# When Money Aggregates Failed Why the Money “Abandoned” Us

**Susanna Grigoryan**

**Recent Staff Member, Monetary Policy Department, Central Bank of Armenia**

**Student, Global Forecasting School**

**November 2025**

Hello, I’m **Susanna Grigoryan**, an economist at the **Central Bank of Armenia** and a **Level 1 student at the Global Forecasting School**. In this video, we’ll explore why **monetary targeting** — the idea that central banks could control inflation by trying to control the growth of money — eventually broke down. It’s a story of innovation, disillusionment, and the search for a better anchor for monetary policy.

In the late 1970s and early 1980s, central banks around the world tried to rein in inflation by targeting monetary aggregates such as M1 or M2. The logic seemed straightforward: if inflation was “too much money chasing too few goods,” then controlling the growth of money should stabilize prices.

At first, the strategy looked promising. In the United States under Paul Volcker, and in Canada under Gerald Bouey, central banks announced explicit money-growth targets as a visible commitment to discipline. Markets welcomed the move, and credibility appeared to be built through numbers.

But soon, the relationship between money and inflation began to unravel. Financial innovation transformed how people held and used money. Credit cards, money-market funds, and electronic payments changed the way liquidity moved through the economy, making the velocity of money unpredictable. The once-stable link between money and prices weakened dramatically.

In practice, the quantity of money was never something a central bank could directly control. Small changes in interest rates led to large and erratic movements in money demand. It was as if money itself had “abandoned” us — no longer behaving the way textbooks predicted.

Economists began to realize why. Money is endogenous, not exogenous. It is created inside the financial system through the credit decisions of banks. When banks extend loans, they simultaneously create deposits; when those loans are repaid, money is destroyed. That means the supply of money depends on the demand for credit and on banks' perceptions of risk, not on the central bank's direct control.

Once this insight became clear, it was obvious that trying to hit a precise money-growth target was like trying to control the temperature of a room by guessing how fast the fan should spin. The tool was indirect and unreliable.

This realization led to a major conceptual shift in monetary policy — from trying to control quantities to influencing prices. Instead of attempting to fix the growth of money, central banks began to set the short-term interest rate to influence the cost of borrowing and spending in the economy. By focusing on interest rates, policymakers could work through the credit channel and expectations, providing a more stable and transparent way to guide inflation toward its target.

Armenia experienced this transition as well. In its early years, the Central Bank of Armenia experimented with monetary targeting, hoping to build credibility through visible numeric targets. But the same challenges appeared here as elsewhere: financial deepening and innovation made monetary aggregates unreliable guides. The link between money and inflation weakened, and the numbers themselves became noisy and misleading signals.

Eventually, the CBA shifted toward an interest-rate-based framework, laying the groundwork for the modern inflation-targeting regime that we operate under today. This change marked a decisive moment in the CBA's evolution — a recognition that monetary policy must work through prices and expectations, not through an assumed control of money stocks.

The key lesson is simple: to control inflation, we must influence the price of money, not its quantity. Understanding that money is created within the financial system — that it is endogenous — was a turning point in modern central banking. It represented the move from mechanical rule-following to strategic management of expectations and risks.

This transition also set the intellectual foundation for today's Prudent Risk Management Approach to Monetary Policy, known as FPAS Mark II. Developed at the Central Bank of Armenia in collaboration with the Better Policy Project, FPAS Mark II treats policymaking as a process of continuous learning under uncertainty. It explicitly weighs risks and scenarios instead of relying on a single deterministic forecast. It builds credibility not by claiming precision, but by demonstrating prudence — acknowledging uncertainty, managing expectations, and communicating clearly.

As Freedman and Laxton (2009) observed, credibility depends on consistent frameworks and adaptable strategies. Monetary targeting failed not because policymakers lost control, but because they discovered they never truly had it. The illusion of control gave way to a more accurate understanding of how credit and expectations drive inflation.

Armenia's experience mirrors this global evolution. By the mid-2000s, it was evident that monetary aggregates could no longer provide a reliable nominal anchor. The CBA responded by transitioning to an interest-rate-based operational framework that strengthened the transmission of policy through the financial system and paved the way for FPAS Mark II. Under this approach, policy decisions incorporate risk assessments, scenario analysis, and clear communication — all crucial for maintaining credibility in an uncertain world.

The failure of monetary targeting was not a policy error, but a recognition of economic reality. Central banks cannot directly control the quantity of money; they can only influence its price and the conditions under which it is created. The transition to interest-rate-based policy marked a maturing of central banking — from mechanical rule-making to thoughtful, data-driven management of expectations and risk.

For Armenia, this shift represented a vital step toward institutional credibility and modern policy practice. The lessons of the 1970s and the breakdown of monetary targeting continue to guide our work at the Central Bank of Armenia today — an approach that values analytical rigor, communication, and the prudent management of uncertainty.

This video was prepared with guidance from Douglas Laxton, Jared Laxton, Asya Kostanyan, and Sopio Mkervalidze at the Global Forecasting School.
Thank you for watching, and I look forward to exploring more of the story of modern monetary policy with you in future episodes of the CBA Academy.

**Literature & Further Reading**


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