

Significant Policies Have the Federal Reserve Enacted to Control Inflation from the Pandemic

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Abstract. Since April 2021, headline and core inflation figures in the United States have been above target. The factors behind the price spikes are difficult to clarify and have been the subject of debate among policymakers and academics. Lowering interest rates makes borrowing cheaper, which potentially stimulates demand and causes inflation. Conversely, raising interest rates can decrease demand and mitigate inflation. Tight monetary policy helps curb inflation. The Federal Reserve has increased interest rates 11 times since March 2022, bringing the federal funds rate to its highest level since 2001. As interest rates rise, so do borrowing costs. Higher interest rates not only increase borrowing costs but also make saving more attractive, as individuals can earn higher returns on their savings. This change in behavior can result in less investment and consumer expenditure, further dampening economic growth. Therefore, Federal reserve need to make corresponding and correct responses to better deal with inflation. This paper will mainly discuss what economic policies the Federal Reserve has adopted in response to the inflation caused by the epidemic and will actually look at whether or not these monetary policies have actually curbed inflation.

Keywords: Inflation, US Federal Reserve, Covid-19, Policy.

1. Introduction

One of the key instruments for controlling a country's economic and social growth is monetary policy. Setting and executing monetary policy has traditionally been the duty of the Federal Reserve. The objective of US monetary policy is to promote employment and stabilize interest rates. The United States has been attempting to strike a tough balance between employment and inflation ever since the Full Employment Act was passed in 1946. In April 2020, the rate of unemployment in the US climbed to a record 14.8% (Figure1), the highest level since 1948. A significant decline in the US gross domestic product was also seen in 2020 [1-3].

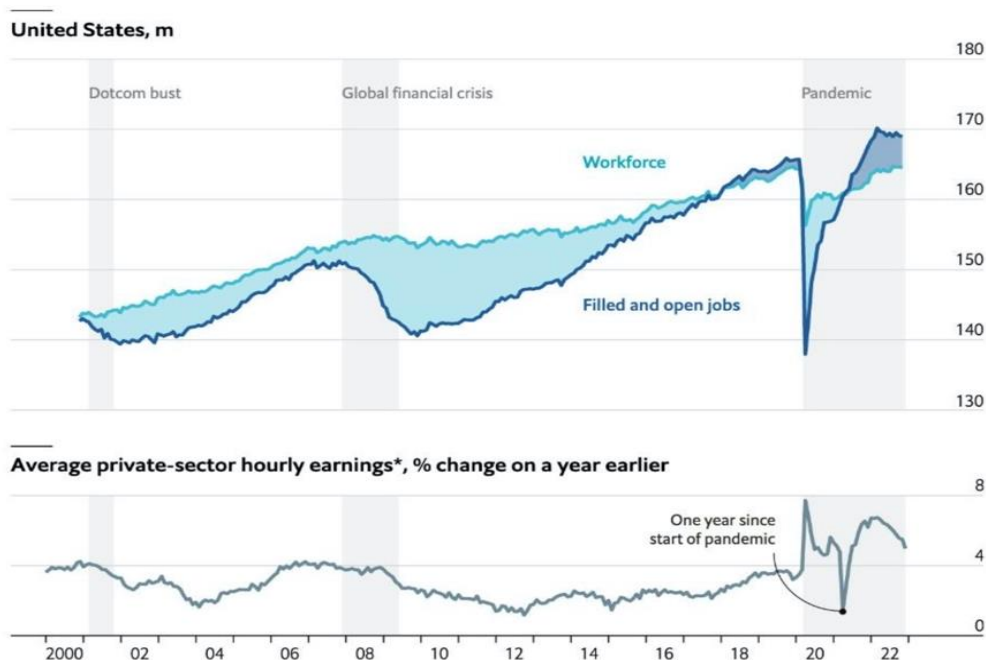


Figure 1. US Unemployment Rate & Average private-sector hourly earnings. [4].

The major objective, according to FED Chairman Jerome Powell, is to stabilize prices and domestic employment while also bringing the inflation rate down to 2% by July 26. In such instance, the bank's primary focus and point of entry in attempting to control inflation is the labor market. The aforementioned graphic depicts the current labor market's total supply and demand scenario. It is obvious that there was a lot of unemployment at the start of the pandemic, but that since the end of 2022, the job market has recovered. The US unemployment rate, however, has remained constant at around 3.5 percent, remaining the same in July 2023 and December 2022. Jerome Powell said that the job market is still uneasy. It would result in a reduction in employee salaries. According to the graph, salaries started to decline about 2021. Although they had significantly improved after 2021, they continued to decline throughout the second half of 2022. In addition, the labor force structure is not in a good shape compared to the job situation, which is getting worse all the time. The monetary policy and financial position of the US would be affected by inflation. Government spending would rise, particularly when it comes to social assistance and salaries, both of which are being affected by the growing rate of inflation. After then, the government could feel pressured to enact policies to control inflation, which would raise interest rates and impede economic development.

The paper is organized as follows: section II is Literature Review, section III is The Fed Reaction Timeline, section IV is responses, and finally section V is the conclusion.

2. Literature Review

To lessen the impact of the virus on the economy of the United States, the Federal Reserve has kept interest rates low during the pandemic. The uncertain outlook for the U.S. in the face of a COVID-19 pandemic has triggered extremely high demand for cash and quasi-cash assets.[5] As dealer capacity declined and liquidity needs continued to rise, volatility spilled over into the key and often liquid market for U. S. Treasuries, prompting the Federal Reserve to increase its open market operations and begin its historic large-scale purchases of U.S. Treasuries. Compared to the 2008 PDCA, the 2020 PDCA accepts a narrower range of collateral, offers longer maturities than overnight, and does not charge frequent-use penalties. The PDCA's outstanding loan usage peaked at \$35.6 billion during the week of April 15, 2020, and then gradually declined.[6]. The Fed also announced that it would purchase \$125 billion in bonds to further bail out the market According the Socio-economic Implications of the Coronavirus Pandemic [7], The Dow Jones Industrial Average and the Nasdaq, two indices of the stock market that track the performance of 500 major US companies' stocks, encountered an abrupt drop before the US government enacted the Coronavirus Aid, Relief, and Economic Security Act, following that the indexes rose by 7.3% respectively. [7] All of this is disguised as an indication that the Fed was indeed trying to change the state of the economy during the epidemic and had an impact on it.

3. The Fed Reaction Timeline

3.1. PDCA Program

On March 16, 2020, through the Primary Dealer Credit Arrangement (PDCA) program, which was established. The Federal Reserve provided low-interest loans of up to 90 days to 24 large financial institutions [8]. These dealers use a variety of securities as collateral, and the program is designed to help them continue to provide credit to keep credit markets functioning during times of economic stress. The PDCA program is part of the Federal Reserve's broader efforts to stabilize the financial system and support households and businesses during the COVID-19 pandemic. The PDCA program, which stands for Primary Dealer Credit Facility, aims to ensure that these financial institutions have access to liquidity and can meet the funding needs of their clients. By providing these loans, the Federal Reserve aims to prevent disruptions in credit markets and maintain stability in the overall financial system. The PDCA program allows primary dealers, who are essential intermediaries between the Federal Reserve and the broader financial markets, to borrow funds on a short-term basis

at a low interest rate. This program not only helps primary dealers fulfill their role in facilitating trading and market functioning, but it also serves as a backstop to prevent any potential liquidity shortages. By supporting these institutions, the Federal Reserve is ensuring that the flow of credit remains uninterrupted, which ultimately helps stimulate economic activity and mitigate the negative impact of the pandemic.

3.2. Ensuring the Consolidation of US Dollar

On March 18, 2020, in order to increase liquidity in the global dollar financing market and to assist the requirements of these central banks to obtain dollar funding domestically, the Federal Reserve launched another important policy by giving dollars to foreign central banks. In return for the foreign currency, the Fed got interest on the swaps. This action was taken in an effort to allay rising worries about a pandemic-related worldwide financial shortage. By providing dollars to foreign central banks, the Federal Reserve aimed to stabilize the global financial system and ensure the availability of dollar funding for international banks.[9] This move was crucial in preventing further disruptions in the global economy and maintaining confidence in the financial markets. By providing dollar liquidity, these countries were able to mitigate the impact of capital outflows and stabilize their currencies. This assistance was crucial in preventing a complete collapse of their financial systems and promoting economic recovery. The Federal Reserve's decision to extend funds to foreign central banks proved essential to maintaining global financial stability during these challenging times.

3.3. Removal of Restrictions on the Number of Bonds to Be Purchased

On March 23, 2020, the Federal Reserve announced that it would no longer limit the amount of debt securities it purchased, stating that it would purchase debt securities as needed to ensure the stable functioning of financial markets and to facilitate the transmission of monetary policy, and that it had broadened the target for its bond purchases to support economic recovery. As a result, the Fed began purchasing corporate bonds, including exchange-traded funds (ETFs), to provide liquidity and support to struggling businesses during the COVID-19 pandemic [10]. This move aimed to boost investor confidence and stabilize financial markets, ultimately helping in the economic recovery efforts. By purchasing corporate bonds and ETFs, the Fed aimed to address the liquidity concerns faced by businesses and prevent a further deterioration of the financial system. This unprecedented step not only provided immediate relief to struggling companies but also sent a strong signal to investors that the central bank was committed to doing whatever it takes to support the economy. The decision to broaden the scope of its bond purchases reflected the Fed's recognition of the interconnectedness between financial markets and the broader economy, as disruptions in one could quickly spill over to the other.

By expanding its bond purchases, the central bank aimed to stabilize the financial markets and restore confidence among investors. This proactive approach demonstrated the Fed's understanding of the potential ripple effects that could arise from a weakened financial system, emphasizing its dedication to maintaining economic stability and growth.

3.4. Municipal Liquidity Fund

On April 9, 2020, the Federal Reserve established the Municipal Liquidity Fund to lend directly to state and local governments to help them respond to fiscal distress caused by the COVID-19 pandemic. On April 27, 2020, and June 3, 2020, it additionally widened the pool of qualified borrowers, to expand lending to support governmental entities affected by the pandemic [11]. The Federal Reserve's actions, such as the establishment of the Municipal Liquidity Fund and the expansion of eligible borrowers, demonstrate its commitment to helping state and local governments address the fiscal challenges posed by the COVID-19 pandemic. These measures are designed to provide financial support and stability so that governments can effectively respond to the economic distress caused by the crisis. By extending credit to government entities affected by the pandemic, the Federal Reserve is playing a critical role in maintaining economic stability and promoting growth

during these uncertain times. These actions were taken to ensure that the financial system remains resilient and able to provide necessary support to governments in times of crisis. By providing direct credit to state and local governments, the Federal Reserve aims to alleviate fiscal distress and enable these entities to continue to function effectively. This proactive approach not only demonstrates the Federal Reserve's commitment to maintaining economic stability, but also underscores its understanding of the challenges facing governments in the wake of the pandemic.

3.5. Use of Forward Guidance

In December 2020, the Federal Reserve updated its guidance, indicating that it would gradually reduce the size of its purchases once the economy had made substantial progress toward employment and price stability. The Fed also indicated that it would continue to assess its purchases as economic conditions evolve and that it would adjust its purchases as necessary. This update was in line with the Fed's commitment to support the economic recovery. The Federal Reserve's commitment to supporting the economic recovery is evident in its ongoing assessment and adjustment of its purchases based on evolving economic conditions. By gradually reducing the size of its purchases once substantial progress is made towards employment and price stability, the Fed aims to mitigate the adverse effects of the pandemic and ensure a sustainable recovery. This approach allows for flexibility in addressing any unexpected changes in the economic landscape. The Federal Reserve's actions demonstrate its dedication to ensuring a strong and resilient economy for the benefit of all Americans. Additionally, by providing clear guidance on its intentions, the Fed is instilling confidence in the markets and allowing businesses and consumers to make informed decisions. This proactive approach by the Federal Reserve is crucial in navigating the uncertain and challenging times caused by the pandemic.

3.6. Control of Interest Rates

In September 2020, The Federal Reserve reiterated its framework for monetary policy once more, stressing that it would keep interest rates low until the labor market reaches full employment and inflation rises to 2 percent, which is anticipated to remain above 2 percent for some time. The labor market will be close to the Fed's maximum employment aim by the end of 2021, and inflation will be significantly higher than the Fed's 2 percent objective [12]. The Fed's policy-making committee said during its meeting in December 2021 that the majority of its members anticipate raising interest rates three times in 2022, each time by a quarter of a percentage point. The need to control inflationary pressures and preserve price stability in the economy motivates the decision to boost interest rates. The Fed attempts to restrain economic growth and stop excessive inflation from eroding consumers' buying power by gradually boosting interest rates. These anticipated rate increases reflect the Fed's confidence in the strength of the economy and its commitment to maintaining a balance between employment and price stability. The gradual increase in interest rates also signals the Fed's belief that the economy can withstand tighter monetary policy without significantly impacting growth. It is a delicate balancing act for the central bank, as raising rates too quickly could stifle economic activity, while raising rates too slowly could allow inflation to spiral out of control. The Fed closely monitors various economic indicators such as unemployment rates, GDP growth, and inflation data to make informed decisions about rate hikes. The decision to raise interest rates demonstrates the Fed's proactive approach to managing the economy and ensuring its long-term stability.

4. Responses

From the current point of view, the Federal Reserve will be able to control the inflation caused by the epidemic in the future, but not now.

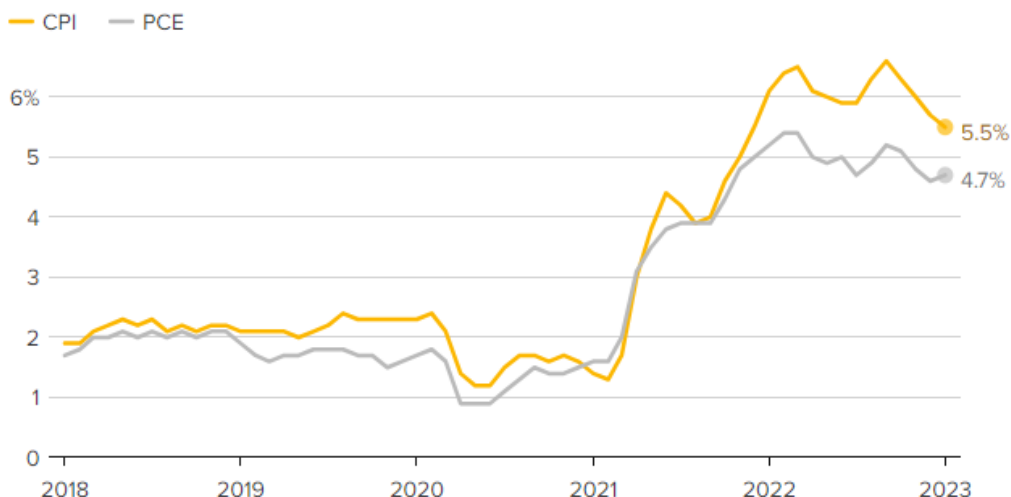


Figure 2. US 2018-2023 CPI& PCE Rates [13]

According to Figure 3, The personal consumption expenditures price index has also been trending lower, to 5.4% yearly, and is approaching the CPI. This seems to be a good economical phenomenon, but this is just an indicator but not a fundamental solution. People need to use more money to buy more expensive goods than before. According to statistics from the Federal Reserve, the energy prices were up more than 41% at one point in 12 months. The price of food surged at above 11%. Individually packaged goods like eggs, plane tickets, and pet food all saw considerable price increases. Currently, inflation is still significantly higher than the Fed's objective. According to the Fed's projection, the Federal Open Market Committee, which sets interest rates, has reduced the pace of increases in recent months from four straight three-quarter-point increases to a half-point increase in December and a quarter-point increase in early February.

5. Conclusion

The Federal Reserve enacted a number of strategies to deal with inflation during the epidemic. The PDCA Program, Ensuring the Consolidation of US Dollar, Removal of Restrictions on the Number of Bonds to Be Purchased, Municipal Liquidity Fund, Use of Forward Guidance, Control of Interest Rates, and the PDCA Program are presented in this study, mainly from the actual data as well as from the theories, and are presented in the following sections. These strategies have slowed down the onset of inflation to some extent and maintained the stability of the economic system. But the enactment of these policies has not met the expectations that the Fed wanted to achieve.

By the end of this year, the Fed might bring key inflation measurements down to about 4%. Compared to the most recent core CPI of 5.6% and core PCE of 4.7%, it would be preferable. While a reduction to 4% would certainly be a step in the right direction, there are still lingering questions about the long-term sustainability of these measures. The unprecedented levels of fiscal stimulus and accommodative monetary policy implemented during the pandemic have undoubtedly played a role in driving up inflationary pressures.

The Federal Reserve's post-pandemic monetary policy has played a crucial role in managing inflation and stimulating economic output. However, the delicate balance between these objectives presents ongoing challenges as the economic situation evolves. As the Fed continues to monitor and adjust its policies in response to changing conditions, and the economy continues to recover and supply chain disruptions persist, it remains to be seen whether the Fed's actions will be sufficient to bring inflation back under control.

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