Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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Last week, we sent you an analysis of a new Fed study reinforcing previous research, my own included, finding that U.S. economic inequality exacerbates financial instability. Notably, this paper added an important, novel element: the extent to which economic inequality increases the role of NBFIs and thus heightens systemic risk even more than was the case when banks ran the financial show. But does economic inequality lead to greater NBFI reliance and resulting risk or do NBFIs on their own have a still more pernicious inequality effect that makes the risk of financial crisis still more acute? In short, yes – this is a potent negative-feedback loop of prodigious power.

What makes this feedback loop reverberate so dangerously? More research is essential, but breaking down the income and wealth components of economic inequality into the key drivers of systemic risk along with the regulatory and monetary-policy determinants of financial-sector competitiveness suggests a causal connection between more inequality leading to more NBFIs and more risk leading to more inequality and still more NBFIs and then heightened financial risk and consequential inequality.

In super-short, income inequality is determined in part by wage/salary and capital (i.e., investment) income. The more income from whatever source, the better for buying what one needs and wants unless recessions, progressive taxation, or other personal or policy actions prevent the cumulative increases in income that power up spending and, still more importantly, generate wealth.

Wealth equality is judged by net worth – that is, how much you have versus how much you owe. Here, as Thomas Piketty also showed, some wealth drives more wealth unless something such as a financial-market crash, natural disaster, profligate ancestors, or steep inheritance taxation takes it away.

Translated into the NBFI question, these components of economic inequality and their cumulative effect mean that financial products that offer rich people a better rate of return than lesser-income mortals accelerate the income-inequality engine not only because even like-kind returns on saved income grow more quickly for the wealthy because they spend less relative to income, but also because returns are no longer like-kind. NBFIs, through no fault of their own, increase the equality gap because wealthier households have another ready alternative to traditional bank savings. These are MMFs and mutual funds thought to provide the same safety as a bank deposit at a considerably higher rate of return that generates more capital income compared to bank-deposit interest rates.

Is the link between NBFIs and inequality correlation or causation? U.S. economic inequality began to skyrocket after 1980 as regulatory restrictions on the interest rates banks could charge led to the invention of MMFs at a time of rising interest rates. I suspect the beginning of the NBFI boom

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initially played only a small role in burgeoning inequality. But, thanks to the cumulative power of income and wealth inequality, it was a spark in dry kindling that sparked the disastrous S&L crisis.

Thus, as the Fed paper posits, inequality fostered NBFIs in the early 1980s when anyone with a large enough minimum investment (they had them then) moved it to an MMF and these MMFs contributed to financial instability due to the competitive stress they visited unto insured depositories and the risks these insured depositories were allowed to run. In more recent years, nonbank cash-equivalent offerings have systemic power all their own because the influence of banks on financial-system structure and risk is far less than it was forty or even fifteen years ago – see 2008, 2019, and 2020.

The MMF example shows the interplay among income inequality, NBFIs, and systemic risk. The negative feedback loop also works all too well when it comes to wealth inequality.

The Fed paper also points to another systemic risk: "over-borrowing" by lower-income households that find ready lenders at NBFIs outside the reach of prudential and consumer-protection regulation. This risk has more than clear systemic and market-structure impact.

For example, much of all the incendiary mortgage borrowing in the early 2000s initially came from nonbank finance companies. They were enabled by complicit credit-rating agencies flush with AAAs, GSEs – high-risk NBFIs if ever there were any – and, in time, banks trying to hold on to what was then a core business which engaged in extraordinarily risky lending without any of their federal agencies breaking a sweat.

Bank regulators now know risk all too well, but several of the ways they seek to counter it accelerate the role of NBFIs. For example, banks trying now to keep pace with nonbanks are an increasingly-potent systemic flash point, one that capital rules have only made still more potent as banks enable private lending because lending costs too much capital. Inequality feeds regulatory arbitrage, powering up NBFIs, moving more and more risk outside the reach of regulators and official emergency backstops.

In all-too-short, income and wealth inequality put more and more households at greater risk as NBFIs offer products banks can't or shouldn't, banks chase scant profit opportunities and NBFIs recycle high-risk borrowing for the vulnerable into high-yield investments for the comfortable. Inequality gets still worse, NBFIs chase dollars, banks chase NBFIs, the financial systems become more fragile, and the macroeconomy turns still more financialized and thus more prone to booms and busts.