The U.S. Federal Reserve and Economic Inequality

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Bill Nelson/January 26, 2022

How does monetary policy work?

- Traditional: The FOMC lowers interest rates, which increases aggregate demand, which lowers the unemployment rate, which raises the inflation rate.
- QE/Large Scale Asset Purchases: The FOMC lowers interest rates, which increases aggregate demand, which lowers the unemployment rate, which raises the inflation rate.
- And vice versa.
- LSAPs reduce longer-term interest rates by taking longer-term securities out of public hands, pushing up the price (supply and demand), reducing term premiums.

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How do lower interest rates stimulate the economy?

- Interest rate channel: If interest rates are lower, the return to saving is lower, so households elect to consume now rather than later. The cost of borrowing to invest is lower, so businesses and households increase investment.
- Wealth effects: Equity prices go up (including in 401Ks and mutual funds); people are wealthier, so they consume more, especially the middle class.
- Exchange rate: The dollar weakens, so it is cheaper to buy domestic goods than foreign goods.

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Who benefits?

- Unemployment is devastating for the unemployed and their families; lower interest rates reduce the amount of unemployment.
- Less important:
  - Borrowers benefit from lower interest rates.
  - Borrowers benefit from higher inflation, which reduces nominal debt.
- Homeowners benefit from higher house prices and lower mortgage rates.
- Owners of financial assets, especially equity, get wealthier, increasing wealth inequality.

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What’s the alternative?

- If the FOMC had not cut interest rates in March 2020 and not purchased assets, the ensuing Depression would have reduced wealth inequality, but at the expense of unemployment rising further from 15 percent.
    - That does not seem like a good solution for the underprivileged.
- Karen discusses helicopter money in her book, but it is not clear if she is a fan.
    - Bernanke’s (2016) shows that the Fed can use helicopter money to fund a tax cut.
    - Quarles (2020) said the Fed may need to keep buying Treasuries for some time to support market functioning given the amount of debt outstanding.
    - I don’t think this is what she has in mind.

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Petrou (2022): …Rapid policy normalization combined with regulatory rewrite…

Rapid policy normalization

- In economic models, it's the level not the change in monetary policy that stimulates (or restrains) the economy. So it makes no sense in these models to "keep your powder dry" (refraining to cut rates so you have room to cut later) or to sell assets so that you can buy them again.
- But if long-periods of easy policy are socially costly, perhaps because they reduce financial stability, maybe central banks should adopt a bias toward normalizing policy (see Borio (2021) "Back to the future: intellectual challenges for monetary policy.")

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"Regulatory rewrite" – Stress tests

- Bank losses come from multiple sources. Stress tests create stress using only one dimension: a severe recession. To be sufficiently stressful (to match historical loss rates), the recession must be implausibly severe.
  - As a result, loans to small businesses and LMI households do poorly in the tests.
  - See "Capital Requirements and their Adverse Impact on Small Business Lending" Covas (2017), "Stress Tests and Capital Surcharges Are Curtailing Lending to Small Businesses in LMI Communities" Covas and Freedman (2018), "Estimating the Implicit Capital Charges in the Stress Tests" Covas (2021).
- Banks reduce subprime lending in a recession. Stress tests assume bank balance sheets remain constant, biasing up expected losses.
  - See "Bank Stress Testing & Underserved Borrowers: Potential Distortions to Risk-Based Capital Allocations and Adverse Impacts on Underserved Borrowers," Committee on Capital Markets Regulation (2021).
- Solutions: Base stress tests on averages of multiple scenarios and a realistic path for bank balance sheets.

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“Regulatory rewrite” – Allow banks to use AI in credit underwriting.

- Credit underwriting using FICO scores is biased against those without a credit history. Machine learning and AI expand the pool of potential borrowers.
  - Removing regulatory hurdles so that banks to use AI/machine learning in credit underwriting, as nonbanks can, would increase lending to LMI communities.
  - See “Machine Learning and Consumer Banking: An Appropriate Role for Regulation,” Baer and Prakesh (2019)

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“Regulatory rewrite” – Fix APR limits on small loans; allow banks to count “Bank On” deposits toward CRA.

- As shown in Calem (2020) “Costs and Pricing of Bank-Provided Small Dollar Loans,” modest fees on small, short-term loans can result in high APRs.
  - As a result, APR limits can keep banks from offering small dollar, short-term installment loan products intended to help underprivileged borrowers build up a credit history such Bank of America’s “Balance Assist” and U.S. Bank “Simple Loan” loans.
- To help bank the nonbanked or underbanked, banks are offering deposits through Bank On initiative, a program run by the non-profit Cities for Financial Empowerment Fund.
  - The accounts generally cap monthly fees at $5 (and in no case more than $10), have no overdraft fees, offer a debit card, and have low opening deposit requirements.
  - Banks need greater clarity that certified Bank On accounts would be eligible for credit under the Community Reinvestment Act (See BPI Staff (2021).

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A discount window lending program for LMI communities.

- In “How to Design a Fed Credit Facility to Help Support LMI Communities” Nelson (2020), I describe how the Fed could use the discount window to help address income inequality.
- Using the Fed’s regular (not emergency) discount window authority, the Fed could provide slightly subsidized credit to the half of Community Development Financial Institutions (CDFIs) that are depository institutions.
- The discount window loans would be available up to the sum of the CDFIs home mortgages to LMI borrowers or in LMI communities, small business loans in LMI communities, consumer loans originated through “small dollar” programs to LMI borrowers or in LMI communities, and CRA-eligible community development loans and investments.

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