Market-oriented economic policy versus quantitative controls

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Market-oriented policy versus "leaving everything to the free market"

It is increasingly recognised that the emphasis placed by the authorities in South Africa in recent years on free enterprise and market-oriented economic policy in no way implies the adoption of a *laissez faire* approach of "leaving it all to the working of the free market". *Market-oriented policy is still policy.* But it is a policy which recognises the existence of markets, and where possible, operates *through the markets* rather than by way of *quantitative bureaucratic control measures.*

In accordance with the recommendations of the Commission of Inquiry into the Monetary System and Monetary Policy in South Africa, the monetary authorities in South Africa do not "leave everything to be determined by the markets". On the contrary, they work actively and consciously towards the attainment of certain ultimate and intermediate policy ends, including effective demand management with the assistance of money supply targets. But they prefer market-oriented instruments of monetary policy such as public debt management, open-market operations and rediscount policy, rather than quantitative controls such as bank credit ceilings and deposit rate controls.

This preference has never implied an absolute commitment to the market-orientation of policy that brooks no exception. Neither the Treasury nor the Reserve Bank regards free markets and market-oriented policies as ends in themselves. In the application of their economic strategy the authorities will often have valid reasons for intervening in the working of the markets in order to bring about a *different* result than would have been produced by an entirely self-directed market. But they remain convinced that such intervention will in most cases be more effective if it takes place by way of market-oriented policies rather than direct bureaucratic controls. In South Africa's sophisticated financial system, measures such as credit ceilings and deposit rate controls can be circumvented too easily and therefore simply do not work, as borne out by the results of such policies in the late 1960's and the 1970's.

When the need arises the monetary authorities *do* resort to direct, quantitative controls. Present examples of this are the restrictions on foreign debt repayments and extensive exchange controls on capital transfers by both residents and non-residents. Nothing could be more direct and quantitative than that.

The Monetary Commission was right when it found that in a sophisticated financial system like that of South Africa exchange control is of limited effectiveness, particularly in times of stress. Exchange control can be legally circumvented in a number of ways and can do little to control short-term capital movements in the form of leads and lags in current foreign payments and receipts. The monetary authorities are also well aware of the problems created for exchange control by a financial rand standing at a discount of around 50 per cent to the commercial rand. But in the present abnormal circumstances characterised by sanctions and capital outflow, they deem it desirable to make use of these direct controls as *supplementary* measures. It was precisely because it was foreseen that such conditions might arise that the Monetary Commission did not recommend the *abolition* of exchange control, but only its streamlining and the elimination of unnecessary "red tape" in its application.

Market-oriented policy, quantitative controls and the "meagre" economic performance since the early seventies

The issue of direct versus indirect controls in South Africa has been discussed in the recent past against the background of what has been termed "the meagre economic performance in recent years".

It is increasingly realised that since the early seventies the South African economy has been adversely affected by a succession of unfavourable economic and political developments. This led to a lower average economic growth rate, a decline in real fixed investment, increasing unemployment, capital outflows, a depreciation of the exchange rate, a higher inflation rate and a decline in the average real standard of living per head of the population.

This process was temporarily interrupted by the sharp rise in the gold price between 1977 and 1980, which was also accompanied by good rainfall and record agricultural crops, and gave the South African economy a couple of very good years. But as the gold price started its long decline from a peak of about $850 per ounce in January 1980, the underlying unfavourable trends in the South African economy reasserted themselves. In addition, since late 1984 and especially since July

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1985 unfavourable socio-political developments have substantially aggravated this process.

Against this background any analysis of the "meagre performance of the South African economy" that uses the year 1980 as base period is misleading if not completely unscientific. This is because 1980 was the year in which the gold price averaged $613 per ounce, which was exactly double the average price of 1979 and more than three times the average price of 1978. Since the gold price subsequently declined to around $285 per ounce in February 1985, South Africa's economic performance during the early and middle 1980's was naturally "meagre" if compared with the abnormal gold bonanza year of 1980. The point to grasp is that *the structural slow-down of South Africa's rate of real economic growth began round about 1974 and not in 1981*. Compared with 4,9 per cent between 1946 and 1974, the average annual growth rate of real gross domestic product in South Africa was only 1,9 per cent between 1974 and 1985. And this despite the inclusion in the latter period of the record-breaking "golden" years of 1979 and 1980.

The low average growth rate between 1974 and 1985 was mainly the result of a decline in the ratio of exports to gross domestic product and a weakening in the terms of trade. The slow-down in export growth was, in turn, related to the levelling out of world production during this period, beginning with the oil price increases in 1973. In the decade preceding 1973 total world production increased on average by 6 per cent per year. Subsequently, during the ten years to 1983, it increased at an average rate of only 2 per cent per year.

Since 1973 the medium-term export propensity of South Africa was also unfavourably influenced by two other factors. The first was the shift in world economic growth from industries which are heavily dependent on raw materials, to service and high technology industries. And the second was the success achieved in the fight against inflation by the large industrial countries, which led to a decline in the demand for "hedge assets" such as gold, platinum and diamonds.

If to this are added the other factors which led to the lower gold price after January 1980, the drought and the deterioration in overseas perceptions of South Africa's socio-political prospects, then it is clear why South Africa's economic growth and stability have been so adversely affected since 1974.

For purposes of the present discussion the point to emphasise is that the above-mentioned series of economic and socio-political shock waves at times made drastic and painful adjustments in the South African economy unavoidable – regardless of whether market-oriented policies or quantitative controls were employed to deal with the situation.

That this was not always recognised is clear from the attempts made from time to time to attribute South Africa's economic problems to either the *excessive* or *insufficient* use of market-oriented policies.

There is no doubt that valid criticisms can be raised against many aspects of past and present official economic policy. But the notion that either market-oriented policies or quantitative direct controls are mainly to blame for South Africa's weaker growth performance since the early seventies is totally unfounded.

The main weakness in this line of argument is the failure to distinguish properly between the *underlying economic situation* and *the economic policy applied to meet that situation*. These are two separate matters. The fact that during the period since the early seventies the South African economy at times experienced certain difficulties *after* the authorities had made more use of certain policies and less of others in no way means that these difficulties occurred because of the policy changes. One must guard here against the classic fallacy of "*post hoc ergo propter hoc*".

It is important at all times to distinguish between the "situation" and the "policy". The "situation" may be good or bad and the "policy" to manage that situation may also be good or bad, but these are two different things.

The influence of economic policy must in any case not be overrated. Often the influence of economic policy is relatively small compared with other economic and non-economic influences which determine the course of the economy. When the going is good in economic terms, for example in South Africa during the gold boom of 1978-80, it is fallacious to describe the favourable developments as being in the main "achievements" of economic policy. And if less good times are experienced and serious problems crop up, it is equally wrong to ascribe that state of affairs mainly to the shortcomings of economic policy.

A further fallacy in this context is to argue that the effects of the unfavourable external influences could to a large extent have been "compensated" or "neutralised" by applying direct control measures such as import control, exchange control, pegging of the exchange rate, quantitative credit ceilings, deposit rate control and more stringent hire-purchase conditions. In the prevailing adverse circumstances meaningful "compensating", "neutralising" or "immunising" measures were impossible. A process of adjustment was inevitable.

For South Africa the series of unfavourable exogenous developments since the early seventies necessarily implied some or other combina-

tion of slower growth, higher inflation and exchange rate depreciation, and therefore a lower average living standard per head of the population. We only had a choice between different *methods* of adjustment and between different ways of spreading the adjustment burden. *But that we had to adjust was quite unavoidable.*

The real debate should therefore be about the advantages and disadvantages of alternative adjustment policies which were at our disposal and not about the question whether we should have adjusted or not. There is always room for divergence of opinion over the way in which the authorities trim their sails to the wind, but they can hardly be blamed for the wind itself.

In reality the South African economy has adjusted well to the adverse economic and social shocks to which it has been exposed. During the past two years, for example, the deficit on the current account of the balance of payments has been transformed into a substantial surplus, real salaries and wages have been adjusted downwards, substantial amounts of foreign debt have been repaid and the country has been living well within its means.

This adjustment process obviously entailed considerable sacrifices and hardships. Belt tightening is never easy or painless. But there is no doubt that market-oriented fiscal and monetary policies have helped the economy to adjust to the prevailing hard realities and in this way have made South Africa better equipped to resist sanctions and disinvestment.

Market-oriented policy, quantitative controls and inflation

Inflation remains a major problem in South Africa. In many developing countries a rate of inflation of between 16 and 20 per cent might be viewed as "relatively low", but in South Africa it is rightly regarded as disturbingly high. For that reason the issue of how best to curb inflation remains relevant.

In this regard it is important to distinguish between two aspects of this debate:

Is inflation caused mainly by excess demand or by structural and/or cost-push factors?

The first is whether inflation is caused mainly by *excess monetary demand,* i.e. by overspending or "too much money chasing too few goods", or mainly by *non-monetary structural and/or cost-push factors.* One example of the latter is *autonomous* increases in wages and salaries in excess of increases in productivity, i.e. remuneration increases that are *not* induced by increases in either monetary demand or prices but are attributable to other forces, such as, for example, labour group pressure. Other examples are inadequate competition and "imported" inflation.

The basic significance of this distinction is, of course, that demand inflation presumably needs to be curbed by restrictive monetary and fiscal policies, whereas structural and/or cost-push inflation might perhaps be better counteracted by direct price-wage controls or guidelines, anti-monopoly policies and other direct or structural measures.

The Reserve Bank's view is that during most of the past 25 years the inflation in South Africa was caused mainly by excess demand fuelled by excessive money creation. At the very least, excessive monetary expansion was a necessary condition for the inflation.

The Bank fully accepts that structural and/or cost-push factors may in certain circumstances impart an *inflationary bias* to the South African economy. This is mainly because they can at times place strong pressure on the monetary authorities to "validate" autonomous price increases by means of large accommodative increases in the money supply. There can also be no doubt that phenomena such as low productivity and inadequate competition constitute serious economic problems which call for remedial action in their own right. But the Bank rejects the view that these factors by themselves constitute the basic underlying "causes" of the inflation that has occurred in South Africa during the past 25 years. It therefore also cannot accept that any strategy of restoring and maintaining reasonable price stability should be aimed principally at the direct removal or suppression of these non-monetary and non-fiscal "causes".

"Cost-push" and "demand-pull" factors are largely viewed by the Reserve Bank as interacting elements or different aspects of the same process, rather than as totally separate causes of different processes. Autonomous cost-push influences cannot by themselves sustain an inflationary process. If not accommodated by monetary expansion, they are self-terminating. Accordingly, to the extent that the monetary authorities succeed in resisting the pressure for accommodation, the force of cost-push pressures should abate.

The Monetary Commission found little evidence that so-called "autonomous" wage and salary increases in excess of productivity increases – attributable, for example, to labour group pressure – have been a major "cause" of inflation in South Africa. There have been exceptions. One such exception was the large autonomous increase in public sector salaries and wages that occurred in 1983/84. It is true that salaries and wages have risen much more rapidly over the years than the productivity of labour, however measured. And the resultant imbalance has inevitably been reflected in rising labour costs per unit of output. But this has been more a *symptom* than a *cause* of the inflation.

Whatever supplementary measures might be desirable, the application of an effective monetary and fiscal demand management policy must therefore in the normal course of events form the crux of any strategy against inflation. This emphatically does not mean that demand must necessarily be dampened *whenever the consumer price index rises* – a point to which reference will again be made.

There is much validity in the view that inflationary expectations and a tendency to link wage and salary increases to the rise in the consumer price index play an important role in the inflationary process in South Africa. In theory, therefore, official wage-price controls or guidelines might shorten lags in the price index behind the demand restraining measures, and might reduce the real economic cost of curbing inflation. But the practical problems and more fundamental disadvantages that would arise from any such direct intervention would probably outweigh any such possible advantage. Comprehensive direct wage and price freezes or controls cannot therefore be recommended for use under present South African conditions.

The arguments against direct wage and price controls are well known. They include the distortion of *relative* prices that result from fallible human beings setting some prices too high and others too low, and the consequent maldistribution of scarce production resources. There is also the danger, borne out by experience, that direct price and wage controls might come to be regarded as a *substitute* for appropriate monetary and fiscal policies and might lead to an undesirable easing of such policies. The upshot is that price and wage controls can at best treat the symptoms of inflation but never the real causes. Inflation artificially "suppressed" by direct controls is still inflation.

In present-day South Africa it is nevertheless important that both employer and employee organisations adopt a responsible attitude towards the fixing of wage and salary rates in the normal bargaining process. It would be short-sighted to shift all costs from the consumer price index to wage rates, and from wage rates to prices. That would perpetuate the inflationary bias in the economy.

In this regard a particular responsibility rests on the Government and other public sector bodies to guide the labour market towards greater harmony with the aggregate demand policies of the authorities. It must also be recognised that the influence exerted in this field by the public sector covers a broad range of "administered pricing", including the determination of the prices of many agricultural products, electricity, basic steel and transport and postal services. Through the determination of these administered prices the public sector automatically exercises a powerful autonomous influence on the processes of wage and price formation and the pattern of *relative* prices in the economy as a whole.

This does not mean, however, that the answer to inflation lies in a policy of suppressing wage and price increases in the public sector as a substitute for appropriate monetary and fiscal policy. On the contrary, any policy of artificially suppressing such wages and prices for a considerable time usually results in disruptively large and sudden upward adjustments at a later stage.

Should excess demand be curbed by market-oriented or quantitative policy measures?

The second aspect of the inflation debate is whether, in situations where it is accepted that the inflation is being caused mainly by excess demand, *quantitative* monetary controls should be used to reduce demand rather than *market-oriented* policies.

In this debate, as already indicated, the monetary authorities come down on the side of market-oriented instruments of monetary policy and specifically the following:

- Public debt management (including public borrowing policy);
- open-market operations;
- discount and general accommodation policy; and
- "intervention" in the spot and forward exchange market.

These market-oriented methods can then be supplemented in exceptional circumstances by the use of the semi-market-oriented technique of varying the banks' cash reserve requirements.

Quantitative or "direct" methods of monetary policy, which attempt to suspend or bypass the operations of the financial markets, are avoided as far as possible. This applies in particular to credit ceilings, deposit rate controls, lending rate controls (excluding usury rate restrictions), direct controls over private sector capital issues and import deposit schemes. These controls not only obstruct the efficient operation of many financial markets but inevitably also lead to large-scale "disintermediation" and other distortions in the flow of funds in the economy. They therefore vitiate the attempts of the monetary authorities to exercise adequate influence over monetary demand.

Was it necessary to tighten monetary policy in August 1984?

The question is sometimes asked whether, in retrospect, the tightening of monetary policy in August 1984 was really necessary. The Reserve Bank's answer is an unqualified yes, *given the circumstances prevailing at that particular time*. It is true that the preceding mini-boom or spending spree of 1983/84 – at a time when the gold price was declining and the drought was taking its toll – could and should have been *prevented* by more effective demand management policy. As was pointed out at the time, the Budgets of March 1983 and March 1984 were excessively expansionary. So were the large wage and salary increases in the public sector in 1983/84. In addition, the Reserve Bank's monetary policy was too accommodative. But when on top of everything else the gold price suddenly slumped further in July 1984 (by about $40 per ounce), the writing was on the wall. Given the inadequate amount of fiscal policy in the overall policy "mix" at that time, there was no alternative in August 1984 but to tighten monetary policy.

In the prevailing circumstances a further marked deterioration in the current account of the balance of payments (already in considerable deficit) and an acceleration of the rate of inflation accompanied by a further depreciation of the rand had to be avoided or counteracted as far as possible. To this end the Reserve Bank simply had to curb its own accommodation to the banking system. The Bank could have done this by closing its discount window, i.e. by simply not extending any further financial accommodation to anyone. But while that would have achieved the objective of curbing the growth of the money supply and eliminating overspending, it would almost certainly have had extremely disruptive effects on the economy. For one thing, interest rates would have gone through the roof as each bank sought to buy funds in the market in order to meet its cash reserve requirements. At the same time banks would no doubt have had to call in some outstanding loans, with serious recessionary consequences. The Reserve Bank therefore chose the less disruptive method of continuing to provide the much needed accommodation, but only after raising its Bank rate by 3 per cent to 21,75 per cent, which meant that the commercial banks' prime rate moved up to 25 per cent. In due course this tightening of discount policy achieved its objective of curbing central bank credit and therefore the money supply growth rate.

The point is that in August 1984 it was imperative to take drastic action to curb total spending before the current account payments deficit and the inflation got out of hand and foreign borrowing became excessive. It is unfortunate that the burden of policy at that late stage had to fall on monetary policy. It would have been better if, in accordance with earlier Reserve Bank advice, fiscal policy had been less expansionary and if more appropriate remuneration and administrative pricing policies had been followed in the public sector during the preceding two years. The unjustified spending spree of 1983/84 would then not have occurred to anything like the same extent, and it would not have been necessary for interest rates to rise as much as they had to do in August 1984. *But in the circumstances that actually prevailed at that time, there was no alternative but to use restrictive monetary policies and these inevitably involved higher interest rates.*

Going back still further, it is evident that the gold boom of 1979 and 1980 was not handled as well as it might have been. When the gold price moved up sharply in 1979 and 1980 to a peak of $850 per ounce in January 1980, steps should have been taken to prevent the money supply from rising as excessively as it did and interest rates from falling to levels that were abnormally low in nominal terms and substantially negative in real terms. Such steps could have included a relaxation of exchange control and special issues of government stock with a view to building up a stabilisation fund. In retrospect it is also clear that a policy of adhering to a predetermined money supply target in the years 1979 to 1981 would have greatly eased the handling of the subsequent adjustment problems that inevitably followed the decline in the gold price, the drought and the capital outflow.

And so one could keep on going back in history pointing out what should have been done at the time in order to improve economic policy. Some of these steps were recommended *at the time* by both public and private sector economists; others have only become evident with the benefit of hindsight.

If the above analysis is accepted, and in particular if the need to tighten monetary policy in August 1984 is acknowledged, consideration still has to be given to the question whether direct monetary controls such as credit ceilings would not at that juncture have produced better results than the market-oriented methods actually applied.

Without any hesitation my answer would be in the negative. The imposition of quantitative ceilings on bank credit in August 1984 would have been much less effective than the policy instruments actually used and would at the same time have had more harmful and disruptive effects on the South African economy than those actually experienced.

Any notion that credit ceilings imposed in August 1984 might have had the effect of curtailing aggregate demand while keeping interest rates relatively low must be rejected. *To have prevented interest rates from rising in the prevailing circumstances the Reserve Bank would have had to continue expanding its own credit creation through its discount window and in other ways. And given the strong and rising demand for bank credit at that time*, ceilings on specified on-balance-sheet assets of registered banking institutions (which is what bank credit ceilings are) would not have been effective in curtailing aggregate demand. *"Disintermediation" would have been rife.* The rising demand for credit would have been met *outside the banking system*, in some cases with the active participation of the banks themselves.

The related notion that credit ceilings would have taken effect "almost immediately" whereas the market-oriented policies actually applied were slower to do so, is therefore also without foundation. The suggestion that credit ceilings would have penalised only new borrowers and would have promoted savings via non-availability of credit for spending must accordingly also be rejected.

No, it is precisely in situations such as those of August 1984 that credit ceilings imposed on certain specified on-balance-sheet items of registered banking institutions would *not* have been effective. The position would have been somewhat different if the Reserve Bank had at the same time closed its discount window and also refused to create additional credit in any other way. *But that would have pushed interest rates much higher than they actually went. And the economic consequences of that would have been very disruptive.*

The moral of the story is that, if at all possible, monetary authorities should not allow situations like that which prevailed in South Africa in August 1984 to arise. As already indicated, this state of affairs could have been prevented by means of more appropriate fiscal and remuneration policies in the public sector in the preceding two years. But once a situation like that of August 1984 has actually come about, a tightening of monetary policy is imperative in the interests of the economy.

One need only ask the question what would have happened to the South African economy after July 1985 (when the problems of enforced debt repayment and other capital outflows erupted) if the tightening of monetary policy in August 1984 had not succeeded in eliminating excess demand and transforming the deficit on the current account of the balance of payments into a huge surplus during both 1985 and 1986, and probably also in 1987.

The recent inflation: Neither demand-pull nor wage-push

The accelerated rate of inflation in South Africa during 1985 and 1986 is difficult to explain in conventional terms.

During this particular period the increases in the consumer and producer price indices have clearly not constituted demand inflation. During the twelve months to October 1986 the broad money supply M3 increased by only about 10 per cent, compared with a target rate of 16 to 20 per cent between the fourth quarter of 1985 and the fourth quarter of 1986. In addition, total spending has been rising too slowly rather than too rapidly.

Nor has the inflation of the past two years been of the conventional wage-push kind. As part of the inflationary spiral, wages and salaries have, of course, risen by more than productivity. But they have risen by *less* than the rate of inflation, so that *real* wages and salaries have declined quite markedly. Thus the rate of increase in the nominal remuneration per worker in the non-agricultural sectors of the economy, compared with the one-year-earlier level of remuneration, declined from 17,9 per cent in the fourth quarter of 1984 to 10,0 per cent in the first quarter of 1986, before accelerating again to 14,7 per cent in the second quarter. *Real* remuneration per worker in the second quarter of 1986 was 6 per cent *lower* than in the second quarter of 1984.

If the inflation of the past eighteen months was neither *demand* inflation nor *wage-push* inflation, what kind of inflation was it then? What caused the consumer price index to rise by 19,2 per cent between October 1985 and October 1986?

Clearly a major part of the answer lies in the depreciation of the rand from its relatively stable level of around 50 US cents between January and late-July 1985 to between 36 and 38 US cents during most of the remaining part of 1985. Although the rand then appreciated sharply to over 50 US cents by mid-March 1986, it subsequently declined again to around 37 US cents in mid-June before commencing a new upward movement to around 44 US cents by early October. Moreover, unlike most other exchange rate depreciations, these two particular ones could clearly *not* be laid at the door of excess money creation and spending. In both cases they were caused by an outflow of capital that occurred largely because of a deterioration in overseas perceptions of the domestic political and economic outlook, which resulted in a withdrawal by foreign banks of credits to South African banks and other enterprises and a net outflow of capital in other forms, including leads and lags in current payments and receipts. For this reason the upward pressure exerted on the price index by the depreciation of the rand was a special form of cost-push rather than demand-pull pressure.

This analysis is supported by the fact that the quarter-to-quarter percentage changes in the consumer price index, at seasonally adjusted annual rates, increased from 13,6 per cent during the third quarter of 1985 to 17,7 per cent during the fourth quarter and 27,2 per cent during the first quarter of 1986. It then declined sharply to 12,8 per cent during the second quarter of 1986 as the effects of the currency depreciation in the second half of 1985 began to peter out. It is more difficult, however, to explain the subsequent rise in this figure to 18,3 per cent during the third quarter of 1986. This acceleration mainly reflected sharp increases in the prices of food, vehicles, furniture and housing, which to some extent probably represented further delayed effects of the 1985 exchange rate depreciation plus the impact of the temporary new depreciation during the second quarter of 1986.

In these circumstances the monetary authorities deemed it undesirable to attempt to curb the rate of price increases by a new tightening of monetary policy. Such a tightening would have contributed little to removing the underlying abnormal causes of the exchange rate depreciation and the inflation, and would merely have delayed the domestic economic recovery.

Curbing inflation remains a high priority of official policy. But when one is dealing with a rising consumer price index which is (exceptionally) neither the result of excess demand nor of undue wage-push pressure, then the short-term answer (equally exceptionally) does not lie in more restrictive monetary and fiscal policies.

In the months ahead the official short-term monetary and fiscal strategy will therefore remain growth-oriented.