Fed Policy, Inequality, and Equality of Opportunity

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It is a real pleasure for me to be here at the Fed to discuss the issue of equality of opportunity. As all of you know, America has not been doing well in either equality of outcomes or opportunity. The country has obtained the dubious distinction of being the country among the advanced countries with the highest level of inequality of outcomes, and among the lowest levels of equality of opportunity. As I wrote in my book *The Price of Inequality,* the American dream is, today, to a large extent simply a myth. The life prospects of a young American are more dependent on the income and education of his parents than in almost any of the other advanced countries.

The Link between equality of income and equality of opportunity

When a few years ago, concerns about America's growing inequality surfaced, some seemed to suggest that we should not be too concerned. What really mattered, it was argued, what really had made America a great country, was its equality of opportunity. But then, upon closer examination, it turned out that we were failing there too.

For scholars of the distribution of income and wealth, this did not come as a surprise, for inequality of income and inequality of opportunity are closely linked. We can see this if we look across countries, or even if we look across counties in the United States.

Equality and Economic Performance

As Americans, we should be concerned about inequality of opportunity because it runs so counter to broadly shared values. But as economists, we should be concerned because inequality and inequality of opportunity is associated with poorer economic performance. This was, in fact one of the central themes of my book, highlighted by the title *the Price of Inequality.*

It is one of the reasons too that the IMF has put the issue of inequality at the center of its economic agenda. The IMF is concerned with helping countries achieve better economic performance, including greater economic stability. It now recognizes that greater equality and equality of opportunity is linked with improved economic performance, higher growth and greater stability. An important research topic is the channels through which these effects are realized.

That equality and economic performance can be complementary represents one of the major changes in perspectives in economics in recent decade. Arthur Okun, chairman of the Council of Economic

Advisors under President Johnson, wrote a famous book called the *Big Trade-off*, the theme of which was that we could only have more equality if we were willing to give up on economic growth. The new perspective argues to the contrary that equality and economic performance can be complementary.

What does good economic performance mean?

As an aside, I have deliberately been vague about what we should mean by economic performance. The International Commission on the Measurement of Economic Performance and Social Progress, which I chaired, unanimously concluded that GDP was not a good measure of performance. Certainly, if an economic system fails to deliver for significant fractions of its population, it is questionable whether that system should be viewed as a successful economic system.

The channels through which monetary policy affects distribution

In this talk, I want to describe the various channels through which the policies of the Fed (or other central banks) affect equality and opportunity. I should emphasize that these are under-researched topics. Upon close investigation, I am sure some of these will turn out to be more important than others. What I also am sure, though, is that the overall conclusion—that central bank policy has significant distributional effects—will stand. These distributional effects are not only important in their own right—with significant social consequences—but they can even affect the impacts of monetary policy. I commend the Fed for taking the lead in opening a national dialogue on the subject.

The distributional consequences of the failure to maintain full employment

The first, the most obvious, and the most closely linked with one of the central missions of the Fed, is its role in maintaining full employment. High unemployment hurts ordinary workers in three ways. It does so directly, not just for those who lose their jobs but also through the stress imposed on other workers as they worry about keeping their jobs. It also hurts ordinary workers through the downward pressure on wages that inevitably results, and through the cutbacks in public expenditures, especially at the local and state level, that follow from weak economic performance.

Today, there is a wide acceptance of a trade-off between inflation and unemployment, at least in the short run, and perhaps in the long run. But how that trade-off is managed can have important implications for inequality. There are two critical issues.

Uncertainty

One concerns uncertainty: we don't know for sure, for instance, the value of NAIRU, the level of unemployment below which inflation starts to increase. There are risks of targeting too low a value of unemployment—an increase in inflation; and risks associated with targeting too high a level—an unnecessarily high level of unemployment. But those different risks are borne differently by different parts of our society. (The overall risk is more complicated, as I pointed out in my Marshall lectures a number of years ago: the overall societal costs depend on the costs of correcting a mistake made at time t at later dates, and the relationship between expected costs and benefits of a marginally more aggressive policy depends on the concavity or convexity of the augmented-Phillips curve.) What I want to emphasize here is that an excessive focus on inflation stability rather than output stability itself could lead not only to a larger average output gap but also to an increase in inequality. On both accounts, societal welfare is lowered.

Asymmetries in the effects of monetary policy

It appears that the way that monetary policy has been conducted has asymmetric effects: what workers lose in the downturn they do not seem to make up in the recovery. This is related in part to asymmetric effects of monetary policy—which is more effective in reducing output than in expanding production—but is also related to the aggressiveness with which the objective of avoiding inflation is pursued. Typically, when the economy goes into a recession, real wages fall. As the economy recovers, wages start to rise. To recover lost ground, and to keep up with productivity, wages should rise significantly. But if, as this happens, the central bank, worried about the incipient inflation that this may bring about, tightens monetary policy, workers will *never* be able to make up in the recovery what they lost in the downturn. There is a downward ratchet effect. There is some evidence that such a process has been in play.

For individuals too, there is an asymmetry—the loss of a job implies a loss of human capital, and therefore expected wages going forward will be lower: hysteresis is real.

Contributing to a jobless recovery

There is one more effect of monetary policy as conventionally defined—an unintended effect, but one which cannot be ignored. Lower interest rates have two effects. They are intended to induce more investment. But they change the relative cost of capital and labor. Even though real wages have not done well in recent years, the decrease in the cost of capital (at least for those firms having easy access to funds) has been much greater. Standard micro-theory would suggest that this would lead firms to invest in more capital intensive technologies. It may (and has) paid them to invest in machines that replace even low skilled workers—e.g. the automated check-out machines at grocery and drug stores throughout the country. This can have long lasting (hysteresis) effects, evident most clearly in vintage capital models. It implies, in particular, that if we were able to restore output at time T to a given level Q*(T), the level of employment at that output will be lower than it otherwise would have been, had we not had this period of super low interest rates. To put it another way, it means that the level of output that we have to attain at time T to achieve the same level of employment will have to be that much higher. In effect, the low interest rates help create a jobless recovery. And the jobless recovery has all the adverse effects on inequality that I discussed earlier.

Of course, when there is a deficiency in aggregate demand, as there has been since 2008, it is natural that the Fed lower interest rates. This recession has been, as we all know, extreme. If the Fed focused more on increasing credit availability (rather than *just* lowering interest rates), these adverse effects might be mitigated. (I will return to this theme later in this lecture.)

In the current context, the observation of this adverse effect on income distribution is mostly a reminder of the limitations of monetary policy. It would have been far better—for this as well as other reasons—if we had stimulated the economy through fiscal policy. But that is a bigger question, for another day.

Impacts on the elderly

There is still another effect of monetary policy, as conventionally defined: lower interest rates have a particularly adverse effect on those retired individuals who have, out of prudential concerns, put much of their savings into short term government bonds. The representative agent models often used by macro-economists (or at least used before the crisis) by definition paid no attention to this and other distributive effects. Whether differences in marginal propensities to consume among different groups are sufficiently large that these distributive effects have *macro-economic* significance may be debated; but that these policies have distinctly different effects on different groups cannot. But if there are differences in marginal propensities to consume (and I believe the evidence is overwhelming that there are), then inequality affects the monetary policy transmission mechanism.

I will shortly explain, however, why traditional policies focusing on lowering interest rates may be less effective than hoped, and not *just* because of the consequences for aggregate demand which arise from redistributive effects when there are differences in marginal propensities to consume.

Older theories discussed how low interest rates helped borrowers at the expense of creditors. But that view is too simplistic for understanding the distributive effects of monetary policy in a modern economy. Increasingly, workers are relying on defined contribution pension programs, which mean that they are *very* dependent on the returns to their savings for their livelihood.

Similar effects arise, perhaps with even greater strength, with Quantitative Easing (QE). One of the main channels asserted for its effectiveness was through the wealth effect—the increase in stock prices, the benefit of which went overwhelmingly to the top 1%—one of the reasons perhaps for the relative weakness of the effect, and one of the reasons QE contributed to wealth inequality. Data on wealth ownership show clearly that the portfolios of the rich are weighed more towards equity. Lowering interest rates benefits owners of equity. There is, in effect, a transfer from holders of T-bills to holders of equity.

The importance of fixing the credit channel

One of the criticisms of QE was that much of the increase in liquidity went abroad and into increases in asset prices, and disappointingly little went into an expansion of credit. One of the reasons is that the credit channel was blocked. When the crisis struck, much of the focus of attention was on the big banks, who had engaged in such speculation. They were saved, but hundreds of smaller and regional banks were let go, institutions which were more involved in lending to real businesses, to small and medium sized enterprises. (There was a rationale for this behavior: it was natural that the Fed and the Administration focus on systemically significant institutions; but from a macro-economic perspective, cutbacks in lending of the large number of smaller financial institutions have systemic effects as well. The consequences of this unbalanced program were given short shrift.)

This is one (though only one) of the reasons that lending to SME's remained so far below its pre-crisis level years after the crisis. And the lack of flow of lending to SME's is one of the reasons that our recovery remained so anemic for so long.

In short, the Fed (like the Administration) seemed to practice and believe in trickle down economics. To me, it is not a surprise that it didn't work, and that the recovery was so weak.

The Importance of *Making markets more competitive*

Another channel through which it was hoped that QE would stimulate the economy was lowering the cost of mortgages, and increasing the prices of homes. While it almost surely had some effects along these lines, again the effects were sometimes disappointing, and again because we failed to address underlying problems in the financial system. The mortgage market is now less competitive than it was before the crisis, and the lower interest rates were typically not passed through fully to borrowers. Sometimes, it seemed a major effect of the Fed's actions in lowering interest rates was to enrich the coffers of the banks.

The failure to ensure adequate competitivity of financial markets leads to higher inequality in several ways: there are transfers from ordinary citizens to well-off banks (as a result of higher interest rate spreads and higher fees charged for services, including those associated with the running of the payments system through debit and credit cards). And if the effects of monetary policy are less effectively transmitted to consumers, the economy is less likely to remain close to full employment.

Making financial markets serve all Americans

These observations lead me to what I believe should be one of the main responsibilities of the Fed, which is *to ensure that the financial markets serve all Americans.* Too much of the recent discussions about regulatory reform have focused on preventing the financial sector from imposing harm on the rest of the economy, especially by the excesses of risk taking which brought on the 2008 crisis; too little has been about how to ensure that the financial sector actually does what it should. I have just described two examples: making financial markets more competitive and fixing the credit channel. I will describe other aspects of this positive agenda shortly, but first, I want to emphasize the importance of preventing the financial sector from imposing harms on the rest of the economy.

Preventing the financial sector from harming the rest of the economy

This is important—and it is especially important to mention this in any discussion of the role of the Fed in inequality. The worst harm that they have imposed is bringing on crises—many of our major downturns, including that of 2008, arise from financial crises, typically generated by excessive credit and excessive risk taking. Crises are particularly hard on the poor, and this crisis especially so, as millions of Americans lost their homes, their jobs, and their retirement accounts. The Fed, through its failure to fulfill its responsibility to maintain stability, bears some onus for the enormous increase in inequality that has occurred since 2008. The excessive focus on inflation, which, as I have suggested contributed to the growing inequality *before* the crisis—had an even more adverse effect: It detracted from a focus on stability. This was ironic, because the Fed itself was founded in response to the Panic of 1907—not because of a bout of inflation. The losses from the crisis—the deviation from where the economy would have been had the economy continued on its normal path and the output actually experienced—has already mounted to trillions of dollars, far larger than any cost that could have been attributed to mild inflation.

Preventing the financial sector from exploiting others

Preventing the financial sector from doing harm to our society entails, of course, doing more than ensuring that it does not act in a reckless way. We also have to ensure that it does not act in ways which exploit others—and especially exploit those who are poor. America's financial sector has excelled at this—moving money from the bottom of the pyramid to the top, and thus increasing inequality and reducing equality of opportunity. We now all know about the predatory and discriminatory lending that was rampant in the run up to the crisis. But such lending practices, though diminished, still continue, contributing to the impoverishment of large numbers of our citizens, through pay day loans, subprime auto loans, usurious credit card fees, predatory education loans, and rent-a-center and similar abusive attempts to circumvent the little regulations that we have on usury. These are problems that have been long with us. When I was in the Clinton Administration, we tried to curtail the predatory for-profit education sector, which prospered solely because of government loans and other forms of government support, including government guarantees for student loans from an equally predatory private financial sector. We failed because of the political power of the sector.

But it is not just the poor that the financial sector has exploited in ways that increase inequality. They have also exploited average Americans through non-competitive practices that have led to high fees imposed on merchants for the use of credit and debit cards. These fees represent in effect a tax that is imposed on every transaction—ironically, a transactions tax that is far, far higher than the minimal financial transactions taxes that some countries have proposed and to which the financial sector has objected so strenuously—but it is a tax that does not go to public purposes, but simply to again enrich the coffers of the financial institutions. Inevitably, the costs of these fees get shifted to ordinary consumers, and since the benefits of the high reward-high fee cards go to the rich, the effect of these non-competitive practices has been to redistribute income from the poor to the rich. Other countries central banks—most significantly Australia—have taken strong actions to curb these abusive practices, and they seem to have worked. Finally, recent court decisions in the US provide some hope that they will be curbed here too. But I cannot but remark that I think the implementation by the Fed of the Durban Amendment, the Congressional provision attempting to curb these abuses, limited as it was to debit cards, was woefully inadequate, as Judge Richard Leon concluded, even if the Appellate Court decided that such a decision was within the discretion of the Fed.[1]

[1] As a matter of disclosure, I have served as an expert witness in the litigation against the credit card companies. The most recent Court decisions have concurred with my judgment that the practices of the credit and debit card companies have been highly anti-competitive.

It would have been far better for our economy—and for inequality—if Congress had acted earlier; if when it acted, it had included credit cards as well as debit cards; and if the Fed, when it came to implement these regulations, had acted more vigorously to ensure competitive pricing.

The Fed's Positive Agenda

The Fed, as I have said, has important regulatory responsibilities, besides its macro-economic management responsibilities, and among those are to ensure that the financial system does not impose harms on the rest of the economy. I have just detailed many of the ways in which the financial sector's actions have increased inequality.

But the responsibility of the Fed is broader. There is a positive agenda—to make the financial system actually act like a competitive, transparent, financial system should, serving the interests of the country rather than just its own interests. In particular, this means ensuring that the credit channel works; that, for instance, funds are provided to small and medium sized enterprises. Access to funds for new entrepreneurs, for ambitious young people striving to get ahead, is an important way in which opportunity is enhanced. Interestingly, a couple of weeks ago when I was in China, discussing with the Premier the high level of inequality that afflicted that country, he put particular stress on this aspect of their agenda.

If the banking system is to do this, its attention needs to be redirected, from the kind of activities which were more recently the focus of its attention—such as trading, speculation, market manipulation, etc. That's why regulations like the Volcker Rule, the Lincoln Amendment (which was unfortunately repealed), and similar provisions are so important.

Ensuring access to credit

But the Fed and other regulatory agencies overseeing the financial sector have a larger responsibility. They need to affirmatively work to create a competitive and transparent financial sector focused on providing broader access to finance. This was, of course, one of the intentions of CRA, the Community Reinvestment Act, which I believe, overall, has worked.

CRA illustrates how a government mandate to lend to underserved communities can actually focus attention on a critical issue in an effective way. Once their attention was focused on lending to underserved communities, our financial sector figured out how to do it in ways that were profitable. They used their ingenuity to identify good potential borrowers, and to work with them to make sure that the businesses were a success.

Supporting community and regional banks

But there is much, much more that needs to be done and can be done. I mentioned earlier that in the crisis we paid too little attention to our community and regional banks and other financial institutions. These local banks play an important role in the development of the communities of which they are a part. In the years since the repeal of Glass-Steagall, our banking system has evolved into one that is not only more reckless, but more concentrated, with less competition, less concerned with providing finance to the small businesses of our country, and in which our community and regional banks play a less important role. But acknowledging the potential role of these banks is not an argument for allowing them to engage in the bad practices of the larger banks.

Helping create a housing mortgage market that works—for Americans and not just for the financial sector

Or consider the housing finance market. Our private system clearly failed, at great cost to millions of homeowners and our economy. I was among many who pointed out, at the very beginning of the securitization movement, the inherent flaws, related to problems of imperfect information. It is noteworthy that 8 years after the breaking of the housing bubble, seven years after the beginning of the recession, we have not been able to restore the private mortgage market. Part of the reason, I believe, relate to the inherent flaws in the securitization model that I have discussed elsewhere. But we also have to admit that for all the so-called innovativeness of the financial sector, they failed to innovate in ways which would enable ordinary American homeowners to manage the risk of homeownership. Their innovation was more directed in their ability to (to use George Akerlof's expression) "phish for phools," to identify better those that they could exploit better. There are alternative mortgage products that would be far more efficient in lowering transactions costs and managing risks, but evidently, our financial markets were not interested. In a forthcoming Roosevelt Institute Paper, we set out a set of reforms that we believe would lead to a better performing mortgage market.

I emphasize this here because nothing has done more to increase inequality of wealth and decrease homeownership rates, which are markedly down (after peaking at some 69 percent in the mid-2000s, it is now at a 20-year low, under 64 percent). The impacts have been particularly severe upon Hispanics and African-Americans.

Financing higher education

Building up our communities entails not just providing better access to credit for our businesses and families, but also enhancing opportunities for individuals to get ahead. We need a better way of financing higher education. We need to do better than just the modest proposal to provide better access to community colleges that the President has put forward. We have to provide access to the best education for which each person is qualified. We can't have a system which says that if you are poor, you can go to an underfunded community college; but if your parents are rich, you can go to a higher tier school. And we especially shouldn't have a system that allows private for-profit schools to engage in their predatory activities, taking advantage of poor Americans—with private lenders and the government complicit in providing loans that will be a noose around their necks. Australia has shown has that there is an alternative: an income contingent loan program can provide opportunity for all, enhancing societal mobility.

Concluding Comments

Let me conclude. The central theme of this talk is that no matter what the Fed does, it has an effect on inequality, for good or for bad. Given the importance of inequality in our society, it needs to pay attention to these effects. It would need to pay attention to these effects even if it saw its only mission as macroeconomic performance and stability. We are long past the day when economists could appeal to the Second Welfare Theorem, to use the jargon of economists, saying that the role of the economists is to maximize GDP and that issues of distribution should be left to others. Today, we understand why both the first and second welfare theorems are of limited relevance.

If there are these large distributive effects of monetary policy, a question naturally arises: how can we justify delegating fundamental social trade-offs to technocrats? Can we really justify the kind of independence that Central Banks seem to prize? And especially when many "independent" Central Banks seem to have been captured by the financial sector, a kind of capture that might have been more difficult if there was more accountability, or more representativeness in their boards. Was it an accident that many of the so-called "independent" central banks performed far more poorly in the run-up to the Great Recession than those who were more politically accountable? Did their independence make them more easily captured by the financial sector, which saw increased profits in the agenda of deregulation and loose regulation? There are subtle questions in institutional design that I cannot adequately address here; suffice it to say that once one recognizes the distributive consequences of central bank policy, a more nuanced approach is required.

Central banks have responsibilities both in macro-economic management and financial sector regulation. It is natural that their responsibility should embrace the latter, for as we have seen, a major source of economic instability is the financial sector.

The issues of inequality are intertwined with all the other issues that the Fed has to deal with. I have highlighted how this is true for the standard policies of macro-economic management, as the Fed faces the difficult trade-offs that it regularly confronts.

But it is especially true in the arena of regulation. For instance, if more had been done to prevent predatory lending, perhaps the economic shock would have been less; certainly, the adverse effect of the crisis on inequality would have been diminished.

It is not an accident that the innovations of the financial sector in the years before the crisis did not lead to stronger economic performance, though they led to higher instability and greater inequality. Much of the financial sector innovation, as I have suggested, centered around creating better ways of exploiting poor and financially unsophisticated individuals. Such exploitation may succeed in moving money from the bottom of the pyramid to the top, but such innovation does not provide the basis of stronger, sustainable growth. More effective regulations preventing these activities would have led to more stable growth, and more equality.

But we need to move away from just focusing on how we can prevent the financial sector from doing harm, to a most positive agenda. How can we create a financial sector that actually enhances opportunity? It would be a different financial sector from the one we have today, but I believe it is achievable, and I believe the Fed has an important role in attaining this goal.

The Roosevelt Institute, where I serve as chief economist, has been actively engaged in two research programs, one focusing on how to make our financial markets function better, the other on how to create more shared prosperity—how to reduce the country's high level of inequality and promote equality of opportunity. The two strands of our research programs are, in fact, closely related, because our flawed financial system is part of the reason for the growth in inequality. The Fed is at the center of our financial system, which is why what the Fed does is so important for what happens to inequality.

We need to realize that what has happened in the last third of a century is fundamentally different from what was occurring in the previous third of a century. Then we were in the process of creating a middle class society based on opportunity for all. Since 1980, we have been creating a society where all the benefits of growth go to a very few at the top. Median income, adjusted for inflation, is lower than it was a quarter century ago. We have moved into a negative sum world, where the gains at the top have not led to gains for all, but to slower growth overall and stagnation for the majority. The problems we have created are not amenable to small tweaks or minimalist solutions. They are simply too large. There is a need for a fundamental rethinking of the structure of our economic and legal framework and the policies by which we manage our economy. A re-examination of our macro-economic and financial policies will be an important part of this rethinking. The Fed can and should play an important role in this process. The Roosevelt Institute's soon to be issued report, *Rewriting the Rules,* provides a framework for these reforms.

In short, we can have a better performing economy, with higher growth and more equality, if monetary policy and financial regulation is conducted with an eye to the impact of policies on distribution. It is great that Janet Yellen has opened up a dialogue on this subject. Her comments on the Fed and inequality are most welcome. This conference on equality of opportunity, and the earlier Boston Fed conference on, are, to me, important signs that the subject is being treated with the seriousness that it deserves.

I congratulate you, and look forward to a continuation of these discussions, and welcome your support for this research agenda, on a subject that I believe is the most important one facing our society today.