



MORNING BRIEFING

August 19, 2020

Fed Watching for Fun & Profit: Inflation, Fedcoin & Inequality

(1) The Fed fights the virus. (2) Trying to get inflation right on average. (3) The whites of inflation's eyes. (4) Kaplan and Evans weigh in. (5) Making up for misses with overshoots. (6) Yellen briefed Biden and champions average inflation targeting too. (7) Fed's Don Quixote mission: to reach the unreachable stars. (8) Central bankers getting high on CBDC. (9) The equity mandate: Can monetary policy level the playing field? Should it?

Fed I: Lots of Content. I published my book [Fed Watching for Fun & Profit](#) on March 9. At the time, I regretted that I hadn't thought to write a book about pandemics instead. Then, the Fed responded to the Great Virus Crisis (GVC) with QE4Ever on March 23. That certainly boosted my book sales.

Now, I'm already working on a sequel tentatively titled *The Fed Fights the Virus*. There's already plenty of material. Fortunately, this project coincides with my day job. In addition, my colleague Melissa Tagg has turned into a top-notch Fed watcher under my tutelage and continues to work with me on regularly updating the latest developments in the world of the world's major central banks.

Today, our focus is threefold: the Fed's latest thinking on inflation targeting, its thinking on digital currencies, and the role of monetary policy in dealing with income inequities.

Fed II: Averaging Inflation. Inflation rebounded slightly during July, according to CPI data released last week, but certainly not enough for Fed officials who would like to see it move even higher. Let us explain.

The Fed remains committed to the ultra-easy monetary-policy stance it adopted in reaction to the GVC. In fact, we think the Fed will soon confirm that commitment by effectively raising its tolerance for higher inflation. Specifically, we see the Fed embracing the long-standing (pre-pandemic) [analysis](#) of someone who is very influential to the Fed: Senior Fellow at the Peterson Institute for International Economics and MIT Professor Olivier Blanchard. His conclusion: Don't tighten until you see "the whites of inflation's eyes."

In other words, we see the Fed letting go of its typical approach of raising rates preemptively, before inflation heats up. As we [wrote](#) on August 4, we believe the Fed would welcome inflation running above its 2% inflation target for a while as a long-overdue offset to rates that have run below that pace since January 2012, when the Fed publicly started targeting inflation at 2%. We expect this change to be announced publicly soon as the Fed synthesizes its year-long monetary policy strategic review.

There's plenty of recent evidence informing our expectation:

(1) *Averaging inflation.* At the start of the Fed's policy review during December 2018, we [outlined](#) several options for inflation targeting that Fed officials have discussed. In May of last year, we [wrote](#) that Fed officials were leaning toward average inflation targeting, whereby the Fed would seek an average inflation rate over a period of time, making up for "misses" that may have occurred with future "overshoots" that average inflation levels out. That sort of approach seems to be in line with the recent comments from two Fed officials.

On August 14, Dallas Fed President Robert Kaplan [suggested](#) that he is for the average-inflation-targeting approach in the current environment: "I would be willing to see inflation run moderately above 2.0% in the aftermath of periods where we've been running persistently below." Specifically, Kaplan said he would be comfortable with inflation rising to 2.25% or 2.38%.

Chicago Fed President Charles Evans is also comfortable with inflation rising above 2.0%. He [told](#) reporters virtually on August 5 that he could see inflation moving up to 2.5% before the Fed considers raising rates again. Kaplan is a [voter](#) on the Federal Open Market Committee this year while Evans is a non-voting participant in the Committee's meetings.

The two regional Fed bank governors are clearly involved in the Fed's latest strategic policy review. Fed Chair Jerome Powell said at a July 29 [press conference](#) that the review would be wrapped up in the "near future." Powell also said on that occasion that the central bank is "not even thinking about—thinking about raising rates." By the way, former Fed Chair Janet Yellen (who [reportedly](#) has briefed Democratic presidential nominee Joe Biden) has advocated for average inflation targeting.

(2) *Muted inflation*. Considering the amount of monetary stimulus that the Fed has injected since the pandemic hit, inflation remains relatively muted, particularly so compared with the Fed's apparently higher goalpost. The core CPI excluding food and energy increased 1.2% y/y in June and 1.6% in July. The headline CPI rose to 1.0% y/y during July from 0.6% during June. So inflation remains below the Fed's stated 2% inflation target and even further below the rates Fed bank presidents Kaplan and Evans wouldn't mind seeing, as noted above.

(3) *Fed of La Mancha*. Frankly, we are mystified why Fed officials are discussing tolerating inflation above their 2% target when they haven't been able to get it consistently up to that level since they officially adopted that inflation target during January 2012! It reminds us of the theme song "Dreaming the Impossible Dream" from *Man of La Mancha*. Here are the relevant lyrics: "This is my Quest, to follow that star, No matter how hopeless, no matter how far ... To reach the unreachable stars!"

Fed III: Going Digital? The race for a COVID-19 vaccine isn't the only high-stakes time-is-of-the-essence contest playing out on the global stage. There's also the central bank digital currency (CBDC) race. China has revealed that it wants to win the CBDC race to usurp the US dollar's global currency supremacy. Other countries have joined so as not to be left behind.

"One in 10 central banks surveyed in 2019 said it was likely to offer digital currencies within the next three years, covering about 20% of the world's population according to a report from the Bank for International Settlements [BIS]," [reported](#) the January 23 *WSJ*. On January 21, the BIS issued a press release announcing that the "Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, the Sveriges Riksbank and the Swiss National Bank, together with the [BIS], have created a group to share experiences as they assess the potential cases for [CBDC] in their home jurisdictions."

Until recently, Fed officials were lukewarm on the idea of a US digital dollar. Just last year, Fed Chair Powell [wrote](#) in a November 19 letter to congressional leaders that the US central bank has no plans to launch a digital currency, adding that doing so for general use "would raise important legal, monetary policy, payments policy, financial stability, supervision and operational questions that need to be considered carefully."

Nevertheless, the Fed has begun to prioritize its own CBDC research in recent months, given China's significant progress. Whether the Fed will go all the way to implementing a CBDC is uncertain; but if the other major central banks' currencies go digital, would the Fed have much

of a choice? Interestingly, CBDC could provide the Fed with more monetary policy leverage, as we discuss below. Consider the following:

(1) *FedNow in the game*. On August 13, the Fed [announced](#) that it had undertaken research “to enhance its understanding of the opportunities and risks associated with central bank digital currencies.”

The same day, Fed Board Governor Lael Brainard [spoke](#) on the topic, stressing that “China has moved ahead rapidly on its version of a CBDC.” She added: “Given the dollar's important role, it is essential that the Federal Reserve remain on the frontier of research and policy development regarding CBDCs. As part of this research, central banks are exploring the potential of innovative technologies to offer a digital equivalent of cash.” Research on CBDC will go together with the Fed's *FedNow* Service, currently underway. It will “enable millions of American households and small businesses to get instant access to funds rather than waiting days for checks to clear.”

Brainard summed up some of the opportunities and risks presented by CBDCs as follows: “[B]anks, fintech companies, and technology firms are all exploring the use of innovative technologies to enhance payments efficiency, expand financial inclusion, speed up settlement flows, and reduce end-user costs. Digital currencies ...present opportunities but also risks associated with privacy, illicit activity, and financial stability. The introduction of Bitcoin and the subsequent emergence of stablecoins with potentially global reach, such as Facebook's Libra, have raised fundamental questions about legal and regulatory safeguards, financial stability, and the role of currency in society. This prospect has intensified calls for CBDCs to maintain the sovereign currency as the anchor of the nation's payment systems.”

(2) *Dollar decoupling threat*. Japanese lawmakers have [pushed](#) for the discussion of cooperation on CBDCs to be on the agenda of the upcoming annual G7 summit. The impetus for the discussion is the threat that China's CBDC might pose to the US dollar's dominance. In February, Japanese Minister Akira Amari said: “We live in a stable world led by dollar settlement. How should we respond if such a foundation collapses and if (China's move) gives rise to a struggle for currency supremacy?”

Indeed, China likely has plans to leverage its digital currency prowess to challenge the US dollar. Zhou Li, a former deputy director of the Communist Party's International Liaison Department, recently [wrote](#) that “By taking advantage of the dollar's global monopoly position

in the financial sector, the US will pose an increasingly severe threat to China's further development."

(3) *China in first place*. At the forefront of the digital currency race, China's "big four state-owned commercial banks have started large-scale internal testing of what would be the world's first sovereign digital currency, as the launch of the digital yuan appeared to move a step closer" [reported](#) the August 6 *South China Morning Post*, according to the *21st Century Business Herald*. The People's Bank of China (PBOC) has [suggested](#) that it could be ready for testing at the venues for the 2022 Winter Olympics. Former PBOC VP Wang Yongli said last week that the digital currency would eventually replace not just M0, but all currencies in circulation.

(4) *Back below zero*. One reason for the Fed to consider a US CBDC now is an issue Melissa and I discussed a few years back, in the October 16, 2017 [Morning Briefing](#), reviewing a quarterly BIS [report](#). We noted: "If cash were to become obsolete, that could effectively free the Fed from the dreaded ZLB, i.e., the zero lower bound. The ZLB is feared by monetary policy makers because it's the point at which interest-rate tools become ineffective at creating stimulus. Cash can become a nuisance for monetary policy if the Fed needs to implement a negative interest rate policy (NIRP) in order to meet its goals for employment and inflation. Under NIRP, cash would be in higher demand as it would be cheaper to hold onto cash than to deposit it in a savings account with a negative interest rate."

JP Koning explored how the Fed might get around this problem with the introduction of a hypothetical "Fedcoin" in a 2014 [blog post](#) that was cited by the 2017 BIS report. Koning hypothesized that interest could be paid on each Fedcoin at a rate determined by the Fed. "After all, if the Fed wished to reduce the rate on reserves to -2 or -3% in order to deal with a crisis, and reserve owners began to bolt into Fedcoin so as to avoid the penalty, the Fed would be able to forestall this run by simultaneously reducing the interest rate on Fedcoin to -2 or -3%. Nor could reserve owners race into cash, with only low denomination and expensive-to-store" bills available, Koning theorized. So just as interest could be earned on Fedcoin, a negative rate could be imposed on Fedcoin.

The Fed has not said that it would go to a NIRP to combat the GVC, but as we have all learned since March 23, 2020, anything is possible.

(For more background, also see Jackie's earlier notes on a Swedish digital currency, as well as her initial report on China's initial progress [here](#) and [here](#).)

Fed IV: The New Third Mandate. Currently, the Fed has two congressional mandates to follow: maintaining a balance of stable inflation and maximum employment. But on August 5, Democrats introduced a bill that would create a third mandate for the Fed: reducing economic inequality. We think that this matter, though pressing, is better handled by fiscal authorities. Powell thinks so too, as he said during his July 29 [press conference](#) that the Fed doesn't "really have tools that can address distributional, disparate outcomes as well as fiscal policy." This view is nothing new; it was shared by former Fed Chair Ben Bernanke in a 2015 Brookings [blog post](#). Here's more:

(1) *Monetary problems.* Historically, monetary policy has been used as a blunt tool that aims to raise the standard of living broadly. Of course, we are in unprecedented times, and the Fed and US Treasury jointly have undertaken highly unconventional policy measures targeting specific groups. But were the Fed to target income inequality routinely going forward, wouldn't that complicate the broad objective of monetary policy? Wouldn't it also necessitate that the Fed become more intertwined with fiscal agencies, jeopardizing its important independence? How would the Fed even address income inequality with its current (albeit expanding) toolkit? We have no answers but will be watching to see how far the Democrats' bill goes in the legislative process.

(2) *Mandate alteration.* Cowritten by Senator Elizabeth Warren (D-MA), Senator Kirsten Gillibrand (D-NY), and Representative Maxine Waters (D-CA) and cosponsored by Senator Bernie Sanders (I-VT) and 17 other Democratic leaders, the Federal Reserve Racial and Economic Equity Act requires the central bank to take action "to minimize and eliminate racial disparities in employment, wages, wealth, and access to affordable credit." It would be the first major change to the Fed's mandate since 1977.

Similarly, Joe Biden recently called on the Fed to "aggressively enhance" its monitoring and targeting of "persistent racial gaps in jobs, wages, and wealth." But the bill goes further, explicitly requiring the Fed to address such gaps. That's all as [reported](#) by the August 5 *Washington Post*.

(3) *Overshooting for broader opportunity.* Average inflation targeting arguably might serve a Fed "equity mandate," implied a 2019 [article](#) in *Medium*, as the unemployed might face better

odds of being hired if the Fed were to wait longer before tightening monetary policy. On the other hand, higher price inflation could reduce the purchasing power of the nominal wages of everyone who has a job. Such a mandate would certainly throw the Fed into the boiling cauldron of our nation's extremely partisan political debates.

CALENDARS

US: **Wed:** MBA Mortgage Applications, EIA Crude Oil Inventories, FOMC Meeting. **Thurs:** Leading Indicators 1.1%, Initial & Continuous Jobless Claims 925k/15.0m, Philadelphia Fed Manufacturing Index, EIA Natural Gas Storage, Daly. (DailyFX estimates)

Global: **Wed:** Eurozone Headline & Core CPI 0.4%/1.2% y/y, UK Headline & Core CPI 0.6%/1.3% y/y, Canada CPI 0.4% m/m/0.5% y/y. **Thurs:** UK Gfk Consumer Confidence -25, Japan CPI, UK-EU Brexit Talks, ECB Monetary Policy Meeting Accounts. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Growth vs Value ([link](#)): The S&P 500 Growth price index leads ytd through Monday's close with a gain of 18.8% versus an 11.2% decline for Value. Since their lows for the year on March 23, Growth's 59.5% gain is well ahead of the 40.0% rise for Value. Growth has been making new record highs since July 2 and is now 9.4% above its prior record high on February 19. Value is still in a correction at 12.3% below its January 17 record high. Looking at the fundamentals, Growth is expected to deliver higher revenue growth (STRG) and earnings growth (STEG) than Value over the next 12 months. Specifically, 8.1% STRG and 13.9% STEG are projected for Growth, respectively, versus 2.3% and 5.9% for Value. Through Monday's close, Growth's P/E of 28.0 was down from a 19-year high of 28.5 on August 5 and compares to a 15-month low of 16.8 on March 23. That also compares to a record high of 40.9 in July 2000 during the height of the Tech Bubble. Value's forward P/E of 17.1 is down from 18.6 on June 8, which was then the highest since July 1999 and up from 10.0 on March 23, which was its lowest reading since November 2011. Regarding NERI, Growth's was negative in July for a 12th straight month, but has improved markedly to -9.3% from its 11-year low of -35.0% in May. That compares to a record high of 22.3% in March 2018. Value's NERI was negative in July for a 21st month, and up to -13.5% from an 11-year low of -39.0% in May; that compares to a record high of 21.2% in March 2018. The Tax Cuts and Jobs Act (TCJA) sharply boosted the consensus forward earnings estimates and the forward profit margin for both Growth and Value in 2018. Growth's forward profit margin improved from a low of 14.9% during May to 15.5% on August 6. It remains above the 14.4% prior to the TCJA's passage but

is down from its record high of 16.7% during September 2018. Value's forward profit margin of 8.4% is up from a low of 8.0% during May but is well below the 9.1% prior to the TCJA and down from a record high of 10.5% in December 2018.

US ECONOMIC INDICATORS

Housing Starts & Building Permits ([link](#)): Builders are building again as confidence rallies to a record high. Housing starts soared 22.6% in July, and 60.2% during the three months through July, to 1.496mu (saar). For perspective, starts had plunged 42.2% during the three months ending April to 934,000 units (saar); it was at a cyclical high of 1.617mu (saar) at the start of the year, before COVID-19 hit. Single-family starts rebounded 38.4% during the three months ending July to 940,000 units (saar), after plunging 34.3% during the two months through April—from 1.034mu to 679,000 units. Multi-family starts soared 118.0% over the three-month period to 556,000 units (saar) after a three-month plunge of 59.4% to 255,000 units (saar). Building permits jumped 18.8% in July and 40.2% the past three months, to 1.495mu (saar), after plummeting 30.6% during the three months through April. Permits were at a cyclical high of 1.536mu (saar) in January. Single-family permits soared 47.6% during the three months ending July to 983,000 units (saar)—to within 1.1% of its pre-pandemic peak. Meanwhile, volatile multi-family permits rebounded 22.5% in July to 512,000 units (saar), following an 11.1% loss and a 17.5% gain the prior two months. NAHB's Housing Market Index (HMI) climbed 48 points during the four months through August (back up at its record high recorded in December 1998), after plunging a record 42 points in April alone to 30—the lowest builder confidence since mid-2012, and the first reading in negative territory (below 50) since mid-2014. All four measures of the HMI moved sharply off their lows: current sales (to 84 from 36 in April), future sales (78 from 36), and traffic of prospective buyers (65 from 13)—with the latter at a new record high.

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