Federal Financial Analytics, Inc.

# MEMORANDUM

**TO:** Federal Financial Analytics Clients

**FROM:** Karen Petrou

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As a *New York Times* op-ed today has it, ultra-low or even negative rates are just what's needed to stoke growth and increase equality. The Fed in fact buys into this narrative, at least to a point. The problem with it is that an increasing body of evidence shows it ain't so.

Earlier this week, we assessed a new IMF study that, while not taking direct aim at the Fed, nonetheless shows clearly that the Fed's new "make-up" policy will be at least as disequalizing as the ultra-accommodative policy that came before. The IMF's paper is, like all too many, model-based and thus dependent on both the validity of the model and the soundness of the assumptions on which its theorizing is premised. However, its internal logic is persuasive and, lest there be any doubt of it, a new Federal Reserve Bank of Boston empirical study provides a chilling case study of precisely why things don't always go the Fed's own theoretical and model-driven way.

Indeed, as we pointed out yesterday, this study shows how ultra-low rates actually increase racial and ethnic inequity. Systemic racism is surely not the Fed's fault; still, it doesn't have to help, no matter how accidentally and unintentionally.

As expressed most recently at the Federal Reserve Banks' racial-equity conference last week, the Fed believes that ultra-low rates advantage low-and-moderate income (LMI) households and thereby many minority ones due to enhanced employment opportunity. This is to some degree the case. However, as a forthcoming FedFin ***EconomicEquality*** blog post will demonstrate, the putative gains evident in the most recent Fed Survey of Consumer Finances show little income equality in return for continuing wealth inequality due to negligible returns on any effort to save for the future. A bit of wage improvement thus is lost at considerable cost to financial security.

The Boston Fed's paper goes farther by demonstrating how ultra-low rates adversely and directly affect racial and ethnic wealth equality. Another of the Fed's defenses for ultra-accommodative rates is that these reduce borrowing costs that then give LMI families improved odds for financial security and even consumption equality.

There is little evidence that ultra-low rates transform the high cost of credit card, payday, or installment lending for LMI and minority households. Even more important, though, is LMI access to mortgage refinancing when rates fall. As the Boston Fed paper shows, hundreds of billions of family wealth hang in the balance.

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This study shows that, while the difference between the interest rate paid by Black and Hispanic borrowers differs only a little – albeit all too much – from those of white borrowers at mortgage origination, they quickly widen to a 35-45 basis point gap as white borrowers refinance higher-cost loans to gain the benefits of lower interest rates. One might argue that this refi gap is due to higher minority-borrower credit risk, but the Boston Fed paper is devastating when it takes on this bit of conventional wisdom.

While Black and Hispanic borrowers are nominally more than twice as likely to default on their mortgages as white borrowers, this difference disappears and even reverses when critical underwriting criteria – e.g., income, credit score, home equity, etc. – are taken into account. Black and Hispanic borrowers are thus at worst no riskier than like-kind white borrowers and in some cases less so.

Other studies have shown that low rates do not advantage lower-income, creditworthy mortgage borrowers seeking to gain income by virtue of a mortgage refinancing. Where the Boston Fed study goes farther is in its direct attack on the link between "expansionary" monetary policy and increasing economic inequality. It shows that the refi gap based on race and ethnicity began when the Fed started large-scale asset purchases – i.e., QE – in 2009 and never looked back. It of course could be that many other GFC factors – i.e., all the new rules – widened the refi gap. It seeks to test for other explanations and finds only QE at the heart of the refi gap, but the paper does not include the contemporaneous tightening of mortgage-credit underwriting standards along with the start of big-bank stress testing in 2009.

To us, it seems more likely that persistently low rates combined with tightened credit underwriting that failed fairly to evaluate like-kind borrowers combined with QE's market distortions to widen the gap from 2005 through 2020, when the paper's data stops. A very troubling *Bloomberg* story yesterday showing unprecedented refi gaps due to minority status makes it clear, though, that what was is even more the case now despite the record-breaking refi boom. God willing it doesn't get worse.