2.3 THE CAUSES OF INFLATION — AND WHAT CAN BE DONE

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There has been nothing unusual about recent inflation in South Africa. The increases in consumer prices were an entirely predictable and unavoidable response to the increase in import and export prices that follows a major devaluation. Indeed, the devaluation worked in a classically effective way. It reduced the volume of domestic spending and imports, and increased the volume of exports, just as a devaluation is supposed to do. The criticism one can make is that the reduction in demand was, if anything, too severe and more, rather than less, monetary accommodation was called for.

The devaluation of the rand, against the currencies of our trading partners which began in 1984, accelerated after we crossed the Rubicon in July 1985, and continued through most of 1986. The volatile performance of the trade-weighted foreign exchange value of the rand is illustrated in Fig. 1. Had the rand held its gains of early 1986, the inflation would have been substantially lower by the end of the year. Unfortunately, we had to suffer a further substantial devaluation in mid-year. The rand is now back to where it was in early 1986 and the benefits of this recovery for the inflation rate are still to be seen.

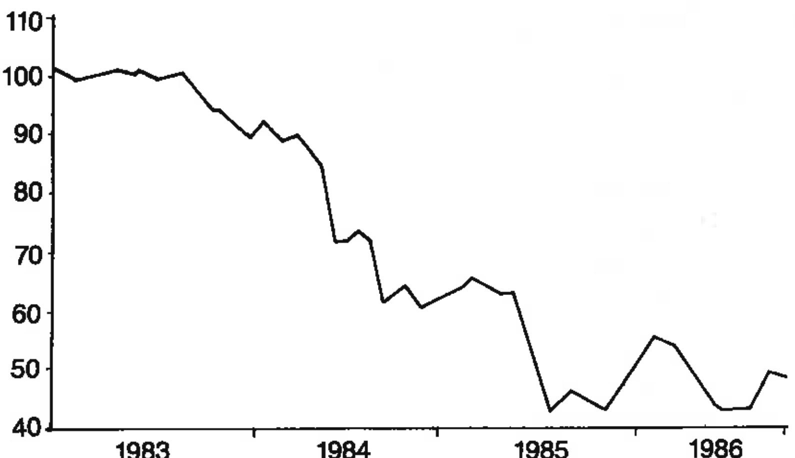

Figure 1 RAND EFFECTIVE EXCHANGE RATE (trade weighted)

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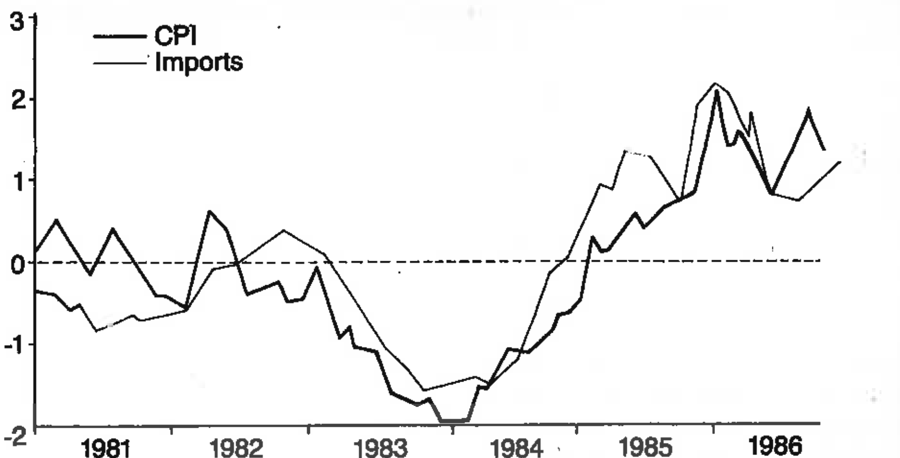

Figure 2 CPI AND IMPORT PRICE INFLATION (normalised)

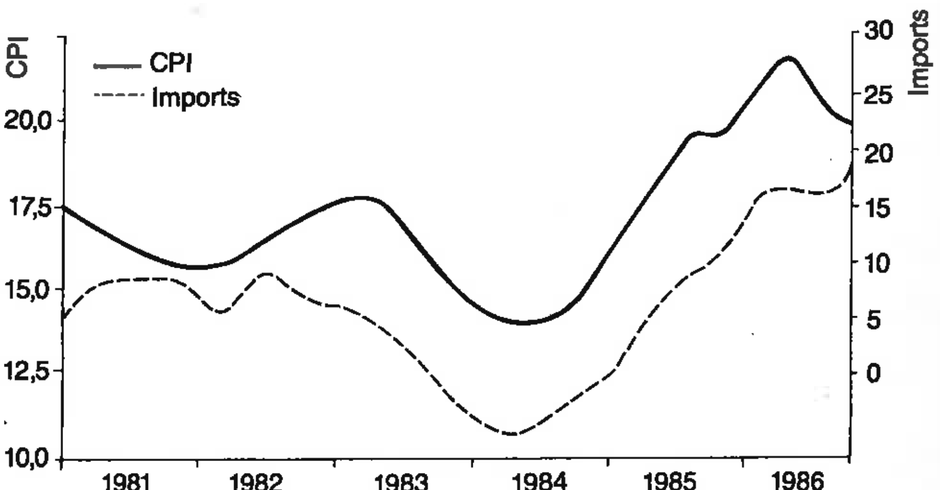

Figure 3 CPI AND IMPORT PRICE INFLATION (smoothed)

The devaluation has caused the prices of imported goods to rise rapidly and almost continuously between mid-1984 and November 1986, the latest month for which import price statistics are available. Imported price declines were recorded in only three months — April 1985, and May and June 1986. There are very strong links between import and consumer price inflation and this is best

illustrated graphically, as in Fig. 2. Inflation is defined as the percentage change in prices over the previous 12 months. In Fig. 2, the two inflation rates are drawn to the same scale for the periods 1981–1986.

Fig. 3 illustrates the relationship when some of the variability of the year-on-year inflation rate has been smoothed. One factor that can disturb this relationship is relatively fast food price inflation, as occurred in 1986 and 1981 for example. In 1981, when the economy was enjoying boom time conditions, food producers could take advantage of buoyant demand and the absence of direct imported competition. It is this competition that other producers are faced with that explains the links between the exchange rate, import prices and domestic inflation. Unless the economy recovers strongly, it is unlikely that food prices will continue to rise faster than other prices. The recent reduction in the price of yellow maize was a reaction to poor demand and came despite rising costs of production. This was a strong pointer to the demand forces that restrain the prices set by producers with monopoly power.

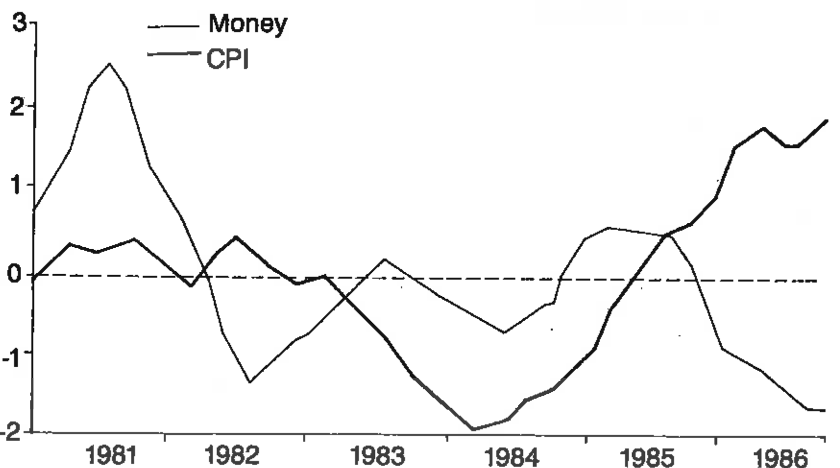

Figure 4 INFLATION AND MONEY GROWTH (% p.a.) normalised

Inflation in 1986 also had nothing to do with excess issues of money and the demand associated with monetary growth. The money supply grew much more slowly than prices, as is illustrated in Figs. 4 and 5, and helped restrain price increases — if anything, too much so. The relationship between money growth and inflation generally in SA is not a close one, as may be seen in Fig. 4. The relationship between money growth and spending is much closer.

The increase in prices in 1986 served to depress greatly the demands for goods and services and wages grew significantly more slowly than prices, so depressing real disposable incomes.

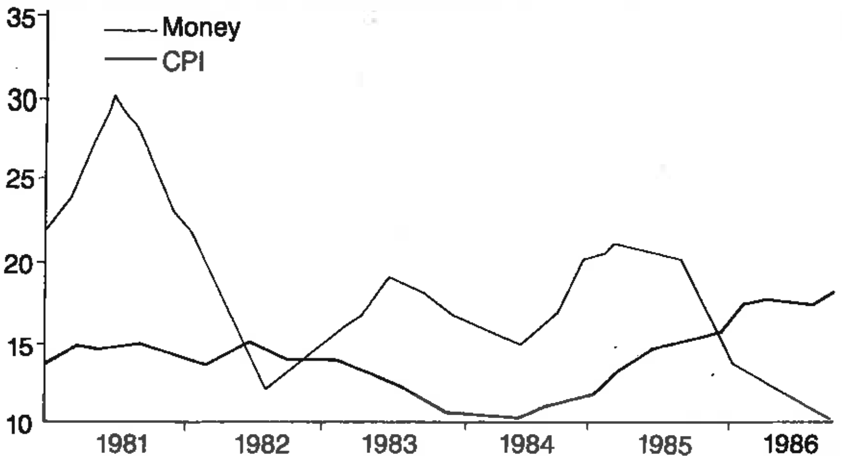

Figure 5 INFLATION AND MONEY GROWTH (% p.a.) smoothed

The devaluation of 1985 and 1986 acted on prices in the same way as would a substantial increase in sales taxes. The intended effect of higher prices — the result of a devaluation or a tax increase — is to reduce the value of goods and services consumed. Capital resources previously made available for use in South Africa were being withdrawn on a large scale. The demand for foreign exchange to satisfy capital withdrawals led to the devaluation which, in turn, brought higher prices, lower disposable incomes and depressed levels of domestic demand. Lower demands and higher prices for imports and exports — coupled with wages and salaries rising much more slowly than inflation — meant more profitable production for exporting and import replacing and more freely available supplies of export and import replacement goods. The growing surplus of exports over imports provided the foreign exchange to meet demands for capital withdrawals. The monetary authorities, as indicated by relatively slow growth in the money supply (see Fig. 5) seemed unable or unwilling to offset the depressing effect of higher prices on domestic demands. They naturally welcomed the export surpluses with which to repay foreign debts. Unfortunately, the decline in real consumption power and the shift to exports did not occur without less employment and much excess capacity.

The outlook for inflation in 1987 and beyond will be determined approximately as before by the performance of the rand against other currencies and world inflation. There are three major forces at work that influence the foreign exchange value of the rand. They are:

- political shocks and their effects on capital withdrawals;
- changes in the terms of trade, particularly in the price of gold; and
- money supply growth, which, by affecting the demand for goods and so for

imports and, in turn, trade surpluses, also affects the exchange rate and so prices.

The monetary influence on prices works mainly through the effects of money on demand and, therefore, on the trade balance and, in turn, the exchange rate in what may be a highly lagged way.

It is possible to have an appreciating exchange rate and fast money supply growth, as may happen when the gold price rises rapidly. However, should the gold price reverse itself or stop rising, the exchange rate will fall, as the trade balance deteriorates because import demands remain at high levels, the result of the previously rapid growth in the money supply.

It would be theoretically possible to counter every negative influence on the exchange rate — for example, capital withdrawals or gold price reductions — with a sufficient decline in money supply growth. The money supply might be reduced sufficiently to produce a decline in imports necessary to stabilise the exchange rate and so prices. As may be imagined, such a policy could be very severe indeed, should either foreign capital be withdrawn on a large scale or the gold price fall dramatically as occurred over recent years. Such a policy of maintaining price stability at all costs is surely not to be recommended. Exchange rate flexibility, and all it implies for higher prices, can help the economy adjust to adverse circumstances more easily.

The money supply should best be made to grow highly predictably at a rate consistent with low inflation over the long run. That is to say, the money supply growth rates should not decline when the economy is under stress or accelerate when the economy is booming. It is the failure of money supply policies to remain neutral in the face of real shocks to the economy, either favourable or unfavourable, that has made inflation and recessions unnecessarily difficult to control in South Africa.

Should the economy continue to recover, and confidence with it, money supply growth rates will be pushed upwards. Unless the growth in the money supply is then limited, the exchange rate sooner or later will again come under downward pressure, irrespective of the gold price factor or the confidence factor.

It is in the nature of the South African economy, subject as it is to shocks in the form of gold price changes and political developments, to have to put up with more variable inflation rates than those of more diversified and politically stable countries. What is completely avoidable is the additional instability caused by highly variable money supply growth rates. If the money supply growth rates were stabilised, the authorities would be doing as much as they could do to help stabilise the economy.

Any attempts to interfere further with the necessary adjustments of prices to any of the real or monetary forces at work would be highly counterproductive. The monetary causes of inflation can be treated and the real factors causing prices to rise are best understood for what they are, and tolerated accordingly.

2.4 INDUSTRIAL CONCENTRATION AND INFLATION IN SOUTH AFRICA 1972–1979

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In the search for the cause of South Africa's inflation problem, and also for an appropriate solution, a new candidate has appeared. This is the so-called *non-competitive structure* of the South African economy, sometimes also called the question of 'administered prices'. This is being mentioned in publications and speeches more and more often. The purpose of this paper is to make a contribution to this debate and to see whether the popularity of this view is based on the quality of supporting theoretical arguments and empirical evidence.

In the first part the basic lines of the standard argument are set out, and in parts 2 and 3 the micro- and macroeconomic theoretical aspects are looked at critically. Part 4 contains some of the empirical results that shed light on the question, and part 5 contains conclusions drawn with regard to both the basic arguments and the related policy recommendations.

1. AN EXPOSITION OF THE STANDARD ARGUMENTS

The history of the theory of so-called administered inflation dates back to about 1957 (or even to the 1930s), when Gardiner Means in the USA maintained that the main source of inflation (in the USA) since 1955 had been the upward movement of so-called administered prices. Since then the theory has appeared in various forms (Scherer, 1980, ch. 13). In South Africa it is mostly found in two forms (De Wet, 1982a and 1982b, and Mohr, 1981).

In its simplest form the basic argument is that the non-competitive structure of the South African economy is the real cause of inflation because prices in such a structure are 'administered' and are therefore not a true reflection of so-called 'impersonal market forces'. More specifically, the accusation is that producers in non-competitive sectors have discretion over their prices (in contrast to those in competitive sectors) and that consequently they are able to increase their prices continuously in order to increase or maintain profit rates. The point at issue, therefore, is price increases — independent of, for example, cost increases (i.e. exogenous price increases). In this way they create inflation either directly or indirectly, the latter when their higher prices imply cost pressure for other producers. In addition, the point is sometimes made that the consumer does not have many alternatives; the inelasticity of demand facilitates price increases.

* Professor of Economics, University of the Orange Free State. This paper was read at the Conference of the Economic Society of South Africa, Johannesburg, September 1983, and is an extension of a paper read at the Conference of Economists and Business Economists, Port Elizabeth, November 1987.