Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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Last week, OMB issued another edict redesigning the way most of the federal government writes rules, going beyond its earlier directive to consider competitive impact now also to demand detailed consideration of the broader public good, especially when it comes to economic equality. I focused on public-good regulation in last week's memo because it is sadly alien to federal financial regulation even though, as OMB says, "the benefits and costs of a regulation are ultimately experienced by people." I grant that economists are people, but some are also people who don't like people, at least when qualitative assessment of what people need challenges the quantitative conclusions they cherish. Pending banking rules thus ignore the public good in favor of complex market constructs, rationalizing them on assertions that, whatever else befalls finance, crises are less likely. This is a methodology fraught with perverse consequences, the most important of which is that the agencies' standards will hike the risk of financial crises precisely because they omit distributional analysis.

A demand for distributional consideration is not – repeat not – a plea for the banking agencies to go easy on banks. It's a plea for them to be as sure as they can that none but banks that need to be reined in are throttled. As OMB now also says, "some alternatives may change distributional effects even without significantly changing stringency." The extent to which this is the case with bank standards is unknown because not one regulator has ever asked a distributional question carefully enough to get a coherent answer about the distributional costs needed to achieve the agency's anticipated benefits.

Is distributional analysis a road to socialism as another comment on my memo last week asserted? Of course not. Understanding income and wealth distributional results and corollary equity impact does not reallocate capital in predetermined ways that accrue only to the disadvantaged and dispossessed. Safety-and-soundness standard-setters have to make hard choices and some of these won't be in the interests of low-, moderate-, or even middle-income households. But failing to think through choices and arbitrarily ignoring distributional deliberations is not just inexcusable. It also dooms the agencies' quest to avert financial crises because unequal economies are the most crisis-prone of all advanced economies.

Is this just a hunch? No – distributional analyses tell a frightening tale.

A good deal of recent academic work demonstrates that, while financial crises may be triggered by factors such as geopolitical risk, commodity-price crashes, and wild speculation in ill-managed markets, nothing does them in with greater certainty than rampant economic inequality. Empirical and theoretical research also demonstrates that financial-crisis risk where there is acute inequality is not just due to correlation, but in fact results from causation. This isn't intuitively surprising – many studies find financial instability results from large populations of low-income households who

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must sustain consumption with debt they cannot afford under even a bit of stress. Indeed, research across decades in 17 countries based on statistical correlations of inequality, productivity, credit growth, and financial crises finds that, while productivity has a strong impact on crisis risk, widening income share of the top 1% is the most predictive antecedent to a crash even when controlling for an array of other possible causes, including asset-price bubbles with distorted risk premia.

OMB's new directive does more than describe distributional analytics – it also tells federal agencies how to conduct them, mindful as they must be not only of the benefits of economic equality and equity, but also of the fact that Congress may demand inequitable rules agencies must promulgate no matter how much they wish they didn't. OMB also recognizes that some public-good determinations are subjective and that others involve complex trade-offs with rival public goods. Its new methodology doesn't demand that all rules are equitable, just that agencies know what they are doing when rules must be inequitable.

We know from hard experience not only that prior prudential rules proved inequitable, but also that inequality breeds financial crises. Maybe there's a reason bank regulators should run these risks but they should rethink proposals very, very carefully given the inexorable, indisputable link between making economies less equal and stoking the financial crises the banking rules are meant to prevent.