Federal Financial Analytics, Inc.

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Contact: Matthew Shaw
mshaw@fedfin.com
202.589.0880

FEDERAL RESERVE URGED TO REVERSE MONETARY, REGULATORY POLICY TO IREVERSE ECONOMIC INEQUALITY

Karen Petrou lays out how the Fed unintentionally exacerbates U.S. economic inequality as a result of its large portfolio, ultra-low interest rates, and some new rules. Given populist backlash to growing inequality, she urges the Fed quickly to correct policy to protect its independence and post-crisis reforms. The Fed should start with recognizing its own adverse equality potential and then normalize policy as quickly as possible. Post-crisis rules should be refined and the Fed should press for new incentives for equality-boosting lending and savings products.

WASHINGTON, DC, May 3, 2017 – Following participation in an IMF seminar on income inequality and central banking, Federal Financial Analytics' managing partner Karen Petrou has released a paper laying out what she urged the Federal Reserve to do and why. First and foremost, this is to recognize that economic inequality is at its root and economic phenomenon and a central bank thus must take at least partial responsibility for it. Building on prior FedFin research and a recent article, this new paper lays out the link between Fed action and widening gaps in the income and wealth enjoyed by rich, middle-class, and lower-income Americans. The interplay of post-crisis monetary and regulatory policy is particularly important, and Petrou thus presses the Fed to expand its policy framework to reflect the negative-equality feedback loops it inadvertently creates.

"One way the Fed exacerbates economic inequality results from the downward cycle created by the interaction of new capital rules and ultra-low interest rates," Petrou said. "Banks aren't philanthropic institutions and thus must take profit impact into consideration. The combination of new bank capital requirements and ultra-low interest rates means banks cannot lend to higher-risk borrowers – that is, those taking their first steps to prosperity," she continued.

Because markets reflect not only what the Fed wants banks to do, but also what they actually do as a result of central-bank monetary and regulatory actions, this new paper lays out collision points between what banks can do to remain viable enterprises in the post-crisis framework and economic equality. Non-banks, including financial-technology ones, may come to substitute for banks over time due to their exemptions from most new rules, but the paper concludes that the equality impact of this substitution and its impact on financial stability is uncertain.

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