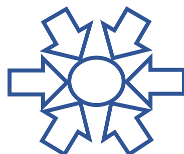

Inflation, Inequality, and the Problem This Time: Monetary Policy and Its Discontent

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Updating prior analyses of the impact of Federal Reserve policy on U.S. economic inequality, this paper shows the causal link between still more ultra-accommodative policy after 2020 and even worse income and wealth inequality. The Fed's official response to prior assertions of these causal links is described and rebutted, bringing discussion forward now also to address why inflation has risen so high so fast and its likely inequality impact. Key to this analysis is a comparison between monetary policy in 2022 and in the relatively equal 1980s when financial intermediation depended almost entirely on regulated banks and depositors still received a positive real return even on small savings. Now, intermediation is stymied, small savers earn deeply negative rates and economic inequality blocks monetary-policy transmission, heightens financial instability, and is immediately and adversely affected by inflation. I conclude by saying that my prior recommendations for gradual normalization may no longer remedy these structural flaws due to embedded financial-market and macroeconomic factors. I thus propose a new system of automatic stabilizers governing Fed's market interventions. These would preserve Fed independence but require a focus on shared prosperity, not just financial-market return.

When I finished my book in June of 2020,[1] the top one percent in America held 30.4 percent of U.S. net worth. As of the third quarter of 2021, it held 32.1 percent, increasing its share 5.6 percent to a total of $43.94 trillion.[2] Wealth for the bottom fifty percent was up 73.6 percent over this time period, with its share of U.S. wealth increasing from a measly 1.8 percent to a not-exactly munificent 2.5 percent or $3.42 trillion.[3] In 2021, the average income of a member of the top one percent was $1.4 million, 13 times that of someone in the middle forty percent, who on average earned $78,400.[4] This too was up a bit from 2020 based on weekly wage data.[5] However, these minimal gains – often cited by the Fed to validate its policy – largely washed away even under the low inflation preceding current, sharp rises hitting the most vulnerable with the greatest ferocity.[6] Thus, even though low-, moderate-, and middle-income households may seem to be doing a bit better in absolute and/or nominal terms, they are falling farther and farther behind in the real ones that matter the most.

Questioned directly about my book in recent Congressional hearings,[7] Chairman Powell grew angry. He denied that Fed policy drives financial markets in ways that favor the rich, asserting also that low-wage workers have done well by ultra-low interest rates.[8] In this talk, I'll respond, updating my assessment of the inequality impact of post-2010 U.S. monetary and regulatory policy also to take inflation into account.

We already know that economic inequality is inimical to economic growth[9] and financial stability.[10] We also know that inflation makes it even harder for lower- and even middle-income households to gain an economic foothold when, as now, most of them are living paycheck to paycheck. Thirty-seven percent of Americans now say that even a "surprise $100 expense would make them anxious."[11] What we don't know is how inflation above target levels interacts with these already-dangerous factors.

I will show that we should be very, very worried. Not only will growth slow, instability worsen, and families suffer, but I think the combination of inflation and structural financial-system transformation in recent years will further sever the financial-intermediation lifeline. Should this occur, there may well be a vicious negative feedback loop of slow growth, financial instability, and personal hardship unless the Fed balances its plans for long-overdue policy normalization with an astute understanding of how unequal economies behave under the stresses sure to redouble in 2022 and beyond.

The Inequality Engine

Let me say first that my book does not lay the responsibility for economic inequality solely at the feet of the Fed. I say there and now that there are indeed demographic, globalization, fiscal, and other inequality causes. But the Fed has an important -- albeit unintended role. Given inequality's noxious impact, it must be redressed wherever possible and it's possible via the Fed.

Despite a growing body of research to the contrary, many – the Fed most emphatically included – still refuse to admit that financial policy affects economic inequality. Questioned frequently about this on the Hill, Chairman Powell also says that the Fed's mandate limits it to a narrow, pure employment and price-stability mission, referring all inequality matters back to Congress and the Administration on grounds that only fiscal policy has an equality impact. The Fed is, he says, a neutral, data-driven authority doing a darn good job under its mandate within the boundaries fiscal policy sets for the economy as a whole. In short, even if financial policy has distributional impact -- which he says it doesn't -- fiscal policy is the only possible clean-up squad.

But, as I have shown in another recent paper,[12] monetary policy has taken on such scale and drives the markets so inexorably that it out-guns even the super-stimulus Congress has authorized in Covid's wake. Further, the Fed's oft-cited apologia – that its dual mandate allows it only to seek maximum employment (whatever that is) and price stability (should we have any) – is incorrect when judged not just within the narrow confines of the Federal Reserve Act, but also of the law governing that Act: the Full Employment Act of 1946 as amended over the years.[13] We thus cannot let the Fed off the inequality hook on grounds that its power is limited or that its mandate is targeted or that it's done very well by any of the tasks Congress has set for it.

Indeed, how could the Fed not have an impact on economic inequality when economic equality is fundamentally about who has how much money and the Fed is the nation's monetary-policy powerhouse. One analyst calculates that the Fed printed more money in the two months after Covid struck than in the prior 300 years.[14] It might be just correlation that as soon as the Fed loosed quantitative easing in full force after 2010 that inequality took off. But, causation is demonstrated at every turn.

As soon as the Fed started buying up trillions in assets, financial markets took off, but macroeconomic recovery was tremulous, slow, and increasingly unequal. The contrast between soaring markets and a disastrous macroeconomy was starkest in April of 2020, when the S&P reached untold-of highs even as the Covid death rate reached its first, awful peak. Now that the Fed is talking tightening, the equity and bond markets are pushing back, correcting for some of the excesses propelled by the distorted risk premiums generated by a scarcity of safe assets at a time of lackluster growth. Money has moved into the markets not just from individual investors, but also from corporations sitting on record cash balances that, if invested in capital formation, might have generated shared prosperity. QE also required the Fed to pay interest on the reserves banks now pulling in trillions of central-bank deposits, an option initially necessitated by the crisis but now combines with the Fed's other trillion-dollar backstop, the overnight reverse repurchase program (ONRRP), to distort market incentives and helps to sever the vital intermediation cord I will shortly discuss in more detail.

Rebutting Congress about my book's findings, Mr. Powell also said that companies will invest when the private markets tell them it's the right time. How, though, can private markets say anything loud enough to contradict an investor holding assets equivalent to about one-third of GDP?[15] As a Bank for International Settlements study concluded as early as 2017,[16] QE did ten times more for equity prices than output.

The second inequality force loosed by the Fed is ultra-low rates now so far below zero in real terms that anyone with a savings account is out 6.94 percent based on current savings and inflation rates. How is it good for economic equality if those without enough money or sufficient sophistication to hold equities or bonds lose any hope of the wealth accumulation essential for a down payment, financial security, or a safe retirement?

It's little wonder that about twice as many African American households as white ones hold cryptocurrency[17] – no matter the risk, it's their only chance at wealth accumulation.

Mr. Powell also defended the Fed against the inequality impact of ultra-low – and even negative – real rates by saying that ultra-low rates spur employment, but employment actually began its rise in the last decade right as the Fed nudged rates up a bit in 2015.[18] And, as my book makes clear, employment

judged without regard to labor participation is a poor indicator of actual employment – labor participation is an artifact of the reason people seek employment: wages. It's usually not all that much fun to hold a lower-wage job or, for that matter, any at all. Wages haven't budged for the middle class since 2001 when judged in real terms[19] and household income is up only because more family members are working.[20]

Mr. Powell also defends the Fed with assertions that low rates are good for lower-income borrowers. However, mortgage refinancings go disproportionately to wealthier, white households,[21] lower-income borrowing often comes from high-cost sources such as payday lenders, and – no matter the rate – even middle-class households are highly leveraged. The latest data show that those with wealth below the fifty percent median have non-mortgage debt equal to 166 percent of the value of their durable assets.[22]

The third inequality driver over which the Fed has considerable control is the combination of its continuing decision to backstop financial markets even as it regulates banks out of key segments of the banking system. I am emphatically not calling for a relaxation of the big-bank rules implemented after the great financial crisis. What I am saying is that the combination of scare supplies of safe assets, ultra-low rates, markets that never go down much without Fed intervention, and regulatory costs that redefine banking mean that nonbanks and, increasingly, tech-platform companies play an ever more critical role in delivering core deposit, loan, and payment services often at cost to financial inclusion, safety and soundness, and monetary-policy transmission.

Inflation's Dangerous Impact

As I've said, the Fed is obdurate: it says that the central bank doesn't affect economic inequality and, all things considered, the macroeconomy is in pretty good shape despite Covid's ghastly impact. This puts it dangerously out of step when the macroeconomy is judged by inclusive measures such as the labor participation rate, real wages, capital formation, the current state of the marginal propensity to consume, the sharp drop in financial intermediation, and the wicked combination of financial-market transformation and fragility. However, to this toxic mix and surely in part due to it we must now add inflation at rates not seen in forty years.

Quite simply, nothing we know about inflation then tells us what will happen now because America in the 1980s had a still-robust middle class and an economy that relied almost exclusively on regulated financial intermediators which were then an efficient transmission channels for monetary policy. Now, we don't.

Although monetary policy even then created a deep, deep recession, a middle-class economy is more resilient to stress than the unequal one we have become. Paul Volcker radically raised interest rates in the 1980s to curb inflation. Despite this, savings rates as represented by CD rates nonetheless stayed well above real negative thresholds throughout virtually all of the 1980s inflation spike.[23] The only competitors to bank deposits then were money-market funds, which grew exponentially at the time but were still only a minimal deposit substitute for the wealthiest households.

Now, savings rates are really, really negative for the average saver and MMFs and open-end funds are viewed by investors large and small as higher-yielding cash-equivalent holdings. This is a perception validated by the Fed's rescue of the sector in 2008 and again in 2020 and by the ONRRP's giant MMF

backstop. The SEC's reform proposal[24] acknowledges this and may dim a bit of the cash-equivalent luster of prime institutional funds, but the sector is now a powerful alternative to bank deposits. Indeed, because of capital pressures, banks are now discouraging deposits and sending them over the transom to MMFs in their asset-management divisions.

In sharp contrast to investment funds, the purpose of banks has long been to transform deposits into loans – i.e., to provide financial intermediation. This is seen as their raison d'être going back to Adam Smith[25] and is now known as the "modern theory of financial intermediation"[26] atop which rests the entire theoretical and policy construct of the increasingly outdated U.S. bank regulatory framework. Resilient financial intermediation is not only essential to financial stability, but also to macroeconomic growth.[27] This is not without risk, as banks all too often prove at far too much cost. But, the transformation of deposits into less regulated investments such as MMFs or wholly-unregulated holdings such as cryptocurrency combine the worst of risk-taking with the least of financial intermediation. Yes, open-end funds often invest heavily in corporate debt, but this is also often the riskiest debt originated without the incentive alignment born of having capital at risk.

An era of negative real rates and unregulated market choices has thus turned depositors into investors or speculators and who can blame them? However, this transformation cuts the vital cord that ensures through-the-cycle financial intermediation and, thereby, stable growth founded on capital formation. When deposits are turned into MMF or mutual-fund investments, they go to institutions that are far less efficient financial intermediators than fractional-reserve, regulated banks. When deposits turn into cryptocurrency, they go God knows where.

Conclusion

That, though, was then. What I'd like to address now is now, a time when the Fed finds itself in an almost-impossible monetary quandary entirely of its own making. As the last set of FOMC minutes makes clear[28] even this august body has no insight into what the planned course of quantitative tightening or rate increases may mean for markets or the macroeconomy.

The Fed's insouciance to worrisome inflation last year also suggests that its overall forecasting skills have failed. In my book, I show that one reason for the continuing blockages to monetary-policy transmission and thus also for forecasting mistakes is the failure to take account of inequality's structural impact. That remains an urgent fix the Fed must quickly undertake, but the combined impact of inflation, current policy and inequality must be rapidly redressed, not await another multi-year, theory-based policy review.

What then to do?

Clearly, the Federal Open Market Committee doesn't know. Its last report argued for rapid reduction of the Fed's huge portfolio even as members differed about what that might entail for economic growth and financial stability.[29] Had the Fed normalized faster when it touted the "good place" it claimed it crafted from 2015 through 2020,[30] it would have had some tools in its kit with which to confront the combination of inequality, inflation, and uncertain growth in the midst of a relentless pandemic.

Indeed, inflation might well have been less because the money supply would have been smaller, inequality would have been less pernicious, household savings would have been remunerative in real terms, market risk premiums would be at least slightly more realistic, consumer demand would have been greater over a sustained period, and more constant supply to meet demand would have ameliorated at least some of the current asset-price bubbles and supply chain shortages.

If the economy were not so unequal due in part to all these previous Fed decisions, then fiscal policy would not have to be as super-simulative and inflationary pressures would be more subdued. If fiscal policy was less inflationary and middle-class households more prosperous, then consumption might be better geared to capital formation and output better shared across the income and wealth distribution.

The Fed has tried to have its cake – claiming the economy is robust, employment maximum, and prices stable – and eat it too-- hoping to secure financial-market stability by retaining market-distorting policies that accelerated economic inequality. This negative feedback loop is now a vicious cycle.

In my book, I urged rapid policy normalization combined with a regulatory rewrite to revive financial intermediation within the boundaries of the safety-and-soundness rules we are forced by crises to reinstate each time we let them lapse. I also detailed a series of normalizing steps for both regulatory and monetary policy, urging the Fed quickly to abandon its focus on the representative-agent data that give it so much comfort in favor of heterogeneous data that shows the U.S. as it is and much solid research projects it may well become.

I fear, though, that it is now too late for gradual change and, sadly, Fed recognition of the need for it. For this reason, I've concluded that we need to transition from the unlimited discretion the Fed now enjoys backstopping financial markets so it also exercises its power under law to protect the family financial security that truly ensures effective monetary-policy transmission, shared prosperity, and financial stability.

To do this without destroying Fed independence, we need a system of automatic stabilizers that stipulate how the Fed may intervene in the financial market above and beyond its usual open-market operations. I spelled out one such stabilizer – a "Family Financial Facility" in 2020[31] and I am now thinking through how best to establish several others for different acute-risk scenarios. In the rest of this discussion, I look forward to the astute views of my distinguished discussants and those from all of you.

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