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The post-covid monetary hangover

Mario Teijeiro, August 3, 2022*

When the Covid started, the Federal Reserve reduced interest rates to zero and increased the money supply unprecedentedly. It was a reckless policy whose consequences have been inflation of 7% in 2021, of 9.1% in the 12 months to June 2022 and it reached an annualized rate of 13% in the first half of 2022. The purpose of this note is to discuss how inflation could evolve after past mistakes and under current policies. It starts by discussing the magnitude of the monetary shock, the monetary imbalances that remain after the recent inflation run off and finally, a discussion on the chances for success in bringing inflation back to the 2% target.

The monetary shock of 2020, in numbers

The following chart shows the evolution of selected monetary aggregates and liabilities of the Federal Reserve since December 2019.

Selected monetary aggregates and liabilities of the Federal Reserve
(In trillions of dollars)

	M2	Currency in circulation	Monetary Base	FED Total Liabilities
2019	15.3	1.79	3.43	4.14
2020	19.1	2.07	5.21	7.32
2021	21.5	2.22	6.41	8.72
Jun-22	21.7	2.28	5.51	8.87

* The points of view of the author do not necessarily represent the position of Universidad del CEMA.

Selected monetary aggregates and liabilities of the Federal Reserve
(Evolution of the variables in relation to December 2019=100)

	M2	Currency in circulation	Monetary Base	FED Total Liabilities
2019	100	100	100	100
2020	125	116	152	177
2021	141	124	187	211
Jun-22	142	127	161	214

It is clear from the tables the enormity of the monetary shock. In the two and a half years between December 2019 and June 2022, the Federal Reserve increased its liabilities by 114%, buying Treasury Notes and Bills and Mortgage-Backed Securities (MBS). The Monetary Base increased by 61%, Currency in circulation by 27%, and M2 (an aggregate that includes most private bank deposits) increased by 42%.

The excess of monetary expansion over inflation and production.

The behavior of economic activity and prices has been inferior to the monetary expansion, whatever definition is taken. In the same period since December 2019, nominal GDP increased by 14.7%, of which 12% is explained by inflation and the rest (2.5%) for real economic growth. The difference with the 42% growth in M2 is a primary indication of the monetary overhang to impact future inflation. Prices and output should rise further by 24% (1.42/1.147) to restore the relationship between the monetary aggregate M2 and nominal GDP preexisting in December 2019. As the economy is at, or close to, full employment, most of that gap should be covered with more inflation.

Of course, I am relying upon a back-of-the-envelope calculation that cannot be precise. But to be exact is not of the essence. The comparison grossly indicates that the monetary hangover is enormous, and a lot of inflation could be coming down the road. If the gap were to close in two years, it would grant inflation of the order of 10% per year.

Furthermore, this simple calculation has assumed that the increase of 42% in M2 will not go further. But this is not guaranteed: the rise of FED's liabilities has created excess liquidity that could further increase the money supply. The timid QT program will not prevent this outcome, at least in the next year.

Finally, the calculation also assumes that money demand in terms of GDP does not diminish, which is unlikely in the presence of higher nominal but still negative real interest rates. If the real demand for money were to fall, future inflation should be higher.

About the unpleasant present

Inflation has been accelerating. It was 7% in 2021. It was 9.1% in the 12 months to June 2022. And it was 13% when the inflation of the first semester is annualized. The FED's policies have finally changed starting this year. But the change occurred late; it is still insufficient and running far behind the events. After the monetary shock began in March 2020, the FED was surprised by the inflation initiated in early 2021. For many months it was assumed to be a transitory phenomenon that originated in a supply shock, with no relation to the FED's monetary excesses. After the policy pivot in early 2022, the FED reversed the interest rate policy. Still, it will take the whole of 2022 to get to an interest rate of 3%, when current inflation is 9.1% (indeed, it is 13% if we take the annualized inflation of the first semester). Moreover, the announced reversal of QE (quantitative easing) is irrelevant compared to the accumulated excess liquidity. At the current pace, by the end of 2022, the FED will absorb only 10% of what was injected during the Covid reckless monetary policy.

Chairman Powell declared in June 2022 in an ECB forum in Portugal: "I think we now understand better how little we understand about inflation." The fundamental problem is, believe it or not, that the FED does not connect the relation between monetary expansion and inflation. They assume that the apparent irrelevance of monetary expansion when inflation is low and interest rates are near zero is something to be generalized to any monetary expansion in any economic context.

This self-recognized ignorance bolds wrong to the anti-inflationary objective of bringing inflation back to the 2% level. For example, the established protocol of monetary policy is entirely asymmetric. When a crisis develops, the FED is supposed to immediately reduce interest rates to zero and inundate the financial markets with liquidity. On the contrary, when inflation erupts, gradualism seems of the essence: interest rates are not raised but in moderate steps, no matter the starting disparity between inflation and interest rates. Moreover, quantitative tightening (QT) cannot proceed at the speed quantitative easing (QE) was previously executed because "it is unchartered territory" that may disrupt financial markets. This asymmetric policy demonstrates that the FED typically has three objectives, two of which are primary (economic activity and financial stability) and a third one treated as subordinate (price stability).

However, the inflationary explosion and its political repercussions have made the FED reconsider current priorities. Now it has committed to doing whatever it takes to bring inflation down to 2%, bragging about its capabilities of doing so. Still, the FED is not using its capabilities, but it is trying to manage market expectations, "to do an omelet without breaking the eggs" (that is, to bring inflation back down without paying any cost for past mistakes). Based on the historical protocol, markets are betting that the Fed's anti-inflationary commitment will cave in as soon as a recession starts. The timid QT and interest rate policy give the markets still plenty of ammunition to play against the declared intentions of the FED (as they have done in July 2022).

About the uncertain future

What will happen to inflation? I don't have the answer. I can only identify critical conditions that may decide the outcome. Will inflation decelerate per se in the second semester? The timid monetary policy reversal and the magnitude of the remaining monetary overhang make a significant deceleration improbable. Several qualified economists like Larry Summers, Bill Dudley, and Mohamed El-Erian have rightly emphasized that current tightening must continue beyond what is considered neutral for an inflation of 2%. The interest rate should soon go over current core level inflation to avoid chronic inflation to settle at a much higher level.

In my opinion, the requisite for securing success in reversing the current inflationary process must also include an aggressive QT policy to soon mop up the excess liquidity created during the pandemic. Using only a more aggressive interest rate policy will not be sufficient on this occasion. It is like trying to stop a speeding car by pushing the brake with the left leg while keeping the right leg on the gas pedal to the metal. Nonsense.

In summary, the magnitude of the monetary overhang and current gradualist policies argue in favor of an outcome of stagflation that will require a Volcker-type approach in some distant future. However, there is some chance that the FED learns fast to overcome its self-recognized ignorance; after an awful midterm election, the Democratic party foresees a complete success on the inflation front as a necessary condition to revert a bleak future in the presidential election of 2024; and therefore, the FED finds 2023 a propitious year to seriously tackle the inflation problem, whatever it takes. It may also be the opportunity for the FED to rebuild its tarnished reputation as the custodian of price stability.

The field is open to anyone's guess.