RONDELI FOUNDATION

GEORGIAN FOUNDATION FOR STRATEGIC AND INTERNATIONAL STUDIES

METAMORPHOSIS OF THE MONETARY POLICY OF THE LEADING CENTRAL BANKS

MALKHAZ CHIKOBAVA

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EXPERT OPINION

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საქართველოს სტრატეგიისა და საერთაშორისო ურთიერთობათა კვლევის ფონდი
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Introduction

In recent years, the central banks of the world's leading countries have resorted to a policy of the so-called "quantitative easing" which means that they are no longer limiting themselves only to the purchase of government securities but they are expanding their assets by additionally purchasing corporate securities. These innovations are aimed at saving degrading economies, although the desired results have not yet been seen. Therefore, the question arises: how long will the Coronomic crisis last and to what extent is it possible to overcome this crisis with the policy of "quantitative easing?"

The Decline of World Economy in 2020-2021

Signs of recession were observed in some countries of the world by the end of 2019. The economic downturn in the fourth quarter of the same year was exacerbated by the "pandemic." Lockdown was introduced all over the world which further dampened the economy. According to the International Monetary Fund, the economies of developed countries lost 5.8% of total output in 2020 of which the US - 4.3%, and the Eurozone - 8.3%. It should be noted that the decline was 12.8% in Spain, 10.6% in Italy, 9.8% in France and 6.0% in Germany (IMF, 2021).

In absolute terms, the losses of the world economy, according to the International Monetary Fund, amounted to USD 3.6 trillion in 2020 which corresponded to the total annual gross domestic product of France and Spain combined (IMF, 2021). We can firmly assert that last year's world recession was the deepest since the crisis of the 1930s.

However, the world is still not feeling the full extent of the economic downturn. We see an amortization of crisis events - first of all, in developed countries. The population received aid, companies were given subsidies and almost interest-free loans. In addition, the state bought corporate securities, keeping companies afloat.

Last year, the US Federal Reserve, the European Central Bank, the Bank of Japan and the Bank of England poured a total of USD 10 trillion into the economy. The combined assets of the US Federal Reserve, the European Central Bank, the Bank of Japan and the People's Bank of China amounted to USD 5 trillion at the beginning of 2007. At the beginning of 2020, it was USD 19.2 and by the end of 2020 it was USD 28.6 trillion. As a result, the yearly increase is USD 9.4 trillion (Yardeni and Quintana 2021).

In March 2020, stock platforms saw a drop in indexes when no decision had yet been made on monetary injection, but already in April the stock markets recovered. After crashing, the US stock market rose by 75% in March according to the S&P 500 index and reached an all-time high. The capitalization of global stock markets has increased by USD 30 trillion since March 2020, approaching the USD 100 trillion mark.

In August 2020, the market capitalization of US technology companies exceeded the total market capitalization of the entire European stock; namely, it reached USD 9.1 trillion from USD 8.9 trillion. Back in 2007, the situation was the opposite: American stocks were four times behind the European markets.

The S&P 500 index, which measures the state of the US stock market, increased by 16.3% in 2020 while the Nasdaq Composite index - by 43.6%. The major indexes have reached new record levels in January 2021.

Stock market optimism is supported by the expansion of money supply by central banks. For example, the US Federal Reserve raises the money supply by USD 120 billion a month and the European Central Bank by USD 80 billion. However, to stimulate the economy, it is necessary to achieve the level of growth of the money supply at least of the previous year, and this cannot happen. An increase in the money supply by another USD 10 trillion in 2021 means that leading currencies will face a serious threat of collapse.

The probability that the economic crisis will continue is high. If in the last year this was reflected in the decline of key macroeconomic indicators (GNP, investments, employment), stock bubbles may burst in the future, provoking a deeper global economic crisis than that of the 2008-2009.

Biden's «Helicopter Money»

President Joe Biden, upon arriving to the White House, has begun delivering another aid package through the US Congress. The Senate, on March 6, 2021, and the House of Representatives, on March 10, approved the COVID Relief Act (CRA), allocating USD 1.9 trillion for its implementation. The law was branded as the "American Survival Plan" (The White House, 2021).

Under the plan, USD 160 billion was allocated for the coronavirus testing and vaccination of the population. Several hundred billion dollars were allocated to help businesses, reopen schools after quarantine and strengthen government agencies, etc. More than half of the allocations under the CRA (approximately USD 1 trillion) were intended to help the population. Each adult American would receive a check for USD 1,400 (The White House, 2021). This is purely "helicopter money" which means the implementation of an unconventional monetary policy when the base interest rate during the recession is close to zero. At this time, the state can reduce taxes and increase the government expenditures through massive purchases of government bonds by the central bank (Bernanke, 2002). In this case, "helicopter money" is the outcome of the interaction of monetary and fiscal policies.

Therefore, if we count the amount of all aid packages from March 2020 to date, it is about USD 5 trillion. The amount is colossal. For example, the total amount of all expenditures in the US federal budget was USD 4.4 trillion in 2019. It turns out that the means allocated to combat COVID-19 and its socio-economic consequences in the last year exceeds the total budget expenditures of the US fiscal year of 2019.

It is quite difficult to calculate the total amount of "helicopter money" that has been allocated over the last year. The most commonly used number is USD 1.5 trillion. For comparison: defense spending (the largest section of budget expenditure) in the US federal budget for 2020 was USD 738 billion.

Proponents of the "helicopter money" practice emphasize that it is not only a means of social policy (supporting the poor) but also a tool to stimulate the economy.

However, opponents of "helicopter money" point out that citizens spend more than half of the money received through the assistance on imported and not on domestic products. "Helicopter money," to put it mildly, inadequately stimulates the American manufacturer. It would be more appropriate to direct money directly to American businesses, especially small and medium-sized ones while citizens should receive goods instead of cash as assistance.

Opponents of “helicopter money” uncovered another interesting argument - the argument of Deutsche Bank AG - which is based on an anonymous poll of Americans. When asked how they plan to spend the next portion of “helicopter money,” 37% of the respondents said they want to buy shares in the stock exchange (Ossinger, 2021). In absolute terms, this is about USD 150 billion.

Analysts from the JP Morgan Chase bank made the following comment on the results of this study published on March 10, 2021: “If we assume that the transfer of payments in the amount of USD 1,400 will start this or next week, there is a high chance we will see a repetition of events which unfolded in December of the last year” (Ossinger, 2021). It is noted that the earlier stimulus payments boosted US stock indexes to record levels.

We can expect that the upcoming emission of helicopter money under the CRA will lead to a new anomalous increase in quotations in the stock market. This money is not only a tool for social policy but also a tool to inflate financial soap bubbles.

Banks and the Pandemic: Base Interest Rates of the Central Banks

The pandemic has exacerbated the global economic crisis in every country in the world to which many central banks have responded by cutting base interest rates.

For example, on March 4, 2020, the US Federal Reserve reduced the base rate from 1.50-1.75 to 1.00-1.25%; that is, by 50 points at once. On March 16, another jump was made towards the reduction - to 0-0.25%; that is, a fall of another 100 points (Trading Economics, 2021). The Federal Reserve has never made such drastic leaps towards a reduction. It seems that in March of last year the situation in the US was really critical.

Other central banks were not so radical but they also undertook base rate cuts. For example, the Bank of England reduced the interest rate from 0.75% to 0.25% on March 11, 2020 and to 0.10% on March 19. The Reserve Bank of Australia cut its base interest rate from 0.50 to 0.25% on

March 19. The Bank of Canada made the following series of cuts: March 4 - from 1.75 to 1.25%, March 13 - to 0.75%, and March 27 - to 0.25% (Trading Economics, 2021).

The People's Bank of China was also involved in the reduction process: on February 20, 2020, it reduced the base interest rate from 4.15 to 4.05% and on April 20 - to 3.85% (Trading Economics, 2021).

The peak reduction of the base rate for most central banks came in March last year. A year and a half have passed and the situation is still unchanged. Some central banks say they intend to maintain their base interest rates. A similar statement was made by the head of the US Federal Reserve, Jerome Powell. At the first meeting of Open Market Committee in 2021, it was announced that the interest rate would be maintained at the level of 0-0.25%. According to Powell, there will most certainly be no increase in 2021.

The European Central Bank holds a similar position and has no plans to change the base rates throughout the year. The same can be said about the Bank of England and the Bank of Japan. Incidentally, there is no inflation in Japan at all but, rather, we see the opposite phenomenon - deflation.

Why is inflation a real threat outside the "Golden Billion" countries? They created "printing products" worth about USD 10 trillion last year. However, the inflation is minimal in the "Golden Billion" zone. What is the reason?

Firstly, a fairly large portion of the currencies issued by the US Federal Reserve, the European Central Bank and other leading central banks finds its way to the markets of developing countries.

Secondly, the money issued by central banks hardly reaches the commodity markets even in economically developed countries themselves but, rather, goes to the stock markets from the very beginning. The stock markets of developing countries are weak and so the emissions of local banks immediately go to the commodity markets, leading to the rising inflation.

Money typewriters of the world's leading central banks are not going to stop. According to the latest data published in the bulletin *Central Banks:*

Monthly Balance Sheet, the US Federal Reserve, the European Central Bank, the Bank of Japan and the People's Bank of China owned total assets worth USD 29.4 trillion by the end of April. At the beginning of 2007, this number was equal to USD 5 trillion; that is, assets increased almost six times in 14 years (Yardeni and Quintana, 2021).

The leader is the European Central Bank whose assets in USD at the end of May amounted to 9.3 trillion. In second place is the Federal Reserve with USD 7.9 trillion. The assets of the Bank of Japan were valued at USD 6.6 trillion by the end of May while those of the People's Bank of China were USD 5.9 trillion (Yardeni, and Quintana, 2021).

In relative terms, the ratio of central bank assets to the gross domestic product at the end of the first quarter of 2021 is as follows: Bank of Japan - 130.8%, European Central Bank - 60.9%, People's Bank of China - 35.1% and the Federal Reserve - 33.9% (Yardeni and Quintana, 2021).

The assets of the US Federal Reserve at the beginning of 2007 amounted to approximately USD 0.8 trillion. Subsequently, it increased sharply as a result of the quantitative easing policy. This policy began in the midst of the 2008 financial crisis and continued until the fall of 2014 when its assets reached USD 4.3 trillion.

The currency of its balance sheet shrank to USD 4 trillion after the Federal Reserve stopped emission. However, in 2020, with the "pandemic" and its aftermath lockdown, the US economy entered a phase of acute crisis and the Federal Reserve returned to a policy of quantitative easing. It has been buying treasury and mortgage securities worth USD 120 billion every month for many months through which it injects the same amount of money into the economy. Experts had previously forecast an increase in Federal Reserve assets to USD 9 trillion by the end of 2022 but they have since adjusted their predictions and anticipate this figure to be reached by the end of 2021.

Until recently, dollars issued by the US Federal Reserve were absorbed by banks which managed to make small profits at the expense of the further distribution of this dollar mass in loans and investments. But it seems that the American market is already over-saturated with dollars and inflation exceeds the allowable value. Further attempts by banks to transfer the issued dollars into the economy contains a risk of incurring loss for them.

A new trend emerged in the spring. Banks began to return excess dollar liquidity to the Federal Reserve at a zero interest rate. These deals are reached as reverse REPO deals. Recall that REPO (repurchase agreement) is the purchase (sale) of securities with the obligation to buy back. Direct REPO was still in high demand by the commercial banks in the recent past: they received dollars from the Federal Reserve in exchange for securities (with an obligation to repurchase). A deficit of dollars on the REPO market was formed in the fall of 2019 and rates on overnight loans rose to 7-10% but the REPO market turned 180 degrees in a year and a half. This turn is called “Reverse REPO.”

Until recently, the Federal Reserve used to buy treasury and mortgage securities from commercial banks and today the opposite is happening: the commercial bank returns the dollars it received to the US Federal Reserve and the central bank returns the securities to the commercial bank. Back in mid-March, the demand for reverse REPO deals from commercial banks was non-existent. By the end of April, the amount of liabilities on such overnight transactions (exchange transactions within one business day) was already USD 200 billion, on May 20 it exceeded USD 300 billion and on May 27 it rose to USD 485 billion.

Andreas Steno Larsen, a strategist at Nordea Capital Markets, described the situation in the US monetary sector: dollar liquidity in the system has become so high that it transformed into “a hot potato that no one wants to hold” (Maliszewski, 2021). Many experts point out that the emerged reverse movement of dollar liquidity towards the direction of its source indicates that the American economy is oversaturated with money and the quantitative easing policy needs to end.

According to the Federal Reserve Bank of New York, 59 entities placed USD 502.9 billion dollars in the Federal Reserve system via reverse REPO operations on June 9. If such rates continue in the future, then reverse REPO operations may return not less than USD 1 trillion to the Federal Reserve by the end of the year, although, most surprisingly, the Federal Reserve does not intend to stop quantitative easing (Harris and Purvis, 2021).

Due to the COVID-19 pandemic in 2020, the activities of certain sectors of the economy, and the firms operating within, were temporarily suspended. The latter proved to be an effective mechanism hindering the spread of the virus by restricting contacts between humans. However, having the economy in this state for a more or less extended period of time led to an economic crisis caused by the coronavirus; that is, the Coronomic crisis (Papava, 2021).

In addition, the global economic crisis not only led to a worldwide economic downturn but also global total debt has reached unprecedented levels (Papava, Charaia, 2021).

In this regard, a rather difficult situation has been created in Georgia. As of September 30, 2021, government debt reached USD 7.8 billion and total external debt USD 20.6 billion. If we compare the dynamics of the public debt of Georgia and the gross domestic product of Georgia, as well as the dynamics of the ratio of the public debt to the gross domestic product in recent years, we will see that the share of debt is growing which threatens the sovereignty of our country. The situation is further aggravated by the fact that the National Bank of Georgia, in response to the growing inflation, increased the monetary policy (refinancing) rate to 10% on August 4, 2021. According to its forecast, the tightening of monetary policy will reduce the actual inflation rate to about 8% by the end of the first half of 2022 and to the targeted mark; that is, 3% by the second quarter of 2023. However, the problem is that the increased inflation in Georgia is caused by a non-monetary factor; in particular, the rise in prices of imported goods. As a result of the Coronomic crisis, which led to a forced lockdown, local production was reduced, accompanied by an increase in import prices. Clearly, the attempt to curb inflation (negative supply shock) caused by rising expenditures through monetary restrictions is accompanied by an increase in interest rates which in itself becomes a factor that precipitates inflation (negative supply shock) caused by growing expenditures. And, eventually, this will indeed make inflation targeting policy entirely unproductive.

Conclusion

The world's leading central banks are relying on the pandemic to justify emission. However, in our opinion, the reason why these banks continue to employ quantitative easing to this day as a primary monetary policy is the global financial-economic crisis of 2008-2009 and the depression caused by it. The latter, unfortunately, continues to this day and is still far from over. At the same time, the global depression has intertwined with the so-called pandemic caused by the spread of a coronavirus for the last two years and transformed into the Coronomic crisis. If the quantitative easing policy persists, a sharp devaluation of world reserve currencies is highly likely, leaving a low-income, import-dependent country like Georgia in a very difficult position.

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