# THE NEW FED-TREASURY ACCORD

*The culture and policy focus of the Fed are changing*

*What does it mean for inflation?*

# THROUGH GREAT TRAGEDY COMES UNITY

*The Fed and Treasury united to serve the greater needs of the country*

- In April 1942, at the request of the Treasury, the Fed formally committed to maintaining a low interest-rate peg on short-term T-bills while also capping the rate on long-term Treasury at 2.5%
- The goal of the peg and yield curve control was to stabilize the market and allow the government to engage in cheaper debt financing of World War II.
- The Fed maintained the low interest rate by buying large amounts of government securities, which also increased the money supply
- Marriner Eccles, Fed chairman at the time, favored financing the war via other means, such as tax increases coupled with wage and price controls. But ultimately the FOMC concluded that winning the war was the most important goal, and that providing the government with cheap financing was the most effective way for the Fed to support that goal

President Truman and Secretary of the Treasury John Snyder were both strong supporters of the low interest-rate peg in order to protect the value of war bonds

# THE ORIGINAL TREASURY-FED ACCORD… THE DIVORCE OF FISCAL AND MONETARY POLICY

*A continual need to finance the military industrial complex could not be accommodated by the Fed*

- After the war ended in 1945, inflation began to rise and by the time of the Korean War the FOMC was worried it would have to finance a whole new war effort and this would lead to excessive inflation
- In March 1951, the US Treasury and the Federal Reserve reached an agreement or "accord" to separate government debt management from monetary policy, laying the foundation for the modern Federal Reserve system and policies
- The Treasury and the Fed issued a statement saying they had "**reached full accord with respect to debt management and monetary policies to be pursued in furthering their common purpose and to assure the successful financing of the government's requirements and, at the same time, to minimize monetization of the public debt**"

William Martin Jr. is sworn in as Chairman of the Fed in 1951. Martin, while still at Treasury, met with Fed officials and negotiated a compromise under which the Fed would continue to support the price of five-year notes for a short time, but after that the bond market would be on its own.

# PRICE STABILITY WAS THE FOCUS

*Historically, we attribute the price stability, which the U.S. has enjoyed for some time, to the Fed's credibility and independence. With that policy goal secure, the Fed can now expand it's reach*

- Paul Volcker's war against inflation through prohibitively high interest rates cemented the view that the Fed was for the most part independent of the influences of politics given how unpopular and painful the approach was at the time
- Under Greenspan there was a more formalized rule-based (Taylor Rule) policy adoption/approach, however "communication" was still often limited and price stability less defined
- Policy evolved under Bernanke, who drove r* targeting and re-introduced QE, and Yellen, who chose to re-enforce this policy with greater transparency, emphasizing forward guidance and optimal control (which introduced the concept of full employment targeting)
- With inflation expectations well anchored and the concern more on deflation, the Fed is now well into a structural regime change regarding its culture and policy

"He came to represent independence," Mr. Bernanke said in an interview for [Volcker's obituary]. "He personified the idea of doing something politically unpopular but economically necessary."

"What a sound money system does is to stabilize all the elements in it, and reduces the uncertainty that people confront. And the one thing all human beings do when they are confronted with uncertainty is pull back, withdraw, disengage, and that means economic activity, which is really dealing with people, just goes straight down."
- Greenspan

"The Committee therefore agrees that, in future situations in which the funds rate is at or near zero, a necessary condition for raising the funds rate will be that average inflation since the date at which the federal funds rate first hit zero be at least 2%."
- Bernanke

"As I noted, simple rules have the advantage of delivering good policy outcomes across a broad range of models and are thereby relatively robust... --in contrast to optimal-control policies, whose prescriptions are sensitive to the specification of the particular model used in the analysis. However, simple rules also have their shortcomings, leading them to significantly understate the case for keeping policy persistently accommodative in current circumstances." - Yellen

# THE FED'S MANDATE IS EXPANDING

*The Fed's policy goals have evolved and are more aligned with a progressive Biden Administration (and potentially a Democrat run Congress)*

- The re-writing of the "Statement on Longer-Run Goals and Monetary Policy Strategy" has de-emphasized a balanced approach, increased focus on an un-defined "maximum employment" objective while expanded the emphasis of needing a stable financial system to implement policy
- Fed speeches, panels and conferences have become increasingly focused on what we are calling "ESG" topics, such as environmentalism, social injustices, and changes to the structure of the Federal Reserve system and policy objectives (aka governance) to address these issues
- Fed officials are losing confidence in the historic relationship between employment and inflation, causing concerns over the effectiveness of r* targeting and creating a potential shift in the ideological approach towards monetary policy more generally
- Using QE to overcome the limitation of the ZLB has shown uneven benefits for "main street" and Fed officials are discussing this more and more
- Growing emphasis on ESG topics and the failure of traditional accommodative policy approaches to address these topics are moving many Fed officials to push for new approaches through non-traditional tools and channels
- **With inflation concerns now secondary to maximum employment, the Fed will be more ideologically aligned with the Biden Administration and potentially Congress to tackle specific ESG issues and the market is underestimating the impact this will have on inflation**

# THE NEW FOCUS: ESG ISSUES

*The growing focus on helping Main Street will lead to a more accommodative and multi-channeled policy agenda*

# A WHOLE NEW WORLD AND FIGHT

*Widespread focus on Environmental, Social, and Governance issues, why should the Fed be different?*

- The Biden administration will have a more domestic tilt, focused on environmentalism, social injustices, and the governance needed to combat these challenges throughout various parts of society
- Biden has begun to announce members of his Economic Team and it looks to encompass a more progressive lean with a greater focus on labor issues
- Not to be ignored, the actual progressive wing of the Democratic party already sent the Biden Administration their own "Building Back Better" recommendations, primarily authored by Robert Hockett, a leading MMT voice
- The Fed will see this as a reaffirmation that the direction it has already been heading is correct and there will be a closer ideological and cultural connection between the Fed and the rest of government

Will the Democrat's recent win in the presidential election fuel a more progressive period of policy and legislation to adhere to a growing "woke" culture? It will if they win both Senate seats in Georgia

I'm here today because of social programs," Neera Tanden said. She called it a "profound honor" to help shape those programs "to give everybody the fair chance my mom got."

"It's time to invest in infrastructure, clean energy, climate change, manufacturing," he said. "It's time we address the structural inequities in our economy that this crisis has laid bare." - Biden

Ms. Yellen said the economic recovery from the pandemic presented a chance to address "deeper structural problems," such as racial inequality and stagnant wages.

"It's a mistake to think that any increase in wages is inflationary and there is substantial room for non-inflationary wage growth, particularly at the bottom end of the scale." – Jared Bernstein

# TEAM BRAINARD-YELLEN POSSIBLE IN 2022

*Personnel is Policy: A quick review of Janet Yellen and Lael Brainard (our expected next Fed Chair)*

**Janet Yellen**

- Brown undergrad, PHD at Harvard supervised by James Tobin and Joseph Stiglitz
- Berkley econ professor from '99 -'03
- Key career positions/contributions:
  - Chair of the Council of Economic Advisers and Organization for Economic Cooperation and Development under Clinton
  - Optimal Control designer
  - Labor Dynamics and Monetary Policy
  - More recent work at Brookings since leaving Fed
- It's a safe assumption Yellen's focus will be on a more equitable economy focused on promoting and protecting labor and the consumer

**Lael Brainard**

- Wesleyan undergrad, PHD from Harvard
- MIT econ professor from '90 -'96
- Key career positions/contributions:
  - National Econ advisor under Clinton
  - Under Secretary of International Affairs at Treasury under Obama
  - Joined Federal Reserve Board of Governors in January, 2014
    - Outspoken ESG topic supporter
    - Currently focused on CRA modifications
- Editor/contributor to a wide range of ESG themed publications/books

There is a growing **ideological alignment towards more progressive policy intentions** between leadership at the Treasury and Federal Reserve (assuming Brainard is made Fed Chair, but already occurring among other personnel). This will lead to **more directly coordinate or coincidental policy objectives being implemented to tackle ESG issues and create a more accommodative fiscal and monetary policy backdrop**

"Are deviations from full employment a social problem? Obviously" - Yellen

"While admirers of capitalism, we also to a certain extent believe it has limitations that require government intervention in markets to make them work." - Yellen

"Long-term unemployment can make any worker progressively less employable, even after the economy strengthens." - Yellen

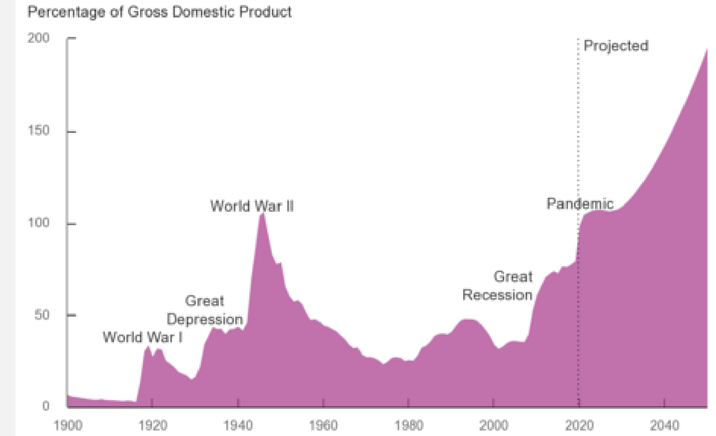
"A lack of clarity about true exposures to specific climate risks for real and financial assets, coupled with differing assessments about the sizes and timing of these risks, can create vulnerabilities to abrupt repricing events." - Brainard

"our continued commitment to consider a wide range of indicators, may be particularly significant for the groups that are most vulnerable to employment fluctuations" - Brainard

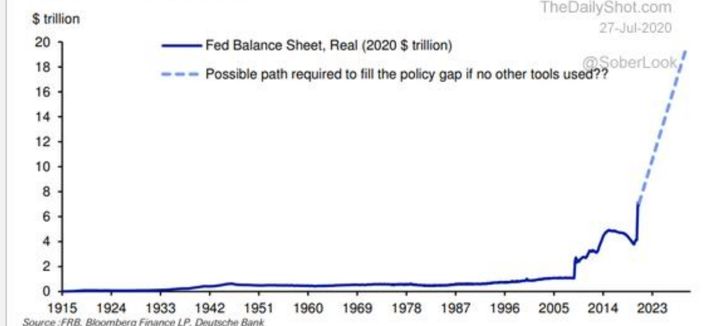
# HOW WILL THESE POLICIES BE FINANCED?

*Saving the world isn't cheap, specially when you're already broke*

- BREAKING NEWS: The breaking of the Fed-Treasury Accord already begun with the Feds and Treasuries response to the Global Financial Crisis a decade ago with QE and 13-3s
- U.S. fiscal deficits have already crossed a key historic threshold (90%+ to GDP) and are being financed by the Federal Reserve
- If the U.S Government makes good on entitlement obligations, expands its defense spending to contain China, and enacts new policies to address environmental and social issues the rate of deficit growth will only increase
- At this point regular monetary seigniorage through QE will probably not suffice as even the mighty dollar could succumb to a loss of confidence
- This is all very forward looking but lays the foundations for what we must now look for/at, which is how monetary policy will adapt to the negative realties while enabling new policies to ensure society functions




The pandemic only made the U.S. Fiscal Deficit worse




The Fed may have to buy a lot of debt to keep nominal yields from rising too much

# NEW POLICY CHANNELS TO WATCH

*If the deficit will be financed and a more progressive agenda is coming what should we watch for?*

## New Long-Term Goals

- The Fed Listens experience will have a longer lasting impact on focusing policy on Main St. over Wall St
- The move away from a balanced approach in the LT Goals means more emphasis on employment
- This allows greater policy flexibility in BS expansion while also maintaining the illusion of greater transparency

## Fed Speeches/Panels

- Changing focus from purely economic and regulatory speeches to a variety of ESG topics
- Increased outreach to various minority and lower-middle income financially-underserved communities
- Growing range of concerns from effects of AI to childcare to racism
- More personality and “woke” cultural flavor

## Regulatory Changes

- Some of the pandemic related supervisory and regulatory relief may be maintained
- There will be capital relief for ESG targeted lending activities
- There is a coming Basel committee’s environmental risk initiatives
- More approaches to be developed here

## Infrastructure Changes

- The 24-7-365 FedNow upgrade expands the reach of the Fed
- The new Community Reinvestment Act allow for greater access to underbanked communities
- The Fed will move to a digital currency allowing quicker direct payments to individuals and firm's digital wallets

“We've held many Fed Listens events over the past 16 months, and it's important to note that these conversations aren't just a nice way to talk to people from around the country, although they are that. What they provide—what you provide—is insight that we just can't get anywhere else.” – Powell – Opening Remarks at Fed Listens Event: How Is COVID-19 Affecting Your Community?

“The Board's ANPR seeks to advance the law's core purpose of addressing unequal access to credit for LMI and minority communities and disinvestment in underserved communities. A modernized CRA should help move the needle on credit access, wealth building, and the availability of community development financing.” - Brainard -Modernizing and Strengthening CRA Regulations: A Conversation with the Housing Community

“It was a much bigger challenge to reach those without a bank account. This is a sizeable group: in 2017, this number was almost 8-1/2 million households, or about 6.5 percent of U.S. households.” – Mester – Payments and the Pandemic

“The Committee has noted that climate change may result in physical and transition risks that could impact the safety and soundness of individual financial institutions and have broader financial stability implications for the banking system.” – Stiroh - A microprudential perspective on the financial risks of climate change

“Over the past 40 years, the income of households near the bottom of the distribution—the 10th percentile—rose by about 20%. In contrast, households near the top of the distribution—the 90th percentile—saw their incomes rise by 66%” – FRBSF Economic Letter - Is the Federal Reserve Contributing to Economic Inequality?

# CHANGING THE GOALS OPENS NEW DOORS

*The combo of Price Level Targeting, Maximum Employment, and a Stable Financial System gives greater flexibility to remain more accommodative for longer*

- Since announcing changes to "Statement on Longer-Run Goals and Monetary Policy Strategy" there has been a sense of unhappiness by policy makers on the markets interpretation of the statement, specially regarding the removal of a "balanced approach"
- A number of Fed officials have come out to further clarify what the changes really mean. Powell, Clarida, Brainard, Williams, and Mester devoted specific speeches to the topic
- For Example:
  - "**Price Level Targeting**", aka AIT, allows for inflation, likely a more expectation-based metric, such as the CIE Index, to stay over the 2% target for a length of time equal to how long it took to get to 2% since the Fed Funds hit the ZLB.
  - "**Maximum Employment**" is not defined by a single metric such as the unemployment rate, or even a combination of a few, so a more progressive FOMC could target closing racial and economic gaps
  - There is no attempt to define what a "**Stable Financial System**" is. In the past the Fed has been active in the Treasury repo markets during periods of funding stress. This could change to other markets if a case can be made that they are impeding "the attainment of the Committee's goals."
- **It is our opinion that this is a significantly more accommodative structural change to monetary policy goals and opens the door for greater flexibility by policy makers**

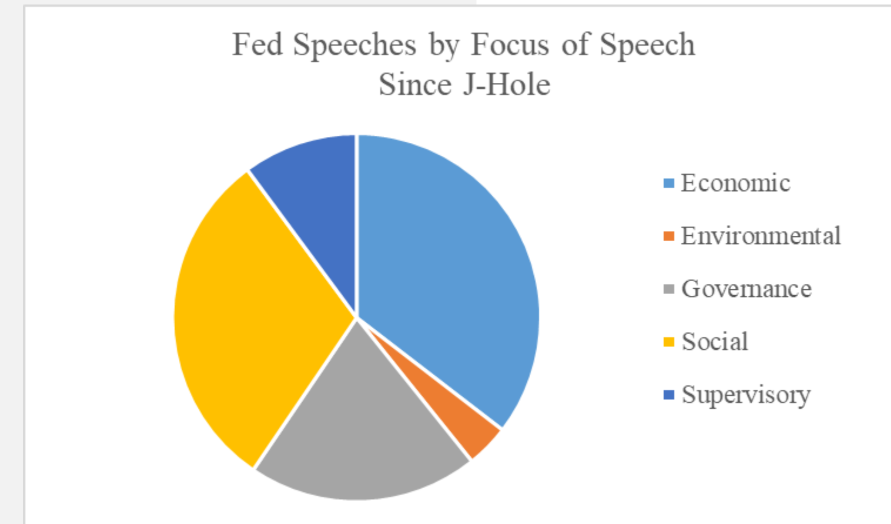
"the statement drops language about a "balanced approach" that might be interpreted as calling for the preemptive withdrawal of accommodation"- Brainard - Bringing the Statement on Longer-Run Goals and Monetary Policy Strategy into Alignment with Longer-Run Changes in the Economy

"The Committee's employment and inflation objectives are generally complementary. However, under circumstances in which the Committee judges that the objectives are not complementary, it takes into account the employment shortfalls and inflation deviations and the potentially different time horizons over which employment and inflation are projected to return to levels judged consistent with its mandate." – Statement of Long-Run Goals

# SIGNIFICANT ESG SHIFT IN FED RHETORIC

*Following the announcement of the changes to the Statement of Long-Run Goals the Fed's official speeches have been over 50% ESG focused*

- Since the Fed released its new Statement on Longer-Run Goals there has been a significant number of speeches and panels focused on ESG specific topics
- Since Jackson Hole's there has been 79 speeches posted on the Board's or the twelve regional Fed's individual websites
- This does not include opening remarks, panels, and "fireside" chats with other notable central bankers, community leaders, and business professionals, of which there were a large amount of ESG "events"
- Defining Speech Types:
  - Economic speeches relate to pure assessments of the economy and make up the largest percent of speeches
  - Environmental speeches were specific to the risk that climate change posses and how financial stability initiatives needs to incorporate this risk
  - Governance speeches ranged from reviews/thoughts on the new Statement of Long-Run Goals to modernizing the CRA or other structural changes to the Fed system
  - Social speeches varied from how the pandemic has affected various demographics differently to differences childhood education makes to how AI may have racial biases
  - Supervisory speeches were mostly split between LIBOR reform and general financial stability goals through supervisory activities




*Speeches by Board Members, Presidents or Executives posted on Official Fed Websites

| Focus of Speech | # | % |
|---|---|---|
| Economic | 28 | 35% |
| Environmental | 3 | 4% |
| Governance | 16 | 20% |
| Social | 24 | 30% |
| Supervisory | 8 | 10% |
| Total= | 79 | |

# DON'T DISCOUNT THE REG RELIEF CHANNELS

*A more targeted effort to support ESG through regulatory and supervisory relief/incentives is just beginning*

- The Fed has repeatedly said they were pleased with the resiliency of the banking system during the pandemic. They took a number of steps to reduce regulatory and supervisory burdens on the financial sector while encouraging lending and credit growth
- Given the likely increased sense of urgency to address environmental and social issues, support from regulatory and supervisory channels by the Fed and FSOC could be more targeted, comparable to what was seen in response to the pandemic
- How might this look:
  - Modification to SLR and LCR to encourage banks to increase loans to environmental orientated or low-moderate-income community development initiatives, in a similar design to the temporary changes enacted in response to the pandemic
  - Relief on the regulatory burden for loans originated through permanent PPP and Main Street Lending facilities targeted at minority or low-moderate-income areas
  - Changes to the Community Reinvestment Act being proposed currently would give significant regulatory and supervisory relief to smaller community banks and minority depository institutions
    - Changing the structure of exams and performance measures to promote improvements to lending
    - Improving the definitions and ratings system around community development activities including expanding what are applicable activities that support minority and women-owned institution
- Watch for greater focus on the nonbank financial intermediation part of the world as well

"While today's conversation is about equitable recovery, everyone here is aware that an equitable economy did not exist before the pandemic. Another important dimension of equitable growth is equal access. And the pandemic exposed just how dramatic the fault lines in racial disparities are, for access to things like healthcare, credit, and housing." – Williams – Building an Equitable Future

"The COVID Event revealed a banking system that withstood this shock quite well with limited official sector support, and a nonbank system that was significantly more fragile. By this measure, the COVID Event demonstrates that we have work to do." – Quarels - The Financial Stability Board's Roadmap for Addressing NBFI Vulnerabilities

# CLIMATE CHANGE RISK TO THE FOREFRONT

*Global central banks are incorporating climate related risks into their oversight, this will move capital allocation to "greener" more sustainable endeavors*

- Identifying and managing risks related to climate change are becoming common conversations at the BIS, IMF, ECB and other central banks
  - **The Fed will increase their focus here and expect new regulatory and supervisory rules**
- In February 2020, the Basel Committee established a taskforce to undertake work on climate-related financial risks
- This taskforce conducted a survey of members' existing regulatory and supervisory initiatives on climate-related financial risks which showed most financial institutions "have not factored, or have not yet considered factoring, the mitigation of such risks into the prudential capital framework"
- Expect this to change and decisions related to capital allocation and risk management to factor climate change risks in significantly more

"A large majority of respondents noted that they do not have an explicit mandate with regards to climate-related financial risks but indicated that such risks could potentially impact the safety and soundness of individual financial institutions and could pose potential financial stability concerns for the financial system." – BIS - Climate-related financial risks: a survey on current initiatives

"Banks are becoming increasingly attuned to the heightened financial risks from a changing climate. These risks can manifest in a number of ways: the impairment of collateral due to severe weather events; mark-to-market losses from the devaluation of companies with stranded assets; stress to contractual cash flows as regional shocks are realized; or the reduced provision of financial services as business strategies adapt." – Stiroh - A microprudential perspective on the financial risks of climate change

# ADDING TO THE TOOLKIT AND CHANGING THE PLUMBING

*New goals need new channels, look for new ways to directly extend credit to Main Street*

- If the Fed wants to target specific ESG issues it will not only need to use its traditional "jack-hammer" toolkit, but also more precise new ones, bypassing traditional channels to reach Main Street
- 24x7x365 FedNow Service: The goal is to have a "financial institutions of all sizes to offer customers the ability to send and receive money in near real time, around the clock, 365 days a year."
  - The Fed is investing in modernizing the payment system and when coupled with digital currency/wallets could bypass traditional banking channels and make direct payments to individuals or firms
- Community Reinvestment Act Reform: The reform is being championed by Brainard, who see the original act as "one of several landmark civil rights laws to address systemic inequalities in credit access"
  - Brainard has given numerous speeches across the country on the process and goals of the reform
  - This will be a channel to provide targeted capital/credit to numerous different social issues
- Digital currencies and wallets give targeted individuals the ability to receive money while fiscal/monetary authorities can better track spending. This coupled with a more fluid FedNow would overcome the troubles encountered during the pandemic, when efforts to get relief to the hardest hit were often hurt by the traditional banking channels

"Thinking ahead, a service like FedNow, coupled with a directory service with accurate information on where to route payments for final distribution to households and businesses, has the potential to solve some of the challenges the government faced when distributing pandemic relief payments." - Mester - Payments and the Pandemic

"Affordable housing is essential to providing low-income households the stability necessary to engage in employment and schooling, provide for essential needs, and accumulate some financial cushion for emergencies." – Brainard - Modernizing and Strengthening CRA Regulations: A Conversation with the Housing Community

"There are a number of ways that a CBDC might improve the payments system, and it is mainly this area that motivates our interest" - Powell

# THREE MORE KEY AREAS TO WATCH

*The Fed has at times "bent" the rules during periods of crisis, here are some additional areas where that might happen*

- Section 14. Open-Market Operations: This authority is relatively broad and allows any Federal Reserve Bank to monetize a wide range of financial instruments
  - The paper purchased is meant to be 6-month or less but there are no roll-over restrictions
  - Coupled with increased CRA activity, "member banks" could sell ESG themed loans/securities to the Fed for capital in a pinch to raise capital/liquidity
- "Spread the Fed": A term that simply refers to the logistical inability of the Fed to sometimes meet needed policy initiatives such as the 13-3s and the need to remedy this
  - During the initial days of the pandemic the Fed did not have enough literal "bodies" to meet the needs of the new 13-3s, which is why the Boston Fed was recruited and in the past the Chicago Fed has helped
  - Any concerted effort to spread the traditional tasks of the NY Fed's Market Group to other Fed districts would mean an increased capacity to implement non-traditional policy
- FHLBs and the GSEs: There has been no real reforms yet and they could once again become political tools to promote housing to minority and lower-middle income communities
  - GSE reform never happened and exit from conservatorship and re-capitalization plans still need to move through Congress and the new administration, which looks unlikely
  - FHLB system has access to the Discount Window and without real reform there is a potential for increased lower credit quality creation/allocation and risky maturity transformation to be bailed out

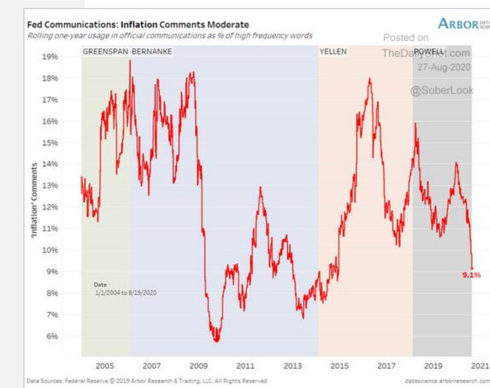
# INFLATION IS ALWAYS AND EVERYWHERE A MONETARY PHENOMENON

*The implications of the changes occurring at the Fed and what the Biden Administration (and potentially Congress) may bring are distinctly inflationary and markets need to catch up to this new structural regime change*

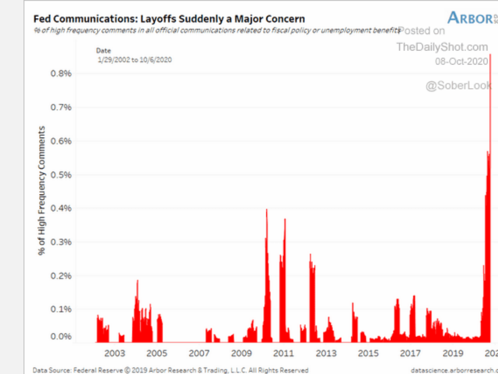
# CULTURAL CHANGES LEAD TO STRUCTURAL CHANGES

*Although we must wait for the Georgia Senate races to find out how much progressive policy is likely from Congress, we already are seeing a significant move towards ESG policy support at the Fed and from the Biden Administration*

- It is clear the Fed is telling us it will tolerate higher inflation to support a more equitable recovery in labor market conditions
- Yellen will have a closer relationship with Powell, who she mentored, and then potentially Brainard, who are already like-minded on key issues
  - **This will allow for soft influence and back channel coordination on policy objectives**
- All this means the more-and-more ESG focused Fed we have already started to see will pick up speed in conjunction with policies implemented by the Biden Administrations and a more evenly split (or potential Democrat) Congress
- The immediate effects on the economy should be expansionary and inflationary




As expected, the Fed is currently less focused on inflation …




…but they are focused on labor markets. This is likely to last a while.

# MARKETS COMPLETELY UNDERESTIMATING THE COMING INFLATION PULSE

*Current consensus for Core PCE in 2021 is 1.8%, doesn't that seem too low?*

There are several different types of inflationary impulses coming and we know the Fed will tolerate them through AIT as "full" labor market conditions take longer to recover

- The initial effects of the unprecedented global policy response to the pandemic has helped hold up discretionary spending (fiscal) and financial assets (monetary) promoting a stronger then expected recovery, but the full effects are still coming as such policy takes time to work as well as additional policy coming
- An increasing ability of goods and service producers to pass on rising labor, supply and operational costs as "survivors" capture greater market share lost to closures by others or see greater demand for their products
- The simultaneous deployment of vaccines globally and a quick return to normalcy will release pent up demand on a scale never seen
- The continuation of a new commodity super cycle as low levels of past CAPEX, changing supply chains, the reemergence of demand from a recovering global middle-class seeking more protein, space, and travel, along with ESG initiatives, traditional FAI, and recovery in energy demand hit the entire commodity complex
- The basing effect from the fall in inflation due to the onset of the pandemic last spring, which fell by ½ percent alone in March and April, will drastically affect the year-on-year optics next spring
- Continuation of the decoupling from China, leading the world to move to a bi-polar hegemony dynamic, causing new global supply chains to be built creating redundancies that will further fuel demand for resources
- A weaker USD is also likely if current trends continue, adding to an inflationary pulses through import channels

# REAL YIELDS CAN STILL FALL MUCH FURTHER

*Higher inflation and "ESG everywhere" can only mean one thing, deeper negative real yields*

- The market seems to be positioned for a steeper nominal curve that will eat into real yields
- We believe this is wrong and we could see real yields fall much further than most believe
- The feed through to more negative real yields means:
  - Equities, precious metals, and even crypto will gain much more
  - Commodities have more upside too, and structural issues discussed will also be a driver
  - The continuation of the current rotation from growth into value, which is only now starting to break-out/catch-up

# THANK YOU

Michael Ball – December 2020