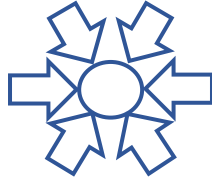

Inflation, Inequality, and the Inexcusable: Fixing the U.S. Economy and Its Discontent

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- No matter what the Fed says about our "robust economy" and in spite of its pledges to tackle inflation, the overwhelming majority of Americans say the economy not only doesn't work for them, but also sets them back. Opportunities to prevent this have passed even though chances to do so were plentiful.
- Monetary policy out-guns fiscal policy, contributing to the slow, highly-unequal recovery of the 2010s, the extra-unequal burst after 2020, and what may now prove a "jobful" recession in concert with acute inflation.
- The Fed blames its persistent policy failures on the birth of a "new economy," but the economy since at least 2000 is characterized most importantly by acute economic inequality that the Fed consistently fails to factor into its monetary-policy projections and resulting actions. These accelerate and exacerbate inequality.
- The mission of central banking is to serve the public good and there can be no public good in the absence of shared prosperity. The Fed must and can quickly change course via better data, a lighter market hand, higher rates, and equitable interventions.

It is a pleasure to join so vigorous a group of advocates for much that is not in their own self-interest. Your dedication to the public good is vital not just to informed debate, but also to positive action for shared prosperity. I would thus like today to add a new issue to your agenda: equitable monetary policy.

As I understand it, most of your focus has been on fiscal policy, looking in particular at progressive taxation and wage equity. These are critical, but I fear that even if you got everything you want in terms of policy changes, you won't get what you want and we all need in terms of the public good. This is because monetary policy has come to out-gun fiscal policy when it comes to driving not just macroeconomic growth, but also who gets the benefits of whatever growth America musters.

In my talk today, I will briefly outline why monetary policy matters so much, turning next to how it's gone so wrong. I know many of you have read my book, *Engine of Inequality*, which details how the Federal Reserve inadvertently, unintentionally, but unequivocally exacerbated economic inequality from 2010 through 2020. I'll briefly recap key arguments, bringing them up to date in light of even worse inequality in the midst of still-malfunctioning monetary policy.

Finally, I'll turn to what can be done as quickly as possible to make monetary policy a force for shared prosperity, not for accelerating inequality. My book has two chapters of policy solutions, but some of them are already anachronistic because the Fed didn't change course when it could. Had it begun to "normalize" immediately after the 2020 crisis eased as I recommended, growth over the last two years would not have been as unequal and inflation would be within more manageable bounds. But thus it is.

These solutions are technical – the Fed must use data that reflects distributional reality, not abstract models formulated decades ago. But they're also radical – in day-to-day decisions and especially in the next financial crisis, the Fed should not confine its support only to financiers; it can and should backstop households and small businesses to ensure grassroots resilience, not just mountaintop retreats.

Monetary Policy's Power

There is no question that the power of the taxpayer's purse is formidable when it comes not just to stimulating or dampening growth, but also deciding who gets access to the public wealth housed in the funds controlled by Congress and the White House. However, it would take confiscatory taxation combined with historic social-infrastructure investments to muster the power for economic change now controlled by the U.S. central bank.

A chapter of mine in another recent book provides more background on the Fed's *de facto*, high-impact fiscal role.[1] In simple terms, the two most important forces determining economic equality are the extent to which low-and-moderate income (LMI) households see appreciable wage gains or government transfer payments and whether wealth grows from accumulated savings and home ownership or from financial-market investment. Fiscal policy in part determines take-home pay, transfer payments, and federal subsidies for housing and other income or wealth generators. It thus has a significant role firing up U.S. output and determining who gets its result.

However, other than the direct impact of near-term income supplements or changes to tax law, fiscal policy takes time to take hold. In contrast, the Fed now overwhelms fiscal policy's long-term impact by driving much, if not all, of what the private sector does every day with every dollar. The Fed's hand is

now not only the heaviest in the market, but also the one with the greatest power over the short-term decisions that lay the foundation of the longer-term investment and growth fiscal policy seeks to foster.

Although the Fed has belatedly begun to reduce its huge portfolio, its policy of "quantitative easing" (QE) gave it a portfolio of almost $9 trillion of Treasury bonds and agency mortgage-backed securities[2] equivalent to about one-third of U.S. gross domestic product.[3] This "monetization" of federal obligations was supposed to spur bank lending to support economic growth, but it actually stoked market frenzy because investors were unable to find safe assets and instead engaged in "yield-chasing" across financial markets. The Fed's portfolio did ten times better for equity prices than output by 2016,[4] and it's grown only larger since.

Although the Fed is now embarking on quantitative tightening (QT) to reduce its portfolio by sizeable amounts, it has sole discretion to halt QT at any time or start it back up again. It thus cannot be considered a sin of times gone by and continues to require correction because, combined with ultra-low interest rates and slow growth, the Fed portfolio sparked greater wealth inequality, a housing boom for those who already had a house, and a blizzard of capital-distribution – not capital-formation – decisions by the nation's largest companies.[5]

Quite simply, anyone who saves is treading water backwards. At current interest and inflation rates, anyone who follows "good advice" and puts money in the bank is earning a rate of at least minus eight percent. No wonder lower-income and minority households are disproportionate investors in cryptoassets – before recent market turmoil, many had no other hope of a positive return on hard-earned savings and those provided by post-Covid fiscal policy.[6]

The Inflation Effect

The Fed's profound impact on inequality may seem puzzling because the Fed's policies since the "great financial crisis" of 2008 have been extraordinarily "accommodative" – i.e., intended to stoke economic expansion. Given its power and Obama Administration fiscal stimulus in 2009, strong growth should have been the result after 2010 as the economy recovered in terms of GDP and other conventional measures. However, economic growth was the slowest ever since any post World War II recession[7] and, even with slow growth, throwing so much money into the economy via both fiscal and monetary policy should have stoked at least a healthy rate of inflation.

The Fed fully expected this and was thus flummoxed when all of its accommodation actually proved somewhat deflationary over the last decade before Covid struck. In fact, the Fed was so perplexed that it decided it was time to craft a new approach to monetary policy. Convinced that it needed to boost growth with still more powerful stimuli and that inflation was no longer a real risk, the Fed devised a new policy construct that would be ultra-accommodative because it would allow early signs of inflation to go uncorrected with tightened policy in order to ensure that growth truly took hold – what then Chair Yellen called running a "hot" economy.[8] This inflation-easy policy[9] persuaded the Fed to keep rates well below zero in inflation-adjusted terms and allowed its portfolio to skyrocket even when disquieting signs of inflation appeared early last year.

As it turns out, Fed policy failed to produce either the growth or inflation that comes with it because QE and ultra-low rates favored financial markets, not long-term capital formation and the high wages it creates which then drive demand and price increases. Post-2008 policy was predicated on old

monetary-policy transmission models in which lower rates spur more households to borrow and more borrowing spurs production of the goods and services thus financed. This virtuous circle of affordable debt and sustainable growth continues until growth is overheated, inflation rises, and the Fed steps in to raise rates, suppress borrowing, and stifle growth.

For this policy to work, the nation needs a majority of its households to have the capacity to take on additional debt that does more than lower the cost of prior debt for the goods or services the family has already purchased. Similarly, the majority of households needs to have the resources to withstand an economic slow-down so that a cooler economy does not generate a costly recession or even another Depression. But, as my book details, America's growing inequality meant that, by 2008, the majority of households had little scope for discretionary spending. Even middle-class households had debt well over 150 percent of their durable-asset holdings (i.e., cars and other goods, but not homes).[10]

Thus, the more money the Fed threw into the air by way first of ultra-low rates and, when these didn't work, QE, the more financial markets skyrocketed and the richer the rich got. The rich did increase spending, but superyachts do not support sustainable economies or lasting jobs at living wages.

In 2022, all this changed. Inflationary pressures weren't all of the Fed's making – fiscal policy in 2020 and 2021 was also super-expansionary. However, Fed policy by then had so distorted money flows across the economy that many households plowed new-found savings from fiscal largesse into financial-market speculations via meme stocks, cryptoassets, and higher-priced homeownership. Even the highest-risk corporate borrowers were bailed out by the Fed, leading investors to throw still more trillions into corporate debt that fueled still more speculation instead of funding plants, equipment, and service capacity necessary for sustained, stable economic growth and the living wages this generates.

By 2022, the combination of stimulative fiscal policy and super-accommodative monetary policy finally supported growth and even lower-income wage gains, but strong inflationary pressures also reappeared. Under its new policy, the Fed did nothing because, it said over and over again, inflationary price growth was nothing more than "transitory." However, it was clear even as early as the spring of 2021 that inflation was becoming endemic in the economy with nothing but risks for all but the super-affluent.[11] Even "modest" inflation harms lower-income families far more than Fed assumptions anticipate. A new study finds that, adjusted for purchasing power, inflation between 2004 and 2020 experienced by the lowest ten percent of workers is 71 percentage points higher than that for the top ten percent.[12]

An unequal economy does not respond with grace to all the pressures for growth fueled by fiscal policy in the presence of all the financial-market stimuli created by ultra-low rates and the Fed's huge portfolio. Higher levels of income inequality are associated with deeper, longer recessions[13] and financial crises are considerably more likely.[14] The result is the economy we have now: levels of inflation not seen in forty years, negative growth ahead of what may prove a recession, collapsing financial-market valuations exposing pockets of possible systemic risk, and a nation of even angrier voters finding it still harder to get by.

The Inequality Effect

The Fed's inflation blind spot is due to its equality blind spot. It has lately bowed to all the pressure my book and others have created to occasionally assess the equality implications of its actions, but its

approach to doing so seems always to validate what the Fed otherwise wants to do based on old models crafted when a middle class enabled the virtuous circle of effective monetary-policy transmission I mentioned a minute ago. For example, when the central bank announced its inflation-easy policy, it for the first time assessed the distributional effect of its decision – that is, whether allowing inflation to run hot for a good long while would harm LMI households.[15] The central bank decided that its approach would have no adverse effect and might even be equality-enhancing because it believed that ultra-accommodative policy even in the face of higher inflation would spur job growth and more jobs meant higher wages for LMI households that would not only overcome inflation's effect, but also position these families for long-term income and wealth equality.

High employment rates would now appear to track the Fed's prediction, but this is only if one doesn't measure employment with an eye to labor participation – i.e., all the people who have given up on finding a job. Even the latest, strong jobs data show that more people are now sitting out employment since 2020, when the workforce was at an historically low rate due to all the manifold shocks Covid wreaked on the workforce.[16] Further, jobs are only good for equality if jobs earn real wages; now, many do not, especially after taking costs such as transport and childcare into account. Even suddenly high wage gains averaging 6.4 percent[17] over the last year in the most recent data leave most workers behind when inflation nudges close to nine percent and the cost of food and energy has gone up still more.

Economists have long talked of "jobless recoveries," but we appear now to be on the brink of the first "jobful" recession if the Fed's take on historically-high employment rates is close to correct. The reason is straightforward – most families can't afford to buy more goods and services at current prices and those who sustained consumption via debt are suddenly facing insuperable interest rates. Even with jobs, families are having a harder and harder time making ends meet. Indeed, one-third of households earning over $250,000 – well into the top ten percent[18] – are living paycheck-to-paycheck and barely making it through each month.[19]

Consumer confidence has also hit an all-time low[20] and the vast majority of Americans say the economy isn't working for them.[21] Instead watching only a few preferred statistics and the models that bounce off them, Jay Powell somehow still calls this a "robust" economy even as he now frets about rising inflation.[22] And, even as he assures us the economy is resilient, he now fears that a "soft landing" may be hard to pull off.[23] Even if the economy is somehow robust and the Fed can quickly restore price stability, it's now stunningly unequal. The top one percent of Americans now controls 32 percent of U.S. wealth or $45 trillion; the bottom fifty percent have three percent or $4 trillion.[24] The median wage as of year-end 2020 was $68,000;[25] as of year-end 2021, the top one percent earned an average of $1.5 million annually and the average income for the top ten percent was $354,000.[26]

As most Americans can readily tell their central bank, this is not an economy in which monetary-policy transmission functions as it once did because the U.S. lacks the middle class it once had. Regressive taxation of course contributes to these wide equality gaps, but monetary policy is now the most powerful driver accelerating inequality. This is clear not only from all the causes I've cited, but also the stunning correlation: the rate of inequality – especially wealth inequality – skyrocketed after 2010 in concert with the Fed's decision to bulk up its portfolio and dive deep on interest rates. Fiscal policy was expansionary through the early part of the 2010 decade and again after 2017, but the Fed's heavy hand on growth, – especially equitably shared growth – pressed hard in the other, downward direction.

How to Fix the Fed

The Fed is far too important and economic inequality so pervasively toxic that change must quickly come to the balance of power between fiscal and monetary policy, with the Federal Reserve retaining its independence by renewing its service to shared prosperity, not ever-upward financial markets. This isn't as hard as the Fed now makes it look.

As I detailed in my book, a vital first step is for the Fed to stop making decisions based on averages and aggregates. It must instead recognize distributional realities, understanding for example how destructive inflation is to lower-income households and thus moving far faster to quell it. It would similarly understand that one employment number does not signify a robust economy unless labor participation rates are broad and workers are gainfully employed so that even those just starting out have a reasonable, rational hope of wealth accumulation and of children who will do better still.

After the 2020 election and George Floyd's murder, the Fed talked more about economic equality and racial equity, putting out useful studies on these issues and marshalling reams of new data. Now, the Federal Open Markets Committee needs to take this work seriously and change course accordingly.

Good data would enable meaningful models that would then better chart the course to effective, equitable monetary policy. This policy has three components: a far smaller portfolio that allows markets to decide their own fate, interest rates that reward savings and investment – not speculation, and financial-system interventions designed at least as much to protect family financial well-being and continuing financial-institution profitability. A sound financial system is vital to shared prosperity, but it isn't the only factor which ensures it – households able to make ends meet and save for the future are the only stable base for sustained growth and disciplined markets.

The Fed has repeatedly used its "13(B)" powers to safeguard financial institutions, not families. This has led to "moral hazard" – market expectations that the Fed always has their back – and profound economic hardship at households that have done their very best to get by until a crisis not of their making sets them back. I have called for a new system of "automatic stabilizers" that set how and when the Fed should act and for whom.[27] Congress should quickly turn to these if the Fed won't.

And the Fed likely won't unless someone forces it to reckon with its most important mission: shared prosperity. The Fed has historically clung to focusing on only a narrow definition of "maximum employment" and its preferred vision of "price stability," arguing that these are the only two requirements Congress has demanded of it under the "dual mandate." In fact, the Fed has a third mandate written into law – "moderate long-term interest rates."[28] The Fed is also under a broader statutory mandate to support the "general welfare."[29] Now, it always defers public-good considerations to fiscal authorities even though, as I said earlier, the Fed is the nation's most powerful instrument of economic prospects and credit allocation. It must stop passing this very big buck, read the law as Congress specified it, and take prompt action to tackle economic equality from the ground up.

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