Inflation under scrutiny

By Dr Gerhard de Kock, Governor of the South African Reserve Bank

Progress in the inflation debate

In South Africa the inflation debate remains alive and well. In recent years good progress has been made in this debate. There are two matters in particular over which greater clarity and a reasonable degree of consensus have been reached:

Inflation is an evil that must be curbed

The first is the realisation that inflation is an evil and that the curbing of inflation deserves a high priority in official economic policy. This view has not always been so generally accepted as it is today. There was a time when many economists, businessmen and politicians took the stance that moderate inflation was conducive to economic growth, and should never be dampened if, even temporarily, this would mean a lower growth rate. The argument put forward was: "rather inflation with growth than price stability without growth".

In those days the Minister of Finance and the Reserve Bank had difficulty in convincing people that inflation was harmful for the economy and that it undermines economic growth over the long term. It was often argued: "What does it matter if the price level increases by nil or 5 or 10 or 20 or 30 per cent per year, so long as my salary or wage or other income increases by the same or a larger percentage?" It is, however, generally accepted today that inflation is harmful for real economic growth over the longer term, *inter alia* because it leads to malinvestment and the inefficient allocation of scarce labour and other resources, discourages saving and promotes speculation. It is also now better recognised that inflation can bring about pressure on exchange rates and/or the gold and foreign exchange reserves *via* the balance of payments, and leads to an inequitable distribution of income and severely harms certain groups such as pensioners.

Greater consensus regarding the causes of inflation

The second matter over which greater clarity and consensus exist in South Africa today, is the *causes* of inflation. At one stage there appeared to be much disagreement among economists and others on this subject. In particular, the debate centred on whether inflation was caused by excessive money creation and spending ("demand-pull") or by so-called "structural" and/or "cost-push" factors.

Although agreement has not yet been reached on this matter, a reasonable measure of consensus prevails today that inflation is normally caused by the *interaction* between excess demand and "structural" and/or cost-push factors. The latter "structural" and cost-push influences include *autonomous* rises in salaries and wages (i.e. rises that are *not* caused by increases in either monetary demand or prices but by factors such as pressure by trade unions, socio-political considerations, etc), inadequate competition, inflationary expectations and the tendency for "indexing" of wages to the consumer price index. These factors lend an inflationary bias to the economy which at times exerts strong pressure on the monetary authorities to "accommodate" or to "validate" price increases through large increases in Reserve Bank credit and in the money supply.

Inflation is not a synonym for impoverishment or a collective noun for all economic problems

This progress in the debate on inflation must be welcomed. It is good that there now exists a larger degree of consensus on the disadvantages and causes of inflation. But because it has important policy implications I would like to caution against a new fallacy that has arisen in some quarters. That is the tendency to use the word "inflation" as a synonym for "impoverishment" and/or as a collective noun for all economic problems.

"Inflation" is not the same as "impoverishment". Inflation impoverishes only those whose nominal incomes do not keep pace with the increase in the price level. Other people and sectors can actually benefit from inflation. Indeed, as in other countries, South Africa has quite often experienced periods of (for us) relatively high inflation *that have been characterised by great prosperity and a substantial increase in the average real gross national product per head of the population.* Two examples of such periods were 1971 to 1974 and 1978 to 1980. It is therefore understandable that on occasion inflation has been defined as "prosperity with high blood pressure".

There were indeed times when inflation was accompanied by a decline in the average real standard of living. It happened, for example, in 1985 and 1986, when the real gross domestic product per head of the population declined on average by 2,4 per cent per year. And most probably it is this fairly recent experience which explains why many people at present see "inflation" as the main reason for their "bread-and-butter" problems, and why the inflation problem receives so much attention in politics and in the media.

*Address delivered at the Annual Dinner of the Kaapstadse Afrikaanse Sakekamer on 22 April 1988.

But "inflation" and "impoverishment" remain two separate things. Inflation need not bring about impoverishment, and impoverishment can occur with or without inflation. Indeed, the great depression and unemployment of 1930-32, which at the time placed the "poor white problem" in South Africa in the limelight was accompanied by the very opposite of inflation, namely *de*flation, i.e. a *decline* in the price level.

"Inflation" should also not be used as a collective noun for everything that is bad in the economy. Inflation is an evil that must be curbed. But it is only *one* of many economic problems and then not always the most important one.

The curbing of inflation is also not the *only* objective of economic policy. There are also other important objectives such as optimal and stable real economic growth and employment; equilibrium in the balance of payments, accompanied by the maintenance of an appropriate exchange rate and a reasonable level of gold and foreign exchange reserves; and coping with sanctions and disinvestment. And in the short run there might at times be a conflict between these objectives. The Government's policy against inflation must therefore be dovetailed with its total economic strategy.

The State President's new economic initiatives

Against this background I now turn to the State President's historic opening address before Parliament on 5 February 1988. The importance of that address cannot easily be overemphasised. The new principles enunciated by the State President on that occasion represent a watershed in the history of economic policy in South Africa. They deserve the full support of the private sector and of all citizens in the country. What must particularly be welcomed, are the decisions to curb the expansion of Government expenditure more effectively, to lower the share of the public sector in the economy, to reduce the deficit before borrowing in the Budget as a percentage of gross domestic product, to proceed with privatisation and deregulation, and to implement certain important tax reforms proposed by the Margo Commission.

It must be emphasised that these measures are much more than just part of an anti-inflationary policy. Most of these initiatives would have been extremely desirable and important even if there had been no inflation in South Africa. The implementation of the State President's new approach will therefore do much more than merely contribute to the fight against inflation. It will improve the productivity and the welfare of the country's citizens. It will contribute to a higher growth rate and a higher standard of living. And it will make the South African economy stronger and sounder.

The abnormal nature of inflation in South Africa from 1985 to 1987

All of this brings me to an aspect of the inflation problem which deserves further emphasis. It is the fact that the inflation which was experienced in South Africa during 1985 to 1987 was of a highly abnormal nature and cannot be explained in conventional terms.

No demand inflation during 1985-87

The increase in the price level during 1985-87 was definitely *not* the normal kind of demand inflation. In 1983-84 South Africa did experience demand inflation and because fiscal policy was *too expansionary* in 1983 and in 1984, the authorities had to apply a restrictive monetary policy. But this policy soon succeeded in eliminating excess demand, and the political and economic situation subsequently evolved in such a way that total monetary demand increased too slowly rather than too rapidly. The period 1985-87 was therefore characterised by surplus production capacity, unemployment and a low rate of increase in real gross domestic product – minus 1 per cent in 1985, plus 1 per cent in 1986 and plus 2½ per cent in 1987.

The broad money supply (M3) also did not increase too rapidly during this period. On the contrary, throughout those two years the rate of increase remained below or within the target range set for M3 of 16 to 20 per cent in 1986 and 14 to 18 per cent in 1987. The *effective* broad money supply or MV, i.e. M3 *adjusted for changes in its velocity of circulation,* also did not increase excessively. Between the fourth quarter of 1985 and the fourth quarter of 1986 it increased by 18,4 per cent, and between the latter quarter and the fourth quarter of 1987 by 16,1 per cent. These rates of increase fell within the target range set for M3.

It is clear that total monetary demand (consumption plus investment) did not exert excessive pressure on resources during 1985-87. During this period there was never any question of "too much money chasing too few goods".

No wage-push inflation during 1985-87

Inflation during 1985-87 was also not of the conventional *wage-push* kind. Of course, as part of the inflationary spiral, wages and salaries naturally increased by more than productivity. But they increased by *less than* the rate of inflation. *Real* wages and salaries consequently declined noticeably. Indeed, in the third quarter of 1987 real remuneration per worker was 9,03 per cent *lower* than in the first quarter of 1984.

The main reason: exchange rate depreciation resulting from a capital outflow

If the inflation from 1985 to 1987 was neither demand inflation nor wage-push inflation, what kind of inflation was it then? More specifically, what brought about the marked temporary acceleration in the rate of inflation from about the middle of 1985?

The main reason was clearly the depreciation of the rand from its relatively stable level of about 50 US cents between January and late July 1985 to between 36 and 38 US cents during the ensuing months. Although the rand strengthened to over 50 US cents early in 1986, it again depreciated to about 37 US cents in the middle of June during the run-up to Soweto day on 16 June 1986, before it once again moved upwards to a peak of about 52 US cents late in December 1987.

But was this depreciation of the rand not, in fact, the consequence of excessive money creation and spending? This is a good question because exchange rate depreciation is normally the *result* of excessive monetary demand. However, this was clearly not the case in 1985-87. The depreciation of the rand during those years had a totally different origin, namely an outflow of capital mainly caused by a deterioration in overseas perceptions of the country's domestic political and economic prospects. This deterioration 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. This outflow of capital did *not* occur because South Africa was suffering from demand inflation, or because the money supply was rising too rapidly, or because interest rates were too low, or because the Budget deficit was too large. It was the direct result of political strains.

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 14,5 per cent during the third quarter of 1985 to 24,9 per cent in the first quarter of 1986. Subsequently it declined sharply to 13,5 per cent during the second quarter of 1986, as the influence of the earlier depreciation of the exchange rate subsided. During the third quarter of 1986 this figure again increased sharply to 20,3 per cent – mainly because of the further delayed effects of the exchange rate depreciation of 1985, and the temporary new depreciation during the second quarter of 1986.

Balance of payments adjustment through exchange rate depreciation and "inflation"

The key point is that the exchange rate depreciation *and the accompanying increase in the domestic price level* after the middle of 1985, formed part of the unavoidable adjustment process which the South African economy had to experience during this period. The economy had to adjust to (a) the lower dollar price of gold, weak commodity markets and the drought, and (b) the large outflow of capital. In order to make these adjustments the average real standard of living of South Africans inevitably had to decline. Belts simply had to be tightened.

These unavoidable adjustments were effected via exchange rate depreciation and price inflation. The toll exacted by these adjustments was substantial. In 1985 and 1986 real gross national product per head of the population declined by an average of about 2,4 per cent per year, real personal disposable (after tax) income per head by an average of 5,2 per cent per year, and real private consumption per head by an average of 4,4 per cent per year.

The fact remains, however, that the South African economy successfully effected the adjustment that had been forced upon it. The current account of the balance of payments showed huge surpluses of between 3,7 and 5,2 per cent of gross domestic product during 1985, 1986 and 1987. About US$5 billion of foreign debt was repaid during that period. The gold and foreign exchange reserves increased substantially after June 1986. The depreciation of the rand was transformed into an appreciation during the course of 1986. The real growth rate increased substantially and the quarter-to-quarter increase in the consumer price index, at seasonally adjusted annual rates, declined from 24,9 per cent in the first quarter of 1986 to 13,5 per cent in the fourth quarter of 1987.

The temporary acceleration in the rate of inflation after the middle of 1985 and the accompanying decline in the real income per head of the population should therefore be viewed as part of the mechanism of balance of payments adjustment and not as conventional demand-pull or wage-push inflation. To effect this adjustment South Africa had to export more and import less, and this in turn necessitated a depreciation of the rand and changes in *relative* prices.

Would deflation not have been a better adjustment method?

The question might well be asked if South Africa could not have adjusted to the unfavourable economic and political developments with *lower price increases?*

In theory the answer is yes. But it would have required draconian *deflationary* fiscal and monetary measures which, among other things, would have meant decreases or very limited increases in *nominal* wages and salaries. In other words, the required decline in *real* income could have been attained by means of a restrictive monetary policy with very high interest rates, higher taxes and lower government expenditure, which would have led to declines or only small increases in *nominal* wages and salaries. But such a deflationary policy would have exacerbated unemployment and further undermined business confidence. Under the old gold standard the adjustment process would indeed have taken place along these lines. The disastrous depression in South Africa during 1931-32 serves as a good case in point. But in the prevailing abnormal socio-political circumstances, such an adjustment *via deflation* would not have been in the country's interest.

The authorities opted in 1985-87 in favour of exchange rate depreciation and a fairly expansionary monetary and fiscal policy instead of a policy of deflation with high interest rates, high taxes, etc. This was the correct choice. In the circumstances that prevailed in 1985-87, inflation was *not* South Africa's main economic problem. It would have been wrong to have made the curbing of inflation the highest objective of economic policy at that stage. Priority was rightly given in the short term to strengthening the balance of payments and counteracting unemployment and recession.

The fact that the rate of inflation was not reduced to a low single digit during 1985-87 therefore does not mean that monetary and fiscal policy "did not work". It simply was not the purpose of monetary and fiscal policy at that time to lower the rate of inflation *at all costs* to a very low figure. The main objectives were to survive the onslaught against South Africa by securing a large surplus on the current account of the balance of payments in order to finance the repayment of debt and the outflow of capital, to preserve the gold and exchange reserves, and thus to create a new and sound basis for more rapid economic growth. Today it is common knowledge that these objectives of monetary and fiscal policy were, in fact, achieved.

The return to more normal circumstances in 1987/88:

The implications for anti-inflationary policy

What about the curbing of inflation in 1988 and beyond?

Danger of new demand inflation

The abnormal circumstances that prevailed in 1985 and 1986 are now something of the past. The South African economy is currently doing better than it has done for years. The latest statistics confirm that the economic upswing has recently gained substantial further momentum, and the indications are that private and government consumption, fixed and inventory investment, production, employment, trade and general economic activity will all continue to rise strongly throughout 1988. The upswing in the economy is undoubtedly more vigorous than was previously thought.

As the upswing gained momentum during recent months, the demand for bank credit and other loanable funds increased substantially. This, in turn, led to increased pressure on the Reserve Bank to supply the banks with additional cash reserves to enable them to keep on expanding their own credit. Under the influence of supply and demand most interest rates increased in these circumstances from the abnormally low levels (negative in real terms) that had prevailed during most of 1986-87. To moderate this upward pressure on interest rates the Reserve Bank created substantial amounts of cash reserves for the banks by increasing its credit extension to them. The Bank realised, however, that in the changed circumstances it could not carry this expansionary policy too far because of the danger that it might lead to an excessive increase in the money supply and new demand inflation. This, in turn, would before long transform the surplus on the current account of the balance of payments into a deficit.

If South Africa had enjoyed reasonably normal political relationships with the rest of the world, such a current account deficit would have been a logical and desirable consequence of the cyclical upswing, and would automatically have been financed to a considerable extent by a normal inflow of foreign capital. But because of our unique political position in the world, we cannot depend on such a capital inflow. We must therefore keep the current account of the balance of payments in surplus or at least in reasonable equilibrium, or else excessive downward pressure might be brought to bear on the exchange rate of the rand and/or the gold and foreign exchange reserves.

Anti-inflationary monetary and fiscal policy

The Government and the Reserve Bank have for some time now recognised the possibility that the present gratifying economic upswing might precipitate new demand inflation. They also know from experience that if "too little too late" is done to curb monetary expansion, drastic measures of one kind or another to curb spending will most probably have to be applied later on, which then may have disruptive results. Realising that prevention is better than cure, the authorities have already taken various steps in recent months to make monetary and fiscal policy less accommodative.

Thus, the Reserve Bank has, with the concurrence of the Minister of Finance, lowered its target range for the rate of increase in the broad money supply, M3, from 14 to 18 per cent for 1987 to 12 to 16 per cent for 1988. If the curbing of inflation had been the only objective of short-term economic policy an even lower target range would have been set. But since it remains an important policy objective to promote real economic growth and employment, it was deemed advisable to provide the necessary monetary scope for a further increase of between 2½ and 3½ per cent in real gross domestic product in 1988. It is believed that the new target range for M3 in 1988 will prove to be consistent with both an acceleration in the economic growth rate and a further gradual decline in the rate of inflation.

Furthermore, on 9 March 1988 the Reserve Bank gave a clear indication of its determination to curb its own rate of credit creation by increasing its Bank rate from 9,5 to 10,5 per cent – the rate at which it rediscounts Treasury bills for discount houses. This increase was partly a technical adjustment to increases in interest rates which had already taken place in the money market. But it was also a consequence as well as an integral part of the Bank's less accommodative monetary strategy.

The determination of the Government to prevent the present phase of strong growth from generating new demand inflation is also evident from the Minister of Finance's Budget Speech of 16 March 1988. The Budget provides for an increase in expenditure of only 12,6 per cent in the 1988/89 fiscal year. Furthermore, it is estimated that government revenue will increase by 16,3 per cent. The estimated "deficit before borrowing" then comes to R9 860 million which will amount to 4,9 per cent of the expected gross domestic product, compared with 5,8 per cent in the previous year.

In accordance with the State President's new economic initiatives we therefore now have a better "mix" of monetary and fiscal policies than for many years. This policy stance also dovetails well with the recent recommendations of the Economic Advisory Council of the State President to curb inflation, which provide for a further lowering of the average annual rate of inflation from 16,1 per cent in 1987 to about 9 per cent in 1990, i.e. by about 2½ percentage points per year.

If unforeseen unfavourable political or other developments are left out of account, present indications are that this intended gradual lowering of the inflation rate is well within South Africa's grasp. One precondition for such a reduction obviously is that the Government and the Reserve Bank should implement their announced fiscal and monetary policies. Specifically, increases in the broad money supply must be kept within the target range of 12 to 16 per cent and government expenditure and the deficit before borrowing should not greatly exceed the Budget estimates.

If these intermediary objectives of monetary and fiscal policies are attained, the inflation rate will probably show a further gradual decline, and more direct controls over prices and wages, or any other form of "incomes policy", will be unnecessary. And if the announced monetary and fiscal policies are *not* effectively applied, more direct controls over prices and wages would not be the answer. In fact, such direct controls would then create more problems than they would solve.

The stronger economic upswing and the higher growth rate represent good news. This is exactly what we wanted. But now we must not back away from the implications of the success of our own growth policy. The return of confidence and prosperity creates its own new challenges that call for adjustments in monetary and fiscal policy. More specifically, full account must now be taken of the danger of excessive money creation and new demand inflation. Already there are indications that the rate of increase of the money supply is overshooting the target range by a considerable margin. If this tendency continues, monetary policy will have to be made still less accommodative.