	119	46	51	51	74	89	134	118	136
Road construction	25	61	66	124	69	71	47	76	92	110	135	164
Agriculture	41	45	46	136	30	59	54	43	55	110	176	138

[a] The weight of these items in the index for the base year (1976) is as follows: housing—20.5 percent; food—19.0 percent; electricity, water, fuel—3.6 percent.
[b] Dwellings purchased from private owners, based on the quarterly survey of dwellings.
[c] Basket of 15 currencies, weighted according to the percentage of imports from the various countries.
[d] Quarterly figures represent the difference between average prices in the current and previous quarter (at annual rates); annual figures represent the difference between final quarter prices in the current and the previous year.

was a departure from established wage agreements and reflected fears of a continued high rate of inflation together with mounting uncertainty, since the cost-of-living increment provided only partial and delayed compensation. An important external factor which contributed to the escalation of inflation was the doubling of international oil prices during 1979.

In the second half of 1979, and particularly in the last quarter, a slowdown in economic activity was apparent. It was first evident in the tailing off of demand for homes and durable goods and a slackening of the labor market. Among other factors, this slowdown may have been due to the implementation of a tight monetary policy, which resulted in the reduction of credit and a rise in real interest rates. Nevertheless, it was during the second half of the year that prices increased drastically: the inflation rate nearly doubled, reaching a monthly average of 8 percent. This happened against the backdrop of a faster devaluation of the Israeli pound (in the second quarter, after a period of more moderate decline), large wage increases, and expectations of continuing inflation. Price hikes in basic commodities, fuel, electricity, and water gave an added boost to the general process.

Throughout this period the upward pressure on prices could be translated relatively easily into price increases due to some unusual features of Israel's monetary system. Most liquid assets are linked, either to the consumer price index or to the exchange rate, while most liabilities to the government are unlinked. The linked liquid assets constitute a liquidity reservoir unaffected by inflation; in contrast, inflation gradually erodes the public's debt to the government. The monetary expansion of 1977-78 was accompanied by a further reduction in the proportion of unlinked assets in total liquid assets, and thus by a further inhibiting of the stabilizing effects of the monetary system. Furthermore, the escalation of inflation produced substantial capital gains on unlinked debts, thus further stimulating demand and, in its wake, inflation too.

It should be noted that many of the factors that spurred inflation in the past two years were themselves products of the prolonged price rise. Though the various indexation arrangements tended to perpetuate inflation even after the factors that had set it in motion were somewhat alleviated, partial or no indexation at such high rate of inflation contributed to a further deterioration in the price structure: since wages were not fully indexed, workers demand agreements called for extremely high nominal wages; unlinked government credit helped to augment demand, and thus prices as well; failure to index the system of direct taxes on wages and profits led to additional wage demands and price hikes. Given the existence of all these practices, even a minor push from external factors can cause a major acceleration of the inflationary process.

During 1979 credit became more expensive and restricted in volume; but because of the factors that had a strongly accelerating effect on prices during the year, this apparently did more to dampen demand than to reduce inflation. In November a "new economic policy" was proclaimed, providing for major price increases through the elimination of subsidies on basic commodities, public transportation, electricity, and water; fuel prices were raised in December. In addition, credit was frozen for a number of months, and an obligatory 10 percent deposit requirement was imposed on imports for a six-month period. These steps were designed to curb inflation by reducing liquidity and causing a slowdown in economic activity. Their immediate effect, however, was a further increase in prices.

At the beginning of 1980 the economic slowdown became more pronounced, and some cooling of inflation was also apparent—prices rose by only 6 percent a month in the first quarter of 1980, down from the previous monthly average of 8 percent. In April a price increase of 10 percent was recorded.

2. THE INFLATIONARY PROCESS

During 1978 the inflationary process that had prevailed since 1973 changed in character. In the earlier period prices went up at an annual pace of about 30-40 percent, with deviations from this rate being related to external factors and were thus short-lived. But from 1978 the factors influencing prices brought about persistent changes in the rate of inflation: the 5 percent monthly rate (80 percent a year) that was reached toward the end of the year was maintained through the first half of 1979; by August the rate had accelerated to 8 percent a month (or 150 percent a year), and this new level also persisted for several months.

The roots of the inflationary process gripping the Israeli economy can be traced to the cost-push on prices that began in 1973 with the rise in world market prices of oil and other raw materials and with the increase in defense expenditure and in the balance of payments deficit following the Yom Kippur War. During that period there was a large growth in the demand and in the liquidity injections by the public sector, and its demand surplus reached a record level. These developments led to a policy of devaluation and tax increases from 1974 on—measures that succeeded in improving the balance of payments, but at the cost of an economic freeze accompanied by an annual inflation of 30-40 percent until 1977. The repeated devaluations and higher indirect tax rates set in motion a cost-price spiral, despite the leveling off of demand.

The contribution of the various cost factors to the rise in prices varied from year to year, but their combined impact remained about the same. Such a high order of inflation, maintained over a number of years, became a self-perpetuating process, fed by expectations and various linkage arrangements. In anticipation of a protracted inflationary spiral, the public was forced to hedge itself by linking both wages and savings schemes to the rate of inflation; but since the cost-of-living increments offered only partial compensation, the wage agreements had to compensate for past inflation as well as for the uncertainty associated with the prospective rates of inflation. Producers adjusted their prices in a similar fashion, and the wage-price spiral was well established. The monetary system underpinned these developments by constant expansion of the monetary aggregates through public sector injections and an increase in directed credit by the Bank of Israel; for much of the period the monetary expansion exceeded the rate of inflation. The private sector's nonindexed debt to the government was an additional cause of inflation;

the subsiby component of this debt grew with each round of price increases (see below).

Toward the end of 1977 the economy came to a turning point. The housing market rebounded from the slowdown which had characterized it for several years. The foreign currency reform went into effect at about the same time; this caused a 26 percent rise in import prices,[1] but also increased the public's wealth, thus stimulating the growth of demand and the emergence from the recession. As usual, the turnabout in the residential construction market, from recession to excess demand, caused a sharp rise in home prices, since the supply of homes is inelastic because of the lengthy construction time. The original shortage of dwellings and the consequent rise in prices usually lead to a further increase in demand, and the short-term inelasticity of supply magnifies the excess demand and drives up prices in the construction industry even further.

The growth of demand spread from the housing market to the entire economy in 1978: the rise in private demand accelerated, purchases of durable goods increased, and investment and public sector consumption turned up after having declined in the two preceding years. The renewed demand was directed toward both local products and imports, but due to the relatively steep jump in import prices in the wake of the foreign currency reform, most of the incremental demand in 1978 was channeled to the domestic market.[2] The heavier demand for domestically produced goods could not be easily satisfied by the rapid expansion of production, primarily because of labor force constraints. In contrast to the economy's emergence from the 1966-67 slump, the 1978 economic rebound occurred in a period of full employment in both Israel and the administered areas. The buoyant demand for labor exerted an inflationary influence on wages from the start of 1978.

To sum up, the aggravation of inflation at the end of 1978 occurred against a quite unusual background:

(a) the prolonged inflation and the expectation that it would persist, especially because previous inflationary expectations had been fulfilled;

(b) the foreign currency reform, which immediately sparked an exceptional rise in prices and hastened the process of import substitution because of the higher relative price of imports;

(c) the rapid rise in wages and import prices, which continued throughout the year;

(d) the virtually full employment situation in the labor market, even in the earlier period of relatively deflated demand;

[1] See the Bank of Israel Annual Report for 1977, Chapter X ("Prices").

[2] In those segments where domestic production competes with imports, import substitution took place. See the Bank of Israel Annual Report for 1978, Chapter IV ("Imports of Goods and Services").

(e) the supplying of more than the required amount of liquidity by the monetary system.

In these circumstances wage-earners, producers, and the government found themselves in a permanent struggle over the division of the national product. When demands revived against such a background, creating an excess demand in the labor market, the struggle intensified, leading to accelerated price increases. The latter development occurred toward the end of 1978, with the rise being steep in the case of consumer prices, and more gradual with respect to wholesale industrial prices.

The trends that characterized 1978 carried over into the first months of the following year. Domestic demands continued to mount, and imports and the balance of payments deficit rose at an accelerated pace. The number of employed went up, and unemployment fell to less than 3 percent of the labor force. The trend in prices also continued, with the consumer price index going up by some 5 percent a month (80 percent annually) in the first half of 1979, the rate that obtained in the last quarter of 1978. Housing prices also rose at the same rate as in the last quarter of 1978, reflecting the continuation of the prevailing trends in the residential construction market. Although housing starts did not increase, construction activity was at a high level owing to the 1978 expansion of starts. Home prices continued to pace the general price advance, and influenced other prices.

Substantial wage increases pushed up production costs in the first half of 1979; public sector wage hikes were particularly steep, but even in the business sector real wages went up noticeably. The higher nominal wage agreements apparently reflected both compensation for the more rapid inflation at the end of 1978 and a hedge against its expected continuation (possibly a premium for the uncertainty associated with future rates of inflation). The more inflation escalated the greater was the loss suffered by workers from the delayed and partial compensation provided by the cost-of-living allowance agreement. When wage pacts were renegotiated, employees tried to protect themselves against such losses by demanding high nominal increases, which themselves further stoked the inflationary process. These increases were thus eroded by ongoing inflation, and resulted in sharp real wage fluctuations, which have characterized the economy in recent years and grew more pronounced in 1978 and 1979. These fluctuations have been particularly sharp in the public sector, while private sector wages have adjusted better to inflation (see Chapter XI, "Employment and Wages"). The belated signing of wage agreements and the reopening of agreements that had already been signed (with the subsequent payment of sizable differentials) aggravated the fluctuations in the public sector. The exceptionally high increases awarded in the public sector not only stimulated demands, but prompted similar wage claims in the private sector, which gave the wage-price spiral another boost.

In this connection it is important to note the increase in direct taxes in recent years. Since tax brackets have not been fully adjusted for the inflation, income tax rates on wages have gone up while taxes have been collected on inflationary profits. The higher rates of income tax on wages have caused a widening gap between gross and net wages, and in a full employment situation this gap induces both wage demands and prices increase. The taxing of nominal inflated "profits" is another incentive for compensatory price increases.

The rate of exchange rose more slowly at the end of 1978 and early 1979, thus closing the gap between domestic and import prices created by the reform of November 1977. Despite the lower rate of devaluation, inflation did not slow down during that period. On the contrary, it accelerated because of the greater demand pressures prevailing throughout 1978. As stated, import prices rose sharply as part of the reform, and the livelier demand was therefore directed first and foremost toward domestic products. Subsequently, as the prices of such products advanced steeply accompanied by a slowing of the rate of devaluation, imported goods became relatively cheaper, and the trend toward import substitution that had prevailed in 1978 reversed itself in 1979. At the end of February the pace of devaluation quickened once again, while prices abroad were going up at a rate of some 20 percent. Thus during 1979 prices of imports (excluding oil) kept pace with domestic prices. It must be noted that the annual averages still showed a relative decline in import prices compared with 1978 (see the section on import prices below).

Imported fuel prices rose precipitously in 1979, after increasing at a relatively moderate rate from 1974 to 1978. The dollar price of oil doubled during the year, and the cost to the economy in the last quarter of 1979 was about four times greater than in the same period the year before. Prices of the various types of fuel for production and consumption were raised in Israel several times during the year. Although these increases did not fully reflect the actual changes in costs, the total percentage increase was far greater than that of the consumer price index.

In the second half of 1979 the housing market began to slow down: sales fell and the stock of units held by contractors expanded. The rise in dwelling prices eased off significantly, after unprecedented increases at the end of 1978 and the beginning of 1979. Other price rises accelerated during this period under the influence of two opposing factors: the mounting cost of inputs on the one hand, and the easing of demand on the other. The latter development was felt in the fourth quarter of the year, both in the labor market and in the consumer products market. In the latter purchases of motor vehicles and other durable goods tumbled, and imports of these products fell off sharply. Regarding the labor market, labor exchange data point to a recessionary situation—a rise in the number of unemployed and a decline in job vacancies—which worsened toward the end of the year (although the labor force surveys do not yet point to a slowdown). In contrast to these demand influences, cost factors had a stronger impact in the second half of 1979. All input prices continued to rise rapidly, pushed by increases in the foreign prices of imported goods, the exchange rate, and wages. Furthermore, the prices of basic commodities and government services (fuel, electricity, water) were raised twice. Except for the wage component in residential construction (see Table IX-1), all indexes point to accelerated rises in input prices in the second half of the year, which, in turn, influenced wholesale and retail prices. Thus the large increases in nominal wages and import prices did not result in real increases; real wages, in fact, declined in the second half of 1979.

It is worth noting that the price increases in the first half of 1979 were very uneven as between products (see details in section 3a) and the monthly behavior of the general index.[3] Differences in the price movement of various items may have occurred due to uneven increases in the prices of various inputs, different import components, or uneven wage increases, but they may also have reflected varying expectations concerning the future rate of inflation, for producers were unable to correctly assess the new trend of inflation in the face of its sharp fluctuations.

On the other hand, the behavior of prices over the last six months of the year showed a striking stability, both on a month-to-month basis and between the various products. Only a handful of items in the index went up by less than 5 percent a month, and the 10 percent mark was surpassed only by those goods and services whose government price support was reduced. All other items increased at a rate close to the average. This development may well indicate that the public adjusted its expectations to the new prevailing level of inflation—a minimum of 5 percent a month and an even higher average. The greater level of inflationary expectations, together with the accelerated increase in all input prices and the rise in the price of basic commodities and fuel, combined to cause the 8 percent monthly inflation rate which characterized the housing market in the first half of 1979 to become the general monthly inflation rate for the entire economy in the second half of the year.

The main monetary variables declined in real terms in the course of the year; this, together with the rise in the real interest rate, helps to explain the slowdown in demand toward the end of the year. It is difficult to estimate the impact of monetary policy on prices, partly because of the strong inflationary factors described above, and partly because of the special monetary background (one of massive expansion) in the previous two years. This expansion had been fed by in-

[3] The monthly rates of change in the consumer price index were as follows (in percentages).

I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
4.9	2.4	5.6	8.7	4.8	3.5	5.5	8.4	8.0	7.8	9.7	8.1

jections from the government and the Bank of Israel, and it served to swell the volume of linked liquid assets in the monetary system. In recent years inflation and the availability of linked liquid assets gradually eroded the role of the money supply as a central liquidity reservoir and enhanced the weight of such substitutes as local residents' foreign currency deposits and linked bonds, which were not affected by inflation. Thus, the traditional means of payment could be used sparingly and efficiently, and the reservoir of linked assets were tapped only when a short-term liquidity shortage appeared. In other words, the circulation velocity of the money supply increased remarkably.

Credit contracted and became more expensive in 1979. The main effect of this development, as stated, was to slow demand and to reduce inventories, which became more expensive to maintain. Because of growing cost pressures in this period, this had little influence on the general price level, apart from those specific segments like motor vehicles, other durable goods, and dwellings, where stocks had to be reduced. A moderating trend in prices was clearly visible in these categories. The unusually large monetary injections during the year were concentrated in the second half. These were partly absorbed by the balance of payments deficit because of the sharp increase in the price of oil; the rest were used by individuals more to acquire foreign currency than to increase their other liquid assets. Yet by the end of 1979 a large supply of linked liquid assets remained in the hands of the public, constituting an inflationary potential for the future.

While the private sector was in possession of this large stock of linked liquid assets, its obligations to the government were unlinked. This fact has played an important role in spurring inflation in recent years. In the past, the government provided credit with a fixed nominal interest rate, which turned into a negative real interest rate as inflation kept escalating. The more prices went up, the greater were the capital gains of those who had received the credits, and this constituted an incentive for enterprises and individuals to take advantage of all the available cheap credit. Unlinked credit was used both by households, through housing loans, and by businesses, through directed credit and development loans. These capital gains stimulated demand in both the consumption and the investment markets. Higher demand added impetus to inflation, which further swelled capital gains, and the cycle continued.

In 1979 it was decided to link directed credit and development loans to the price index or to the dollar. During an intermediate period credit was partially linked; in the future only fully linked credit will be granted. Since the existing supply of unlinked credit is rapidly shrinking in real terms, due to the high rate of price increases, and since most new loans are linked, it is expected that the impact of unlinked credit on both demand and the rate of inflation will decline in the future.

Table IX-2

CHANGES IN CONSUMER PRICES, BY MAJOR COMPONENTS, 1976-79
(Percent annual change[a])

	Weight in 1976	1976	1977	1978	1979
Total	**1,000**	**38.0**	**42.5**	**48.1**	**111.4**
Goods					
Agricultural products	76	42	33	63	88
Fresh fruit and vegetables[b]	52	41	32	74	79
Other	24	46	35	40	112
Industrial products	463	38	49	46	99
Food	174	39	53	39	135
Clothing and textiles	74	47	32	50	63
Leather, rubber, and plastics	27	44	42	45	86
Wood and wood products	27	31	45	45	83
Metal and machinery	9	27	46	48	81
Transport vehicles	29	38	69	84	37
Electrical equipment	45	30	55	45	55
Chemicals	19	26	46	52	101
Petroleum and petroleum products	29	35	53	35	160
Paper and publishing	15	37	52	46	102
Miscellaneous	15	46	48	50	99
Services					
Construction and housing services	207	24	30	58	156
Other services	254	44	44	42	110
Electricity and water	25	26	57	26	171
Transport and postal services	48	44	43	32	146
Education	25	44	29	15	89
Health	32	42	52	66	97
Hotels	36	49	52	43	96
Other business services	6	13	21	52	147
Personal services	50	51	51	51	96
Insurance and taxes	31	44	31	46	77

[a] Change in December levels.
[b] Since fresh fruit and vegetables are subject to frequent seasonal fluctuations it is preferable to compare annual averages; these went up 27 percent in 1976, 32 percent in 1977, 41 percent in 1978, and 79 percent in 1979.
Source: Central Bureau of Statistics, *Price Statistics Monthly*, January 1980.

3. PRICE INDEXES

(a) Consumer Price Index

The average level of prices was 78.3 percent higher in 1979 than in the previous year. The increase in December levels was even greater: on average, consumer goods in December 1979 were 111.4 percent more expensive than they had been in December 1978. A study of the index's behavior shows that the process accelerated as the year wore on. In the first half prices rose by an average of 5 percent a month, but accelerated to an 8 percent monthly average in the second half. Furthermore, while the prices of the various types of consumer goods rose at different rates in the first half of the year, the increases were much more similar in the second half. When the various goods and services included in the consumer price index are ranked according to their average monthly price performance in the first half of 1979, the following picture emerges: at the top of the list, dwellings (which account for about 20 percent of the index) increased by more than 8 percent a month; a broad range of goods and services which constitute another 20 percent of the index rose close to the average, between 4.5 and 5.5 percent; another group of products, accounting for about 30 percent of the index, moved up 3-4.5 percent; in the lowest bracket, various items which also account for some 20 percent of the index rose at the relatively modest rate of less than 3 percent a month (see Table IX-1).

The consumer price index, which is published once a month, is used as the basis for adjusting wages for the increase in the cost of living; the prices of bonds and other items are also linked to this index. Consequently, developments in the index influence the public's estimate of future inflation. In the first half of the year the index fluctuated sharply from month to month (see note 3 above), making it difficult to discern the new pace of inflation. Changes in the exchange rate were also uneven; this precluded any accurate estimate of short-term inflation, thus creating differential rates of price increase among various consumer goods.

In the second half of the year the prices of most items in the index rose faster and at a more uniform rate. Those goods and services which constituted some 10 percent of the market basket for which government subsidies were reduced went up at exceptionally high average monthly rates of 12 to 20 percent. A long list of goods and services, accounting for half of the index, was characterized by rapid price rises of some 8 percent a month in the second half of the year. A variety of other goods and services, accounting for another 30 percent of the index, went up by a monthly average of 6 percent, while only a few scattered items, covering the remaining 10 percent of the consumption basket, went up by less than 5 percent a month. Such a distribution of price increases probably indicates a new rate of expected price increases varying between 5 and 8 percent a month.

Over the year as a whole the low rise in the price of durable goods, including motor vehicles, stands out as an exception to the general trend. In the previous year, with the renewal of economic growth, the sale of such products expanded even though their relative prices rose at an exceptionally steep pace. The uptrend in sales of such goods continued at an even faster rate in 1979, but this year the increase is partly explained by the sharp decline in their relative prices. Like the previous year's relative price rise, the downturn in 1979 was especially strong in household equipment and automobiles, most of which are imported, in contrast to furniture, where a larger proportion is produced domestically. These trends can be explained by the slow rate of devaluation in the early part of the year and by the first signs of the subsiding of demand as the year wore on.

(b) **Import Prices**

The price of the dollar rose 82 percent during 1979, while the price of the currency basket, which has the same mix as Israel's imports, rose 89 percent. In dollar terms, imports (exclusive of diamonds) became 36 percent dearer, reflecting an oil price hike of 120 percent and average price increases of 18 percent for all other imports. Two central features characterized the changes in import prices after the foreign currency reform of November 1977: the uneven movement of the exchange rate, which rose very slowly at the end of 1978 and the start of 1979; and the steep jump in fuel prices in 1979. From the time of the reform until August 1978, the Israeli pound fell by about 2 percent a month against the dollar and 3.5 percent against a basket of 15 currencies. From September 1978 until February 1979, on the other hand, the decline slowed to about 1 percent a month against the dollar and 1.5 percent against the currency basket. This, however, did not result in a similar decline in the rate of domestic price increases, since demand factors and the public's expectations were boosting the rate of inflation at that time. The combination of slower devaluation and more rapidly advancing domestic prices meant a substantial relative decline in import prices, after they had moved up strongly at the start of 1978 in the wake of the reform.

The table below compares the movement of import consumer goods prices with that of the consumer price index, from the reform through 1979.

MOVEMENT OF RELATIVE PRICES OF IMPORTED CONSUMER GOODS, OCT. 1977-DEC. 1979
(October 1977=100)

	Import price of consumer goods (in dollars)	IL/$ exchange rate	IL price of imported consumer goods	Consumer price index	Relative price of imported consumer goods
1977 October	100	100	100	100	100
November	101	126	127	112	113
December	102	127	129	114	113
1978 1st quarter	105	133	140	119	118
2nd quarter	105	141	148	132	112
3rd quarter	108	150	162	141	115
4th quarter	114	154	175	162	104
1979 1st quarter	118	162	191	184	108
2nd quarter	119	194	231	218	106
3rd quarter	131	222	291	259	112
4th quarter	135	264	365	330	108

As a result of the relative increase in import prices following the reform, domestically produced items were prefered by consumers over imports in 1978. Coming in a period of demand recovery, this led to heavier sales of local goods. This demand pressure sharply pushed up domestic prices, and along with the slower rate of devaluations in the final part of 1978, reversed the previous year's declining trend in the import share of domestic consumption.

In the following table the rate of real growth of imported consumer goods is compared with that of total private consumption. It shows the shift from imports to domestic products in 1978 and the next year's reversal, both in total consumption and in the various components. These developments must be seen in the light of the economic recovery of the past two years; the emergence from a recession is always accompanied by a rapid rise in purchases of vehicles and other durable goods.

	1978		1979	
	Change in consumption	Change in imports of consumer goods	Change in consumption	Change in imports of consumer goods
Total[a]	9	10	6	20
Food[a]	6	-3	2	8
Other nondurables	11	12	0	14
Durables (excluding cars)	21	5	32	51

[a] Excluding meat imports, which have exhibited sharp fluctuations reflecting changes in government stocks rather than in consumption.

The rising trend in the import share of private consumption was checked at the end of the year; the monetary squeeze and the slowing of the economy led to a sharp drop in consumer goods imports in the final quarter of 1979 and a more modest one in total consumption.

(c) **Fuel Prices**

After several years of stability in world markets, the price of imported oil more than doubled in 1979. The approximately 120 percent increase, together with an 82 percent rise in the $/IL exchange rate, swelled the economy's imported oil bill by about 300 percent during 1979.

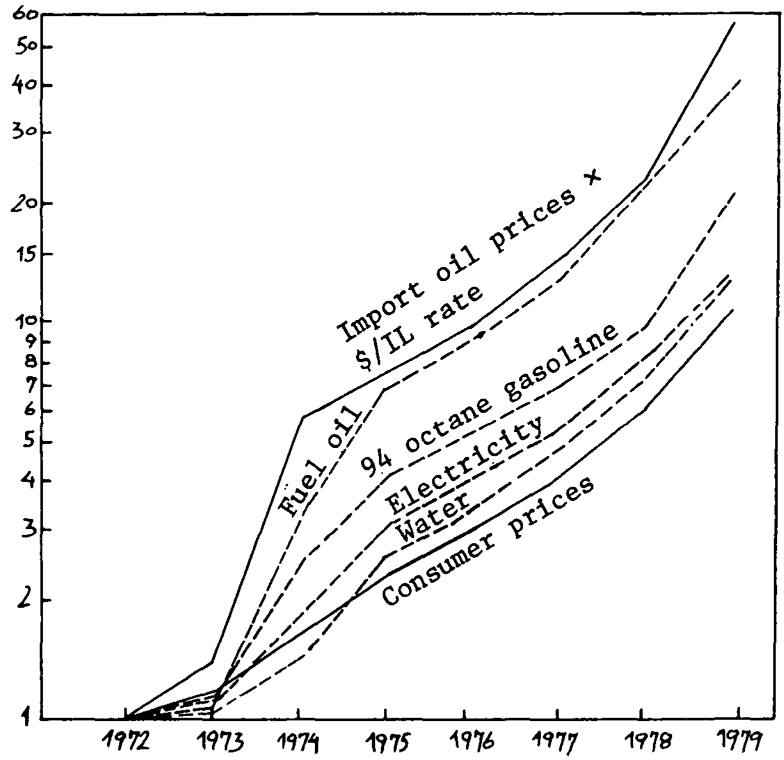
Consumer prices of the various petroleum products went up by some 200 percent in this period, while the consumer price index rose 111 percent. Prices of petroleum products for consumers and producers were adjusted several times during the year, in response to the exceptional jumps in oil import prices.

Figures IX-2 and IX-3 show recent annual price trends, as well as quarterly developments in the last two years. Three distinct subperiods emerge. After the oil

Figure IX-2

OIL AND PETROLEUM PRODUCT PRICES COMPARED WITH SELECTED PRICES, 1972-79

(1972 = 1; annual averages)

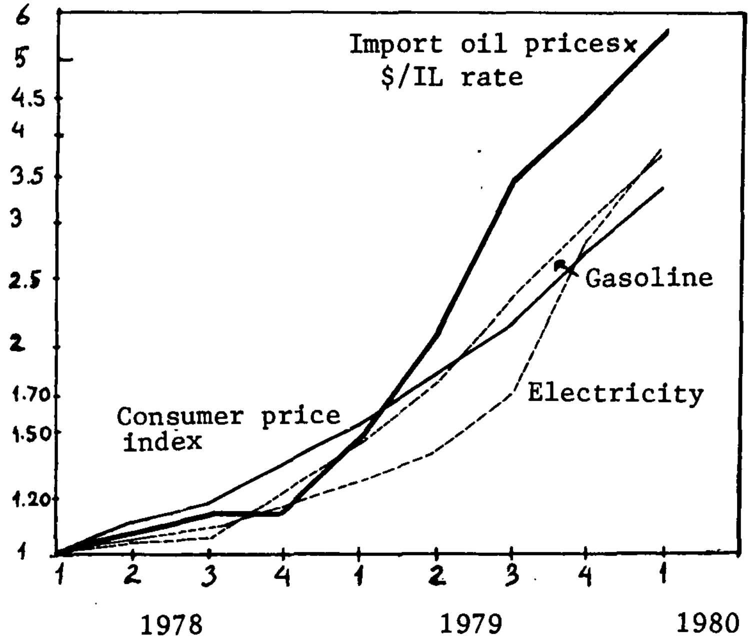


crisis of 1973, consumer fuel prices were increased steeply; even so, they did not keep pace with the rise in the cost of oil to the economy. From that point until 1978, consumer prices were raised more or less in line with costs. In 1979, which witnessed another precipitate jump in the price of imported oil, domestic fuel prices were raised sharply, though not quite to the same extent. It should be noted that while gasoline is heavily taxed, other petroleum products are subsidized. Thus the failure to fully adjust domestic prices reduced the tax on gasoline and correspondingly increased the subsidies on other petroleum products. Most Western European countries also lowered the tax on gasoline in 1974-78 in order to moderate the rise in consumer fuel prices, since such a rise pushes up prices across the board, thereby eroding the increase in the relative price of oil.

Figure IX-3

RISE IN PETROLEUM PRODUCT PRICES COMPARED WITH IMPORT OIL AND CONSUMER PRICES, 1978-79

(Indexes: 1978I = 1; quarterly averages)



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

The rise in wholesale industrial prices accelerated during 1978, from a monthly average of 3 percent in the first three quarters of the year to about 4.5 percent in the fourth quarter. The uptrend continued in 1979, reaching an average of 6 percent a month in the first half of the year. In the second half a further acceleration was recorded, with prices going up at an average monthly rate of 7.8 percent. In most branches the rise was close to the average. Relatively lower increases were registered in the first half of 1979 in the food, textile, and paper industries, and in the garment industry in the second half. There was an especially steep increase in the food industry in the second half after government subsidies were slashed.

(e) Housing and Construction Input Prices

The rapid increase in dwelling prices, which exceeded the general rate of inflation in 1978, carried over into early 1979. As stated above, this was due to strong demand pressure. The price of residential construction inputs, including materials, equipment, transport, and wages, also moved up at an accelerated rate in this period.

In the middle of the year construction activity began to slow down and home prices rose more moderately. This trend became apparent in the index of dwelling prices already at the beginning of the year, becoming more pronounced in the third quarter. For technical reasons, these developments were not immediately reflected in consumer price index data on housing, but a definite moderating trend showed up in these figures as well from the middle of the year. An actual decline in the relative price of homes was evident only toward the end of the year. On the other hand, construction input prices continued upward in the second half at the rapid rate of the first half. An examination of the various inputs shows that in the second half only the wage component went up more slowly than the general price level, and this only in the last quarter. In building materials, equipment, and transport the second-half price rises were similar to those of the first half of the year (for a more detailed discussion see Chapter VIII).

(f) Prices of Controlled Goods

In the past few years the policy of price support for basic commodities and public transportation was aimed at stabilizing prices, with increases being authorized from time to time in accordance with the rise in the general price level. During this period the intention of gradually cutting the subsidies on these products was not realized. Since gradual price adjustments were not carried out as planned but were postponed for various reasons, steep increases eventually became unavoidable. In 1978 the prices of these products were raised just once, and not by very much. In March 1979 they were raised by about 30 percent and there was a further hike of 40-50 percent in August. These big increases then affected other prices. Subsequently, in view of the many shortcomings of this system and in an attempt to slash the subsidies in the government budget, it was decided in November 1979 to abolish subsidies altogether. Large subsidies were retained only on bread and on public transportation, and a reduced subsidy on frozen poultry. As a result, prices of the other basic commodities increased at rates ranging between 50 and 110 percent. As consumption adjusted to these new prices, it became clear that the sharp increases had dampened demand, especially for milk and dairy products and frozen poultry. In fact, a short-term surplus production problem arose, and it became necessary to moderate some of the price increases in order to reduce stocks.

Table IX-3

RATES OF CHANGE IN SELECTED INDEXES, 1968-79
(Percent annual averages)

	Average							
	1968-70	1971-73	1974-77	1975	1976	1977	1978	1979
Consumer price index	11	15	36	39	31	35	51	78
Wholesale price index of industrial output[a]	9	14	40	41	31	39	53	79
Index of agricultural input prices[b]	17	14	41	46	33	31	51	78
Index of housing construction input prices	18	18	34	31	26	31	57	87
Index of road construction input prices	18	15	40	49	26	36	75	92

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

(g) **Price of the Consumption Basket of Various Population Groups**

The prices of the consumption baskets of the two extreme income groups—the lowest and the highest deciles—increased in 1979 at a rate close to the average for all families; this contrasts with 1978, when the figure for the lowest decile increased at a below-average and that for the upper decile at an above-average rate. Excluding housing services, which rose faster in the upper decile, the increase in the lowest decile was 108 percent, compared with 96 percent in the top decile. The differential is explained by the fact that food, water, electricity, kerosene, fuel oil, and public transportation—all of which became much dearer—carry a much greater weight in the basket of poor families. On the other hand, housing maintenance is a more important component in the highest decile.[4]

[4] For details see the CBS *Price Statistics Monthly*, January 1980.

Table IX-A1

GOODS AND SERVICES GROUPED BY AVERAGE MONTHLY INCREASE IN PRICES

(Percentages)

Average monthly increase		Combined weight in consumer price index in base year (1976)
	A. First half of 1979	
0-3	Fruit and vegetables, coffee, controlled rent, government property tax, electricity, education, private vehicles, private vehicle maintenance	19.3
3-4.5	Meat, poultry and fish, edible oils and margarine, tea, beverages, painting and whitewashing, kerosene and fuel oil, furniture, bedding, electrical equipment, nonelectrical equipment, clothing, footwear, medicines and medical equipment, public transport, cigarettes and tobacco, jewelry and watches, handbags etc.	31.2
4		
4.5-5.5	Bread, flour and flour products, spices and cocoa, meals away from home, controlled rent, domestic help, household maintenance and repairs, gas and service charges, household products, culture and entertainment, private medical services, dental care, personal and cosmetic services, sugar, jam and sweets	21.3
5.5-7	Milk and dairy products, Sick Fund services, travel abroad	5.7
7-9	Eggs, dwelling prices and key money, other household expenses, municipal taxes, water, postal and telephone service	22.5
	B. Second half of 1979	
0-5	Clothing, meals at place of work, controlled rent, municipal taxes, private vehicles	10.7
5-7	Uncontrolled rent, private medical services, spices and cocoa, beverages, jam and sweets, kiosk products, domestic help, furniture, bedding and home decoration, nonelectrical equipment, electrical equipment, footwear, culture and entertainment, Sick Fund services, dental care, medicines and medical equipment, handbags etc.	29.9
7-9	Fruit and vegetables, eggs, meat, poultry, and fish, restaurants and coffee-houses, dwelling prices and key money, other household expenses, painting and renovations, water, household products, education, private vehicle maintenance, postal and telephone service, cigarettes and tobacco	46.5
9-12	Bread, flour and flour products, tea, coffee, jewelry and watches	3.5
12-20	Edible oils and margarine, milk and dairy products, sugar, school meals, government property tax, electricity, gas and service charges, kerosene and fuel oil, public transport	9.4