SOME MONETARIST REFLECTIONS ON BUSINESS CYCLES

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Abstract

The important place that currency and bank credit have in the economy, give us the right to indicate them as major factors in determining business cycles. Starting from Mr. R. Hawtrey's famous statement "The trade cycle is a Purely Monetary Phenomenon", the paper aims to offer some guidelines about the role of monetary factors in the cyclical evolution of economy, as understood by the followers of the Monetarism, and some criticism of this theory. We also proposed ourselves to search the applicability of the key Monetarist approach elements on the Romanian business cycle. We found that the Romanian monetary authorities maintain a Monetarist attitude in terms of maintaining the price level stability and using low interest rate to stimulate the economy. We also observed for the case of Romania the existence of a phenomenon which the monetarist theory did not anticipate, the inflationary recession.

Keywords: business cycle, money, credit, monetarism
JEL classification: E31, E32, E51

1. INTRODUCTION

The aim of this paper is to analyze the Monetarist approach of the business cycle and to search for its application in the case of Romania. As among the Romanian monetary authorities'objectives is included prices stability, we have a first indication about the existence of a Monetarist approach. In the same time, these authorities intervene on the interest rate and credit policy, in order to avoid inflation ar deflation, in the name of the same stability. The methodology used includes deduction, the observation of the Romanian monetary aggregates evolution, the processing of information and their interpretation, insisting on qualitative methods. Our theoretical understanding of the Monetarist business cycle is based on the work of W. Ropke [1936], Haberler [1946], Friedman [1971] and Fisher [1933] and the empirical investigation is based on the collection of secondary information offered by the Romanian National Bank (BNR) and the Romanian National Institute for Statistics (INSSE).

The paper is structured in six chapters. We made at the beginning a short taxonomy of the main business cycles' theories and present the relation between money and business cycle, as part of the Monetarist approach. In the third and fourth part we analyze the effects of the credit evolution on the economy, and some critics of the Monetarist business cylcle theory. The fifth part is dedicated to the Romanian monetary evolution in the context of the main Monetarist theoretical frame. In the sixth part, we conclude.

2. THE TAXONOMY OF BUSINESS CYCLES' THEORIES

Before identifying the business cycles' monetarist landmarks, it is necessary to make a brief demarcation of the main approaches to the cyclical phenomenon. A systematic classification of business cycles is a very complicated enterprise, since nearly every theory borrows elements belonging to another. Is it difficult to draw a clear line of demarcation between under-consumption theories and those of over-capitalization, and even between monetary and non monetary theories. Although there have been over time several initiatives to make a classification of business cycles, there is no universally accepted approach. According to W. Ropke [1936], the most successful classifications belong to Wesley Mitchell and Alvin Hansen, so: Mitchell divides business cycle theories into three categories. The first category includes those theories linking business cycles to natural processes such as crop yield fluctuations. The second category refers to the emotional processes impact on crisis and cycles. It is considered here the alternating periods of optimism and pessimism and their consequences for entrepreneurs' initiatives. The third category of theories connects business cycles to institutional processes, being subdivided into further subcategories [Mitchell, 1927]. Alvin Hansen distinguish the Capitalistic Economy schools theories, with emphasis on the processes of capitalist production and distribution, the Exchange Economy school theories, which considers business cycles a function of the competitive exchange economy and in particular insist on recurrent errors of judgments and the Money Economy school, which believes that the root of crises and cycles can be found in the monetary and financial mechanism of our economic system, a school which is, broadly speaking, equivalent to what is more generally known as the monetary theory of crises and cycles [Ropke, 1936, 63].

3. THE RELATION BETWEEN MONEY AND BUSINESS CYCLE

Earliest Monetarist explanations of business cycles are related to the name of the economists Gustav Cassel and Mr. Ralph Hawtrey. According to the latter, the business cycle is a purely monetary phenomenon because the quantity of money flows are the only cause of changes in economic activity, of alternating expansion and depression periods. Thus, a sharp decrease in the amount of money, deflation, has a depressive effect on economic activity, as an increasing amount of money, inflation, stimulates the economy. The reasoning for these connections is the following: Decreasing amount of money determines a reduced aggregate demand, the supply being forced to constrict. The suppliers that have expected a certain level of demand and have produced consequently more are forced to restrict production and to accumulate stocks. This will lead to rising unemployment and reduced wages and incomes, in other words, to depression. Inflation performs a similar reasoning. Demand is higher than manufacturers have anticipated; the supply increases and with it increased the demand for available factors of production in the economy.

The important role of the monetary factors in an economy can be deduced also from the simple observation that, generally, the upward phase of the business cycle is characterized by rising prices, although increased production should lead to a tendency to reduce them. This means that the upward phase should be characterized either by an increase in the volume of money and credit or an increase in velocity of money circulation, or both. Similarly, depression is apparently a time to reduce the amount of money and the velocity. In other words, economic expansion is a kind of inflation and depression a kind of deflation [Ropke, 1936, 112]. But expansion does not always cause an increase of prices and depression a monetary restriction. The American boom of the years 1926 - 1929 has not been characterized by rising prices. The volume of cash increased only slightly in that period, while loans volume has increased significantly. Credit expansion did not mean an increased general level of prices, because innovation and technical progress enabled the reduction of production costs. In other words, rising prices usually determined by money supply growth was offset by reduced production costs.

The Monetarists believe that if monetary cash flows will be stabilized, the economic fluctuations will disappear, and so business cycles will disappear [Haberler, 1946, 17]. This monetarist approach is embraced today by most of the monetary authorities, between whose objectives we can invariably find the price stability. However, the same monetary authorities are those that cause fluctuations in the money supply through the credit policy.

The central point of the monetary business cycle theory mechanism is the interest rate. Diminishing or increasing interest rates by central banks provide credit expansion or contraction. Not the level of the interest rate is the one that matters, but the difference between it and that level set outside monetary authorities' intervention, as a result of the relationship between the preference for consumption and saving. Moreover, sometimes, credit growth does not necessarily mean reducing the interest rate, but omitting its raise. If entrepreneurs' expectations for profits are high, the higher demand for loans, for which the interest rate did not increased, cause an increasing gap between the interest rate and the expected rate of profit. As profit expectations rise, the gap is even higher. We can speak of a race between the two variables, from which the banking system should retreat at a time in order to maintain its liquidity. Increasing the discount rate by the central bank is a signal in this regard.

We will further analyze the way money supply evolution affects economic activity in its two phases, expansion and depression.

4. THE EFFECTS OF CREDIT'S EXPANSION AND CONTRACTION ON THE ECONOMY

Upward phase of the business cycle is driven by credit expansion and lasts as long as this expansion is maintained. Credit expansion is determined by the so-called policy of cheap money, the easy access to financing sources. This is achieved through relaxing the conditions of credit access, such as: increasing the maximum period of credit, extending the funding directions, but especially through interest rate reduction.

Although often is considered that a few percent reduction in interest rates does not cause a significant increase in demand for loans from entrepreneurs, these variations are tempting for merchants. They represent a highly interest rate sensitive to fluctuations segment, trading much greater quantities of goods than their own. Thus, reducing the interest rate leads them to borrow more in order to enlarge their stocks. With more monetary resources at their disposal, the merchants place higher demands for producers' goods. Increased production determines incomes' growth and so the growth of demand for goods and a higher demand from retailers for producers goods. These growths reinforce each other, in the form of a spiral. The productive activities are more extensive, incomes are higher, and thus demand increases and needs the production of more goods in order to satisfy it. Increased activity means increased demand and increased demand means increased economic activity [Haberler, 1946, 19].

But economic growth can not last forever. As production capacities and inputs are limited, manufacturers will be compelled to answer the growing demand by higher prices. But rising prices is a signal for traders for an extra demand for credits. Higher prices offer a similar signal with reduced interest rates. The expectations for higher profits precipitate the demand for goods that can be sold at higher prices.

Summarizing, the expansion occurs as a cumulative process that once initiated, is self-sustaining. Manufacturers borrow to produce more, stimulated by rising prices, not discouraged even by an increase in interest rates, as long as prices are expected to grow even more. Economic growth can not last forever, because the economy is not one-way street. Important outflows of cash from the banking system, in order to meet the growing needs for transactions of the economy, determine banks to tempers the lending process, seeing threatened their reserves. Economic expansion ends when credit expansion stops. But things do not simply stop here, because the cumulative process of growth is every time balanced by a cumulative process of contraction.

Restriction on credits determines the fall of production, income and demand for goods and services. Falling prices and the anticipation of maintaining this trend cause traders to limit the orders placed to manufacturers. Restricted demand determines stocks to grow, despite the measures to reduce them. Things are the same as in the case of expansion, but in the opposite direction. Low demand cause reduced production, lower income and falling demand. During the depression the access to credit is limited and entrepreneurs aim to repay the loans taken during expansion. Money returns to the banking sector, which can thus reinforce its reserves. The climate of pessimism introduced due to the crisis makes than even a very low interest rate not to encourage entrepreneurs to borrow. But the monetary authorities have also other tools available to stimulate the economy, as open market operations. Buying securities on this market determine money inflows in the banking sector and increase bank liquidity. There is a change in bank assets structure, reduced loans and increased available money. But the persistent climate of pessimism in the economy makes the entrepreneurs to respond with adelay at new consolidated bank reserves and the new supply of credit. Accumulated surplus of bank reserves will tempt them to extend again the credit in the future and thus a new cycle will occur.

5. SOME CRITICS ON THE MONETARIST THEORY OF BUSINESS CYCLE

The main criticism of the Monetarist theory of the business cycle come from the Austrian School of Economics, which still share a common ground, namely that related to the role of monetary policy. If in the Monetarist approach monetary fluctuations are responsible both for economic expansion and contraction, Austrians see credit expansion as the causal factor of the economic boom, but further, real factors are responsible for correction.

The Monetarists are accused for focusing their analysis mainly on labor market, in terms of the inflation – unemployment relationship, neglecting the capital market, a central element of the Austrian business cycle theory [Garrison, 1986, 1989]. This neglect of capital theory is it imputed by other Austrians: "The monetary explanation of the cycle may be supported only by a scientistic, ultra empirical methodology of Monetarist macroeconomics, an approach that lacks a theory of capital with a temporal dimension [de Soto, 2010, 529].

The ideal of maintaining a constant level of prices is contrary to the essence of the business cycle fluctuation, an increase and decrease in the price level. Recession is not understood by Monetarists as a necessary reaction to increased investments during expansion. It is missing a causal link between the business cycle phases [Rothbard, 2000, 36].

Another objection to the Monetarist theory is that it seeks only the effects of changes in money supply on the general price level, neglecting the relative prices. Monetarists seem to ignore the effects of inflation on the allocation of resources, causing eventually a rising unemployment.

6. A MONETARIST PERSPECTIVE OF THE ROMANIAN BUSINESS FLUCTUATIONS

A common point in the business cycles' theories is the fact that economic booms are characterized by a low interest rate. We can see this even in the case of Romania, the tendency to reduce the key interest rate being stronger felt after 2005. In early 2008, following the turbulences on the international financial markets, the National Bank of Romania starts to gradually increase the key interest rate, which only confirms the entry of our country into recession. This increase is maintained throughout the year 2008, then, in 2009, following a slight downward trend, due to the efforts to revive the economy.

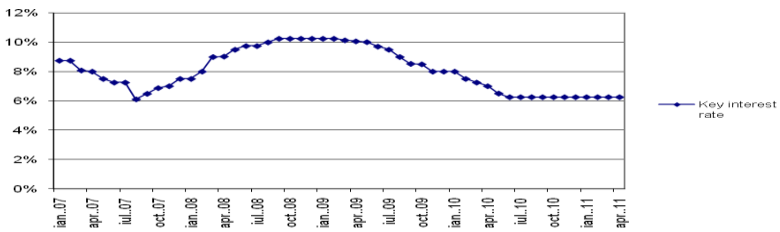

Figure no. 1 The evolution of ey interest rate in Romania's monetary market between January 2007 and April 2011

Source: processed data from [BNR, 2011]

Loans continue to follow an upward trend, with slight oscillations, all over the period 2007 - 2010, registering a slight decline in 2011. This can be observed in the structure of money supply, too. The floating cash remains relatively constant throughout the analyzed period, while the money supply has an upward trend, both during expansion and depression.

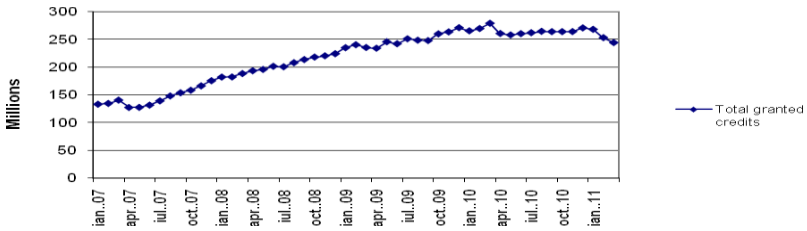

Figure no. 2 The evolution of total credits granted between January 2007 and April 2011

Source: processed data from [BNR, 2011]

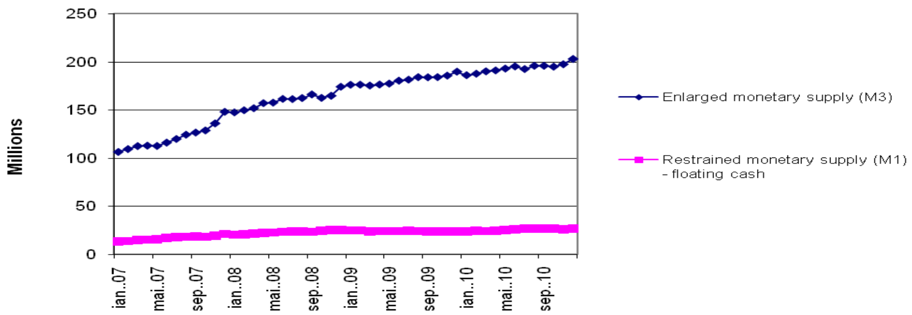

Figure no. 3 The evolution of money supply in Romania between January 2007 and April 2011
Source: processed data from [BNR, 2011]

As we expected, increasing money supply as a result of the continuing upward trend of lending has helped to maintain a level of over 100% of the consumer price index. Thus, we cannot speak of deflation during the recession, but on the contrary, of rising prices.

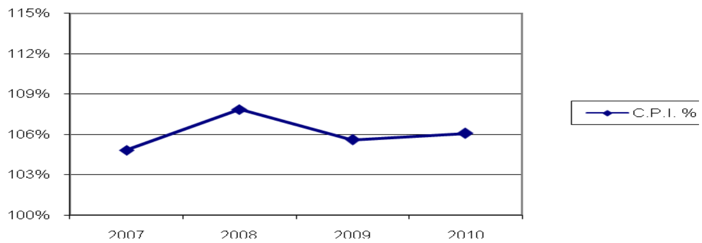

Figure no. 4 The Consumer Price Index evolution between January 2007 and April 2011
Source: processed data from [INSSE, 2011]

These figures indicates that monetary authorities didn't maintained a sufficient high level of interest rate, the credits granted for population fluctuating slightly around 100.000.000 thousand lei. If credits granted to non monetary financial institutions have been reduced constantly from 2008, not the same happened with the credits of non financial societies and those of public institutions. The massive refinancing of credits taken during expansion and the need to cover the public deficits justify this tendency for above mentioned entities.

The conclusion is that prices moved opposite to the business cycle during recession when, as Monetarists sustain, the prices should fall. Thus, it can be observed a phenomenon which the monetarist theory did not anticipate, namely the inflationary recession. The monetary authorities' intervention in order to avoid deflation is mainly responsible for this. All these measures are because of not understanding and accepting that any economic contraction is only a necessary reaction to re-establish the economy on healthy fundaments, when investments rely on savings and not on the artificial credit expansion, induced by authorities.

7. CONCLUSIONS

A very simplistic approach of the Monetarist business cycle theory would be based on the banking system tendency to keep a low interest rate during the upward phase of the cycle; then prices rise, we get a credit inflation, and sooner or later the banks are forced to take steps back in order to protect their reserves by increasing the interest rate and bring about the crisis and the depression. The receipt offered in order to avoid the cyclical fluctuations relies on the monetary authorities' intervention in order to maintain price stabilities. The Monetarists' belief is that without monetary fluctuations there are no price fluctuations, and thus, no business cycles. Prices, in general, fell during recessions because deflation used to be a feature of economic contractions. But, in the last decades, monetary deflation has been prevented by governmental expansion of credit and bank reserves, and the decline of money supply has not really happen. The authorities' decision to avoid deflation means a rise, not an expected fall, of general prices, even in recession, as we have already seen in the case of Romania The fact that the Romanian monetary mass continue to expand even in recession demonstrate the intervention of monetary authorities in order to maintain through credit the expenses of local or central public administrations. Maintaining price stability, demand and consumption, is not always the best solution. Sometimes, we need deflation and recession in order to remove excesses and to restore the economy on a sound basis.

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