

Monetary policy and inflation

The problem with monetary policy, throughout the world, is revealed when one asks the question, “At what level should the Central Bank set interest rates?” The central premise of this question is that central banks *should* determine interest rates. This premise, itself, is rarely questioned.

The role of central banks was once widely seen as covering a range of policy goals, including growth, employment, price stability, and management of the exchange rate. The failure, most notably in the 1970s, of governments and their central banks to avoid inflation, forced a narrowing of policy focus. It became evident that an inflationary policy not only did not promote growth and employment, but was more likely to do the opposite. All else equal, more “successful” economies have less inflation.

Politicians and central bankers are now aware of current “best practices” for maintaining a low inflation rate. They come under popular criticism, however, for not being sensitive to other, broader goals, such as employment. The use of high interest rates to “fight” inflation has become a focal point for criticism; and it is at this point that *both* the critics and the central bankers are clearly in the wrong.

The critics are wrong because they see the problem as a simple trade-off between low interest rates with low unemployment, and high interest rates causing high unemployment. They fail to recognise the real problem, which is the actual targeting and manipulation of interest rates, not the particular levels chosen. Instead of seeing the problem as arising from the broader context of statutory interference in the economy, the critics quibble over the usage of those statutory powers.

It is not necessary to go as far as questioning the very existence of central banks, in order to make significant improvements to the functioning of our monetary institutions. But it is necessary to examine what these banks can and should do – and what they cannot do.

The narrowing of a central bank’s focus, toward price stability, was a definite advancement of practice. It was a loosening (though not an elimination) of the central bankers’ paradigm of centralised control over the macro-economy. It reflected a recognition that the more numerous the goals pursued, the less the likelihood of achieving any of them. And, more importantly, it reflected a grudging recognition that they could not improve on the results of a freely operating market.

If central banks are to enjoy public confidence in the future, they must rediscover their core competencies, and jettison other activities. Innovation in central banking will mean progressively doing less, finding simpler operating procedures, and regaining an understanding of their own core, defining product: base money.

The role of base money in the financial system is one of the least well understood items in mainstream theory. Although a link between the quantity of money and inflation is recognised, it is still imagined that a particular quantity of money produces a particular level of national income. Money is seen less as a medium of exchange, which transmits information and expands options in the composition and timing of transactions, than as a form of “liquid” fuel, which propels or “drives” economic growth. This money-as-fuel mindset is pervasive, and sees a need to inject more money into the economy’s fuel tank to keep up with economic growth. It is also wrong.

Much of our macro-economic problems can be explained by this vision of money-as-fuel; it explains the behaviour of policy-makers. Since money is not recognised, *de facto*, for its medium of exchange nature, it is treated in a mechanical rather than an economic way – as an input, rather than as a medium. When the monetary authorities treat money as a mechanical input (still the current convention), they diminish its functionality as a medium, and quite literally destroy economic information. Current central banking practice, while an improvement on recent decades, remains disruptive and continues to sow the seeds of recurring crises.

The harder central banks work to manage crises, the more crises they cause. This stems from a failure to understand what is meant by the phrase, “market forces,” or to appreciate the self-correcting nature of economic interaction. When an official institution, such as the South African

Reserve Bank, intervenes in a self-correcting process, it can be expected to obstruct correction – and it does. Thus the underlying causes of economic crises are perpetuated.

By what standard can a central bank be judged? If the Reserve Bank were judged by the standard of “what would have happened if a free market in central banking services were allowed, and the SARB were never created,” then the Reserve Bank has clearly been a failure from day one. Given the alternatives that were (both potentially and actually) available in the world, South Africans would have been better off with market freedom. Instead of being allowed to choose freely amongst currencies (which would have included gold-based currency) they were subjected to legal tender laws, monetary and credit manipulation, exchange controls, and a rising price level. Even now the Reserve Bank lives in dread that its “customers” might be able to choose another currency. (Note in passing - with regard to those other currencies, this statement offers them only faint praise.)

If we prefer not to eliminate the Reserve Bank, but only to improve its function, what is recommended? The Bank must come to recognise that its only product is base money (and its prudent supply). Its product is not growth, employment, stable exchange rates, or even financial stability; all these are beyond its practical competence. Nor is its function to manage the broader monetary aggregates. Why, how, and where people choose to deposit their money is a completely private matter; and the Reserve Bank should be forbidden from interfering. Thus, the Reserve Bank’s practice of “targeting” monetary aggregates, such as M3, is a direct interference with private property and should be declared illegal.

The attempted manipulation of M3 is a throwback to the carelessly examined belief that the quantity of money is correlated to national income. The search for the perfect aggregate has wasted countless hours of computer time and, worse, given apparent empirical support to official manipulation of those aggregates. What this really means is that central banks not only control the monetary base (i.e., cash in circulation plus deposits at the central bank) but also directly manipulate the credit markets. In doing so they interfere with the levels of interest rates, and thus destroy huge amounts of information on credit and production that would otherwise be transmitted between individuals in the market. In other words, this misguided manipulation of the “money supply” destroys wealth.

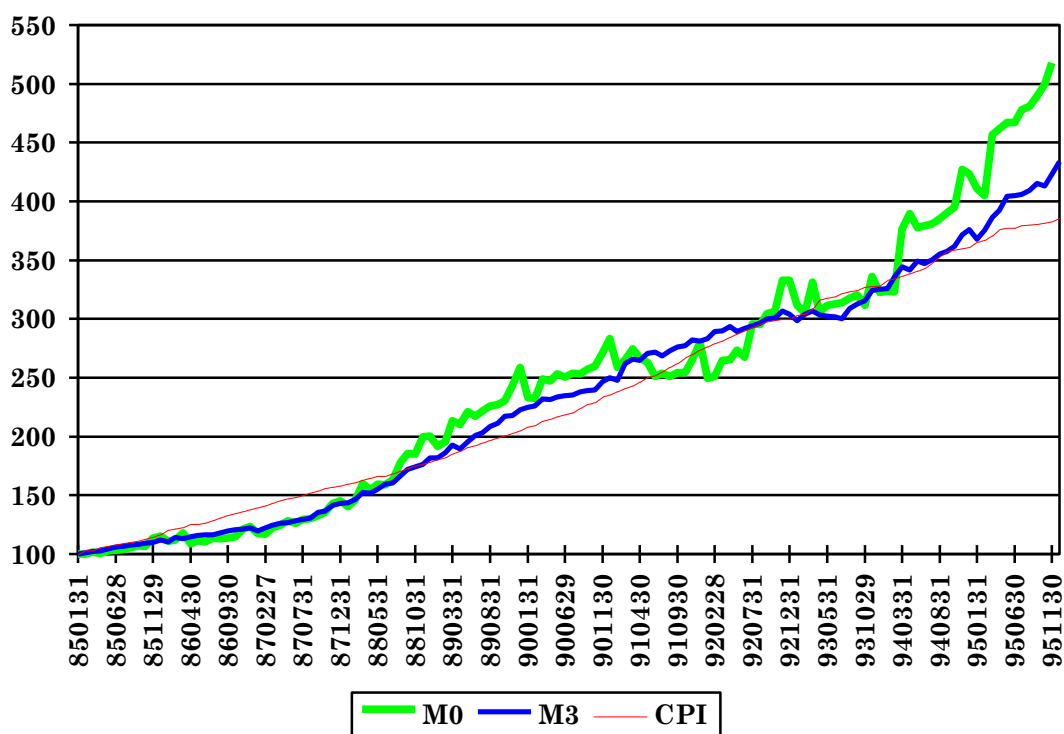
It follows from this that, along with being forbidden to target broad monetary aggregates, the Reserve Bank should be forbidden from targeting, setting or manipulating interest rates. Ultimately, this means the elimination of the Bank Rate and its *raison d’être*, financial “accommodation” -- in which the Reserve Bank goes through the charade of extending credit to financial institutions. The Bank can create currency but not savings; thus its accommodation activities consist of the arbitrary redistribution of credit at non-market rates. This is disruptive. While being presented as stabilising the credit markets, it is, in fact dis-coordinating them. Further, it encourages moral hazard (imprudent behaviour) in the commercial banking industry. The accommodation dependency of financial institutions must give way to the proper development of an inter-bank market for reserves.

Official manipulation of interest rates is an extremely inefficient method of controlling inflation. The fact that other central banks do it does not make it any less foolish. To paraphrase Mother, “If Alan Greenspan jumped off a cliff, would you follow him?” Not only does it bring the fighting of inflation into disrepute (due to excessively high interest rates), but in general it doesn’t work. It only appears to work when it coincides with a reduced growth rate of the monetary base. This has clearly been the case in recent South African history.

The graph shows the standardised relationships of the monetary base (M0), the broad monetary and credit aggregate, M3, and the Consumer Price index (CPI) over time. In the long run they all move together. Changes in M0 cause future changes in M3 and the CPI. Instead of simply maintaining the slow, stable growth of M0, the Reserve Bank tries to control CPI and M3. Thus, with every “unfavorable” movement in these latter two, the Bank takes actions that, for effectiveness, require counter movements in M0. This kind of reaction renders M0 unstable and, in turn, further

disrupts the credit markets (including the components of M3) thereby altering investment decisions to non-optimal levels.

M0, M3 AND CPI BASE INDEXED TO 1985



South Africa's inflationary fate in 1996-97 is clearly foreshadowed by the high growth of M0 (over 20%) in 1994-95. In the absence of a rapid reaction by the Reserve Bank, this implies a return to double-digit inflation by 1997. The falling inflation rate in 1995 was the result of reduced M0 growth earlier in the decade. The gains, in terms of investment structure, that came with reduced inflation have been thrown away by the Reserve Bank, due to its inability to recognise the importance of controlling the only thing that it can control: the monetary base.

The politicised nature of central banks renders them ultimately unsuitable as components in the monetary system. Even when the monetary base was supplied by nature (as gold), central banks were instrumental in the corruption and virtual elimination of the gold standard. The only way to get reasonable behaviour from central banks is to severely limit their functions, and to simplify and make transparent their procedures. The Reserve Bank should, *at the constitutional level*, be strictly bound to do nothing more than manage the growth rate of the monetary base. M0 should grow at a smooth, fixed rate of between zero and three percent.

This Briefing Paper was written by Dr Richard J. Grant, then-Chief Economist of the Chamber of Mines of South Africa.