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Fed 'Stimulus' Has Made Inequality Worse, Hurt Economic Growth

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It appears the Federal Open Market Committee will vote at next week's meeting to raise short-term interest rates by one-quarter of a percentage point. Never have so many waited so long for so little.

Interest rates are likely to remain at historically low levels for some time, perhaps years. It is worthwhile to consider what the economic effects have been and will likely be in the future in the context of the political debate of the 99% versus the 1%.
Fed monetary stimulus did not stimulate the economy. By almost any measure, this has been a notably weak economic recovery.

Monetary policy has certainly buoyed the stock and bond markets, benefiting the ever-decreasing percentage of Americans owning such financial assets. In doing so, the Fed's policy has done much to benefit the top 1% of the income distribution but little for the American public as a whole.

First, the ZIRP (zero interest rate policy) supports bubbles in equity and bond markets. If a bubble is a rise in asset prices that cannot be sustained, the bond market qualifies as one almost by definition.

Elevated bond prices depend on the continuation of ZIRP. How much of the elevated equity prices is due to fundamentals rather than Fed policy will be revealed after the fact. But we suspect that ZIRP has directed capital into stock buybacks, initial public offerings, and mergers and acquisitions at the expense of real productive investments.

The middle class, depending on their holding of financial assets, may benefit or lose from ZIRP. According to the Fed's 2013 Survey of Consumer Finances, the direct and indirect holdings of equities fell between 2010 and 2013, especially in the bottom half of the income distributions. Again, it's the low-income households losing to middle- and upper-income households. Additionally, the ZIRP has contributed to the underfunding of public pension plans, which will ultimately be bailed out by middle-class taxpayers.

Second, the Fed has been paying interest of 25 basis points on bank reserves that it holds since the financial crisis. With those reserves over $2.5 trillion, that amounts to over $6 billion being paid annually to banks. Many of these are foreign banks.

That payment is another taxpayer hit. The reason is that the Fed turns over to the Treasury its entire surplus left after the expense of running the central bank. Paying interest on reserves reduces that payment to the Treasury. That increases the fiscal deficit and future taxes.
The stockholders of banks are likely in the upper half of the income distribution. So, once again, Fed policy redistributes from lower- to higher-income people. And in this case, some goes to higher-income foreign citizens.

Third, when the Fed does raise interest rates, it will likely do so with some combination of the following.

It may increase the interest rate on excess reserves, exacerbating the problem just discussed. It may also pay a higher interest rate on what are called term deposits at the Fed banks. And it may increase interest rates on a special facility at the New York Fed at which the Fed borrows money from major financial firms.

That is accomplished through reverse repos. Money market mutual funds will be major beneficiaries. Perhaps some of that payment will flow through to holders of money market funds, but again, that is not to the public in general.

The Federal Reserve no longer holds Treasury bills. Thus, it cannot raise short-term interest rates as it did in the past by selling short-term, highly liquid assets. Textbook monetary policy is no longer possible.

The ZIRP has been harmful in other ways to broad segments of the population. It has punished savers and benefited borrowers. The largest borrower is the federal government. So the policy has aided and abetted the large deficits being incurred by the federal government. Once again, that increases future taxes.

In sum, Fed policy has contributed to the rise in income inequality in this country. It has also resulted in misallocation of capital in ways that will only be fully discovered when the policy is reversed.

Some have suggested that these economic maladies are the price we had to pay for economic recovery. As previously noted, however, the current recovery has been notably weak by historical standards. That is true whether measured by growth in output, incomes or jobs.
The Fed's defenders say recovery would have been even weaker had it not implemented extraordinary monetary policy. That is an unprovable counterfactual.

To even attempt a justification, the Fed's defenders need to identify why the American economy suddenly proved incapable of growing as it had in the past. Next, they would need to explain how the policy of low interest rates contributed to faster growth.

The arguments we present here on inequality are also arguments about why the recovery has been slow. The American economy is based on democratic capitalism. Economic growth typically benefits the vast majority. For those who lag behind, there are both public and private safety nets.

We now have an economic model in which the few benefit, and many lag behind. The problem of slow growth and rising income inequality are two sides of the same coin. And bad central bank policy has contributed to both.

No fundamental change in monetary policy will be signaled by one modest increase in short-term interest rates. Monetary policy will remain a drag on the economy and a contributor to income inequality.

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