

FEDERAL RESERVE BANK OF CLEVELAND

FED POLICY, INEQUALITY, & EQUALITY OF OPPORTUNITY

Report by
Joseph E. Stiglitz
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ROOSEVELT
INSTITUTE

Joseph E. Stiglitz is a Senior Fellow and Chief Economist at the Roosevelt Institute, University Professor at Columbia University in New York, and chair of Columbia University's Committee on Global Thought. He is also the co-founder and executive director of the Initiative for Policy Dialogue at Columbia. In 2001, he won the Nobel Prize in economics for his analyses of markets with asymmetric information, and he was a lead author of the 1995 Report of the Intergovernmental Panel on Climate Change, which shared the 2007 Nobel Peace Prize.

Stiglitz was a member of the Council of Economic Advisers from 1993-95, during the Clinton administration, and its chairman from 1995-97. He was chief economist and senior vice president of the World Bank from 1997-2000. In 2008, he was appointed by French President Nicolas Sarkozy to chair a Commission on the Measurement of Economic Performance and Economic Progress. Stiglitz helped create a new branch of economics, "The Economics of Information," exploring the consequences of information asymmetries and pioneering concepts including adverse selection and moral hazard, which have now become standard tools of theorists and policy analysts. His work has helped explain the circumstances in which markets do not work well and how selective government intervention can improve their performance.

His book, *Globalization and Its Discontents*, has been translated into 35 languages, besides at least two pirated editions. He is also the author of *The Roaring Nineties*, *Towards a New Paradigm in Monetary Economics* with Bruce Greenwald, *Fair Trade for All* with Andrew Charlton, *Making Globalization Work*, and *The Three Trillion Dollar War: The True Cost of the Iraq Conflict*, with Linda Bilmes. His most recent book, *Freefall: America, Free Markets, and the Sinking of the World Economy*, was released in January 2010.

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America has not been doing well in either equality of outcomes or opportunity. We have obtained the dubious distinction of being the country with the highest level of inequality of outcomes, and among the lowest levels of equality of opportunity, compared to other advanced economies. As I wrote in my book *The Price of Inequality*, the American dream today is to a large extent simply a myth. The life prospects of a young American are more dependent on the income and education of his or her parents than in almost any of the other advanced countries.ⁱ Wages and benefits for American workers grew at the slowest pace in 33 years in the second quarter this year.ⁱⁱ

This paper addresses two issues: first, what role has monetary policy played in the creation of inequality? What are the links between what the Federal Reserve does and the country's inequality? And, second, what can the Federal Reserve do now to address inequality? What implications does the country's long-standing wage stagnation have for raising interest rates?

We will explain that the Fed has played a central role in the creation of inequality, both through its conduct in focusing more on inflation than on unemployment, and through its failure to regulate the financial system, in ways that would ensure stronger job creation. Today, the persistent wage stagnation—in the absence of any serious inflationary threat—means that there is no persuasive reason to raise interest rates; but there are strong arguments for changing certain aspects of the Fed's regulatory stance.

AMERICA'S GROWING PROBLEM OF INEQUALITY

THE LINK BETWEEN EQUALITY OF INCOME AND EQUALITY OF OPPORTUNITY¹

A few years ago, when concerns about America's growing inequality surfaced, some seemed to suggest that we should not be too concerned. What really mattered, it was argued, and 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 studying 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 strongly counters the values we share as a nation. But as economists, we should be concerned because inequality in all of its dimensions, and perhaps especially, 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*.

¹ For a more extensive discussion of the empirical evidence and the theoretical ideas, see *The Price of Inequality*, op. cit. and "Rewriting the Rules of the American Economy: An Agenda for Growth and Shared Prosperity," with Nell Abernathy, Adam Hersh, Susan Holmberg, and Mike Konczal, published by The Roosevelt Institute, May 2015. <http://www.rewritetherules.org>.

The adverse consequences of inequality are one of the reasons too that the International Monetary Fund (IMF) has put the issue 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 of outcome 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.

The view that equality and economic performance can be complementary represents one of the major changes in economic perspectives in recent decades. Arthur Okun, chairman of the Council of Economic Advisors under President Johnson, wrote a famous book in 1975 titled the *Equality and Efficiency: The Big Trade-off*,ⁱⁱⁱ 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: equality and economic performance can be complementary, not competing forces.

WHAT DOES GOOD ECONOMIC PERFORMANCE MEAN?

As an aside, I have deliberately been vague about what we 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.^{iv} One of the ways in which this standard measure is deficient is that GDP per capita describes only the *average* GDP. It says nothing about what is happening to the typical individual (e.g. median income). GDP per capita could be increasing, yet most individuals could be experiencing a decline in their living standards. There are other ways in which GDP is a deficient tool. It does not, for instance, reflect changes in security, an important dimension of well-being. As a result, using GDP to measure of economic performance would not capture the Fed's failure to ensure economic stability or a mortgage market that would enable individuals to retain ownership of their homes in the face of a severe economic downturn.

Certainly, if an economic system fails to deliver for significant fractions of its population, it is questionable whether that system should be viewed as successful. The Federal Reserve plays a central role in the functioning of our economic system. In the next two sections, we will explain how the Fed's policies have contributed to an increase in inequality and how the focus on inflation and on measured GDP has contributed to these aspects of the disappointing performance of the American economy.

THE CHANNELS THROUGH WHICH MONETARY POLICY AFFECTS INCOME AND WEALTH DISTRIBUTION

I now want to describe the various channels through which the policies of the Fed (or other central banks) affect equality of outcome 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. However, I am also sure 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, as they come with significant social consequences, but they can even affect the impacts of monetary policy on GDP as conventionally measured. The Fed and its Chairperson should be commended for taking the lead in opening a national dialogue on the subject.

THE DISTRIBUTIONAL CONSEQUENCES OF THE FAILURE TO MAINTAIN FULL EMPLOYMENT

There are two broad categories of channels through which monetary policy affects distribution. The first is the most obvious and the most closely linked with one of the central missions of the Fed: its role in maintaining full employment and economic stability. These are mediated mainly through the role of the Fed in controlling interest rates and credit availability. The Fed also plays a critical role in regulating our financial system, and how it performs this function has important effects on distribution. We will discuss these effects in subsequent sections of this paper.

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 indirectly 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 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 the Non-Accelerating Income Rate of Unemployment (NAIRU), the level of unemployment below which inflation starts to increase. There are risks of targeting too low a level 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 a later date, 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

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 in part because monetary policy is more effective in reducing output than in expanding production, but it is also related to how aggressively monetary policy avoids increasing inflation. 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 tightens monetary policy to attempt to avoid the incipient inflation this may bring about, 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.^v

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

Another component of conventionally defined monetary policy is lowering interest rates, which has notable unintended effects. Lower rates 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 pay (and has paid) 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, which 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. We all know this recession has been extreme. If the Fed focused more on increasing credit availability (rather than just lowering interest rates), these adverse effects might be mitigated.

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 paper.

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 various 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 have discussed how low interest rates help 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 arguments for the effectiveness of QE is the wealth effect, i.e. the increase in stock prices, the benefits of which went overwhelmingly to the 1%. This is 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.^{vi} 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, partly because 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 – institutions which were more involved in lending to real businesses and to small and medium sized enterprises (SMEs) – were let go. (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 SMEs remained so far below its pre-crisis level years after the crisis. And the lack of flow of lending to SMEs is partly why 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 this had some success, again the effects were sometimes disappointing 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 competition 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 running 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.

PREVENTING THE FINANCIAL SECTOR FROM HARMING THE REST OF THE ECONOMY

Traditional discussions of the Federal Reserve have focused on the role of the Fed in regulating the macro-economy through its control of interest rates. But in the aftermath of the 2008 crisis, attention has shifted to its regulatory roles. It was its failure to regulate the financial system adequately more than its failure to set interest rates correctly that led to the crisis—as both the Fed itself and most academic critics have argued.^{vii}

In recent years, the focus of regulatory reforms has been on preventing the financial sector from imposing harms on the rest of the economy. This is especially important to mention in any discussion of the role of the Fed in inequality. The worst harm that the financial sector has imposed is bringing on crises. Many of our major downturns, including that of 2008, arise from financial crises that are typically generated by excessive credit and excessive risk taking. Crises are particularly hard on the poor, and the 2008 crisis especially so, as millions of Americans lost their homes, jobs, and 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 amounted 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 will of course entail 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, especially the 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, Rent-a-Center loans, 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 higher than the minimal financial transactions taxes that some countries have proposed and to which the financial sector has objected so strenuously^{viii}—but it is a tax that does not go to public purposes, but instead to 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's—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 Durbin Amendment, the Congressional provision attempting to curb these abuses (limited as it was to debit cards),

was woefully inadequate. Judge Richard Leon concluded this as well even if the Appellate Court decided that such a decision was within the discretion of the Fed.^{2,ix}

It would have been far better for our economy and for reducing 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: MAKING FINANCIAL MARKETS SERVE ALL AMERICANS

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 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. Earlier in this paper I described two examples: making financial markets more competitive and fixing the credit channel. The broader positive agenda entails making the financial system actually act how a competitive, transparent, financial system should; serving the interests of the country rather than just its own interests; and recognizing that the financial system is not an end in itself but a means to an end: a more prosperous economy. In particular, this means ensuring that the credit channel works and that, for instance, funds are provided to small and medium sized enterprises. Access to funds for new entrepreneurs and ambitious young people striving to get ahead is an important way in which opportunity is enhanced. Interestingly, when I was in China in the spring of 2015 to discuss the high level of inequality that afflicted that country with the Premier, 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

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

² 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.

sector focused on providing broader access to finance. This was, of course, one of the intentions of the Community Reinvestment Act (CRA), which I believe has worked overall. 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 also more concentrated with less competition, that is 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

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, eight years after the breaking of the housing bubble and 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, relates 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 to (to use George Akerlof's expression) "phish for phools," that is, 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^x, but evidently, our financial markets were not interested. In a forthcoming Roosevelt Institute paper, we establish 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 have markedly decreased (after peaking at some 69 percent in the mid-2000s, it is now at a 20-year low of under 64 percent), than the poorly functioning mortgage market. The impacts have been particularly severe upon Hispanics and African-Americans.^{xi}

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 that 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 that there is an alternative: an income contingent loan program can provide opportunity for all, enhancing societal mobility.

OVERVIEW: MONETARY POLICY AND INEQUALITY

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, the Fed 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 economic jargon, 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 on 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, and to a more 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.^{xii} 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 recent 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.

IMPLICATIONS FOR FED POLICY TODAY

The ideas I have expounded thus far in this paper have some important and immediate implications for Fed policy today. In this concluding section of the paper, I will briefly describe my assessment of the economy's current prospects and the challenges faced in attaining a robust recovery; and then describe how that analysis translates into what the Fed should do both on regulatory and macro-management.

THE CURRENT CONJUNCTION

Many are pleased that the economy seems at last to be recovering, with the unemployment rate down to slightly more than 5%.^{xiii} It has been the slowest recovery since the Great Depression: the housing bubble broke in 2006, and the economy fell into recession in 2007—eight years ago. Still, the recovery can hardly be called robust: GDP is still more than 15% where it would have been had the admittedly slow growth trend between 1980 and 2008 continued, and the gap between where the economy would have been and where it is today is not narrowing.^{xiv} Median household income is lower than it was a quarter century ago.^{xv} Wage stagnation continues; indeed, as we noted in the beginning of this paper, recent wage growth in the second quarter of this year was slower than it had been in a third of a century.^{xvi} The economic crisis too had a devastating effect on median wealth and an even worse effect on those at the bottom and on African Americans and Hispanics.^{xvii} Quantitative Easing may have helped restore the wealth of those at the top, but if anything, it may have even contributed to an increase in wealth inequality.

There are other indicia that the economy is not performing well. Labor force participation is anemic. If the US had the same labor force participation among those of working age that it had prior to 2008, the unemployment rate would be much higher. The numbers of those in part time jobs because they cannot get a full time job or on disability remain highly elevated.^{xviii} (Some have argued that even before 2008, labor force participation of those in their fifties and early sixties was weak, and thus with changing demographics, we should have expected some decrease in labor force participation. Still, there has been a decline in labor force participation even among younger cohorts.^{xix} And the demographic argument, to the extent that it is true, is a description of what has happened, not a justification. The country may not be good in retraining and redeploying our human resources, especially those in their fifties and early sixties. This is a waste of resources and a mark of failure. When there were relatively few in this group, the consequences might be ignored. But as this group has grown in importance, the macro-economic and societal consequences have grown in tandem.)

Conventional diagnoses of what was wrong with the economy have clearly fallen short. These centered on the failings of the financial system, and though these failings were an important part of what had gone wrong, the country's economic travails, I believe, are deeper. The standard analysis held that the central problem was the temporary weakness in our banking system; our banks were sick, so they had to recover, and once they recovered the economy would recover. We could then continue merrily on the rosy path that we were on prior to the crisis. This reasoning led to the focus on giving money to the banks—another instance of trickle-down

economics. It also led to the view that all that was required was a short-term stimulus package to tide the economy over for the relatively short period while the banks were in recovery.

The economy, however, was not well before the crisis; it only seemed to be doing well because of the housing bubble and the consumer binge that it supported. Returning the economy to 2007 but without a housing bubble would have implied a deficiency in aggregate demand, and unless that deficiency was somehow made up for, the economy would be characterized by unemployment.

But changes since 2007 have made things worse. There are weaknesses in some of our major trading partners, notably Europe, which has sunk into recession or near-recession. Initially, Europe's monetary policy, focusing single-mindedly on inflation, gave the US an advantage: it enabled the US to use monetary policy to get a competitive devaluation. But the European Central Bank has now changed its policy, and the euro is far weaker relative to the dollar, posing an even greater competitive challenge to the US.

Moreover, US fiscal policy has, overall, been contractionary—with a loss of some half million public sector jobs, in contrast with an increase of two million jobs that would have been expected with normal expansion.^{xx}

There are, of course, always some positive trends that can be identified in growth sectors like high tech. But unfortunately, the high tech sector does not generate large numbers of jobs, and one of the country's other growth sectors—oil and gas—is facing what appears to be an extended period of weakness.

The underlying problem is that the economy is making a transition from manufacturing to a service sector economy. The magnitude of the transition has been enhanced by globalization; global manufacturing employment will be decreasing as manufacturing productivity exceeds the pace of increase in demand, but the United States will get a decreasing share of this decreasing global employment.

Such transitions are difficult. There are inherent reasons that the market does not make such transitions smoothly. The earlier transition from an agricultural to a manufacturing economy was marked by the Great Depression, and it was only through government action associated with World War II that the transition was eventually accomplished. But today, government cutbacks may be hindering the transition, especially since two of the service sectors into which the economy would naturally expand, health and education, are naturally associated with government support.^{xxi}

Transitions contribute to a weak economy because they often lead to greater inequality—those without resources get trapped into the old sectors. Because those at the top spend a far smaller percentage of their income than those at the bottom, greater inequality is associated with lower aggregate demand (in the absence of countervailing forces, like the creation of a housing bubble). The increase in inequality in the years before the crisis was one of the underlying

fundamentals leading to the “sick” pre-crisis economy. But unfortunately, the crisis, and how it was addressed, has made matters only worse. Inequality is even greater. Thus, I do not see the economy recovering quickly.

BALANCING THE RISKS

Economic policy is often a matter of second or third best. For one reason or another, the ideal tools, or even the second best tools, may not be available. And economic policy is always made in the presence of uncertainty—with different groups bearing different risks, as we noted earlier in this paper.

Given the diagnosis of the economy’s situation, the first best policy would call for a fiscal stimulus, encouraging labor-intensive investment, perhaps through an appropriately designed investment tax credit. Spending would be directed at helping the economy make the transition from manufacturing to a service sector economy and helping the country adapt to globalization. Encouraging the economy to retrofit itself in response to global warming and climate change would provide further stimulus.

But such fiscal measures are unlikely to be enacted. The burden to maintain the economy at full employment thus falls on monetary policy. There are three worries about continuing the low interest policies that have characterized the post-crisis economy: they could give rise to bubbles, or more broadly distort the financial sector; they could contribute to inflation; and they may lead to a jobless recovery by encouraging very capital-intensive investments.

I was never very worried about inflation, and what has happened during the past seven years shows that that perspective was correct. There are no significant inflationary pressures. Expansion of the monetary base would only lead to inflation if it led to excess demand; the problem with monetary policy was that it was not leading to the hoped for expansion of demand. It was conceivable but unlikely that there would be a sudden turnaround to the economy and that the banks, with all of their lending capacity, would then start lending, adding fuel to the fire. Even then, though, the monetary authorities could drain liquidity out of the system or impose further restraints (reserve requirements) that curtailed the ability to lend. Given our diagnosis, however, such a turnaround is unlikely, and a turnaround occurring at a pace that would undermine the ability of monetary authorities taking countervailing measures is even less likely.

The concern about loose monetary policy giving rise to a bubble is legitimate, but the appropriate response to such a concern is not to tighten monetary policy prematurely, but rather to take actions that mitigate the risks of a bubble and which make it more likely that more of the available liquidity be used for productive purposes. Thus, imposing obligations on those making use of the Fed window to increase lending to small and medium sized enterprises and restricting lending that might be used directly or indirectly for asset purchases would make it likely that more of the available funds went to expanding the economy. Increases in margin requirements might help prevent bubbles, or at least limit their growth.

Some of these measures might address the third concern—creating a jobless recovery. If more of the funds went to small and medium sized enterprises, there would be more job creation. Still, there are risks: good policy analysis inevitably entails a balancing of risks and undertaking measures that mitigate downside risks. To me, at this juncture, it seems clear that the major risk is that of an underperforming macro-economy, not of inflation or of a bubble. Those risks can, at least for the moment, be most effectively addressed by regulatory measures described elsewhere in this paper that would simultaneously increase the effectiveness of monetary policy and reduce the adverse effects of monetary policy on inequality. There are many instruments already within the tool kit of the Fed, and there are others that could be placed there. It might be more likely that the Fed would be given these tools if it argued publicly that these tools would increase its effectiveness.

The Fed should, for instance, have taken stronger actions to curb the interchange fees charged by debit cards. Because such fees get passed on to consumers in the form of higher prices, restricting these fees would actually have reduced inflation.

The Fed should have taken stronger actions to prevent predatory lending; such actions would help lead to a less dysfunctional financial system—there would be less moving of money from the bottom of the economic pyramid to the top. By curbing less productive and more speculative activities, banks would be encouraged to devote more of their energies and resources to constructive and productive uses. Over the long run, by discouraging excessive risk-taking, the economy would be more stable. As we have noted, it is ordinary workers who bear the brunt of deep downturns.

CONCLUDING COMMENTS

The Fed was created in recognition of the fact that market economies are not self-regulating. It was created to deal with a problem of financial instability, but over time, its mandate expanded to include full employment, growth, and inflation. In the years preceding the crisis of 2008, it lost its way: it seemed to focus single-mindedly on inflation, in the mistaken belief that doing so would ensure growth and stability. It even forgot its own history: it was not created in response to a bout of inflation, but in response to the Panic of 1907.

Today, fortunately, it seems to be regaining its footing. Many, if not most members, of the Fed recognize its responsibility for the broader management of the economy. Whether it likes it or not, what the Fed does has significant effects on inequality. We have argued further that the effectiveness of Fed policy in turn depends on many features of the economy over which it has some control, both through its macro-economic and regulatory instruments: it depends, for instance, on both the level of inequality and on the competitiveness of the financial system.

Monetary authorities should recognize that they have more tools, instruments and broader objectives than has been traditionally conceived to be the case. GDP is itself an intermediary

goal—the ultimate objective is increasing the well-being of our society. Within this broader perspective, there should be a concern about inequality both because of how it affects overall economic performance and because it affects the well-being of ordinary citizens.

Viewing monetary policy today within this broader perspective, it seems clear that now is not the time to tighten monetary policy.

END NOTES

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