JEBI

Journal of Economics and Business Issues

Monetary Policy Challenges of the Post-Pandemic Period

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Abstract: On November 3, 2021, the Federal Reserve announced that it was ending its quantitative easing program and on December 15 announced that it would double the rate of contraction. For financial market participants and businesses, this decision was a very serious signal for the emergence of expectations of another serious wave of the global economic downturn. At a press conference following the decision to raise the base rate in March this year, Jerome Powell said that the US central bank would do everything to bring annual inflation down to 2%. According to him, the US Federal Reserve is not considering raising the base rate by 75 basis points. However, the opposite has happened: Federal Reserve has raised the federal funds rate by 75 basis points four times in a row, and so far annual inflation of over 7% has been unable to do anything, let alone bring it down to 2-3%. Analysts are asking questions: how strong is the US economy, can it withstand the anti-inflationary drug called "monetary tightening"? According to most economists, tightening monetary policy is very likely to trigger another global recession.

Keywords: Federal Reserve System, quantitative easing, federal funds rate, key rate, global inflation, quantitative tightening, mortgage-backed securities, derivatives, global recession.

Citation: Chikobava, M. & Kakulia, N. (**2023**) Monetary Policy Challenges of The Post-Pandemic Period. *Journal Of Economic and Business Issues, 3(2)*, 40-48.

Received: 22/01/2023
Accepted: 17/07/2023
Published: 31/07/2023

1. Introduction

The term "quantitative easing" was coined and put into circulation by the US monetary authorities back in 2008, in the midst of the financial crisis. As explained in textbooks on macroeconomics, central banks must issue money in a way that does not provoke inflation or deflation. That is, the issue should ensure a balance between the commodity and money supply.

During the era of the gold-dollar standard, which lasted a quarter of a century after the end of World War II, the issuance of dollars by the US Federal Reserve was limited to US gold reserves. In other words, the "gold brake" formally acted on the issue of the dollar. In 1971, US President Richard Nixon announced the end of the exchange of dollars for gold. However, it was precisely this commitment that the United States made at the Bretton Woods Conference in 1944.

In 1976, the Jamaican Monetary and Financial Conference finally abolished the gold dollar standard and replaced it with a paper dollar standard. With the removal of the "golden brake" from the "printing press" of the Federal Reserve System, it became possible to create as many "green papers" as the main shareholders of the US Federal Reserve System wished. De facto, "quantitative easing" began back in the 70s of the last century, when the world financial system began to be flooded with a mass of dollars.

The increase in the mass of the dollar was accompanied by a rapid increase in the total US debt. After all, the dollar is credit money that enters circulation through the accumulation of debt on loans issued or through the purchase of bonds and other debt obligations. This could not but create gigantic disproportions in the American economy. The latter manifests itself in inflating giant "financial bubbles" in the stock markets.

2. Materials and Methods

Over the past half century, the US economy has experienced several crises. The latest of these crises is the 2008-2009 crisis. It was then that the "typewriter" of the US Federal Reserve System was put into action at extremely high speed, to justify which the term "quantitative easing" was coined.

If at the end of 2007 the assets of the Federal Reserve System amounted to a little more than $800 billion, then by October 2014, when the third quantitative easing program ended, they had already reached $4.5 trillion. The expansion of the money supply was carried out mainly through the purchase of Treasury and mortgage-backed securities in the stock markets by the Federal Reserve. It should be noted, that monetary policy should be largely responsible for regulating the business cycle, which means stabilizing inflation rates and interest rates by using inflation "targeting", thus the impact of classical monetary policy channels on the economy is limited because, on the one hand, security markets are underdeveloped in some countries, and on the other hand, interest rate dynamics are more dependent on structural factors than on monetary conditions [10].

In seven years, the money supply created by the Federal Reserve almost quintupled. And this at a time when the mass of goods produced by the US economy has increased by only 20% during this time. According to all the laws of economic science, unbridled inflation should have begun. And this did not happen for the simple reason that almost the entire mass of dollars went to the stock markets, which inflated the "bubbles" of stock indices. The latter periodically exploded, which caused strong fluctuations in the American economy.

"Quantitative easing" entailed another dangerous risk: the astronomical amount of US dollars in the markets of the United States and the world contained the danger that one day the dollar could depreciate sharply and lose its status as a world currency.

Since the end of 2014, the Federal Reserve has been trying to reduce the money supply. It went really bad. By the end of 2019, it was possible to reduce the assets of the US Federal Reserve System to only $3.9 trillion. By March 2020, a "Covid pandemic" was declared. In the same month, the Fed announced the start of a new round of quantitative easing. By November 2021, Federal Reserve assets reached $8.7 trillion. That is, in just two years it has increased by 2.2 times [1].

By the way, many central banks from the very beginning of the "pandemic" act like the Federal Reserve System, i.e. expand the large-scale emission of their own currencies. From the end of 2019 to the end of 2020, the assets of all central banks in the world grew from $30.5 trillion to $41.9 trillion, i.e. by 37% (Norrestad, 2021). By 2021, the combined assets of all central banks have reached $45 trillion.

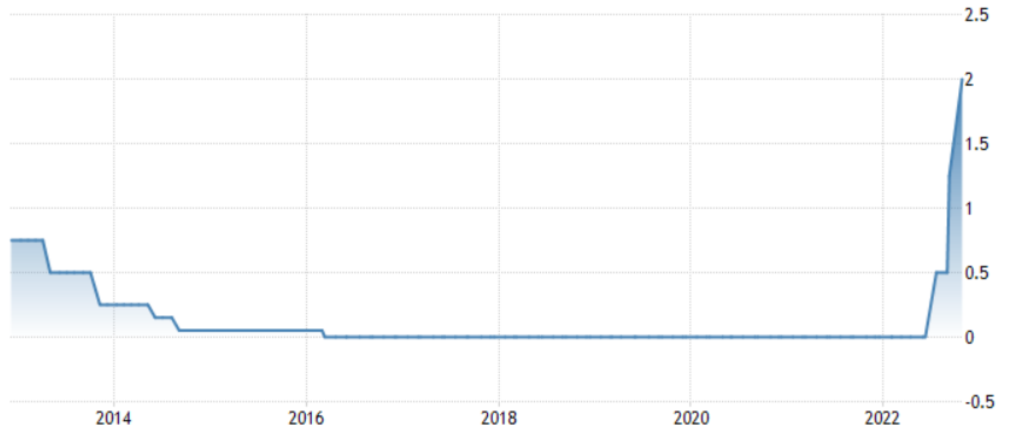
Of course, central banks that issue reserve currencies, such as the European Central Bank, the Bank of Japan, the Bank of England, the People's Bank of China, the Swiss National Bank and others, have shown the greatest issuing activity. For example, the European Central Bank doubled its assets in about two years of the "pandemic", reaching 8.7 trillion euros in November. The total assets of four central banks - the US Federal Reserve, the European Central Bank, the People's Bank of China and the Bank of Japan - reached about $31 trillion by the end of 2021, while at the beginning of 2020 their volume reached only $20 trillion [1].

Analysts and experts are trying to guess how long the leading central banks will be able to continue such a policy of "quantitative easing". There are several versions of the alternative currency system, which we will not discuss now. We only note that the experts named such options as the revival of the gold standard in one form or another, the replacement of "old" dollars with "new" ones, the creation of a supranational monetary unit, etc.

Let's return to the policy of the central banks of the leading countries of the world. Since March of this year, a sharp tightening of monetary policy has begun, which is caused by the provocation of global inflation.

Source: https://tradingeconomics.com/united-states/interest-rate.

Figure 1. US Federal Funds Rate (2012-2022)



Source: https://tradingeconomics.com/euro-area/interest-rate

Figure 2. Base interest rates of the European Central Bank (2012-2022)

Source: https://tradingeconomics.com/united-kingdom/interest-rate

Figure 3. Base interest rates in the UK (2012-2022)

The US federal funds rate has risen to 4.5% from the current 0-0.25% in early 2022. However, in contrast to the standard BJ rise of 0.25 percentage points, this year there was a multiple increase of 0.75 percentage points, which is unprecedented in the history of the Fed. The European Central Bank has raised its benchmark interest rate from 0% to 2.5%, the Bank of England from 0.1% to 3.5%, and the Bank of Japan has kept its benchmark rate unchanged at an unusually low level of -0.1%.

Source: https://tradingeconomics.com/japan/interest-rate.

Figure 4. Base interest rates of the Bank of Japan (2012-2022)

Despite the tightening of monetary policy by the central banks of the leading countries, inflation is still very far from the target level (2-3% per year) (see Table 1).

Table 1. Annual Inflation Rates In The Leading Countries Of The World (as of October 2022)

Countries	Inflation rate (%)
USA	8,2
United Kingdom	11,1
Germany	10,4
France	6,5
Italy	11,8
Spain	9,5
European Union	11,5
Japan	3,7

Source: https://tradingeconomics.com/country-list/inflation-rate?continent=world

According to experts, these decisions mean that the global economic crisis will break out in the near future. If we take into account the accumulated imbalances in the world economy, first of all, the total world debt, which, according to the International Financial Institute, exceeds $300 trillion, the crisis will be very unusual. In terms of its devastating consequences, it will surpass all post-war crises and will probably surpass the most severe world crisis in the history of capitalism - "The Great Depression" [2].

If an economic crisis begins in America, then no amount of quantitative easing programs will be able to save the economies of other countries from an economic collapse. Crises will spread around the world like wildfire. This was the case in 2008, when the

crisis began with the collapse of the mortgage securities markets in the US, then spread to other sectors of the US economy, and a little later to Europe and the rest of the world.

In addition to the huge debt, derivative financial instruments (derivatives) are the most powerful slow-acting mine, which for some reason are rarely talked about lately. No one even knows exactly what the volume of the derivatives market is, because banks and companies do not reflect them in their balance sheets, these are off-balance sheet positions. But the total amount of derivatives (the nominal amount of derivative contracts) reaches hundreds of trillions of dollars [3].

In the mid-2000s, the total amount of unhedged derivatives, according to the Bank for International Settlements, was $1,400 trillion (1.4 quadrillion) dollars. After the 2008-2009 crisis ended, the Bank for International Settlements reduced this figure to $600 trillion, closing most of the positions, mainly through offsets.

The figures are rather arbitrary, because even the Bank for International Settlements itself does not have a complete picture of the off-balance sheet operations of banks and companies. To date, according to the most conservative estimates, the total value of all derivatives in the world has already exceeded 2 quadrillion dollars.

Recall that during the crisis of 2008-2009, the inability of many banks and companies to fulfill their obligations under derivatives led to their bankruptcy. In 2002, the famous American billionaire Warren Buffett called derivatives "a financial weapon of mass destruction."

Now let's talk more about the decisions of the US Federal Reserve System. The “quantitative easing” program launched by the Federal Reserve in March 2020 involved $120 billion in monthly securities purchases, including $80 billion in Treasury bonds and $40 billion in mortgage-backed securities.

The Federal Reserve's November 3, 2021 decision called for a $15 billion cut in monthly purchases, including $10 billion in Treasury securities and $5 billion in mortgages. The Federal Reserve's decision of December 2021 accelerated the rollback of the "quantitative easing" program by half. That is, the Federal Reserve has pledged to cut monthly purchases of Treasury securities by $20 billion and mortgage purchases by $10 billion. By March 2022, the "quantitative easing" program has officially ended! [4].

At the meeting of the Open Market Committee on December 15, 2021, the Fed released figures reflecting the views of committee members on key rates in the medium term (FOMC, 2021).

According to the average forecast, members of the Federal Open Market Committee predicted three key rate hikes in 2022 and 2023, respectively. At the time, the previous forecast called for only one rate hike in 2022 and two in 2023. If we assume that each increase was to be only one standard step, equal to 0.25 percentage points, then in a year the key rate should have increased to 0.75-1%. However, the global financial, economic and pandemic crisis was added to the global cataclysms caused by the Russian-Ukrainian war, which manifested itself in a sharp decrease in energy supplies to the market. And this provoked global inflation, which became the basis for a jump in key rates of the Fed, the ECB, the Bank of England, the Swiss National Bank and others [5].

To express the current world situation in the words of the famous financial speculator George Soros, "the music is no longer heard, but they are dancing again." “The music stops” in November-December 2021, but many market participants “keep dancing.” This means that they get more cheap money from banks and buy securities in the stock markets.

But stock market players act according to their habits. The largest corporations buy back their own shares in the markets, thereby stimulating the growth of the capitalization of their business. But nine out of ten participants of the dance floor (exchange) are still “dancing”, only one has already stopped dancing.

To take an example, in November 2021, Microsoft announced that it would continue to buy back its own shares. And at that time, its CEO Satya Nadel sold more than 50% of its own shares of Microsoft on the stock exchange in one day. Elon Musk of Tesla sold his

shares for $10 billion, but decided not to scare other market participants by saying that the sale was due to non-market considerations, namely the need to get cash to pay taxes [6].

Already after the meeting in March of this year, when the key rate was raised by one "step", Fed Chairman Jerome Powell began to psychologically prepare market participants for possible radical steps by the Fed. He has repeatedly stated that the American economy is facing two big problems: inflation and recession. Inflation is already rising (8.2%) and a recession (economic downturn) is still possible. Loose monetary policy is needed to fight a recession, and tighter to fight inflation. In the second case, it is necessary to raise the key rate and reduce the money supply. The Federal Reserve understands that it cannot fight on two fronts at once, and chooses to fight inflation. In March, annual inflation in the US for the first time in 40 years (since January 1982) exceeded 8%. “We will take the necessary steps to restore price stability. In particular, if we conclude that it is appropriate to act more aggressively by raising rates by more than 25 basis points at the Open Market Committee meeting, we will do so,” said Powell [8].

Meanwhile, most experts believe that a crisis is inevitable in the near future. Among them are such authorities as Wall Street Bank analyst Golgman Sachs, New York University professor Nouriel Rubin, who predicted the 2008 global financial crisis [7].

On June 1, Jamie Dimon, CEO of the largest US bank JP Morgan Chase, speaking at a financial conference in New York, expressed serious concern about the clouds that are gathering over the US economy: “This storm ... is approaching us. . We just don't know yet whether it will be a small storm or a super storm" (Son, 2022).

Elon Musk said the same thing in May: “Will there be a recession in the near future? Rather than not." In early June, Musk said he had a "very bad feeling" about the US economy (Crooks, 2022).

Of all the forecasts for an economic downturn in the United States, Donald Trump's opinion was the most resonant. On June 20, he stated: “This is not something that can happen in two years… We are already in a recession” (Weaver, 2022). Trump's statement is not outrageous at all. The former US president expressed what most Americans feel.

Implications of global anti-inflationary policies

The annual inflation rate in the United States, despite the tightening of monetary policy, has been significantly exceeding the target (2-3%) for several months now. In 2022, the monthly price inflation rate in the US will look like this (see Fig. 5): January - 7.5%; February - 7.9%; March - 8.5%; April - 8.3%; May - 8.6%; June - 9.1% (at the end of June, inflation reached a new high over the past 40 years. This is the highest rate since December 1981); July - 8.5%; August - 8.3%; September - 8.2%; October - 7.7%; November - 7.1%.

Source: https://tradingeconomics.com/united-states/inflation-cpi

Figure 5. Monthly inflation figures in the US (January-November 2022)

To sort out the unpleasant picture, the US Department of Labor started the so-called Core Inflation Calculation. That is, the rise in prices without taking into account such commodity groups as energy and food products. This core inflation was also quite high - 5.9% in June. As for food and energy products, they are not taken into account, they are considered as “distorting factors”. For example, US President Joe Biden called inflationary price increases in America a “Putin tax” [7].

President Joe Biden and US Federal Reserve Chairman Jerome Powell believe that the two main economic threats to America are recession and inflation. But while recession still looms dimly on the horizon, inflation is a daily reality for millions of Americans.

Therefore, Jerome Powell and the Federal Reserve under him chose a course of tightening monetary policy - a tried and true means of combating inflation. So far, with some pauses, the Federal Reserve has been easing monetary policy since 2008. First of all, this was manifested in a gradual decrease in the key interest rate, which was reduced to almost zero. Secondly, the money supply has increased; It was carried out by the American central bank in the financial market through the purchase of Treasury bonds and mortgage-backed securities. As a result of this policy (called quantitative easing), US Fed assets rose from $0.8 trillion at the end of 2007 to $8.9 trillion by early 2022. In a word, there was an 11-fold increase. Therefore, the mass of the dollar increased by almost the same amount.

In the period from the beginning of 2020 to the beginning of 2022, the key rate of the Central Bank of America was at the level of the plinth: it was 0-0.25%. And since February 2022, the US Federal Reserve has sharply perked up. Jerome Powell, always careful in his speeches, suddenly grew bolder. He said without his usual half hints and ambiguity: the Federal Reserve is choosing a course of tightening monetary policy and will carry it out to the extent necessary to eliminate inflation (more precisely, to reduce its level to 2-3 percent).

On March 16, the US Federal Open Market Committee (FOMC) raised its key rate by 0.25 percentage points (25 basis points) to 0.25-0.5%.

The next step was taken on May 4, when the key rate was raised by two standard steps: (i.e. by 50 basis points) to 0.75-1%.

Another step was taken on 16 June. This move caused a great uproar both in the US and abroad. The Fed raised the key rate by three “steps” at once (75 basis points), and it amounted to 1.5-1.75%. The last such three-stage jump was made by the Federal Reserve in 1994. On July 27, the Federal Open Market Committee took another step towards raising the key rate. He once again raised the key rate by three "steps" - 2.25-2.50%. This was followed by an increase in the federal funds rate to 3.25% in September, and on November 11 it was raised to 4%. In other words, for the first time in its 109 years of existence, the Federal Reserve has made four consecutive 75 basis point rate hikes!

An increase in the key rate is accompanied by a movement towards “quantitative tightening”. The latter includes the Federal Reserve selling from its own portfolio the same Treasury and mortgage-backed securities it has accumulated over the years. Monthly sales of $30 billion in Treasury bonds and $17.5 billion in mortgage-backed securities took place during the summer. In September, bond sales more than doubled to $60 billion in Treasury bonds and $35 billion in mortgage-backed securities [3].

3. Results

Analysts are asking questions: how strong is the US economy, can it withstand the anti-inflationary drug called "monetary tightening"? Some suggest that even the current dose of the drug has serious consequences. Michael Wilson, chief US equities strategist at Morgan Stanley, said investors shouldn't put their money into equities right now, despite the stock market's rally following the Fed's decision to hike rates by 75 basis points. The US stock market will continue to fall due to the economic downturn, Wilson warns. “The market always goes up as soon as the Fed raises rates, but not until a recession hits.” “It is

unlikely that this time there will be a long gap between the end of the Fed's rate hike campaign and a recession," he said (Landsman, 2022).

Some experts believe that the short-term treatment (an increase in the key rate, at most, by two or three more "steps") will be sustained by the body of the American economy. But if the fighting in Ukraine drags on, then energy and food prices on world markets will remain at an unprecedented high level. Even if the US Federal Reserve raises the key rate at the next meeting of the Federal Open Market Committee at the end of December this year, inflation in America will not be eliminated. On the contrary, it will provoke a serious recession. It is extremely difficult to assess the devastating effects of the economic crisis thus provoked by the Federal Reserve.

4. Discussion

The only "plus" of such a crisis can only be that prices will start to fall if the economy enters a depression phase (post-recession stage). Inflation will also be defeated. However, this way of fighting inflation is like "treating" a headache with a guillotine.

Here's what US Department of Commerce macro data for the second quarter of 2022 tells us. The US economy contracted 0.9% year on year in the second quarter. It should be noted that in the first quarter, US GDP fell by 1.6%. Two consecutive quarters of decline in gross domestic product fit the technical definition of a recession. The National Bureau of Economic Research (NBER) also informs us about the onset of a recession, and their definition of a recession is different from the technical one. For NBER, a recession is a significant decline in economic activity throughout the economy that lasts for several months. Private sector fixed investment fell 3.9% in the second quarter, while federal government spending fell 1.9% [9].

5. Conclusions

Thus, the tightening of monetary policy by the central banks of the world's leading countries in 2022 has not yet led to the fact that the actual inflation rate is at least slightly closer to the target, instead, as a result of such a policy, the likelihood of provoking another wave of the global economic crisis is growing.

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