FedFin Client Report

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FedFin Forecast: The Future of the Fed

Client Report: FEDERALRESERVE59

Executive Summary

It's hard to envision a Federal Reserve still more central to every aspect of U.S. macroeconomic, financial, and fiscal policy, but that's what FedFin forecasts for 2021. This won't, though, make it an unalloyed joy to be on the Board of Governors. In concert with this still more omnipotent role will be calls by Democrats for a new racial-equity mandate, faster FedNow implementation, CBDC, and use of the Fed's portfolio for environmental and social-welfare objectives. The Fed will also be a critical player as Janet Yellen's FSOC reinstates systemic designations for institutions and activities, likely starting first with initiatives aimed at Fannie Mae and Freddie Mac. Conversely, the GOP, especially likely-incoming Banking Committee Chairman Toomey (R-PA), will call for a far less fiscal Fed, a smaller Fed portfolio, more expansive fintech policies along lines advocated by Acting Comptroller Brooks, and a smaller Fed payment-system footprint. Legislative stalemate seems most likely on most of these issues, but areas of bipartisan agreement – i.e., certain CBDC versions – are possible. Further, Biden Administration pressure will lead to the Fed to use its formidable powers in novel ways.

Chairman Powell and Vice Chairman Quarles also face the end of their terms in these positions late next year and in early 2022. At this point, Gov. Brainard seems likely to be named Fed chair, but Mr. Powell could retain his position through the Biden Administration. We doubt Mr. Quarles will win reappointment as supervision head given Janet Yellen's strong disagreement with an array of Fed supervisory and regulatory decisions. All of these Fed-specific issues will also be highly event-driven – if the economy recovers quickly and the financial system is stable, then the Fed's centripetal role will increase; if renewed Fed facilities are ineffective or seen to be disequalizing even as equity-markets accelerate to new heights, then the Fed will come under bipartisan equality-focused critiques that go beyond racial equity and could more broadly challenge its independence and dual mandate. This report thus forecasts Administration and Congressional action as well as the Fed's own policies ahead of or in response thereto.

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Analysis

- Emergency Facilities: Given the furor at the end of this Congress, this will be the most immediate controversy involving the Fed's fiscal role. The final version of COVID stimulus bars CARES-like facilities, but expressly leaves the Fed's 13(3) powers as is (see FSM Report **RESCUE70**). However, this doesn't mean that they'll stay that way. We expect two competing forces: a push from the Biden Administration and Democrats to directly or indirectly revoke the COVID law's limits and a sharp pull in the other direction from Sen. Toomey and his Republican colleagues. An uneasy truce is the likely upshot – in it, the Fed will retain its current financial-market facilities, acquire alternative assets only for other purposes (see below), and otherwise keep its powder dry to ensure maximum-force facilities in case of crisis. These facilities will require Treasury approval and perhaps also Exchange Stabilization Funds. In such cases, the Biden Administration will condition Fed intervention on adherence to policies such as bans on corporate dividends, salary constraints, and perhaps even on fossil-fuel related ventures.
- Liquidity Facilities: The dry powder on emergency-liquidity facilities doesn't mean that the Fed will step back from others. As noted earlier (see *Client Report* **REFORM200**), we expect the Fed to reconsider Treasury-market illiquidity and address it not by easing the SLR, but instead by seeking express statutory authority to support broker-dealer affiliates. Emergency-liquidity for CCPs is another option, but we expect this only to come if Treasury and the Fed conclude that central-clearing for Treasury obligations must become the norm, not exception. We will address this issue in depth in a forthcoming report.
- Racial-Equity Mandate: We expect the House quickly to move legislation along the lines introduced in 2020 (see FSM Report **FEDERALRESEVE58**) with this revised to far more of a monitoring, reporting, and data-gathering role if Republicans retain the Senate. Although Democratic control of the Senate would toughen this up, control would be so narrowly maintained that a stringent, truly-binding mandate will prove difficult to enact. The Fed will also seek to preempt statutory change with still more policy statements, conferences, and voluntary activities highlighting racial-equity considerations. Tougher anti-discrimination enforcement is also likely (see *Client Report* **CONSUMER36**).
- Fed Portfolio/"People's QE:" One of the results of the Fed's unprecedented COVID facilities combined with post-2008 QE is widespread awareness of the central bank's ability to print money to support key sectors or policy goals. Although QE is aimed solely at monetary-policy transmission and the COVID facilities were targeted at financial and market crises, the trillions the Fed deployed for its own goals and, after the CARES Act, Congress' have recast the central bank as a far broader macroeconomic actor. We expect both demands and Democratic legislation seeking to force the Fed to back green bonds, public banks, and lending to specific sectors (e.g., small business). Democrats will also demand that Fed asset purchases stipulate eligibility criteria aligned with the "stakeholder capitalism" model Democrats will also press next year. Janet Yellen as Treasury Secretary will be more mindful of

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the need to support Fed independence than most Administration officials, but she has from time to time taken a broad view of the Fed's authority and could do so now to further Administration objectives. Republicans in the Senate will push back hard, but the Fed's existing statutory authority may give it latitude to do at least some of the non-traditional purchases Democrats advocate. For example, the Fed has set precedent with its corporate-bond backstops and could come to purchase some corporate debt -- i.e., of minority depository institutions – if it deemed this within this mandate and helpful to politically-sensitive sectors.

- Payment System: Democrats have demanded fast action on FedNow (see FSM Report **PAYMENT16**), but Sen. Toomey is skeptical, telling Chair Powell (see Client Report **FEDERALRESERVE54**) that he doubts the Fed's inter-operability intentions and fears the adverse impact of uniform pricing on small banks. We expect continued inaction by Congress on a question of relatively-low public interest and thus ongoing work by the Fed on its system on the schedule set earlier this year (see FSM Report **PAYMENT20**) in the manner then laid out. The sole exception to this forecast may come from fintech and tech-platform companies; if they use their formidable political capital to seek payment-system access, then the Fed may be forced to construct a new sterile-reserve system for them or otherwise concede. However, we expect near-term fintech and BigTech focus to remain firmly fixed on new charters given the other demands – e.g., antitrust proposals (see *Client Report* **DIGITAL6**) focusing this sector.
- CBDC: Democrats will also push hard for FedAccounts (see FSM Report **CBDC**), but these will face implacable opposition from Republicans opposed to *de facto* nationalization of the U.S. banking system. Instead, the Fed will continue to work on its own version of CBDC (*see Client Report* **CBDC3**), moving cautiously to determine the best way to ensure that any widely-adopted digital currency is fiat currency that poses none of the financial-stability and monetary-policy concerns it has highlighted in connection with Libra. The Fed is also wary of any CBDC options in which bank deposits move to the Fed, fearing loss of financial intermediation capacity and thus growth. Given all of this, the most active Democratic advocacy will shift to seeking to establish the postal-banking system to which the Biden campaign gave limited encouragement and to public-bank promotion at the state and local level. Federal public-bank legislation will face the same obstacles from the GOP as FedAccounts.

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