

### ***Misplaced Faith in Auto-control Mechanisms Begs for Pro-active Policy***

“ A program that succeeds in stabilizing price inflation cannot possibly keep the quantity of money unchanged because lower inflation generates a higher demand for money.....It was (wrongly !) assumed (in Israel) that individuals would therefore obtain the quantity of money they demanded by converting foreign currency assets...and not by expanding bank credits;.....when fiscal and incomes policy is aimed chiefly at a reduction of private disposable income, the public tends to offset this policy by borrowing, especially if the policy is perceived as temporary ” (Bruno & Piterman in Dornbusch 19XX).

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Economics is not a positive science although great strides have been made in that direction. The magnitude of an impact on a variable due to a change in another variable may be estimated, but it remains just that, an estimate. These estimates may, in fact, be somewhat removed from the actual figures. The relationship between certain variables may thus not be one-to-one, although a directional judgement may be made. Other variables may be tied together in tautological relationships through identities.

One such identity is the expression below pertaining to a Central Bank's balance sheet:

1) Monetary Base (MB) = Net Foreign Assets (NFA) + Net Domestic Assets (NDA)

Net domestic assets are net CB credits extended to the rest of the economy.

Net foreign assets are CB's net foreign assets.

Yet another identity –parallel to the expression above, but this time pertaining to the balance sheet of the economy – is given below:

2)  $M3Y = NFA + NDA$

M3Y comprises currency in circulation, demand deposits, time deposits, residents' foreign exchange deposits, official deposits, and CB's other deposits.

Here NFA is the difference of foreign assets and liabilities for the whole economy, while NDA shows the claims of all agents in the economy.

Equations (1) and (2) are clearly related. CB can influence M3Y shown in (2) through its control of MB in (1). There are some complications, however.

- The Central Bank is not the sole agent of money creation in an economy. Commercial banks too create money through their lending activity. Furthermore, lower interest rates lead to greater money demand. Since CB is not the sole agent of money creation, NDA -in (2)- targets may exist which may deviate from the actual figures.
- In an economy where there is substantial currency substitution, CB's control over the money supply is weakened.

It is argued that there exist certain self-regulatory mechanisms within the economic policies pursued at the moment (no timeframe has been given for the sequence of events to play out).

- One such auto-control mechanism – paraded as an instrument which would stem any deterioration in the current account balance – is the sensitivity of foreign capital flows to interest rates. From the equations above, it follows that if foreign exchange flows out, money supply shrinks, rates rise, the economy slows down, imports fall, and vice versa.

↓NFA, M<sup>s</sup> ↓, interest rates ↑, national income ↓, imports ↓, current account balance improves.

- Yet another auto-control mechanism is the following argument made by Professor Akat: The NDA (1) band means that unless NFA rises, monetary base declines in real terms, so interest rates will rise, holding back excessively fast economic growth.  
(  $M^s/ \text{Price Level}$  ) ↓, interest rates ↑, et cetera...

“under a gold standard regime, balance of payments developments provide automatic mechanisms of adjustment which ensures that , ultimately, any balance of payments disequilibria would be corrected. One mechanism is through the variation in the interest rate which induce corrective movements of capital; for example, the surplus country would lower its interest rate while the deficit country would raise its interest rate and capital would flow from the former to the latter. Another mechanism, through the goods markets, operates more slowly. Deflation and inflation of the money supplies will lead to relative changes in prices and/or real output that will correct the imbalances. The adjustment through prices is associated with the classical price-specie flow mechanism while the adjustment through output is associated with Keynesian thinking “ (Argy 1994).

Some important caveats:

- Interest rates fell sharply on January 1<sup>st</sup>, 2000. The cause was NOT an immense increase in the money supply. The immediate cause was the credibility of a pre-announced exchange rate regime. The slower devaluation rate lowered interest rates through the interest rate parity condition. In this instance, therefore, money supply was not the predominant actor affecting interest rates. This means that the self-regulatory mechanisms in which so much faith has been set may be by-passed. At present, we know the exact devaluation rate of the Lira versus a US\$-euro currency basket until mid-2001. We also have a pretty good idea what the devaluation rate will be post-June 30<sup>th</sup>, 2001. The crucial point is that the devaluation rate will fall further from the present levels.
- Pundits had set great store by self-regulating mechanism #1 (ie;NFA changes regulating interest rates). In reality, mechanism # 1 did not work as well as intended because the Treasury borrowed sufficient amounts to preclude NFA from falling. A question that may arise is why did private flows not fall ? Well, **FX and real** rates of return (around 19% and at least 6%, respectively) are still quite high as an international comparison shows below (table below reflects Chase estimates as of August 4):

		Projected US\$ return
Chile	3-month NDFs	24.5%
India	3-month NDFs	12.8%
Poland	5 year bonds	31.6%
S.Korea	3 month NDFs	17.3%
Phillippines	3 month NDFs	15.6%
Turkey	6/01	19.2%

This also means that increasing interest rates might not be the preferable course of action because (a) this would have a non-negligible fiscal cost (2) foreign inflows may rise, causing an increase in the money supply.

It is also a well-known fact that under the present policy combinations the burden of adjustment - under a fixed exchange rate variant regime without recourse to sterilization, and with a relatively high degree of capital mobility – should fall squarely on fiscal policy, NOT monetary policy. Those clamoring for higher interest rates should appreciate that under the present set of policies, monetary policy is impotent.

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Reconciling observations:

Observations-

- 1) Modest national income growth (4.2% rise in GNP in 2000Q1, 5.6% in GDP)
- 2) Low industrial output growth
- 3) Imports are up significantly causing a deterioration of the current account. The ultimate culprit is alleged to be higher energy and raw material prices.

Reality-

- 1) The August 1999 earthquake continues to distort the true state of the economy. Sectors affected firsthand include (a) construction because of an official moratorium in 2000H1 (b) refinery output because of the damage to Tupaş facilities last August. Tupaş was at 85% capacity in July 2000 according to officials.
- 2) Removing the refinery sub-item from the industrial production index shows significant growth in 2000H1.
- 3) Imports are up significantly in part due to higher raw material prices, but mainly due to faster industrial output growth, rising consumer demand due to a fixed exchange rate regime.

The issue is a fundamental misidentification of the importance of the various channels through which the monetary transmission mechanism works; ie; the exchange rate channel is clearly very important in a small, open economy. The degree of tightness of monetary policy can NOT be assessed by a simple examination of money supply growth. An overall monetary conditions index should be examined.

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**Relationship between the money supply and the current account:**

$$M^s = NFA + NDA$$

$$\Delta M^s = \Delta NFA + \Delta NDA$$

where  $\Delta NFA = (X-M) + KA$  : X exports, M imports, KA capital movements

$$\Delta M^s = (X-M) + KA + \Delta NDA$$

The causality through to the current account balance runs via interest rates; eg; if NDA ↑, M<sup>s</sup> ↑, interest rates ↓, national income ↑, imports ↑, the current account balance deteriorates. Note that CBRT has stated that balance of payments developments will dictate money supply changes.

**Relationship between national income and money supply:**

$$MV = PT \quad \text{or} \quad MV = GDP$$

The famous monetarist equation relies on V being stable over time. Such an assumption may be heroic for an economy on the transition to a lower inflationary environment with widespread currency substitution. An argument made by some is that if CB does not print money, then the rate of economic growth will not exceed some desired growth level of output. The important point is again to keep in mind that an easing of monetary conditions does NOT necessarily require an increase in the money supply.

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**Conclusion:**

Several concerns exist -

- 1) Achieving inflation targets
- 2) Preventing further worsening of the current account balance
- 3) Preventing an eventual ballooning of non-performing loans as a consequence of excessive lending today
- 4) Reducing consumption bunching today would alleviate a downturn in economic activity later on

A tight fiscal policy stance (cutting public sector expenditures being the preferable avenue) is the key to meeting all of the concerns listed above. A criticism is that signs of the present concerns were apparent since March. Pro-active (as opposed to ad hoc) economic policymaking - one that does not set too much faith in a Panglossian approach (that everything is for the best of possible worlds) - would be more fruitful.

**Notes:**

Durable goods output

Month	% Change
Jan	37.0
Feb	37.0
Mar	21.6
Apr	23.8
May	23.9
Jun	11.4
Source: SPO	

Durable goods sales

Month	% Change
Jan	62.0
Feb	77.0
Mar	19.3
Apr	15.7
May	22.7
Jun	13.0
Source: SPO	

Automotive sales

Month	% Change
Jan	107.4
Feb	94.7
Mar	77.0
Apr	49.0
May	86.0
Jun	67.4
Source: SPO	

CB statistics apparently show that the growth rate of consumer loans has also slowed down somewhat. On the other hand, imports for July are estimated to be a record US\$ 4.8bn. Our estimate for imports in July is about US\$ 4.5 bn. These are record high levels. The slowdown in percentage changes in comparison to the previous year may thus mainly be a reflection of the fact that 1999Q1 was the nadir of economic activity that year. The bottom of the recession thus creates a low baseline effect seen in 2000Q1 % change figures.

The quote in the first page mentions how households may resort to borrowing if they perceive fiscal measures to be temporary. Well, substantial revenues in 2000 were from one-off measures passed under the guise of 'earthquake taxes'.

M4, a broad money aggregate, grew by 3% between the inception of the Israeli stabilization program in mid-1985 and end-1986.

**References:**

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