How to fight inflation

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Introduction

Fact sheet No. 2 in this series indicates that inflation is a process of continuous increase in the general price level, and that inflation is bad for the economy and for the general public.

How do you stop inflation?

One approach to stop inflation would be to freeze all prices. Many countries have attempted this over the centuries. For example, in the year 301, the Roman emperor Diocletian froze all prices and wages and made the infringement of this edict punishable by death. In spite of some executions, inflation was not contained. Eventually this law against price and wage increases was repealed. Later attempts at directly controlling price increases also failed because all these controls addressed the symptoms, but not the cause.

What triggers price increases?

Price increases can be triggered by many developments, such as:

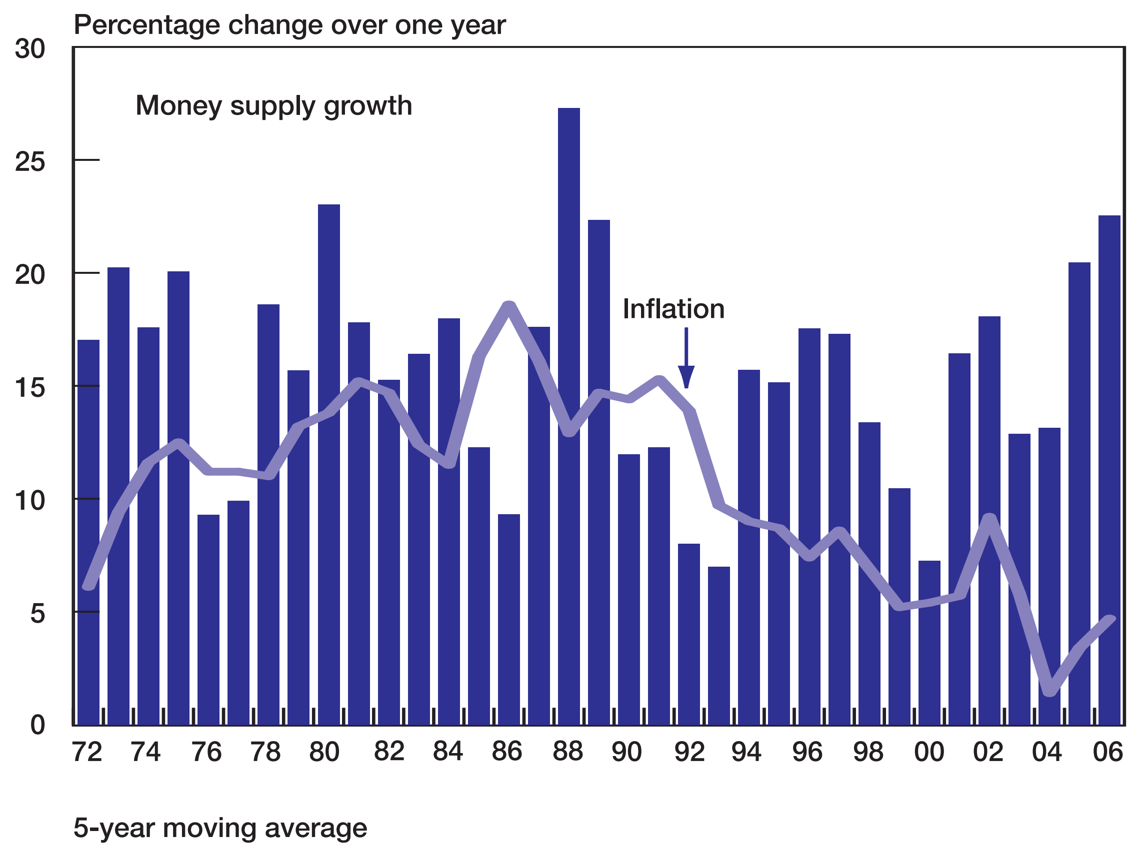
- an increase in international oil prices;
- a fall in the exchange rate;
- a nationwide excessive salary and wage hike; or
- an increase in food prices caused by a drought.

What sustains inflation?

For a continuous rise in the general price level, the money supply has to keep on expanding. Only with "too much money chasing too few goods" can the general price level continue to increase. Graph 1 clearly illustrates that high rates of growth in the money supply in South Africa in the past went hand in hand with high rates of inflation. The only effective way to contain inflation in the long run is therefore to restrict the growth in the money supply. The likely rate of increase in the quantity of goods and services which can be maintained without inflationary pressures is usually related to more labour, entrepreneurship and capital goods, and better skills, management and technology. Growth in the money supply should accordingly be linked to sustainable growth in production.

Preventing excessive money supply growth is therefore a crucial element in combating inflation. But how is this done?

Graph 1: Money supply growth and inflation in South Africa



Preventing excessive money supply growth

The banks in South Africa are usually indebted to the South African Reserve Bank (the Bank). Although the amount of funds which they borrow from the Bank is small compared to the amount of funds which they obtain in the form of deposits, their borrowing from the Bank is important. This is because the Bank is the only supplier of legal tender – notes and coin – to the economy. The terms and conditions under which the Bank is willing to supply cash to the banks are important factors when the banks set their interest rates.

The Bank lends cash to the banks at an interest rate determined by the Bank's Monetary Policy Committee. This interest rate is called the Bank's repurchase rate, or repo rate for short. Banks set their deposit interest rates somewhat below and their lending rates somewhat above the repo rate. Through the repo rate, the Bank indirectly has a strong influence on all the short-term interest rates in the banking system.

If the Bank's analysis shows that inflation is going to be higher than the inflation target set by the government, it has to put a brake on the inflation process. This is done in the following way:

- The Bank raises the repo rate.
- Banks thereafter usually raise their lending and deposit rates.
- When people face higher lending rates, they buy fewer goods on credit.
- This causes less credit to be used and less money ending up with shopkeepers.
- With less money, credit and expenditure in the economy, it becomes more difficult to raise prices and wages.
- Therefore, inflation is reduced.

Conversely, if the Bank's reading of the economy indicates that inflation is going to fall below the inflation target, it would reduce the repo rate and this would reverse the sequence described above.

As a rule of thumb, lending rates must be significantly higher than the inflation rate if excessive credit growth and money supply growth are to be prevented. In addition to the repo rate, the Bank can also influence the banks' ability to lend out money by using instruments such as open-market operations (i.e. buying and selling financial assets in the open market) and cash reserve requirements (i.e. requiring the banks to deposit part of the funds they receive from the public with the Reserve Bank).

Although inflation can only be sustained if the amount of money in the country is rising excessively, the Reserve Bank's task can be made easier by both the government and the public. Monetary policy will be more effective if it is supported by fiscal discipline, i.e. if the government does not overspend or rapidly run up its debt. Inflationary pressures will also be alleviated if the general public works harder and smarter, i.e. if an improvement in productivity raises the quantity (or quality) of the goods and services produced.

Bottom line

Combating inflation requires the prevention of excessive money supply growth. In turn, this requires the private-sector banks to maintain interest rates at levels that are high enough to prevent excessive growth in bank credit extension. To this end, the Bank sets its repurchase rate at an appropriate level. This whole process of changing interest rates to influence credit, money supply and inflation takes time to work through; this is why monetary policy requires patience.

This is the third in a series of fact sheets on the South African Reserve Bank, compiled by the Research Department: Information Division and distributed by the Executive Management Department: Communications Unit.

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