

Bye - Bye “Inflation Targeting”?

Basil Moore

Professor Extraordinary of Economics, Stellenbosch University.

“For the ordinary man in 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*, 1981, p.13.

At the end of the 19th century the famous Austrian economist Eugen Böhm von Bawerk concluded:

“The cultural level of a nation is mirrored by its rate of interest: the higher a people’s intelligence and moral strength, the lower the rate of interest”¹.

At the time market rates of interest in the main trading nations were at historically low levels, 2.5% - 3.5% for long term prime credits, and inflation was not the problem it is at present. The price level at the end of the century was roughly the same as at the beginning of the century.

Sidney Homer’s *magnum opus*, ***A HISTORY OF INTEREST RATES***² attempted to confirm empirically Böhm Bawerk’s insight. It provides a remarkable reference collection of interest rate levels, trends and cycles from ancient times (circa 3000 BC) to the present (1989). Homer explains that cattle comprised the first productive assets of individuals or tribes, and explains the origin of the term

¹ Böhm von Bawerk, Eugen (1851-1914), quoted by J.A. Schumpeter in *Ten Great Economists*, (New York, Oxford University Press, 1951), 182. Had Böhm Bawerk substituted “*financial*” for “*moral*” strength and “*technological*” for “*cultural*” level, more people today would agree with him. But Bawerk meant what he said. Had these substitutions been suggested to him Bawerk would have responded that “*moral strength*” was a precondition for “*financial strength*,” and a high “*cultural level*” was a precondition for a high “*technological level*”.

² Homer, Sidney and Sylla, Richard, *A History of Interest Rates*, 3rd Edition (Rutgers University Press, London, 1991).

“pecuniary”, which comes from the Latin *“pecus”* meaning *“flock”*. Homer documents at length the manner in which the level of interest rates has varied inversely with the level of economic prosperity over this huge time span. The historical fluctuations of interest rates, and the succession of crises that accompanied them make for dramatic reading. But over centuries the increase in income and wealth is clearly associated with a secular downward trend in interest rates.

The level of interest rates in fact summarizes how we in the present value income in the future. Before the founding of central banks the theory of interest held a central and critical position in the history of economic thought. Most outstanding economists felt called upon to make a major contribution to the unresolved and contentious theory of interest and capital.³

Haberler stated:

*“The theory of interest has for a long time been a weak spot in the science of economics. The explanation and determination of the interest rate gives rise to more disagreement among economists than any other branch of economics”.*⁴

Similarly Vera and Friedrich Lutz began their 1951 *“Remarks on the Theory of Interest”* as follows:

*“The theory of interest is, at present, in a state of great confusion.”*⁵

Early in the postwar years (1959) Conard provided a comprehensive and exhaustive summary of Boehm-Baverk’s, Fisher’s and Knight’s nonmonetary saving and investment theories of interest (time preference and productivity), and Hicks’s and Keynes’s monetary theories (loanable funds and liquidity preference, and did his best to sort out their interrelationships. Conard extensively examined the validity of nonmonetary and monetary theories and recognized there was not one **“rate of interest”** but an entire structure of rates depending upon term to maturity. But he was unable to integrate the implications of market imperfections and uncertainty for the rate structure, or

³ Joseph Conard, *An Introduction To The Theory Of Interest*, (University of California Press, Berkeley, 1959).

⁴ Gottfried von Haberler, *Prosperity and Depression*, Geneva, League of Nations, 1939), 195.

⁵ Vera and Frederich Lutz, *The Theory of Investment of the Firm* (Princeton University Press, Princeton, 1951) 237.

produce a resolution of how monetary and nonmonetary forces together determine interest rates⁶.

This long-outstanding controversy at the very core of macroeconomics has finally been made obsolete by the Post Keynesians, who emphasize the fundamental role of central banks as the residual supplier of liquidity in all monetary economies, and in the process **exogenously** set the supply price of liquidity in the economy. Commercial banks are one special type of financial intermediary whose deposits are generally accepted in exchange. Banks act as price-setters and quantity-takers in their retail deposit and lending markets, and supply newly-created deposits endogenously in response to borrowers' demand for bank loans.⁷ Central banks set "**Bank Rate**" the rate they make reserves available to the banking system, as an **exogenous control instrument**, and supply cash reserves **endogenously** to the banking system as demanded. Central Banks set the level of **Bank Rate** at the rate they believe will enable the economy to achieve their various stabilization goals: **full employment, price stability and rapid growth**. Long rates are market-determined, and are based on financial market participants' expectations of the levels of Bank Rate they believe central banks will set in the future.⁸

The SA Reserve Bank stunned markets last June with its decision to keep interest rates at 7.5 %, in the face of the world and SA's unprecedentedly severe recession. "*Decision to leave rates on hold dismays business and angers trade unions*" (Business Day, 26 June). This was explained as due to the Reserve Bank's "**Inflation Targeting**" policy, because the inflation rate was above its assigned 3-6% target range.

Business Day argued that due to the "stickiness" of the inflation rate, and the long period that inflation had remained above its 3-6 % target range, if the Reserve Bank had not left rates on hold its inflation targeting credibility would have been questioned. After stating, "**Mboweni's view is that there should be no further rate cuts,**" Business Day concluded:

"This is not the time to let go of the inflation fighting levers, and the decision to hold rates was the right one....The danger is that monetary policy may

⁶ Conard, 1959.

⁷ Moore, Basil, *Horizontalists and Verticalists: The Macroeconomics of Credit Money*, (Cambridge University Press, London, 1988)

⁸ Moore, Basil, *Shaking the Invisible Hand: Complexity, Endogenous Money and Exogenous Interest Rates* (Palgrave Macmillan, London, 2006)

need to go looser in the future to prevent deeper damage. Let's hope that doesn't happen and yesterday's decision turns out to be right.

Since then a new Governor, Gill Marcus, has been appointed to the Reserve Bank and the issue of ***'Inflation Targeting'*** has been reopened. At its August meeting the Reserve Bank "surprised" markets with a one half of a percentage rate cut, although the inflation rate remained above its the 3-6% target range, due to the escalation of services prices (8%). The bank justified this reduction because it believed ***"adverse economic conditions"*** stemming from the world recession had substantially lessened the risk of more rapid inflation. Rather than reporting that output had ***fallen by another 3%*** this quarter the fall in output was given a positive twist: ***"the pace of contraction slowed to 3% in the second quarter of this year from 6.4 % in the first quarter,"*** perhaps to counter criticism that the 50 basis point reduction was insufficient.

The fact that all developed countries in the world have now abandoned their "Taylor Rule" behavior in setting rates, and have now reduced rates to near-zero levels, provides a strong case for the Reserve Bank to question its inflexible pursuit of inflation targeting, where rates can only acceptably be cut when inflation falls within its target range. Governor Marcus must next face the difficult question: ***"should the repo rate be further reduced, even if inflation exceeds its 6% target?"***

A recent issue of the ***Economist*** states that of the 42 countries summarized in ***Economic and Financial Indicators***, all the developed countries, and a large **majority** of the developing countries (27 in total), have now abandoned Taylor Rule calculations and have sharply reduced Bank Rate to 2 percent or lower in response to the severity of the world depression. Of the few (8) developing economies who are keeping Bank Rate near or above SA levels, 6 are facing double-digit inflation and so now have very large negative **real** rates.

As Ben Bernanke recently explained to the US Congress, ***"The Federal Reserve needs to keep interest rates close to zero until unemployment begins to come down"***. Both the Reserve Bank and the SA public must become better informed about the current **stagflation** in SA. It is critical that two fundamentally different reasons for inflation must be distinguished: ***"Demand-Pull"*** and ***"Cost Push"***:

Demand-Pull Inflation occurs when newly-created bank deposits, issued in response to increases in demand for bank credit, finance increases in the demand (AD) for goods and services and cause their costs and prices to rise. Demand-pull inflation occurs primarily during cyclical expansions, and wars. Such inflation can indeed be restrained by higher interest rates. But very few or no economists would argue that in today's depressed world inflation is caused primarily by "excess demand".

Cost-Push Inflation occurs when factor prices rise more rapidly than factor productivity and so raise unit costs, prices and sales volumes. Higher wage bills result in an increased demand for bank credit, and an expansion in bank deposits. In the case of **Cost Push** inflation, even though increased money growth is statistically **associated** with inflation, the increase in the money supply is not itself the **cause** of inflation. Costs and prices rise because the average increase in money wages is in excess of the average rate of labour productivity growth. So the **cause** of the inflation lies in the labour markets.

In all economies wages account for from one-half to three-quarters of total income, so labour is by far the most important productive factor. In SA current union wage demands in both the public and private sector are for increases between 10-20 %, far above labor productivity growth rates of 2-3%. Such wage demands are justified by the need "**to offset**" past inflation and "**rationalize**" existing wage differentials.

Under **Cost-Push inflation** price increases are **caused** by increases in factor costs. The resulting inflation rate is broadly equal to the excess of average money wage increases over the rate of growth of average labor productivity. Wage increases that are above average labor productivity growth necessarily raise unit labor costs, and so are inflationary unless firms can somehow be induced to reduce their price markups, and to accept lower profit rates.

But how are such high inflation rates possible in SA in the face of its world-leading unemployment rates? The existence of high unemployment (an excess supply of labour) is supposed to operate in labor markets to depress the rate of money wage increases? Why doesn't this happen in SA?

The answer is manner in which wage increases are negotiated in SA, due to the huge political power of trade unions (COSATU). Wages are set in industry-wide

collective bargaining among the largest firms and unions in the industry. Once a wage increase has been negotiated and accepted by the largest firms in the industry, it must be adopted by all firms in the industry so long as they have a (small) minimum number of employees.

Market concentration is extremely high in SA, and the leading firms possess substantial market power to set prices. Large firms in SA are willing and able to pay double-digit wage increases to their employees, even in the face of astonishingly high levels of unemployment on the part of unemployed labor “outsiders”, since these SA firms can never be undercut by lower-wage domestic firms in the same industry. Since increases in unit labor costs are common to all firms in the industry, in concentrated markets they can easily be passed on to restore profit margins by higher prices.

The main constraint on high wage increases is their effect on the external sector and the trade balance. The value of the Rand appreciates in response to short-term capital inflows, which have been attracted by the very substantial interest rate differential between the level of interest rates set by the Reserve Bank and the much lower levels set by CB's in core economies. High wage increases raise the price of exports in the export sector, diminish the quantity of exports demanded, and reduce the rate of profits earned in the export sector. The high value of the Rand also reduces the price of all imported goods, causing imports to increase and the current account balance to deteriorate. The lower price of imports serves somewhat to reduce the SA inflation rate.

As stated in both the private and the public sector most labor unions have set their wage demands for next year between 10 - 20%. Unions currently sense a golden opportunity, since in the World Cup year of 2010 the last thing the ANC government desires is for SA to be displayed on world screens as a country riven by violent and disruptive striking workers.

There appears to be an approaching consensus within the ANC that the one-instrument-one target ***“Inflation Targeting”*** policy has now clearly outlived its usefulness. Due to a whole number of factors: the extra market power of labor unions in a World Cup year, worker fury about the existing high degree of income inequality, the inability of ANC municipal governments to deliver promised services, the fact that CEO's and Government Ministers and fat-cats can receive 100 times average worker wages, the government's election

promises to reduce unemployment in the country by half by 2017, the formal participation of COSATU in the ANC government, the political debts President Zuma owes to COSATU and the Communist Party, even the world's highest formal unemployment rate (24%) is no longer sufficient to moderate union wage demands down to the average productivity growth levels as required for price stability.

In the present depressed situation the continued pursuit of inflation targeting under current wage inflation leads simply to higher interest rates, lower investment spending, lower growth rates of investment and consumption demand and output, higher levels of unemployment, and the inability of government to approach its employment targets, with little or no reduction in the ongoing inflation rate.

What must be done? Union leaders are of course aware that higher money wages will lead to higher prices. They also know that prices are generally set by firms at stable markups over unit costs. Union leaders also understand that in the long run *real* wages cannot continue to exceed the rate of growth of average labor productivity.

But union leaders are currently also caught in their own wage trap, due to the ignorance of their members, and their fury with their current situation. As a surprise bonus they find their bargaining power greatly enhanced vis-a-vis business and government by the 2010 World Cup. Union leaders are forced to demand current astronomic wage increases, in order to satisfy their angry members. Should they fail to do so others will quickly come forward to take their place.

What is required in SA is first more thorough analysis and understanding of the basic roots of the **stagflation**. Money wage demands must somehow be moderated. There appears to be only one viable solution to achieve price stability. A new **"Social Contract" between labor, business and government must be developed**, as has been done in China and in all the Asian Tigers, and was supposed to be (but never was) developed by NEDLAC.

Such a **Social Contract** must be initiated and administered by NEDLAC at the national level in a system of nationwide collective bargaining. It must be targeted to begin some time in the future, say 2012, so all parties are able to

thoroughly inform their members and fully understand and anticipate the interdependencies and constraints. Only a national **social contract**, and with it a new set of wage and price increases can lead SA out of its current stagflation toward a higher level of growth and output, with full employment of labour, stable prices, and a healthy positive balance in the current account.

- 1.) All **Labor Unions** must agree by 2012 to moderate their wage demands. Average wage increases demanded and received in all sectors must be aligned to the average rate of labor productivity increase experienced in the economy over some recent period, say 2010-11, a figure in the order of 2-3%.
- 2.) All **Business Firms** must agree by 2012 to maintain their average prices constant, so long as their unit labor costs remain constant. So long as average wage increases in 2012 are equal to the average rate of labor productivity growth experienced in 2010-11, unit wage costs and prices will remain stable.
- 3.) The **Reserve Bank** must agree by 2012: a) to reduce its repo rate to 0-1%, b) to require banks to set their Prime Lending rate at a modest markup over the repo rate, say 2-3%, c) to persuade banks to unlock lending markets and grant to all their credit-worthy customers the quantity of credit demanded, up to their previously-negotiated overdraft ceilings.

Both the Government and the Reserve Bank must educate the SA public about the most important causes of stagflation. They must explicitly acknowledge that high interest rates act as a break on AD growth, and are in fact designed to depress the growth of AD and output. By directly reducing investment and consumption demand, high interest rates constrain the total level of income, output and employment created in the economy. By raising the cost of borrowing and reducing the present value of all reproducible and non-reproducible assets, high rates reduce the market value of all durable assets, reduce the total amount of deficit-financed investment and consumption spending, and so reduce total income, output and employment.

Short-term capital inflows respond strongly to interest rate differentials among economies. Differentially higher interest rates than in the rest of the world cause an inflow of short-term capital, and an appreciation of the exchange rate. Economic theory teaches that this appreciation will continue and will cause the exchange rate to overshoot, until the expected future annual rate of

exchange rate depreciation has is sufficiently large to offset the local-foreign interest rate differential, so that capital inflows cease.

Despite of all the talk about **Green Shoots** no one knows or can predict how deep long the current recession will be, or how long it will last. But we do know some things:

1) Unemployment rates are a lagging indicator, so unemployment will continue to rise long after AD stabilizes.

2) Economies are complex adaptive systems, where change is the only constant. The future is intrinsically both unknown and unknowable.

As Keynes emphasized when **"animal spirits"** are thoroughly depressed and expectations of future profitability have fallen to very low or negative levels (as at present), only governments have a sufficiently long term horizon to be willing to borrow to undertake new capital projects. Even if the repo rate were reduced to zero, the private sector would be unwilling to undertake a volume of investment spending sufficient to generate a full employment level of AD and output. In the current recessionary climate government spending must be relied upon to generate full employment. (This is why President Obama undertook his US \$780 billion government spending program.)

But as we also know only too well governments, particularly in developing economies, have great difficulty delivering on their declared promises. But in fact governments should **not be in the business of directly building** roads, houses or any other capital assets. **They should leave all such capital investment projects to the private sector**, as is currently the case for highway construction. Conservative legislators in all countries have now become excessively pessimistic about the ability of governments to undertake any productive projects efficiently. (This is why no Republicans were willing to vote for Obama's spending bill).

The job of central banks is to set Bank Rate at the level that is expected to generate in full employment and stable prices. Because business expectations are now so hugely depressed, even after the Reserve Bank has reduced the repo rate to zero the volume of private sector demand for investment and consumption goods will still be insufficient to generate full employment levels of AD and output.

Granted most governments frequently fail to deliver on many of their promises. But governments are able to do many things private business cannot. In the present depressed situation governments have an enormous advantage over the private sector in being able to undertake long-term borrowing, since ***only they have the long-term horizon required***. At the moment governments could borrow extremely cheaply simply by issuing Treasury Bills, if only the CB would reduce Bank Rate. Governments also have the ability to conduct benefit-cost analysis, and to develop lists of desirable capital infrastructure projects (e.g. schools, houses, roads, hospitals, water and power stations, etc.) They also have the ability to simply put such projects up for bidding by the private sector, who could compete for the right to produce such goods efficiently. All such social infrastructure projects, with highly positive expected rates of return, can now be undertaken at near-zero interest costs, because the private sector is unwilling to undertake long term projects in the face of highly depressed AD!

There remains one big problem. Does the ANC government have the honesty, ability and dedication to ensure that the private bidding for such projects is done competitively, so that the new projects are not simply given to friends and cronies to undertake.

The current world slump in fact presents all today's governments with a marvelous once-in-a-lifetime opportunity, which also happens to be completely do-able: The Reserve Bank should immediately reduce the repo rate towards zero and attempt to persuade capital markets that they intend to keep rates low until AD has recovered and full employment levels of AD have again been attained.

Lower interest rates would of course cause the exchange rate to depreciate, since the current carry-trade will dry up: borrowing short term at low interest rates to invest in higher-yielding SA financial securities,. As stated all developed countries and many developing countries have now lowered rates to near zero levels. After some unknowable time period low interest rates will eventually result in a huge future increase in production and employment in all capital goods, export and import-competing industries.

A fall in interest rates will concurrently result in an increase in the prices of all long term assets, including houses, which will enormously encourage new

housing construction. The government should create and transfer clean title to existing owners of low-cost public housing ASAP, to create a market in low-income houses and encourage their purchase, sale and mortgage-ability. This renders their owners much more mobile and so greatly widens and increases their employment opportunities.

This would serve to persuade both business and consumers of the huge advantages of a low interest rate monetary policy. As Galbraith said, ***“Lenders have more money than borrowers, which is why they are lending the money.”***

There is also nothing to be gained on the inflation front by maintaining the repo and the unemployment rate at their present high levels. ***Animal Spirits*** have now fallen so low that no sharp burst of AD can be expected, even after interest rates are reduced to near zero levels. But lower lending rates will encourage some additional private borrowing, even if due to depressed ***Animal Spirits*** such borrowing will remain insufficient to generate full employment even at zero repo rates.

So long as expectations are deeply depressed and AD remains insufficient to generate full employment, governments must keep the repo rate low, and select those investment projects with the highest benefit-cost ratios, whose expected returns are most in excess of their costs of funds. The private sector must be encouraged to produce such projects by open competitive bidding, and either operate the capital goods themselves or sell them to the highest bidder.

Even though ***Animal Spirits*** are currently depressed, there will only be some as yet unknowable time period until investment and consumption demand respond strongly to very low and near zero levels of borrowing costs. Investment, consumption, AD and employment will eventually increase, and unemployment rates will eventually fall. So long as money wages are not allowed to rise more rapidly than average labor productivity growth, full employment can always be achieved, at some low but positive level of interest rates, without any accompanying inflation.

Increases in government borrowing to finance additional capital accumulation, when private investment demand is insufficient, will result in increases in the ratio of government debt to income. The government debt burden is

conventionally calculated as the ratio of government debt to GDP. After the Second World War many countries found their debt/GDP ratio above unity. They survived even though a D/Y ratio of unity was considered to be an upper limit for the debt burden. Above this ratio it was believed the tax rates required to service the debt would be so high as to debilitate incentives and erode public confidence that such a high government debt could ever be serviced.

But the government's debt-burden is properly based on the ratio of government interest payments to income, not government debt to income. It is only the interest rate obligations that must be financed by current taxation. Alternatively put, when interest rates are halved, the government's debt burden is also halved. Countries like Japan, with very low levels of interest rates, have shown governments ability to service much higher debt-income ratios.

Surely such a Keynesian and Asian "**Social Contract**" solution is vastly more efficient and more civilized than a Monetarist labour-bludgeoning anti-social high unemployment-high interest rate "**Inflation Targeting**" policy? It would clearly seem to be the preferred way simultaneously to achieve price-stability and full-employment?

One may reasonably question whether the ANC leadership and the SA electorate and have the skills and imagination to formulate and adopt such a **Social Contract** proposal? One may also reasonably ask whether the ANC government and the SA highly unionized labour force have the skills and ability to carry out such a **Social Contract** successfully, and make it work? Only time will tell. But like life, **Social Contract** it is better than the alternative!