Money Matters

Florin V. Citu
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Money Matters

- "If the coin be locked up in chests, it is the same thing with regard to prices, as if it were annihilated." David Hume — *Of Money*

- $M*V=P*Y$

Money and Prices

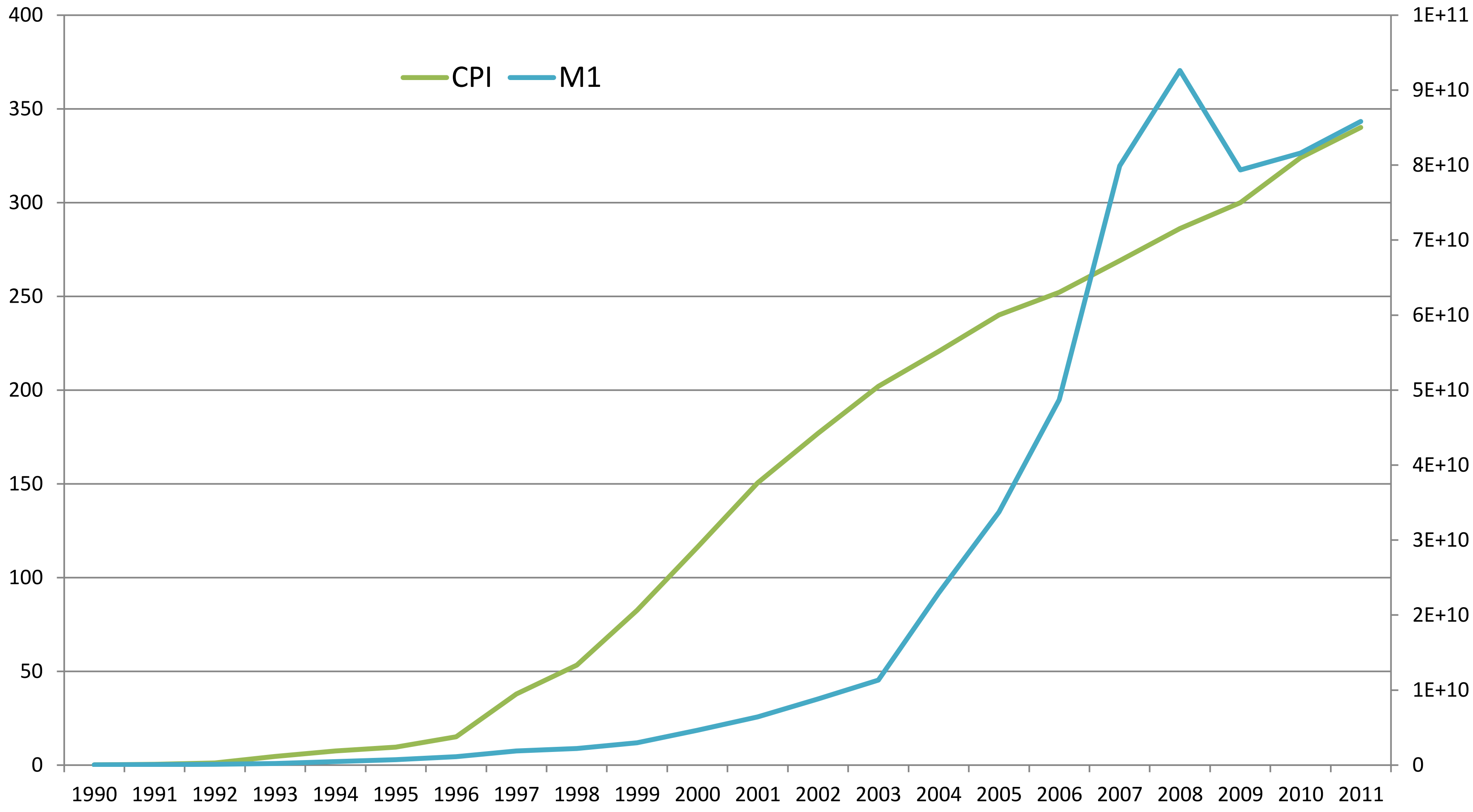
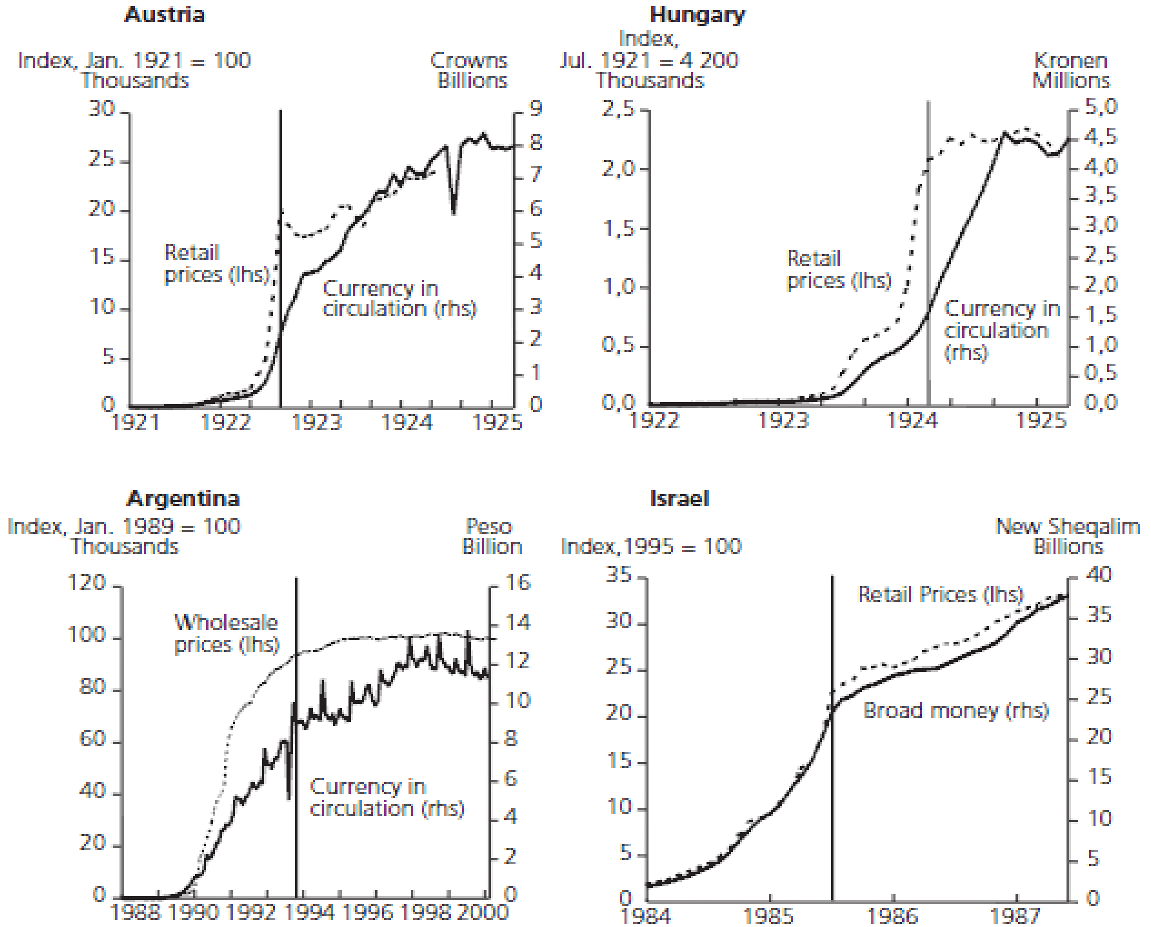


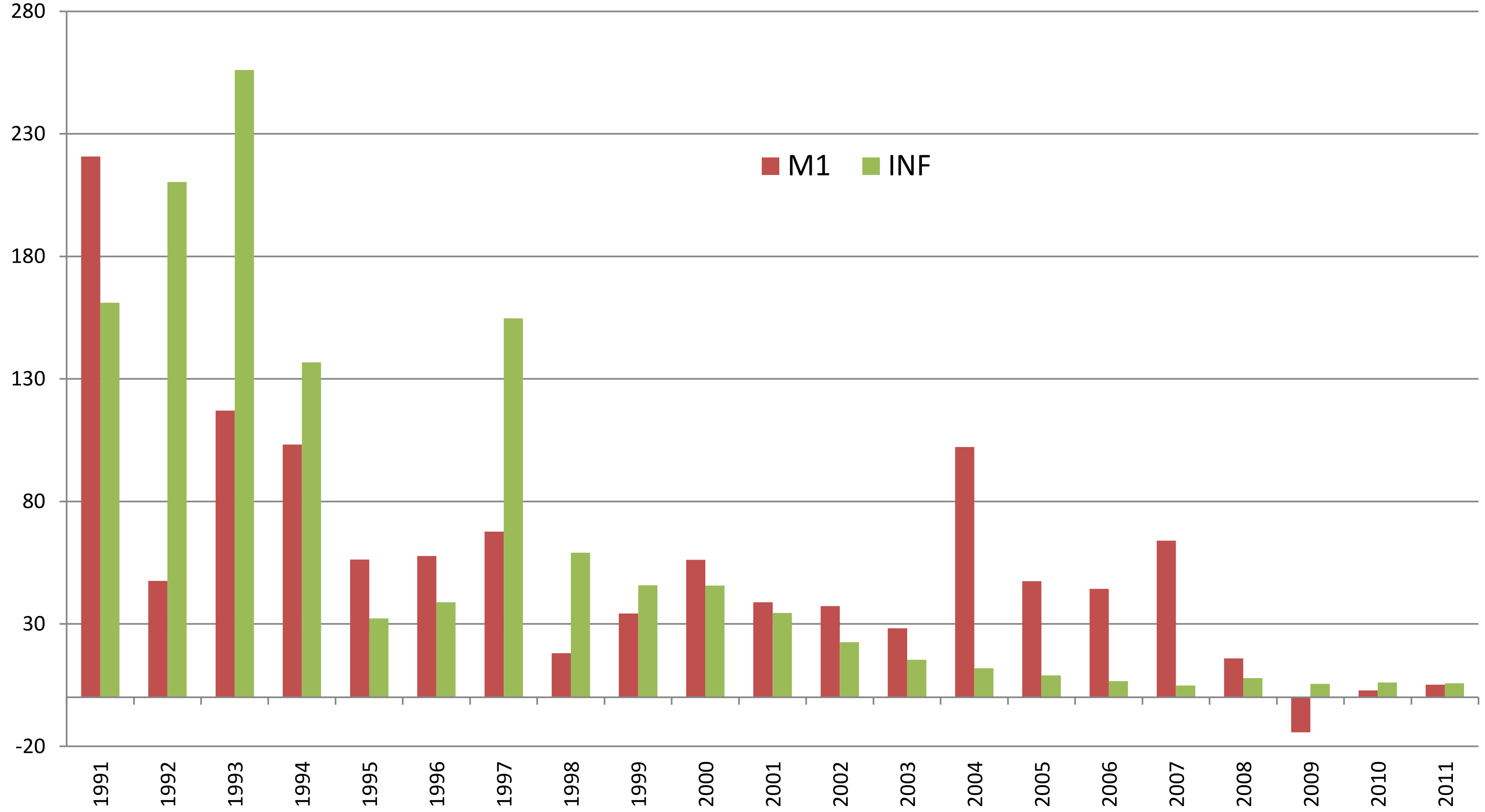
Chart 5 - Money and prices during four hyperinflations



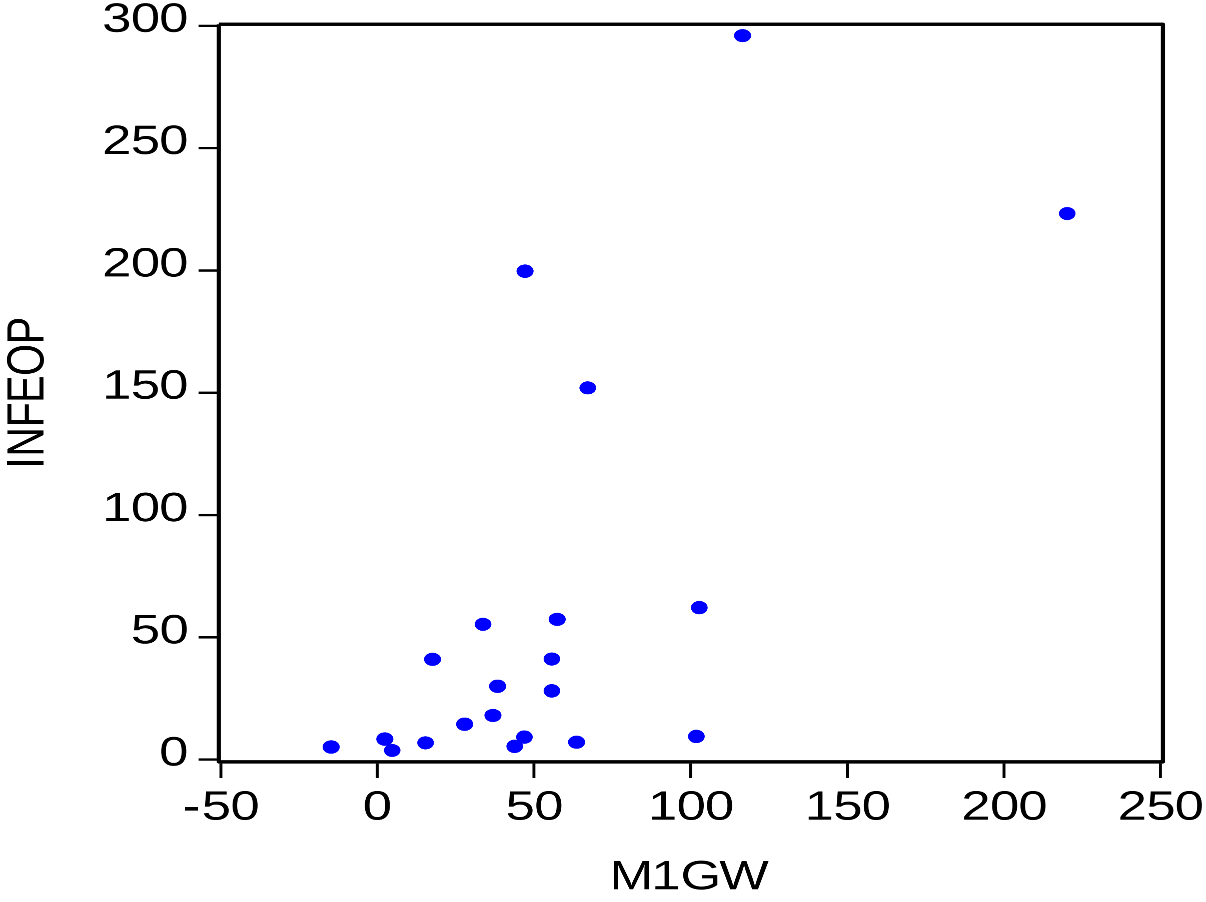
Note: Vertical lines indicate the date at which a stabilisation plan involving fiscal and monetary reforms was announced.
lhs: left-hand scale; rhs: right-hand scale.

Sources: Austria and Hungary: Sargent, T. (1993), *Rational Expectations and Inflation*, Harper Collins College Publishers, New York, p. 80-92.
Argentina and Israel: *International Financial Statistics*, International Monetary Fund.

Money and Inflation



Money and Inflation



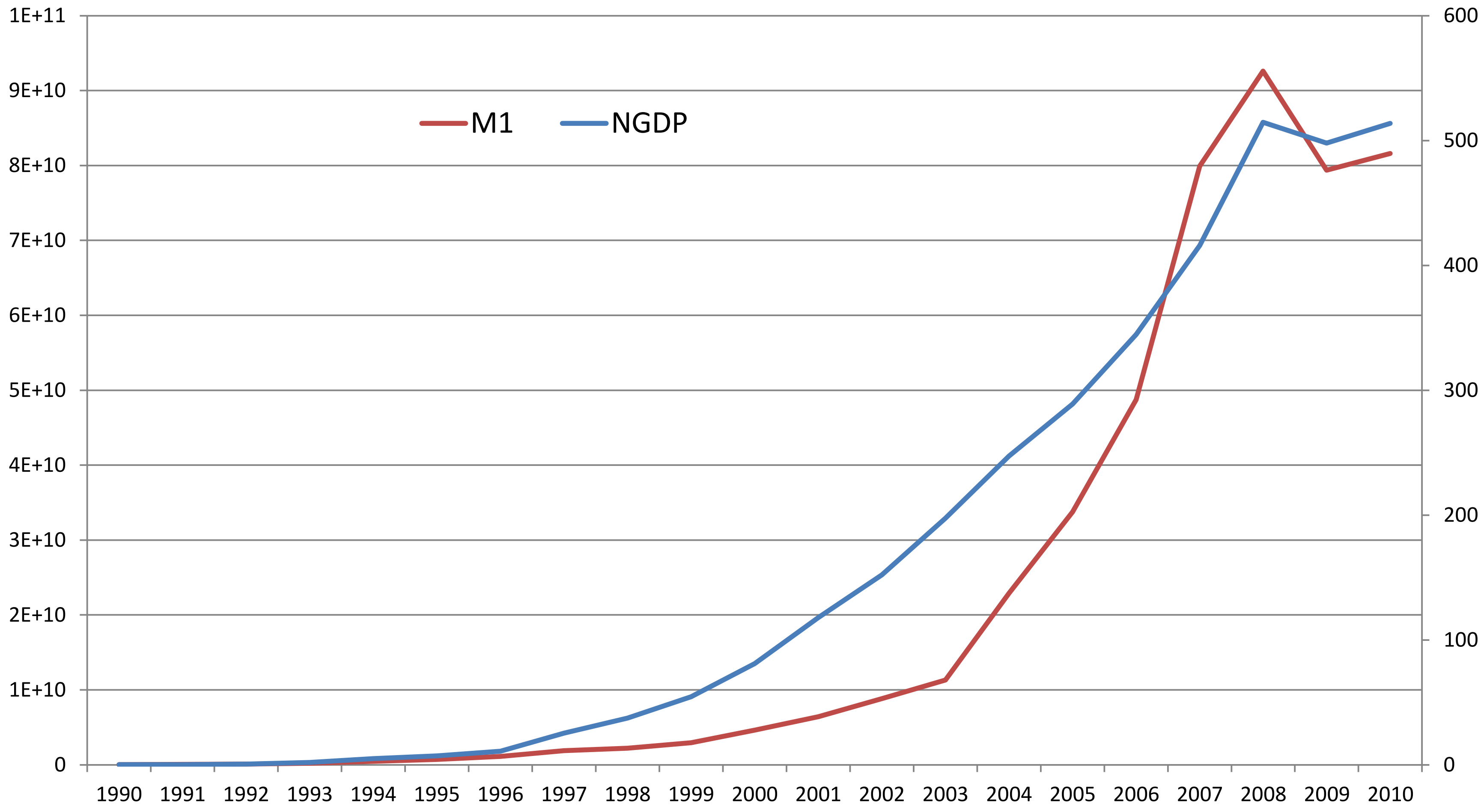
Conclusions so far

- There is a positive relationship between money growth and inflation (.65 correlation coefficient)
- Not a surprise as most economists believe in the “inflationary monetary policies”
- Basically: no money no inflation

Sudden less money matters also

- Referring to the Great Depression Friedman and Schwartz argued that "the contraction is in fact a tragic testimonial to the importance of monetary forces [p. 300; all page references refer to Friedman and Schwartz, 1963]."
- Also Friedman said “monetary policy can prevent money itself from being a major source of economic disturbance.”
- Or, in the short term if M falls PY can fall also

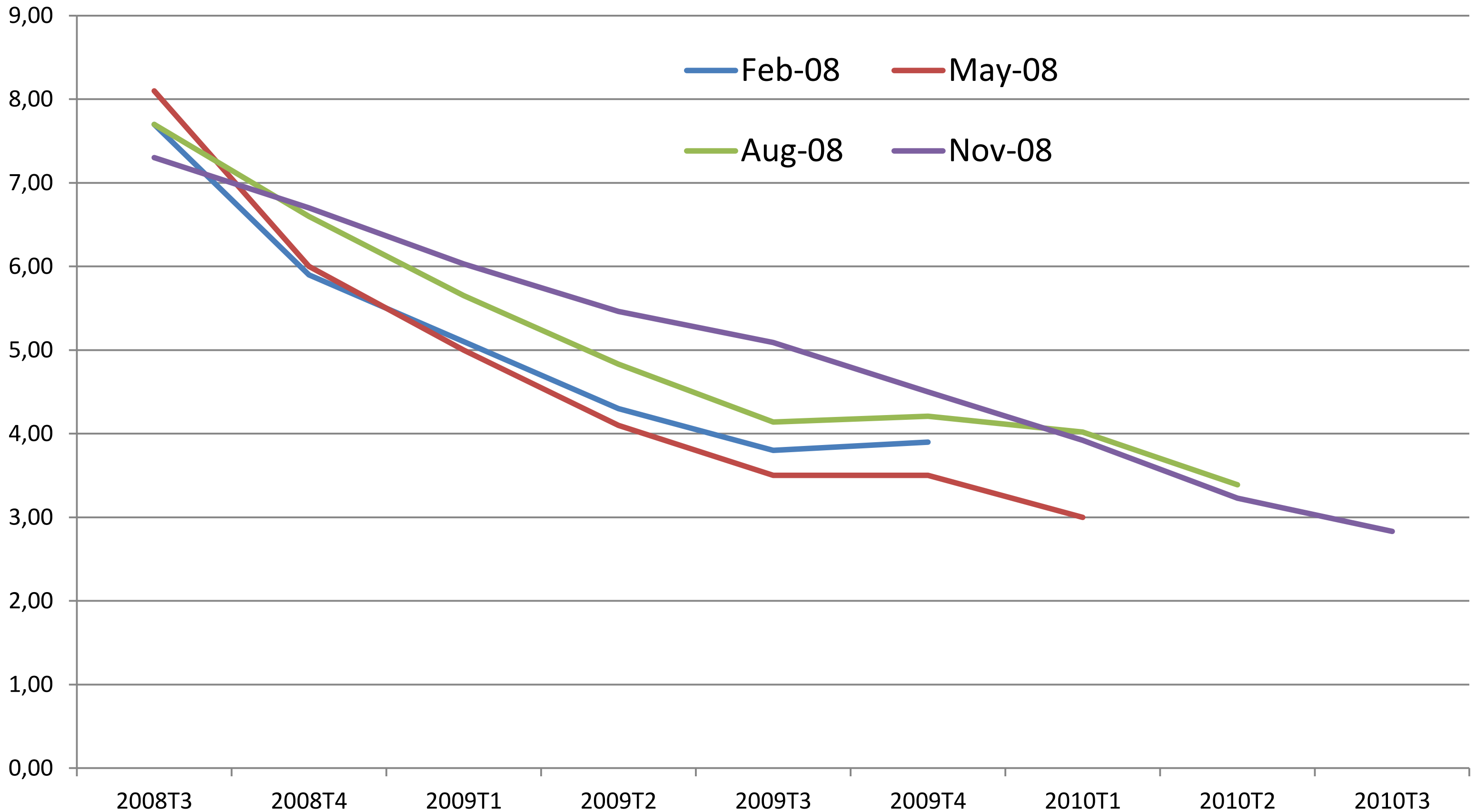
Can money explain this for Romania?



M1 growth versus NGDP growth

This is what NBR was seeing in 2008

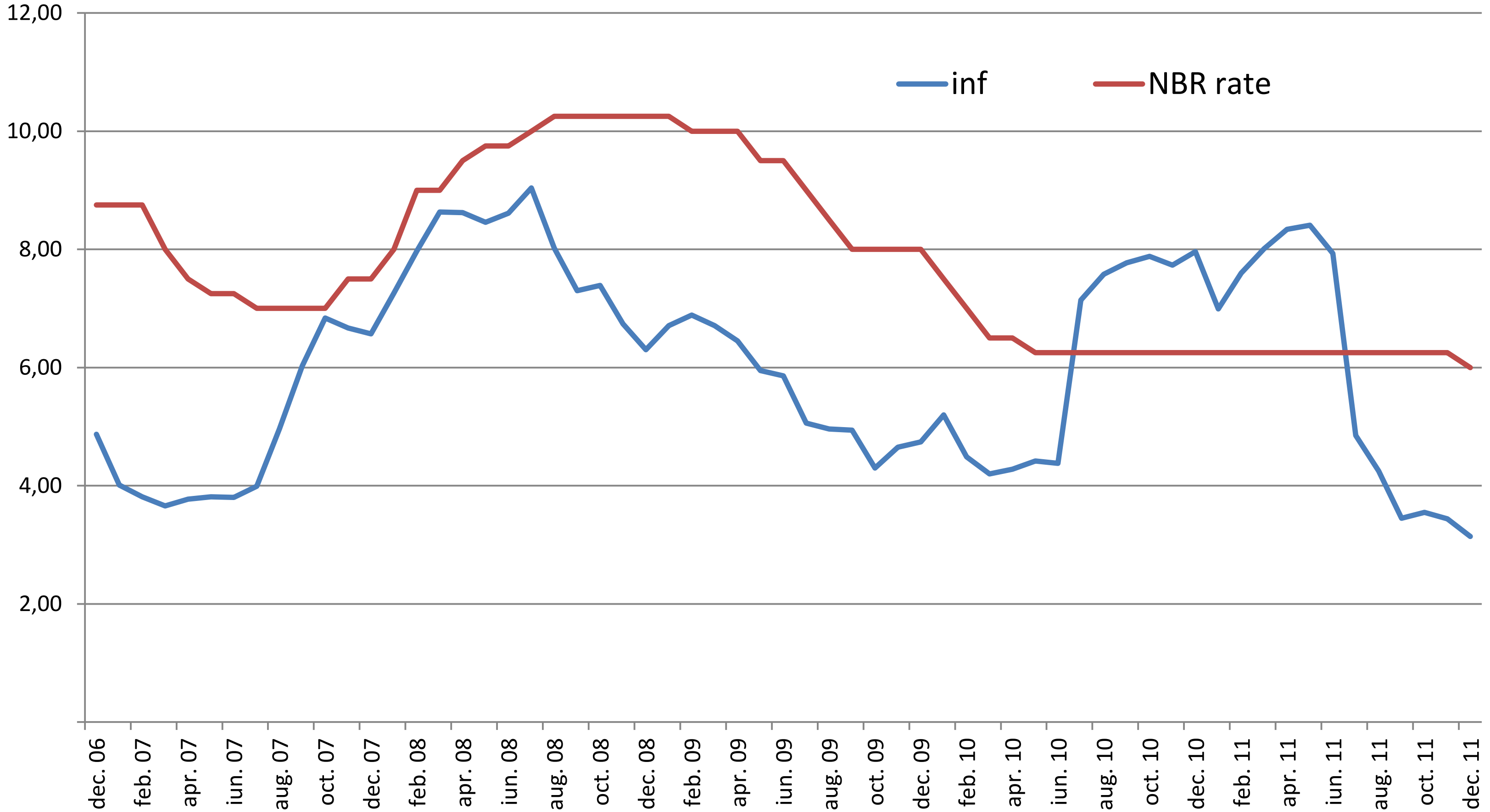
- Inflation was forecasted to fall



And on December 2008 NBR said…

- Inflationary pressures **are not** likely to subside next year
- **Excess demand will still be there**, fuelled by the recent hikes in personal incomes
- While Romania still enjoys significant economic growth there is room for a relatively smooth correction
- A **restrictive** monetary policy alone cannot accomplish this task –

Still key rate up almost 50% by Aug08

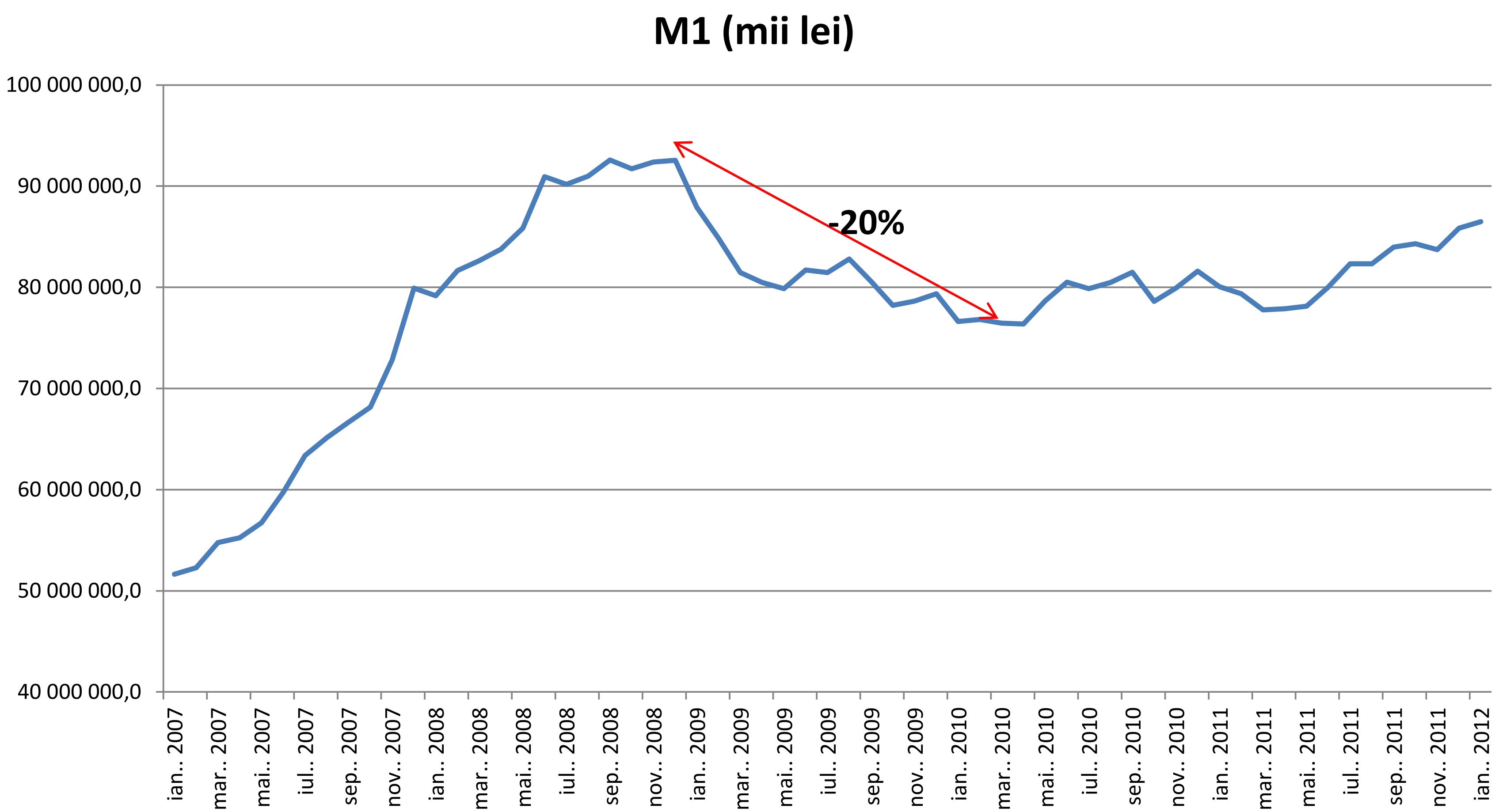


Leading to high restrictive real rates

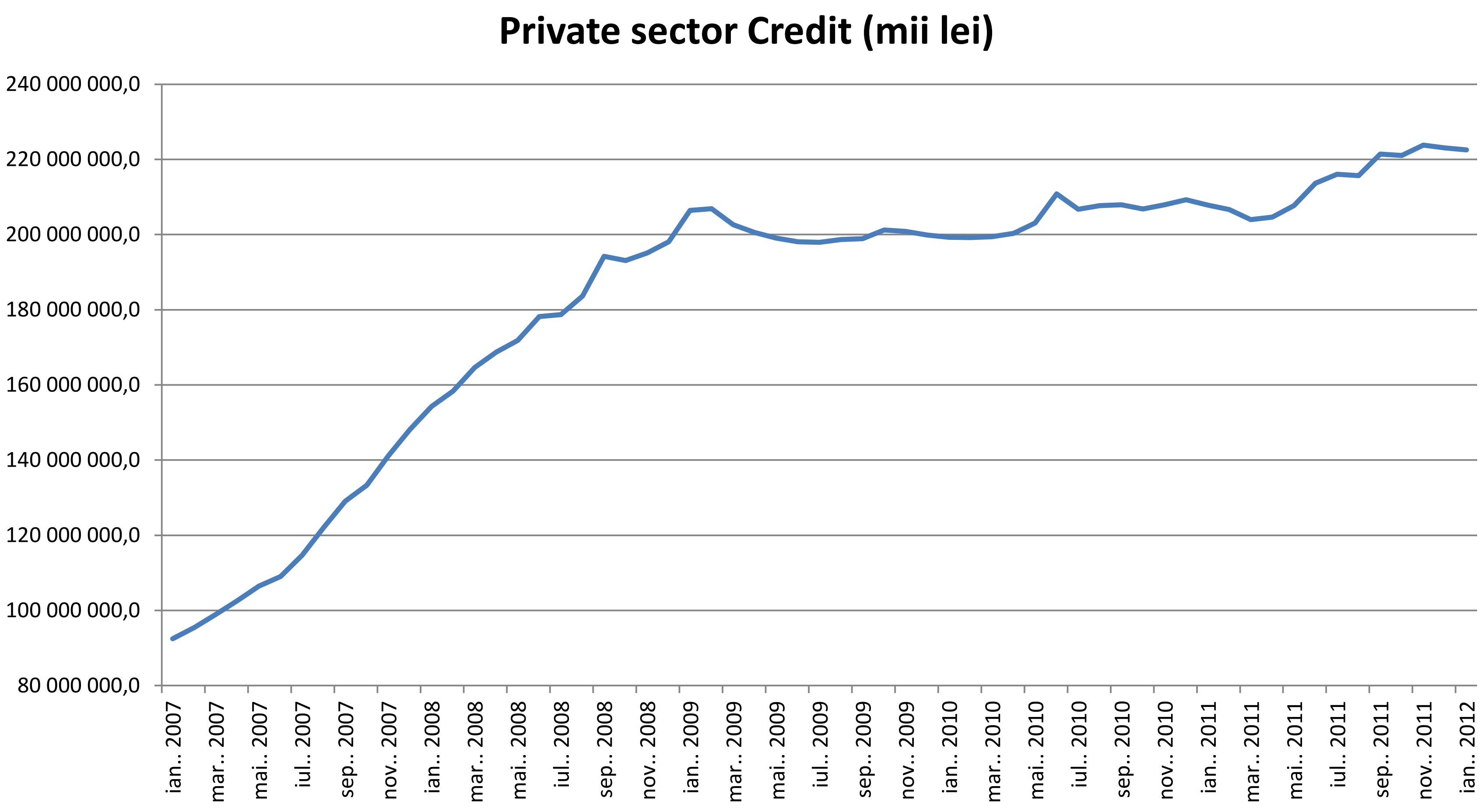
But nominal rates lost meaning

- **October 23 2008**
- **NBR imposes a new rule to deal with “market anomalies” in the interbank market:**
- For ROBOR rates 25% higher than the Lombard rate the NBR temporarily suspend the publication of the ROBID/ROBOR rates
- The rule is still in place today

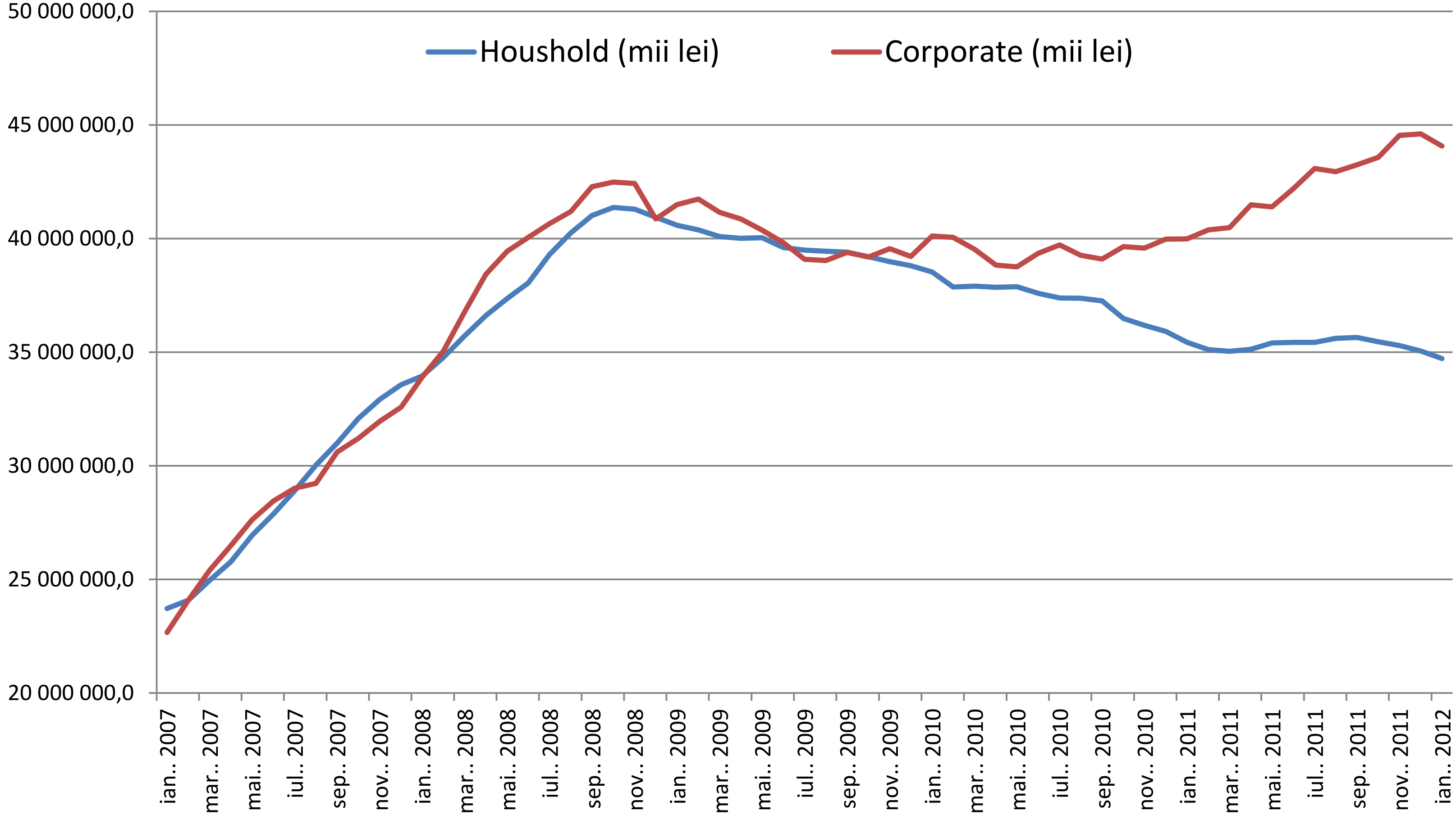
Then this followed



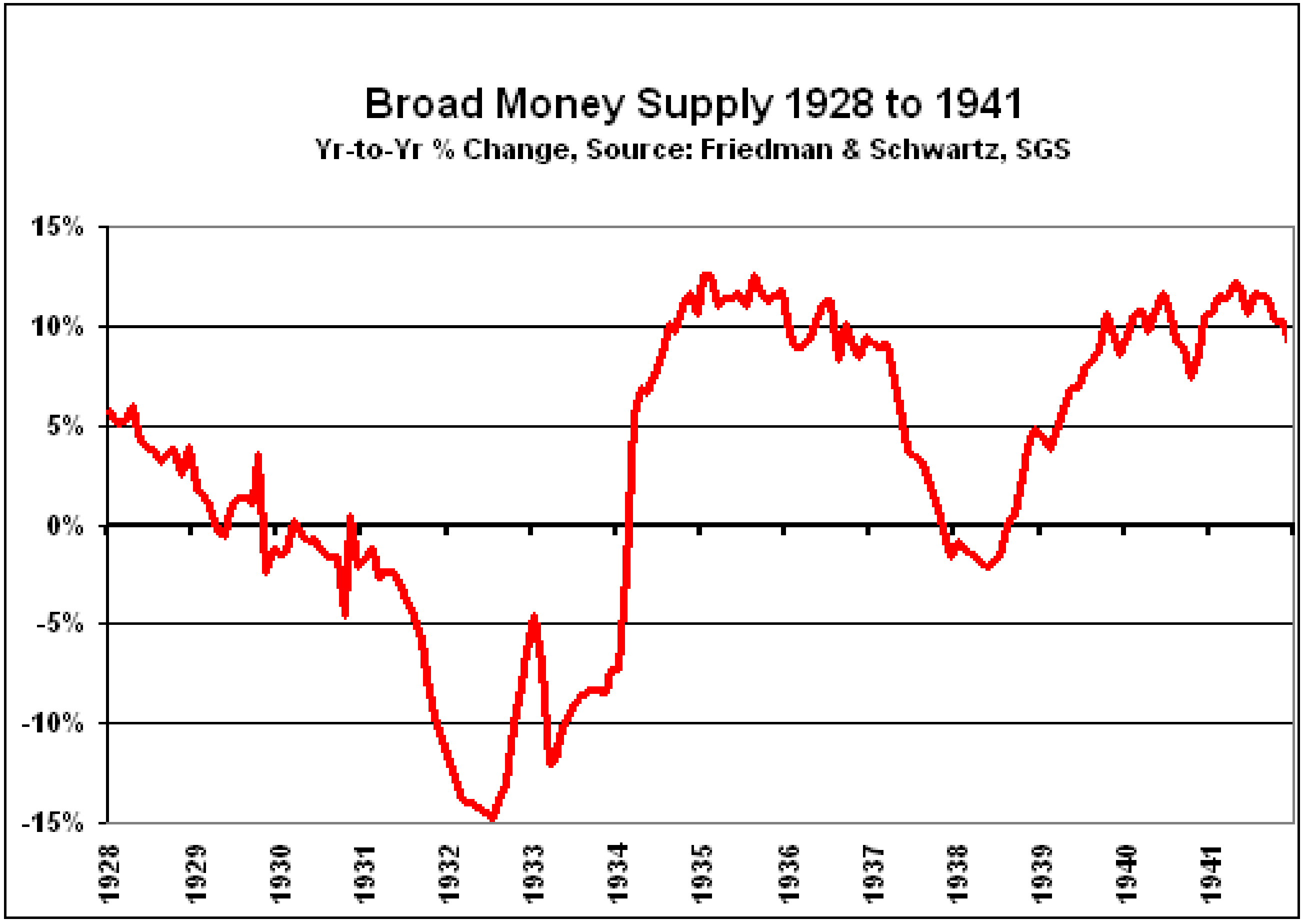
Private Credit -6%

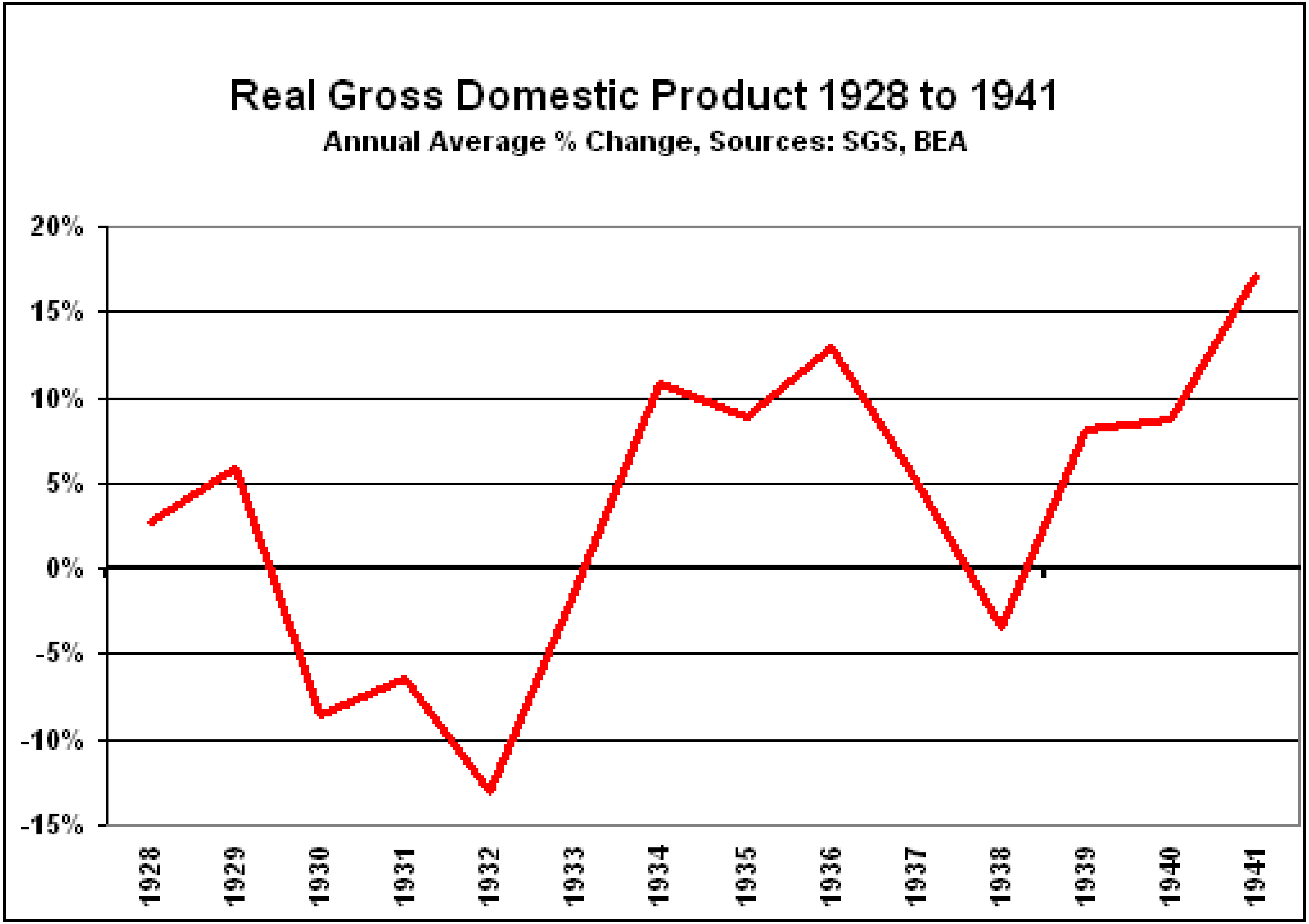


RON Denominated Credit

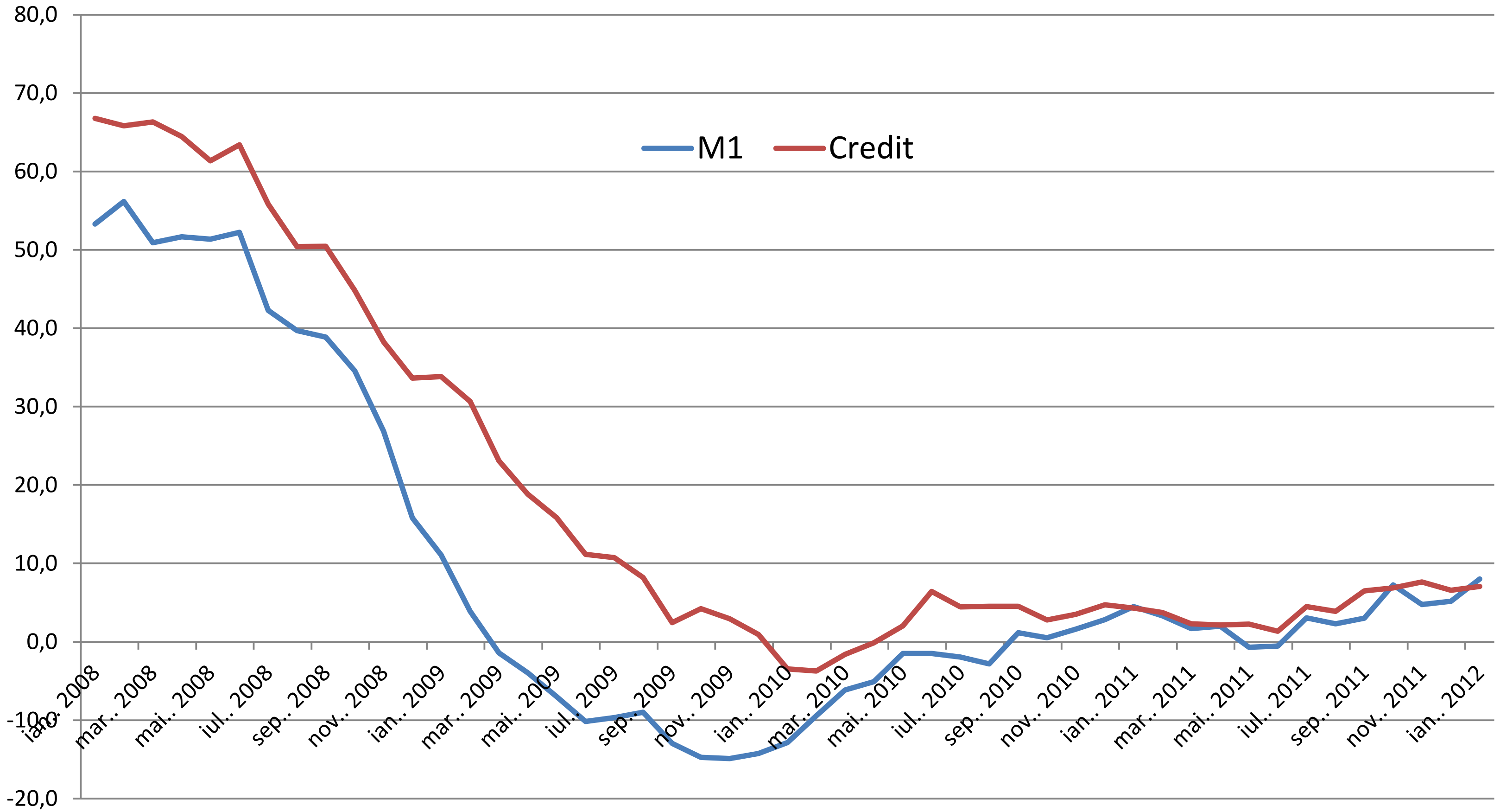


And this was then

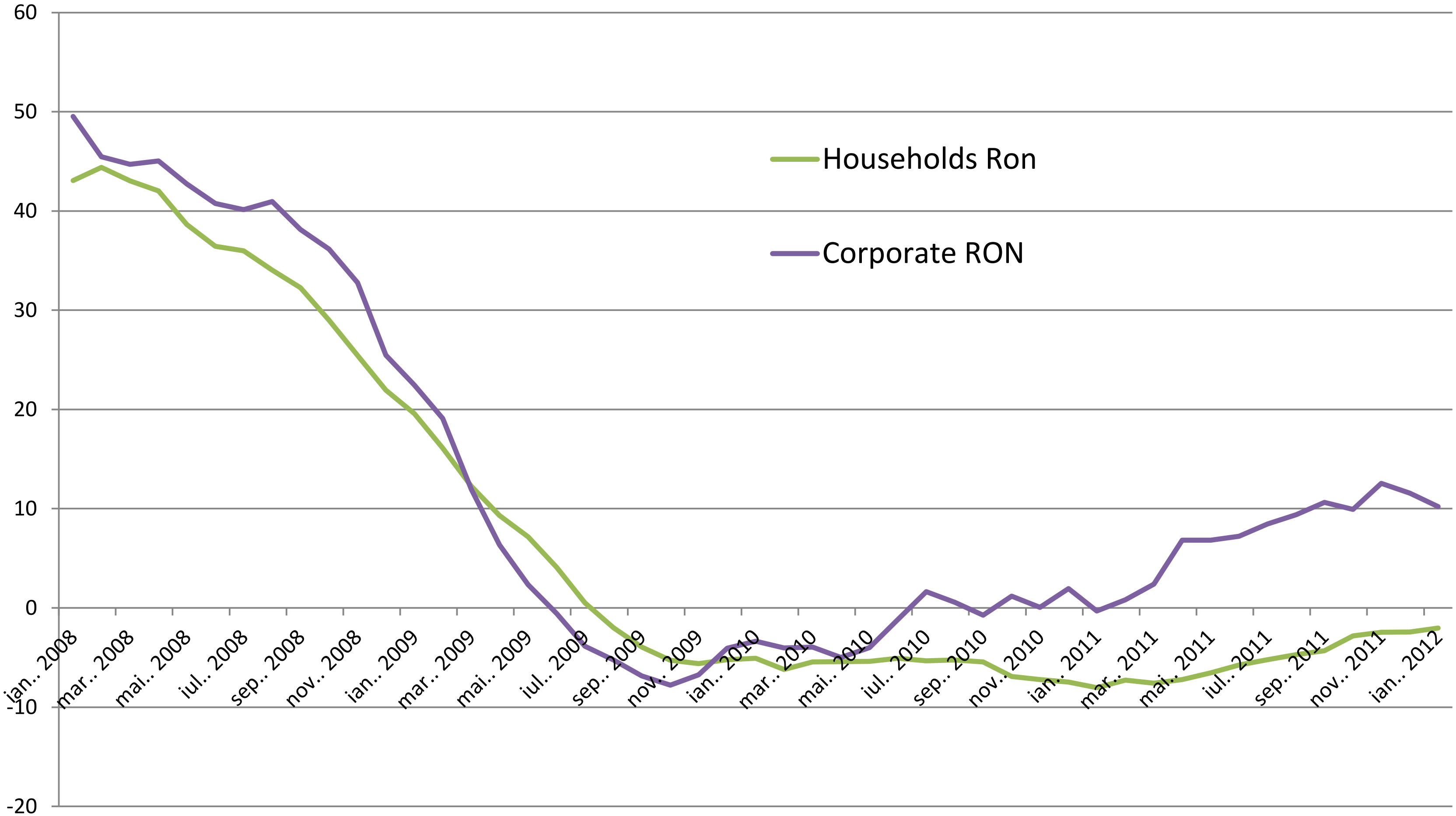



Real Gross Domestic Product 1928 to 1941
Annual Average % Change, Sources: SGS, BEA
20%
15%
10%
5%
0%
-5%
-10%
-15%
1928
1929
1930
1931
1932
1933
1934
1935
1936
1937
1938
1939
1940
1941

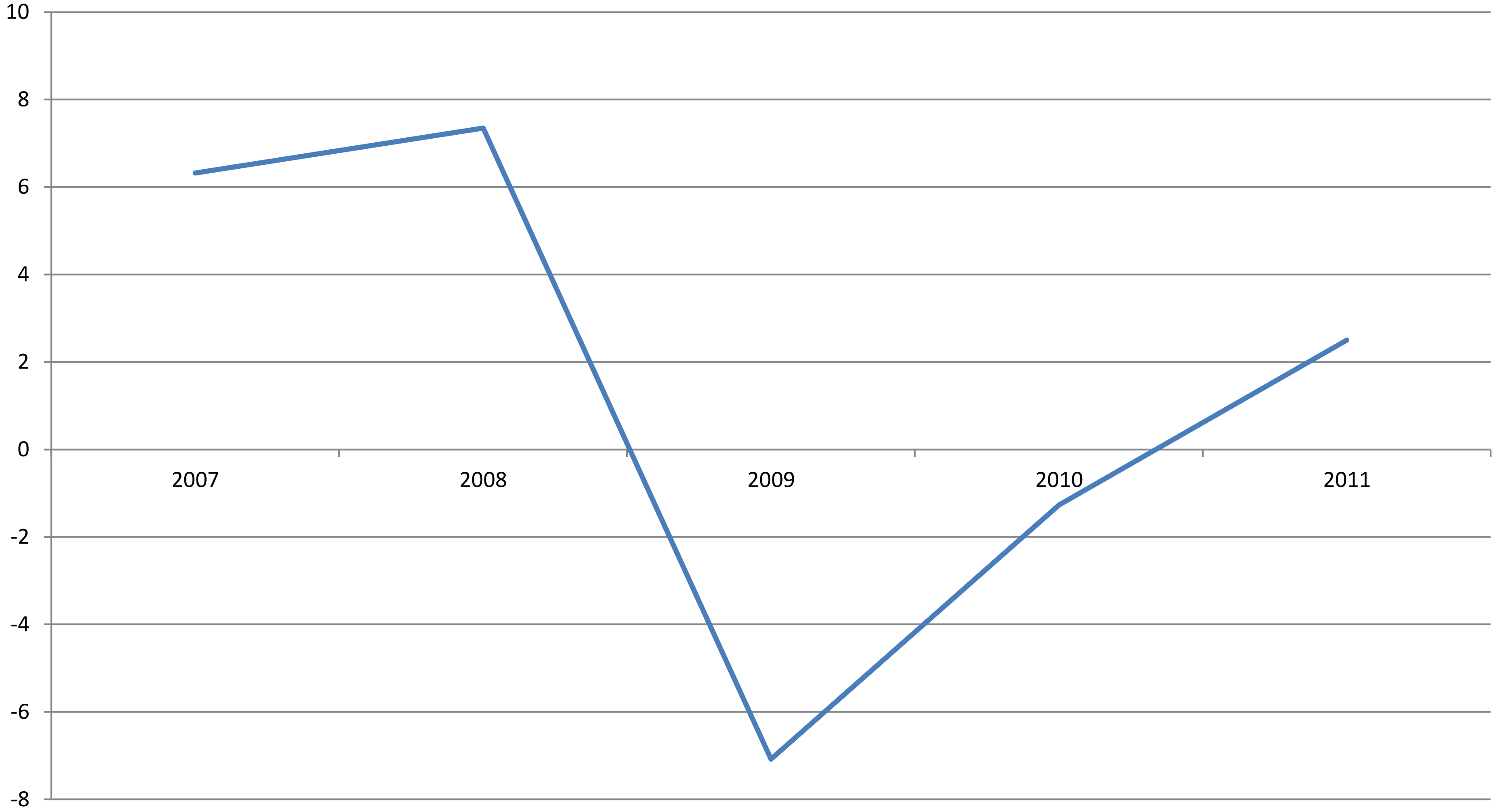
And this is Romania's contraction



Still Romania



And the real GDP “response”



What happened in my view

- NBR misdiagnosed the effect of the negative shock to aggregate demand from global crisis and the policy response was the **wrong one**: - NBR tighten monetary policy further after September 2008 by lowering the money supply, increasing the real rates, appreciating in real terms the domestic currency to deal with what it perceived to be "excess demand and inflationary pressures in 2009"
- Much like in the Great Depression when money supply dropped by 1/3, a drop by 20% in money supply led to recession in 2009 and low growth since then

Could have been different?

- Yes if **money supply** was a **more important** variable for monetary policy than the **output gap**
- Yes if FX interventions to protect RON would have been sterilized keeping the **money supply unchanged**
- Yes if NBR would have reversed much faster the tightening cycle in order to l**ower real rates** faster

The real conclusions

“For practical central bankers, among which I now count myself, Friedman and Schwartz's analysis leaves many lessons. What I take from their work is the idea that **monetary forces**, particularly **if unleashed in a destabilizing direction, can be extremely powerful**. The best thing that central bankers can do for the world is to avoid such crises by providing the economy with, in Milton Friedman's words, a "stable monetary background"--for example as reflected in low and stable inflation.

Let me end my talk by abusing slightly my status as an official representative of the Federal Reserve. I would like to say to Milton and Anna: **Regarding the Great Depression. You're right, we did it.** We're very sorry. But thanks to you, we won't do it again.” (Ben Bernanke, November 8 2002)

- TO BE CONTINUED…