# The Hale Report

# Episode 12 with Karen Petrou

## "Inequality and the Fed"

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**0:00:10.5 Lyric Hughes Hale:** Welcome to The Hale Report. My name is Lyric Hughes Hale, and I'm editor-in-chief of EconVue and your host today, Tuesday, February 23rd. EconVue, based in Chicago, is a home for independent voices and expert analysis of critical economic issues worldwide. If you'd like to subscribe to our free monthly newsletter, please visit our site, and if you can, support us on Patreon. My guest today is Karen Petrou, co-founder of Federal Financial Analytics in Washington, DC, and our subject is inequality. Miss Petrou is widely thought of as one of the brightest minds in Washington. Her research focuses on economic policy, especially in regard to banking regulation. If you don't know her work yet, I promise you you will after the upcoming publication of her new book, "Engine of Inequality: The Fed and the Future of Wealth in America."

**0:01:08.1 LH:** A keen Fed watcher, Miss Petrou blames Federal Reserve policy for the rapid increase in inequality in the US, since the great financial crisis especially. Not only does she explain how that happened, but she also has specific policy recommendations necessary to reverse the trend. What I like about her book, especially, is that it's not only descriptive, but it's also prescriptive. Her thoughtful, iconoclastic new book comes out March 3rd, when this podcast will first air, and I promise you, it will garner a lot of attention. Karen, welcome to The Hale Report. I wish we were getting together in person, as we have in the past, in Chicago and DC, but hopefully we will again soon. Congratulations on your new book.

**0:01:57.0 Karen Petrou:** Oh, thank you so much, and thank you so much for your comments about it. I hope it does make the impact that you suggest. That's my goal.

**0:02:05.4 LH:** Yeah. I always ask our guests first how they first became interested in the work that currently absorbs them. I read that you began life as a dancer.

[chuckle]

**0:02:16.8 LH:** And coincidentally, my last guest, Bill Overholt, became interested in Asia policy by studying Filipino dance. So how did you make the leap from dance to economic policy?

**0:02:31.3 KP:** Actually, it was pretty easy. I wasn't that good at dance.

[laughter]

**0:02:36.7 KP:** Though, I was dancing, if anybody's ever seen the Alvin Ailey Dance Theater when I was... I was a pretty good high-school student, so I basically played hooky my whole last year of high school 'because I got admitted to college early and danced in their studio company, which is the entry-level company. But I realized I was dancing with phenomenal dancers, that I really probably better go to school, so I did.

**0:03:02.2 LH:** But maybe good training for a very disciplined life.

[chuckle]

**0:03:08.6 LH:** To give our listeners some context, can you describe the problem with the Fed as you see it? How unequal are we? Do we really even know? Or more to the point, does the Fed accurately understand one of its key mandates, unemployment? Is the data they utilize reflective of reality, in your view?

**0:03:29.1 KP:** No. I think, sadly, the data the Fed uses are often way off base, because they're averages and aggregates. And in a highly unequal country, as the United States has become, that's very misleading. I'm, as all of your viewers can see, I'm not young. And when I graduated from college in 1975, the United States was not equal, and we had rich and we had poor, but when you were in the lowest wage group, you still earned your share of the GDP. Your hard work, productivity was rewarded across the wealth distribution, and evenly rewarded. In 2019, the last year in which we had data, the top 1% earned over 300% of the equitable share that it earned in 1975. And of course, there have been many reasons why the United States has become so unequal, in terms of both wealth and income.

**0:04:38.5 KP:** But what's most troubling, I think, is this huge spike since 2010. Because inequality has causes, trade policy, fiscal policy, educational policy, workers' rights, you can point to a lot of things, but nothing changed. Demographics, we didn't all get a lot older all of a sudden, or a lot of us old folks didn't disappear in 2010, but something happened in 2010 and income and wealth inequality grew far worse, far faster than ever before. And the one thing that clearly changed, starting in 2010, after the great financial crisis's worst effects were behind us, was new monetary and regulatory policy. And that's what this book is about. What happened in 2010, and how could it have made us so much less economically equal and, as you said, what now we can do to change?

**0:05:36.0 LH:** Right. So are there... You focused on very much on changing Fed policy and you actually talk about financial policy. And you define that as monetary policy and Fed regulations and guidance, basically, and that's what you see as wrong. But what about, you just mentioned education. Isn't that a great source of inequality? And hasn't inequality been growing all over the world as well? For example, China. When you mentioned 1975, I was thinking 1979, when I went to China, the Gini coefficient meant that everybody there was pretty much equal, in terms of income. And of course, that has skyrocketed out of control in China as well. But... So with all of this, do you think that given the post-COVID economy, some of this will disappear on its own? Or do you think this lingering effect that the Fed policy has, will continue to increase inequality unless something else is done?

**0:06:39.9 KP:** Let me try to answer your questions. It was a great question, but there were several embedded in it.

**0:06:45.4 LH:** Right.

**0:06:45.8 KP:** First, I think the comparison to China is just really difficult to make. The United States is structurally so different, and in fact, that's true, we're very different even in the European Union. I've seen lots of studies which look at the issues of European Central Bank policy on European inequality. But it works really different than here, because for example, Europeans have very different style mortgages and interest rates through the system. So I think when you think about economic inequality, you can think about great, big things like those in Thomas Piketty's book, "Inequality", and how inequality is an engine of cumulative increase or decrease. But after you get through those big mechanical points, in a sense, you have to go country by country.

**0:07:31.3 KP:** But that cumulative power point is why I think educational policy, while really important, is not going to be as effective in quickly changing income and wealth inequality as changing financial policy, monetary and regulatory, as you rightly said. And the reason for that is quite simple. As I said, the richer you get, the richer you get. We've seen that in the United States, where riches have gone exponentially up, even since 2010. The United States became more wealth unequal just between 2010 and 2016 than ever before. We've seen this power working. And if you start with education, particularly primary education, it's going to take a generation before these better educated kids start to try to earn their equal way into the workforce. And in my opinion, we can't wait that long.

**0:08:24.7 KP:** The final point I would make about financial policy in the United States especially, is that to make the kind of changes, I think, essential to reducing inequality doesn't take new law. Congress, I think we can all agree, has not been operating at its maximum best of late, and proposing anything especially controversial or complicated moving through Congress can take years. But the Fed can change and make major changes for equality's benefit, if it wants to change. And that's what I hope in my book, I want to make it want to change. I know it doesn't want to make America unequal, but it is, and that has to change.

**0:09:05.6 LH:** So that's why you want to pick on the Fed, in other words, because they can take action more quickly than anybody else.

**0:09:12.1 KP:** Well, think about it though, economic inequality, what's it about? It's about income and wealth. That's the engine that makes us more or less equal. But what's its fuel? In economic inequality, the fuel is money. There is no agency in the United States with the power over money other than our central bank. That's what monetary policy is all about. Bank regulation, what is it about? It's about who has the money, who gets the money, how much does it cost to get the money.

**0:09:44.9 LH:** So in other words, in addition to the Fed's current dual mandates of price stability and employment, what you're suggesting is that there should also be an equality mandate. And what would that look like and what kind of data would the Fed need to be collecting in order to operationalize that?

**0:10:06.4 KP:** The Fed's current statutory mandate calls for maximum employment and price stability. You hear a lot about that from the Fed. But if you read the law, and I have a lengthy discussion about this in the book, the law says one other thing. It says maximum employment, which it defines as full employment. It defines price stability, looking not only at the indices at which the Fed focuses, but at how much does it cost to be a middle-class household and pay your bills. And then the third part of the mandate is what the law calls moderate interest rates. The law understands that when you have interest rates way too high, you have a dangerously out-of-control economy with high inflation, but it also understands that when rates are ultra-low, or as they have been since 2010, generally negative in terms of inflation-adjusted return, no one who isn't wealthy and in the stock market can save.

**0:11:08.0 KP:** We have a whole... 90% of America, even if they try to save for the future, are falling further and further behind. We have the first time ever, when you put your money in your bank, you lose money. No wonder people are getting... Economic inequality is getting worse, not better. You asked about COVID, that's going make it worse. Because the rich, those of us working remotely, those of us who have been able to buy new homes, million-dollar home prices are the highest they've ever been. But many people have lost their jobs, their companies have closed, their small businesses are shuttered, and they won't come back any time soon.

**0:11:47.8 LH:** So just to make the counterargument, I know one of the things that you've said is that you feel the Fed is too focused on the stability of financial markets, and that has helped to lead to inequality. But according to a Gallup survey, actually 55% of Americans own stock, either directly or indirectly. And now we have new phenomenon like Robin Hood, for example, and they have 13 million new customers, people who... Many of whom did not own shares before. So could it be that one of the path, if the stock market is a path to wealth, couldn't it be that we should encourage more ownership in the stock market and making people also stakeholders at all level? And thinking about the markets as well, if companies, the purpose of the markets is to allow companies to raise money for their growth and expansion, if they're less able to do so, won't that have a knock-on effect on employment, that they're able then to hire fewer people? So, I'm just taking the oppositional point of view, and just to get your response to that. Thank you.

**0:13:00.5 KP:** That is a very good set of questions. I would not look at that Gallup poll about how many Americans own stock. First of all, that shows that 45% of us don't. But most important, the top 1% of Americans own 53% of the stock in this country, financial assets. The top 10% owns 88%. So when the markets go up, wealth disproportionately accrues to the wealthy. Now that might be an avenue, even so, to capital formation, but it isn't. You've seen, because the rates have been so low, most of the money in the market is actually yield chasing and companies are not using those funds for new clients, for new employment. Growth has been tremendously weak, that's one of the amazing parts about the post-2010 financial policy, is that the Fed has never thrown so much at the economy or supported the markets as unblinkingly as it has. But even before COVID, we had the weakest recovery in US post-World War II, US history.

**0:14:12.2 LH:** Right. They talk about a long expansion, but it actually was a long weak recovery. [chuckle]

**0:14:17.7 KP:** That's exactly right. And when the Fed called the economy "a good place", that it was supposed to be till 2019 and it cited record low unemployment... Back to your original question about averages and averages, when the Fed was talking about low unemployment, it wasn't counting people who were working part-time, who used to have, hold full-time jobs, people whose wages had been badly cut, who never were earning back to what they were earning before. At that time, one out of five Americans said they wanted to work more than they did, and people who had given up on the job market were a significant portion of the economy. So the unemployment average numbers did not speak to the broad pain, even during that "good place".

**0:15:07.1 LH:** It's all about data, isn't it?

**0:15:09.9 KP:** Wages have... Real wages for the middle class in 2019 were the same as they were in 2001, but the cost of being middle class and hoping to be able to pay to keep their healthcare, and 25% of Americans in 2019... I'm sorry, 25% of middle-class Americans in 2019 were skipping medical care, they couldn't afford. That's the middle-class.

**0:15:33.0 LH:** Right. And so they don't have pricing power for their own labor. So you wonder how is inflation then going to happen under these circumstances, where you have really depressed wages?

**0:15:44.4 KP:** You need to start sustainable growth, and that is not going to come from markets running ever upward. A lot of it has to come through the other avenue of capital formation, which is stable, long-term, low-cost lending, and at ultra-low rates, and with the high capital requirements the new rules require, rightly require, but they still... Banks are very safe, but they're not banks anymore. They're not paying people a return on their deposits, because at ultra-low rates, they can't. And they're not making the kinds of loans anymore that generate economic growth because they can't afford to. That's where you see corporate lending going into the high-risk leveraged loan market, and what is it? It's paying the dividends of private equity companies. Those aren't jobs, those are dividends.

**0:16:33.8 LH:** Alright. And low interest rates don't really mean that much to people who are paying 29.99% on their credit card debt.

**0:16:42.6 KP:** That's right. The Fed likes to talk about things like mortgage refinancing, because that's a major way low-interest rates work through the economy, and they used to and we've seen that with ultra, ultra-low rates. We've seen a huge burst in mortgage refinancing, or a lot of that cash-out refinancing where people are using their homes as ATMs, which did not work all that well in 2008.

**0:17:06.2 LH:** It did not.

**0:17:07.3 KP:** But when you actually look again, you look away from total numbers and you look at parts of the number, what we call distributional data, you see that African Americans are far less able to refinance their mortgages and lower income households are still stuck in their loans. They can't refinance because they don't meet the new credit scoring requirements. All of the benefits of ultra-low rates, in terms of powering the housing market, are going to upper-middle class and upper-income households.

**0:17:36.5 LH:** So thinking back to the Fed, are you worried that the Fed is turning Japanese? That actually, we're becoming the Bank of Japan, and that the expansion in the Fed balance sheet could soon match that of Japan's, or maybe already has? But the Bank of Japan is itself a listed entity on the Tokyo Stock Exchange, and in turn, it owns the majority shares of many, many major Japanese corporations. Is that what's happening? How could that be unwound and how could the Fed's balance sheet be unwound? And is that really necessary for... Is it necessary for quantitative easing to end in order to create more equality, long-term?

**0:18:28.7 KP:** Well, there's a significant difference between the Bank of Japan and the Federal Reserve, which is that the Federal Reserve does not own corporate equity. It had toyed with doing that, but its charter ability to do that is, at best, uncertain. But the Fed's entire portfolio is just solely of treasury obligations and the bonds issued by Fannie Mae and Freddie Mac and Ginnie Mae. It owns no stock, and it doesn't play the direct role in the economy, picking and choosing, buying exchange-traded funds and all of the kinds of things the Bank of Japan has done.

**0:19:06.4 KP:** But you still have to ask the same kind of question, which is when your central bank owns, at last count, $7.5 trillion of assets, it's about half the size of the total banking system, and by some measures, are certainly going to grow, many think, to $10 trillion, if not more this year. It is taking funds out of the economy, out of the banking system, and putting them on its own portfolio in government debt, and that is crowding out private sector growth. So the phenomena is similar in that it's a huge central bank portfolio; the details are very significantly different and how the Fed's portfolio works in the economy is different than the way the Bank of Japan's does.

**0:19:55.0 LH:** Also, Japan invented negative interest rates, and what I'm wondering is if you think... And one of the things that you have advocated for is an increase in interest rates to normal levels, whatever normal is, but how do we... Given the huge debt that we're talking about in the US now, that we've taken on as a result of the stimulus and more is coming, isn't that going to cause a problem? Because how will the US service the debt? How will other country service the debt if we raise rates? And could that lead to a situation of debt defaults even with sovereign nations, do you think, along the way to getting back? How do we get back to where we started?

**0:20:42.9 KP:** Well, none of this is easy, but the Fed is not supposed to be the Treasury's banker, it should not be setting rates to support deficit spending. The fact that it is conveniently doing so is an artefact of its policies and it is making it much cheaper for the Treasury to issue debt. But if we have the Fed running both the monetary and fiscal policy sides of this country, essentially by buying up the debt and keeping rates really low, I think we're facing a structural change in the economy, and we're going to lose tremendous amount of growth, shared prosperity and dynamism. Now, it's not easy, I'm not recommending a quick increase to 5%, 6% rates. I think we would need to move very slowly and cautiously, but I would strongly contest the need for the Fed to keep rates ultra-low to pay for the deficit. That's not what it's supposed to do, and nor is it what it should do, in my opinion.

**0:21:42.8 LH:** Yeah, in your book, you talk about the doom loop. Can you explain the doom loop concept? [chuckle]

**0:21:49.1 KP:** The doom loop is a little bit different. The doom loop is what happens when private sector banks buy a big percentage positions in sovereign debt. We certainly saw then in Greece, remember when Greece was issuing loads of debt, French and German and UK banks had big positions in that, Greece began to suffer. The banks all of a sudden looked at their portfolios, and then of course, we saw the weaker Euro start to falter, and all of a sudden, banks that thought they were rock solid because they were sitting on big portfolios of sovereign debt were actually remarkably weak without the regulatory capital to absorb any of those losses. So weak sovereigns led to weak banks, which then led to the markets worrying still more about those sovereigns, which led to weaker sovereigns, which led to weaker banks, and that's the doom loop.

**0:22:43.3 LH:** That's the doom loop. Well, hopefully, we'll avoid that in the US, at least.

**0:22:47.5 KP:** I hope so.

**0:22:49.6 LH:** One of your most interesting recommendations is for a Federal Reserve digital currency, and this is a favorite topic of mine. Would the idea be to help the un-banked? I saw in an interview, you said it's not about being un-banked, it's about having no money. Or would this be a way in a period where we needed stimulus that that money could be distributed directly to people, what would be the purpose of the digital currency in terms of creating equality?

**0:23:26.7 KP:** The central bank digital currency, not my idea. There's a lot of people talking about it, as you say, we are... A central bank digital currency is not a way of giving money to people, if you think about it. The central bank right now prints our fiat currency, the dollars, but it doesn't give them to people; that's the job of fiscal policy, deciding who needs welfare, who gets social security, who pays how much in taxes. The central bank digital currency is not meant to be a wealth-transfer device, it's meant to be a new way to move money through the payment system. And some fans of central bank digital currency, including some Democrats in Congress, see it as a still broader concept in which the Federal Reserve would open something called Fed accounts, and individuals, instead of putting their money in the bank, put their money in the Fed.

**0:24:20.4 KP:** Now that might well lead to more financial inclusion, especially if people perhaps would cash their checks at the Post Office, but I think we need to to really think hard about, if people take all their money out of the bank and put it at the Fed, who makes loans? 'Cause that's when banks disappear, because that's their business. And all the money is at the Fed, does the Fed start making loans? And if so, to who? And would it only make the loans that the national government thought were good for us? I think we need to think that part of central bank digital currency through, very carefully. We do need a more efficient payment system, we need a faster payment system, and we need a more equal one. But I'm not sure we want the Fed not only owning all the government obligations in paying credit debt, but also making every loan we get. I don't feel good about that big essential government with a humongous central bank, we're not China, not yet.

**0:25:20.9 LH:** I was just going to say that is what exactly is happening in China, the eCNY, and one of the purposes, talking to somebody who was running that project, is to actually gather more data. The government would then, not private organizations, would now own that data to enable them to make better policies, for example, but also there's an element of control there that they would definitely gain, but perhaps to disintermediate some of the newer entrants into payment systems in China that have been gathering their own steam. You mentioned, too, that you're leery of Facebook's Libra, for example, which would be a digital currency controlled by a powerful private company. But how do you feel about non-central cryptocurrencies on decentralized public blockchains not tied to data aggregation or profit per se? How do you feel about crypto versus central bank digital currencies?

**0:26:28.0 KP:** I think you have to answer some other questions, I'm very intrigued with some of the ideas in which crypto creates a fiat currency denominated tokens, so that the cryptocurrency is freely exchanged into fiat currency. But you have to, from an equality as well as a financial stability perspective, answer very key questions about cryptocurrency, particularly if it's not fiat tokenized. I ask this about Facebook, for example, how does it insure payment finality? Banks do that now because they hold giant amounts of reserves at the Federal Reserve, as well as big capital bases. Now, Facebook has said that it's going to hold centralized reserves against its currency, but how much? Denominated in what? It wants Diem, the new name for Libra, to be a basket of currency. But, how many dollars, how many euros, how many yen?

**0:27:28.2 KP:** And who takes the foreign exchange risk there? Who takes the foreign exchange profit? Are they going to be there in the event that the payment system breaks down? You have to look at payment systems and the currency in them in terms of finality and certainty. Otherwise, if you get paid in Facebook's currency, you want to be able to go to the store and buy shoes in it, and not necessarily just the shoes that Facebook is advertising. There are some significant conflicts of interest buried in some of these private currency issues as well. We have a long-standing rule in the United States against the integration of banking and commerce, that's why you don't see banks making cars, and I think we want to really think hard before we have tech platform companies making money.

**0:28:16.5 LH:** Okay, I think that's very prudent. [chuckle] So the Fed can take the lead, but What can these private companies do, not only to create more profitability for themselves, but increase equality? What can the private sector do... That now, there's a huge emphasis on ESG, on environment, social and corporate governance, and that is really... A lot of investors I talk to are quite focused on ESG right now, and especially sovereign funds. Do you think that there should be another E to ESG, which would be equality? Should that be a mandate that investors…that could be woven into ESG to make it truly sustainable?

**0:29:01.1 KP:** I think equality is inherent in those ESG goals, but there are also other major goals for ESG investing. And Derek Yu and I have talked about one of the big problems we have in this country, which is slow biomedical research, and that's been hard hit by COVID. American clinical trials are just stuck, and cures for cancer, heart disease, blindness like mine are far slower today than they were a year ago, which is going mean much more suffering. We need to think about a way to speed up biomedical research in this country at the early, most critical stages before the big bio-pharma companies and venture capitals get into it, I think is a critical ESG investment issue.

**0:29:45.6 LH:** Health is wealth.

**0:29:47.4 KP:** Health is wealth, and health is also... Even if it's not wealth, it sure beats the alternative.

[laughter]

**0:29:53.7 LH:** Exactly.

**0:29:54.3 KP:** So it's a major policy goal.

**0:29:58.2 LH:** Right, absolutely. So, Karen, if Jay Powell were to resign tomorrow, he's had enough of all this, and if President Biden were to appoint you as the head of the Fed...

**0:30:12.5 KP:** No, thank you!

**0:30:12.8 LH:** Something I would support...

**0:30:14.1 KP:** No, thank you.

**0:30:16.0 LH:** What would your priorities be if you had that mandate? What were the first three things you would do?

**0:30:21.7 KP:** First thing, I would revise the way the Fed thinks about the economy. I know this sounds very geeky, and it is, but bad data will lead to bad policy. You started off by asking me, Lyric, about how the Fed measures its success, measures the economy, and this is really critically important. When the Fed says it's achieved price stability, for whom? When the Fed says, "We have maximum employment," for whom? When the Fed says, "I hope (inaudible) our interest rates," how do we measure that? I think we need to measure things with a strong equality focus, because you know what, we know, we know from a lot of research that economically unequal countries grow far more slowly.

**0:31:09.9 KP:** It's not just that we're unequal and that's wrong from a social justice, political stability, and financial stability perspective; it's also economically wrong. So the first thing the Fed needs to do is to get its head straight about how to think about the country and how to think about the success of monetary policy. Next step: Forward guidance, making it clear that it will begin to normalize as conditions warrant, and most importantly, that it will stop bailing out markets, that it will go back to its mission. The law says in Section 13 [3] of the Federal Reserve Act, that the Fed only intervenes in urgent and exigent circumstances. That's not all the time, that's not when the markets had a temper tantrum, has happened in 2013, those... If we need...

**0:32:07.2 KP:** We won't have market discipline until the markets know that they're much more on their own, and that's the third thing I would have the Fed do. Finally, I would re-write some of the rules not to deregulate the banking system. They've been the rock... If we didn't have the big bank capital requirements that we had put in 2010, in March of 2020, when the financial system blew up again, we would have been in a far worse shape. But that's an asymmetric regulatory system, regulating only banks, but more and more of the economy depends on non-banks. So the last thing I would do is move very quickly for symmetric rules, same function, same rules, same systemic impact, same systemic protections.

**0:32:53.6 LH:** Well, Karen, I think you would have a lot of votes from our listeners.

[laughter]

**0:33:00.3 KP:** I hope so.

**0:33:00.8 LH:** So I really thank you for joining us. And for everyone, if you'd like to follow Karen on Twitter, as I do, there's always something interesting, and I think it's a rare newsletter I don't include a link to one of your pieces, Karen, and also your blog, which I highly recommend, it's Economic Equality blog, which I have recommended to the groups of female economists I'm with, so I think you've got some new readers there. And of course, your new book, the "Engine of Inequality" by Wiley, available wherever fine books are sold, as they say. And do I have the date right? Is it coming out March 3rd?

**0:33:44.0 KP:** March 3rd.

**0:33:44.5 LH:** That will be wonderful. Thank you, you've given us a lot of things to think about. It's a pleasure to have this discussion with you.

**0:33:51.1 KP:** It's been an honor.

**0:33:52.4 LH:** Please join us again, we'll see how we're doing in a year post-COVID. And I'd also like to thank all the people behind the scenes who helped us, Karen, at your shop, and also EconVue, our managing editor, Ying Zhan, and our sound engineer, Sam Fu. Please join us for our next podcast during the World Bank IMF virtual meetings in Washington DC this spring. And Karen, I think that's where I first met you.

**0:34:16.9 KP:** I think it is.

**0:34:18.2 LH:** So thank you very much, everybody, for joining us. Please send any questions and we'll be happy to forward those on to Karen, but I think you'll find a lot of answers in her book. Thank you so much.

**0:34:30.7 KP:** Thank you again.

[music]