# Issue Brief

# The Link Between a Smaller Fed Portfolio and Economic Equality and What the Fed Should Do About It

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**September 18, 2017**

- The Fed's $4.5 trillion portfolio in concert with ultra-low interest rates alters asset valuations and helps to make the rich richer.
- A short-term hike in inequality might have been warranted had accommodative policy spurred the economic growth essential for lower-income households. To date, this has not occurred.
- Plans to reduce the Fed portfolio are slow, tentative, and reversible. The size of the Fed's holdings is now so large that rapid tapering could well create systemic risk, but these are of the Fed's own making and do not obviate its duty to let markets set values so that lower-income households have a better chance of wealth accumulation.
- A certain, clear, and quick disposition plan with an "out" only for emergencies will in concert with higher rates reduce yield-chasing, normalize markets, and improve equality.

As the Federal Open Markets Committee (FOMC) sets out on the path to Federal Reserve portfolio reduction it announced on July 26, it must consider the uncharted territory it will traverse to ensure that balance-sheet "tapering" comes off without a hitch at a time of fragile financial stability, profound political uncertainty, volatile currency markets, and an uncertain path to the "new neutral" interest rate on which monetary policy must henceforth be balanced. Perhaps due to all of these challenges – some of its own making – the FOMC has resolutely refused to contemplate what the $4.5 trillion of assets now held by the Fed have done since their inception to U.S. economic equality. This is a critical question the Federal Reserve ignores not only at grave cost to social welfare and political harmony, but also to its own future as an independent force for prudent monetary and regulatory policy.

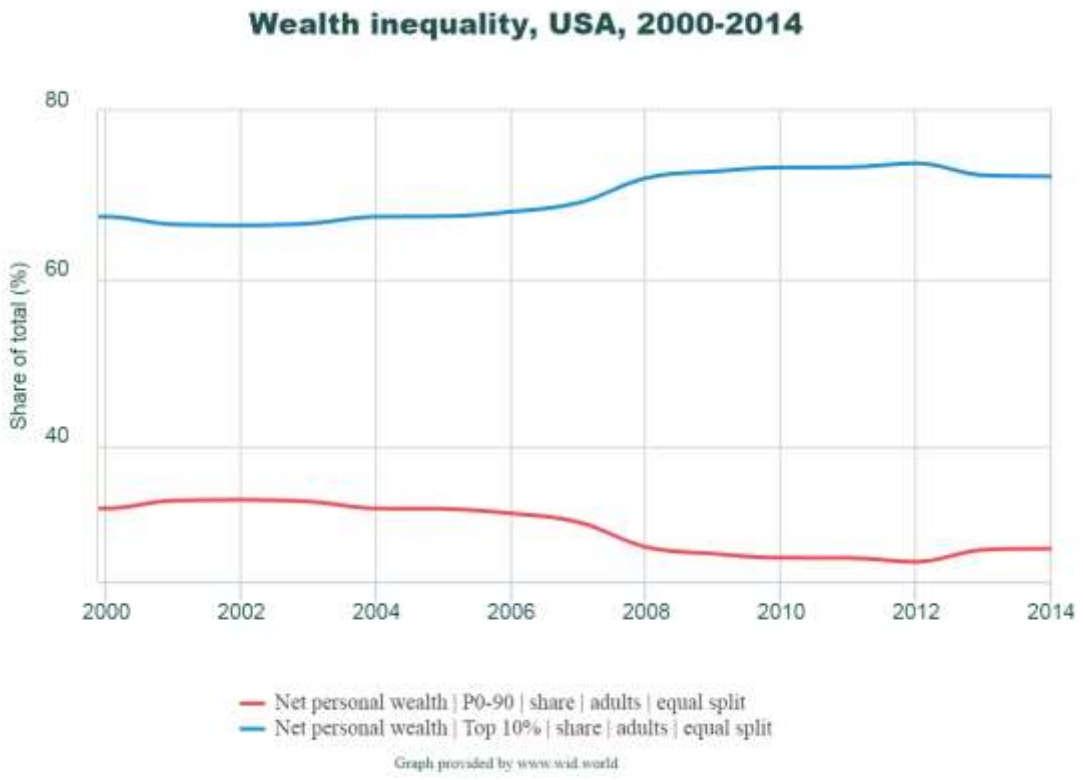
This issues brief considers a host of recent research demonstrating that the Federal Reserve's portfolio has fired up other factors already exacerbating U.S. economic equality and helped to make the rich still richer. The combination of continued, slow growth in the decade since 2007 and heightened return on the capital housed in financial assets held by wealthier individuals has widened U.S. economic equality to levels not seen, if at all, since the Gilded Age of the late 19th century. Given the critical importance of economic equality to social welfare, stable growth, and constructive public policy, we not only make clear the link between Fed policy and economic inequality, but also posit near-term solutions to it.

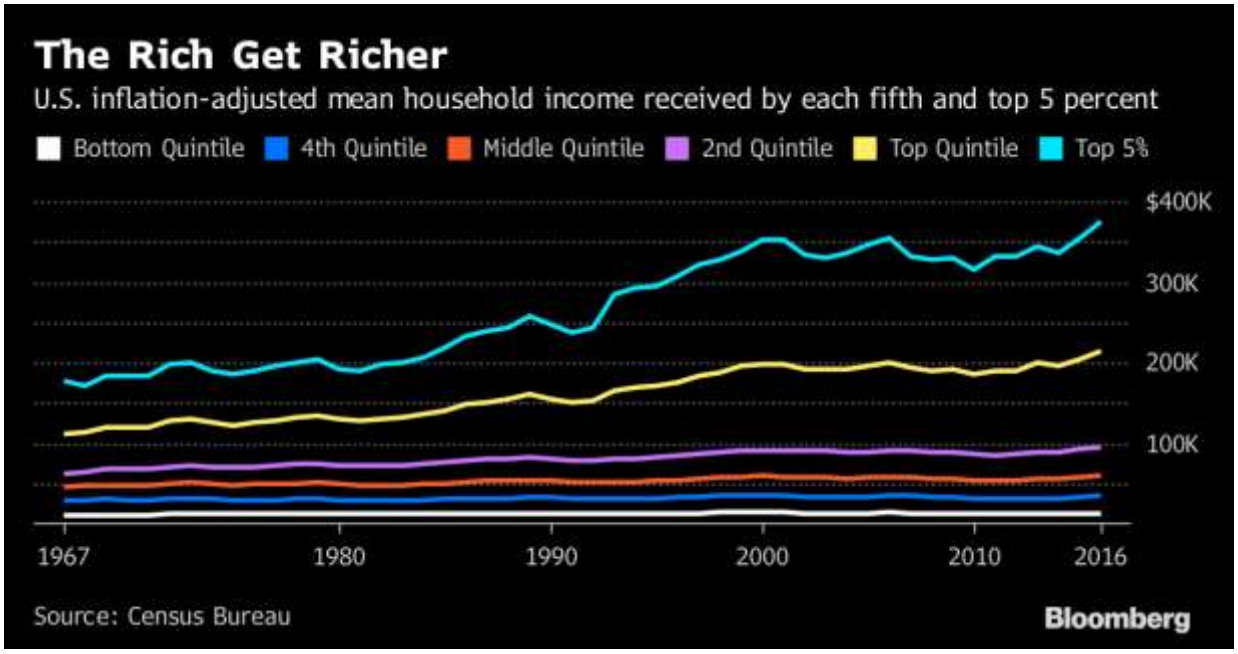
**How QE Makes Inequality Still Worse**

Importantly, economic equality is a complex phenomenon driven by complicated factors – demographics, fiscal policy, and the pace of innovation just to name a few. Although the conclusions below are based on an extensive literature survey, it is not within the ambit of an issues brief to lay out all relevant research; a representative sample of the analyses on both sides of this question is presented below. However, as Thomas Piketty's already-classic book on 21st-century income inequality demonstrated,[1] history has shown that economic inequality derives from the gap between macroeconomic growth and return on capital. Historically, central banks have played critical roles sparking or dampening the growth of output and input; now they also drive return on capital by virtue of the huge portfolios many hold in financial assets such as government securities (the Fed) and a wide array of capital-market obligations (many other central banks).

As noted, U.S. output and income growth since 2007 has remained stubbornly sluggish. At the same time, wealth inequality has widened dramatically. The following charts show the sharp spike in U.S. income and wealth inequality since 2000 – when the U.S. economy and financial markets were relatively

placid through 2007 – the start of the great financial crisis – and to the last date on which comparable, current data are available.



The underlying data on which these excerpts are based show not only the gradual worsening of U.S. equality since 1980, but also the force that financial crises such as the Great Depression have had as sudden levelers of economic wealth. Thus, one would have expected that the years immediately following the U.S. "great financial crisis" of 2008 would have seen a bit of equality improvement largely due to the rich getting a bit poorer while transfer payments sustained the least well-off. This is in fact evident briefly, but then something happens above and beyond the underlying forces that heighten U.S. equality to lead not to a general resumption of the pre-crisis march toward inequality, but rather to a sudden surge in wealth for the highest-income Americans.

Given that crises should work in the opposite direction and improve equality, at least for a time, it seems likely that the radical, unprecedented monetary policy adopted by the Federal Reserve played a significant role to realign equality distribution still more favorably for the rich, especially the very rich.

**Why is QE So Crucial?**

QE is not the only thing that changed after the great financial crisis. Prior FedFin research and much recent central-bank and academic literature demonstrate that QE interacts with other post-crisis changes – most notably many new rules for global banking organizations – with unintended, anti-equality impact.[2] However, QE is among the most powerful equality destroyers precisely because – and virtually unique among the regulatory actions in the U.S. since 2008 – it reaches across the financial system rather than applying solely to banks. As a result – and indeed as the Fed intended – QE does not just influence the banking system; instead, it drives economic activity across the U.S. and indeed around the world.

It is of course the goal of monetary policy to stimulate or contain growth. Conventional monetary policy does this in concert with direct distributional effects – that is, expansionary policy designed to spur growth and employment generally benefits lower-income households because they are most likely to be on the employment "brink" and thus be the first to benefit from simulative policy.[3] However, unconventional monetary policy such as QE alters this traditional alignment between central-bank efforts to spur growth and who benefits or loses in concert with them.

This is because a central bank deploying QE does not work through interest-rate or similar channels to spur or contain growth, but rather by transforming long-term assets into short-term reserves that set a floor under interest rates to prevent sharp drops below the "lower bound" that could then spur deflation and contraction. The central bank also hopes that excess reserves are quickly redeployed to fund credit-spurring growth.

On its own and in concert with ultra-low rates, QE realigns asset valuations by creating "scarcity effects" for ultra-safe assets purchased by a central bank with the goal of forcing banks that receive cash from the central bank for these asset sales to convert these new-found funds into productive assets, principally growth-generating lending. In practice, the relationship between the scarcity effect for assets purchased by a central bank and resulting bank lending is highly complex, especially in a nation such as the U.S. where bank lending is only one part of a credit system heavily reliant on non-bank institutions.[4]

A 2017 literature survey on QE's equality impact[5] shows clearly how widely policy results vary by national factors such as the importance of home ownership to wealth accumulation for low- and

moderate income (LMI) households. The ability of banks to convert Fed cash into credit for key equality sectors (i.e., lower-principal mortgages, small-business lending) is also directly affected by post-crisis rules, with those in the U.S. generally far more stringent than those in many other countries. The post-crisis regulatory framework thus combines with the structure of U.S. asset holdings to unique and, as it turns out, destructive equality effect.

The forces the Fed hoped QE would mobilize for economic growth not only do not work as intended in the U.S., but also turn toxic for economic equality. The reason is the changed incentives resulting from scarce supplies of safe assets and uneconomic rates of interest. The Fed has long hoped that a scarce supply of safe assets with minimal productive value (government obligations) would spur banks to productive lending that ensures financial stability but nonetheless sparks growth. This turns out to be considerably harder than the Fed thought. While lending has to some degree increased in recent years above dismal levels at the start of the crisis, a new Fed staff study in fact attributes a shift in bank lending to higher-risk, less equality-germane loans to two of the three QE rounds by the Federal Reserve.[6] Reflecting other research that finds similar trends in risk-taking due to the combination of asset scarcities and ultra-low rates, this paper determines that banks with large mortgage-backed securities (MBS) holdings – i.e., those demanded by new liquidity rules – now hold larger balances of high-risk loans due to yield-chasing. It is possible that more risk-taking would lead to more lending to higher-risk LMI households for first-time homeownership or lending to start-up small businesses – key equality-generating engines as the FRB has acknowledged.[7] However, the new Fed staff paper – based on confidential loan data not available to other researchers – finds that this higher-risk taking came in the form of commercial real estate lending during the first QE round and commercial-and-industrial (i.e., established business) lending in the third.

In the absence of sufficient new lending to generate growth with equality impact and in concert with ultra-low interest rates that diminish safe-asset return on capital, U.S. investors are engaging in what the FRB and others characterize as "yield-chasing" – that is, a fevered pursuit of higher returns by holding riskier assets such as stocks, bonds, and even speculative "junk" obligations. Yield-chasing creates widely-acknowledged risk to financial stability that in its own right could adversely affect economic equality by precipitating another financial crisis. However, even if yield chasing tapers off in a smooth, stable fashion, it dramatically widens the wealth of those able to engage in complex financial markets – generally the wealthiest – versus those who depend for wealth accumulation on savings accounts (now offering negative returns after taking inflation into account) and home-equity appreciation.

The most focused recent study of the impact on QE for U.S. economic equality was conducted by the Bank for International Settlements (BIS) staff.[8] It finds that the U.S. has become sharply more economically unequal due to QE-driven higher financial-asset valuations versus the value of assets (savings accounts and home value) critical to lower-income wealth accumulation. Another recent study[9] shows clearly the equality divide in asset ownership, laying out the sharp divide in asset ownership in the U.S. Here, home values constitute 67 percent of middle-class wealth but only nine percent of wealth for the richest one percent. Importantly, house prices have grown sharply for higher-priced houses since about 2012 but remain depressed for lower-cost homes across the country, with many regions still experiencing significant amounts of negative equity a decade since the housing "bust."[10] Savings accounts, which are generally the rest of wealth balances for the middle class, have been particularly hard hit by ultra-low rates, with one recent study estimating a total loss across the U.S. economy of $2.4 trillion in savings-accounts and similar balances.[11]

A Federal Reserve Bank of Philadelphia study[12] caustically finds that accommodative monetary policy benefits "Wall Street" at the expense of "Main Street." Another recent U.S. study characterizes quantitative easing as "trickle-down economics" because the disparities in asset prices cited by the BIS do not have their desired impact on unemployment.[13] As this study points out, the unemployed lack assets and thus are not directly helped by accommodative policy. Although Fed policy intends to spur employment by generating demand that creates additional employment opportunities, this study concludes that this indirect impact is "tenuous," using data to argue that quantitative easing in fact exacerbates income and wealth inequality, "violating the principles of social justice."

**In QE's Defense**

Leaving aside all this research, one could counter that QE has worked because U.S. growth has recovered and, with it, the proverbial rising tide soon will lift all boats. This has long been the position of the Federal Reserve Board which, despite Reserve Bank studies such as those noted above and in contrast to other central banks, has resolutely refused to conduct official assessments of QE's economic-equality impact.

The best way to counter the studies cited above and assess the proposition that QE has not adversely affected equality in avoidable ways is to see if QE has worked as the FOMC has hoped. A new paper from the Federal Reserve Bank of St. Louis assesses the extent to which QE adversely affects economic equality.[14] Following an extensive literature survey, this paper finds that QE in the U.S. has not achieved its growth objectives when measured by real GDP in comparison to Canada, a nation with a comparable and linked economy to the U.S. where QE was minimal but growth was greater than in the U.S. This paper concludes that, "There is good reason to be skeptical that [QE] works as advertised," with some studies making a "good case" that it has in fact been detrimental.

This St. Louis Fed paper includes recent U.S. economic performance; a 2015 BIS paper that performed a counter-factual exercise to assess QE's equality impact also found QE contributed to U.S. economic inequality despite then-evident gains in employment and mortgage-refinancing volumes spurred by low interest rates.[15]

A Federal Reserve Bank of Cleveland study assessing QE's overall equality total impact takes an uncertain stand on this question, finding that the evidence that QE exacerbates economic equality so far is "inconclusive,"[16] although the paper says one would need to know more about the income distribution of various assets to understand better QE's impact.

Although external factors such as uncertain fiscal policy and global geopolitical risk have played an important role suppressing U.S. growth, the fact remains that the Federal Reserve's own forecasts – which presumably take all this into account – have been consistently wrong in virtually every quarter since QE began.[17] Further and regardless of assertions that GDP and employment are now adequate even if inflation is stubbornly low, the verdict of Americans at the lower end of the wealth-distribution spectrum have made it clear how ill-served they feel by post-crisis macroeconomic policy.

**On Balance for the Balance Sheet**

Is QE alone responsible for the sharp spike in inequality demonstrated above? Of course not. Is it at least partly to blame? Yes, by virtually all accounts.

Had QE accomplished its macroeconomic goals, one could argue that the inequality effects evident in the post-crisis period are temporary. As noted, research demonstrates that, when conventional monetary policy boosts growth through lower interest rates, employment jumps and the lowest-wealth communities benefit the most. Although FRB officials have of late begun to describe employment as "full," there is considerable dissent on this point, including within the Board of Governors.[18] Much data indicate that employment remains far from "full" due to the challenges facing all but the privileged for achieving desired employment at wages that ensure economic mobility.[19]

As noted throughout this brief, monetary policy is only one factor in a complex framework of inequality causes. However, even if yield-chasing spurred by QE does not exacerbate economic inequality, it poses a risk to financial stability that, to the extent yield-chasing is due to QE, raises significant questions about QE. It is clear that financial crises sharply exacerbate economic equality. This is evident in the historical data described above and all too evident in 2008's wake. If the yield-chasing and other market trends noted above sow the seeds for sharp market corrections or illiquidity crises, as they may, then any equality gains for which the Fed hopes will reverse much for the worse.

**What Should the FOMC Do?**

One final issue warrants consideration by the Federal Reserve: the cost of political anger over economic inequality to the future of effective, independent monetary policy. In concert with unprecedented accommodative policy through channels never before tried in the U.S., the central bank is under unprecedented political pressure. In 2008, voter turn-out from the economically disadvantaged regardless of race or party affiliation was enthusiastic, propelling into office the first progressive Democrat in decades. In 2012, these same voters stood by that Administration, but by 2016 their disenchantment was profound. Some stayed away from the polls while others turned out to vote for a man who said he would break the Federal Reserve's lock on economic policy in concert with cutting down big banks, shredding U.S. conglomerates, and barring what he called unfair trade that put hardworking Americans on the economic sidelines.

Steady-as-you-go monetary policy at a time of so much dissatisfaction is politically disastrous – no wonder so many Republicans demand FRB change and Democrats only defend the Fed when it suits them as a way to criticize President Trump.

In concert with its view that employment now is "full" and economic growth sufficient, the FOMC has crafted a course to gradual portfolio reduction. Timing is to be set, the construct of a new Fed portfolio to be determined, and the size of the resulting Fed portfolio yet to be decided. In short, the FOMC has decided to shrink the portfolio, but how, when, and even why are unknown. There are suggestions that the FOMC will move to a portfolio consisting only of Treasury securities, reducing if not eliminating the illiquidity challenges confronting the central bank from its MBS holdings and at the same time addressing questions Republicans raise about the *de facto* credit-allocation impact of these MBS purchases. It is unknown, though, if a portfolio only of Treasury obligations, especially if maintained at

the $3 trillion or so level some suggest, would do anything to offset the broader asset-valuation challenges to economic equality.

Indeed, by taking its hand off only the mortgage market, equality could worsen because mortgage rates could rise even as financial-asset values remain elevated in response to Fed-driven scarcity effects. Conversely, allowing agency MBS to reach true market prices could end the competitive advantage government-backed paper enjoys by virtue of huge Fed purchases atop an already-sought U.S. Government guarantee. Arguably, getting out of the way might well raise middle-class mortgage costs by increasing the cost of government securitizations, but also open the door to new mortgage products and alternative, private securitization channels.[20]

We don't know the answer to these questions, but neither does the Fed. One is left with a choice: allow the Fed, well-intentioned though it surely is, to call the U.S. economy's shots or let the market begin to allocate capital in accordance with economic and profit incentives under tough new rules designed to ensure that, if these incentives lead to undue risk-taking, then a financial institution's management and shareholders – not the taxpayers – pay the price. If LMI households then remain under-served, fiscal policy – not back-door social engineering by the Fed – should quickly ride to the rescue. Until we know how the post-crisis market functions without the Fed's "nanny state," we cannot tell who is responsible for the sharp divide in U.S. economic equality although a good deal of data suggests strongly that it's at least in part the Fed.

The Fed should thus take its hand off the macroeconomic rudder not to let the economy sail itself as some "free market" advocates argue, but instead to let the winds blow freely unless or until this ship is sailing towards the rocks. Under current monetary and regulatory policy conditions, the Fed had better be right about its macroeconomic and banking assumptions because the Fed has in essence replaced market judgment with its own. This was surely tempting given how far wrong markets steered the economy and financial stability, but any sailor will tell you that over-correction is at least as dangerous as letting the winds blow you where they may.

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