

## BYE-BYE "INFLATION TARGETING"

Basil Moore

Professor Extraordinary of  
Economics  
University of Stellenbosch

- *"For the ordinary man on the street, who was never taught economics or the Quantity Theory of Money, the acceptance of Keynes' basic ideas came far easier. For to him it amounted to no more than the assertion that the Government must see to it that sufficient employment opportunities are made available so that everyone can get a job."*
- Nicholas Kaldor, Origins of the New Monetarism

- *"Monetarism" operates by raising the level of interest rates and reducing aggregate demand for goods and services, thus lowering the level of employment and income, in order to discipline workers and keep them "in line".*
- *"The cultural level of a nation is mirrored by its rate of interest: the higher a people's moral strength and cultural level, the lower the rate of interest."*
- Eugen Boehm von Bawerk, 1896.

- Sidney Homer, A History of Interest Rates (1991) attempted to confirm empirically Boehm Bawerk's insight. Homer provides a remarkable reference of interest rate levels, trends and cycles from ancient times (3000 BC) to the present (1989). Over the centuries the increase in income and wealth is associated with a clear secular downward trend in the level of interest rates.

- In 1959 Conard provided a comprehensive review of Bawerk's, Fisher's, and Knight's non-monetary saving and investment theories of interest, and Hick's and Keynes' monetary loanable funds and liquidity preference theories. He recognized there was not one "rate of interest" but an entire structure of rates depending upon term to maturity. But he was unable to produce a resolution of how monetary and nonmonetary theories together determined interest rates.

- In 1939 Haberler stated: *"The theory of interest has for a long time been a weak spot in the science of economics. The examination and determination of the interest rate gives rise to more disagreement among economists than any other branch of economics."*
- *"The theory of interest is, at present, in a state of utter confusion."*
- Vera and Friedrich Lutz, 1953.

- This long outstanding controversy at the very core of macroeconomics has recently been resolved by the Post Keynesians, who recognize the fundamental role of CB's as the residual supplier of liquidity to the economy, and who set "Bank Rate" as the supply price of system liquidity as their exogenous control instrument. CB's supply reserves to the banking system endogenously on demand. The supply of credit-money then becomes endogenously credit-driven.

- The RB stunned markets last June with its decision to keep rates unchanged at 7.5%, in the face of the world's unprecedentedly severe depression. This was explained by the RB's "Inflation Targeting" policy, because the inflation rate was above the Bank's 3-6% target range. At the August meeting the RB "surprised" markets, with a 50 basis point cut, even though inflation was still above the bank's target range.

- The fact that all developed countries and the majority of developed countries have now reduced rates to near zero levels provides a strong case for the RB to question its inflexible pursuit of "inflation targeting."
- As Bernanke recently explained to the US Congress, "The Federal Reserve needs to keep interest rates close to zero until unemployment begins to come down."
- The RB and the SA public should become better informed about the current inflation and Stagflation.

Two fundamentally different types of inflation, demand-pull and cost-push.

#### 1. DEMAND-PULL INFLATION

- Occurs when newly-created bank deposits are issued in response to increased credit demand, finance increases in demand for G&S, and causes their prices to increase.
- Demand-pull inflation occurs primarily during cyclical expansions and wars, and
- can be restrained by higher interest rates.
- But few would argue that in the current depression inflation is caused by "Excess Demand".

#### COST-PUSH INFLATION

- Caused when factor prices increase more rapidly than factor productivity, increasing unit costs, prices and sales volumes.
- Even though increased money growth may be highly statistically associated with inflation, it is not itself the **cause** of inflation.
- The cause lies primarily in labor markets.

- Under **cost push inflation** price increases caused primarily by increases in factor costs.
- Labor is the single most important factor.
- The inflation rate broadly is broadly equal to the excess of the rate of average money wage increases, over the rate of growth of labor productivity.
- Wage increases above rate of average labor productivity growth cause unit labor costs to rise, and so are inflationary unless firms can be induced to reduce their markups.
- They can be regarded as an indirect tax on everyone outside the labor union.

- How is this possible, in face of SA's world-leading unemployment rates? Why doesn't high unemployment depress the rate of money wage increases in SA?
- Current wage demands are in the range of 10-20 %.
- The answer is how wage increases are negotiated, and the power of trade unions in SA (COSATU)
- In SA wages set by industry-wide collective bargaining among largest firms and unions.
- Once a wage increase is negotiated, it must be accepted by **all** firms in the industry so long as they have a minimum number of employees.

- In both the private and the public sectors unions have set their wage demands for next year between 10-20 %. Unions currently sense an opportunity, since in world cup year 2010 the last thing the government wants is for SA to be displayed on world TV screens as a country with the world's highest unemployment rates riven by violent striking workers!!!

- Under **cost push inflation** price increases caused primarily by increases in factor costs.
- Labor single most important factor.
- Inflation rate broadly equal to the excess of average money wage increases over the rate of growth of labor productivity.
- Wage increases above rate of average labor productivity growth cause unit labor costs to rise, and so are inflationary, unless firms can be induced to reduce their markups.

- Current wage demands in range of 10-20 %.
- How possible in face of SA world-leading unemployment rates? Why doesn't high unemployment depress the rate of money wage increases in SA?
- The answer is how wage increases are negotiated and the power of trade unions (COSATU)
- In SA wages set by industry-wide collective bargaining among largest firms and unions.
- Once a wage increase is negotiated, it must be accepted by **all** firms in the industry so long as they have a minimum number of employees.

- In both the private and the public sectors unions have set their wage demands for next year between 10-20 %. Unions currently sense an opportunity, since in world cup year 2010 the last thing the government wants is for SA to be displayed on world TV screens as a country with the world's highest unemployment rates and riven by violent striking workers!!!

- There now appears to be an approaching consensus within the ANC that the one-Instrument-one target "**Inflation Targeting**" policy has now outlived its usefulness.
- Even the world's highest unemployment rate (24%) is currently insufficient to moderate union wage demands down towards average productivity growth rates as required for price stability.
- In the present depressed situation, continued pursuit of inflation targets will lead to lower growth and higher unemployment with no reduction in the inflation rate.

- What must be done?
- Union leaders are of course aware that higher money wages lead to higher prices.
- But union leaders are caught in their own wage trap, due to the ignorance of their members and their fury about their current situation.
- Should they fail to demand astronomic wage increases, they will be quickly replaced by others.
- There appears to be only one solution.
- A new "***Social Contract***" between labour, business and government must be developed, as in China and the Asian Tigers.

- 1) Labour unions must agree by 2012 to moderate their wage demands. Average wage increases must be aligned to the average rate of labour productivity increase experienced over the period 2010-11, say 2-3%.
- 2) Business firms must agree by 2012 to maintain average prices constant providing their unit cost remain constant.
- 3) The RB must agree by 2012 to reduce the repo rate to 0-1%, require that banks set their Prime Lending rate at a modest markup over the repo rate, say 2-3%, and persuade the banks to grant creditworthy customers credit up to their overdraft ceilings.

- Both the government and RB must educate the public about stagflation, acknowledge that high interest rates act as a break on AD growth and depress AD and output.
- Short-term capital inflows respond strongly to interest rate differentials among economies. Differentially higher interest rates cause an inflow of short-term capital and an appreciation of the exchange rate.
- This will continue until exchange rate overshooting has increased the expected rate of exchange rate depreciation to equal the interest rate differential.

- In spite of all the talk about ***Green Shoots***, no one can predict how long the current recession will last. But we do know that unemployment is a lagging indicator, so unemployment will increase long after AD stabilizes.
- Even if the repo rate were reduced to zero, the private sector would be unwilling to undertake sufficient investment to generate a full employment level of AD and output. We must rely on the government to generate full employment.

- But we also know that governments have great difficulty delivering on their promises.
- The job of CB's is to set Bank Rate at the level that is expected to result in full employment and stable prices.
- Only governments will undertake long-term borrowing during extreme recessions, since only they have the long-term horizon required. They have the ability to conduct benefit-cost analysis, develop a list of investment projects, and put such projects up for bidding by the private sector.

- The current world slump in fact presents governments with a once-in-lifetime-opportunity, which also happens to be do-able. Governments should not be in the business of directly building capital assets. They should leave all capital investment projects to be bid on and produced by the private sector.

- The RB should reduce the repo rate to zero. This will cause the exchange rate to depreciate, since the current carry-trade of borrowing short will dry up. The fall in interest rates will increase the prices of all long-term assets. This will serve to increase employment in the export, import-substitution and capital goods sectors.
- This would serve to persuade the masses of the huge advantages of a low interest rate monetary policy. As Galbraith said, "*Lenders have more money than borrowers, which is why they can lend the money.*"

- Even though "*Animal Spirits*" are currently thoroughly depressed, in time AD will respond to low levels of interest rates.
- An increase in government borrowing to finance additional capital accumulation when private investment is insufficient will increase the ratio of government debt to income.
- But the government's debt-burden should be based on the ratio of interest payments, not debt, to income. When interest rates are halved, the government's debt-burden is also halved.

- Surely such a Keynesian "*Social Contract*" is vastly more civilized than the Monetarist bludgeoning, threatening, high unemployment-high interest rate "*Inflation Targeting*" policy, as the way to achieve simultaneously price stability and full employment?
- One may reasonably question whether the SA electorate and the ANC leadership have the imagination to carry out such a proposal, and whether the ANC government has the skills and ability to carry out a "*Social Contract*" successfully?
- Only time will tell. But like life, it is better than the alternative.