INTRODUCTION

Karen Petrou is cofounder and Managing Partner of Federal Financial Analytics, a consultant firm that provides analysis and advisory services on legislative, regulatory, and public-policy issues. Known for nonpartisan analysis, Petrou has testified before many U.S. government agencies. She is frequently interviewed for expert commentary and her work has been featured in the Financial Times, Wall Street Journal, American Banker, and Marketplace. Recently, Petrou has been featured for her pro bono work developing a new financial instrument to speed treatments and cures for disabilities and diseases, starting with those that cause severe vision impairment. Karen lives in Washington D.C. with her husband Basil and guide dog, Ike.

WHY DO I CARE?

Reading Karen’s work, I see that she shares a view very similar to my own, namely that the Fed’s policies — both on the regulatory and monetary front — have been making America systematically more unequal, not only in terms of income, but especially, when it comes to wealth. That this isn’t a universally recognized phenomenon. That it still isn’t obvious to everyone working in economic policy is dumbfounding.

Karen and I also seem to agree on why monetary policy (both conventional and the post-2008 unconventional policy) has been such an abysmal failure, and this is because it is premised on two things that no longer exist: (1) banks as the primary transmission mechanism through which money moves through the economy and therefore by which interest rate policy affects the provisioning of overnight credit to depository institutions looking to lend and (2) a middle class that when interest rates drop takes out more debt to buy something like a car or a house that then fuels employment and promotes economic growth. As the middle class has decreased in size over the years, replaced...
by an overindebted cohort of people with a low marginal propensity to consume, is it any wonder that the lowering of interest rates and subsequent rounds of QE had a much-less-than-expected impact on stimulating the economy than policymakers seem to have expected? Not only that, but the unusually accommodative monetary policy we have been living with for the last decade plus has levitated the price of every major asset class and reinforced a dangerous strategy of mean reversion that is totally out of step with how markets function under normal circumstances. We are now living with the consequences of these decisions and the opportunity to reverse course has long-since passed in my view. I no longer believe the Fed can play its assumed role as guardian of financial stability, because lowering interest rates and printing money exhibits increasingly diminishing social, political, and economic returns to scale, while raising rates and contracting the balance sheet will bring about an unmanageable deflation that risks collapsing the global economy in a way that would have been impossible even in 2008. So what do policymakers do?

Well, in addition to her diagnosis of what ails us, Karen also has some policy prescriptions that she puts forward in her book. Counterintuitively, one of them is to raise interest rates, which I find rather confusing and unconvincing given the public and private debt levels, so it will be interesting to hear her explain that in more detail.

QUESTIONS:

**Background** — Q: What is your background? Q: What led you to write this book?

**Inequality Engine** — The book's central claim is that rising levels of economic inequality in the US are not evidence of the Fed’s inability to achieve its objectives, but actually a direct result of Fed policy itself; that Federal Reserve monetary policy is actually an “inequality engine.” Q: Can you walk me through the evidence that you put forward to make the claim that the Fed is an inequality engine? Q: How long has Fed policy been exacerbating regressive wealth redistribution in the US?

**Why Didn’t Fed Listen?** — Many people were telling the Fed that the liquidity firehose was a moral hazard. Q: Why didn’t they turn the spigot off sooner given how many alarms were being raised by Fed critics?

**Ghosts of Fed Past** — Q: Do you think any of the former Fed charis like Alan Greenspan, Ben Bernanke, and maybe even Janet Yellen have reckoned with the impact that their own policies have had in this respect? Q: Knowing what he knows now, do you think if Alan Greenspan could go back in time to the early 2000’s, that he would have avoided cutting rates so drastically after 9/11 or at the very least, raising them sooner and pushing for greater oversight of banks and mortgage syndication shortly thereafter?

**America’s Economic Picture** — Q: What does America’s economy look like today? Q: Can you trace the steps that got us here? Q: How much of this do you attribute to monetary policy?

...Fed’s priorities should be stated clearly in forward guidance and other official pronouncements as law demands: full employment for all; price stability not just for investors, but also for consumers; and moderate interest rates rewarding savers and encouraging sound lending. — KP
Transmission Mechanism & the Middle Class — You write that the Federal Reserve is aiming policy at a middle class that no longer exists and that therefore policy is fizzling. Q: What has happened to the middle class? Q: Why does this matter for monetary policy?

Monetary Policy & the Financial System — Q: How many people working in the financial sector actually understand how monetary policy works today? Q: How have regulatory changes altered where and how monetary policy happens? Let’s walk our listeners through the process…

Monetary Policy Assumptions — Q: What assumptions does the Fed make about the economy that inform its policy decisions?

Understanding America As It Is — Q: Can the Fed afford to focus solely on America’s economy when thinking about monetary policy considering how integrated the world is and how dependent the global economy is on the USD? Q: How should the Fed change how it measures employment if it actually wants to meet its “maximum employment” mandate? Q: How should the Fed go about measuring inflation? Q: What impact would raising the official inflation rate (presuming that current measures underreport inflation) on the government’s own unfunded liabilities like Medicare and Social Security?

Raising Real Rates — Q: How can the Fed raise real rates high enough to provide families with a savings vehicle through depository institutions without simultaneously cratering the economy and people’s ability to generate income in the short-term? Q: Have you considered the risk that such a move would create more political instability than the government is equipped to handle?

Raising Real Rates — Q: How do you expect the Fed to shrink its balance sheet back to “as small as possible under ordinary conditions” without sending the Treasury market into the greatest free-fall ever experienced in US history?

Fed & Politics — Q: How do you expect the Fed to suddenly go from being a historically apolitical body to being one that is actively setting equality goal posts through “forward guidance?”

Fed Balance Sheet Limits — Q: What determines how big the Fed’s balance sheet can get?

Market Rebellion? — Q: If the Fed commits to trying to forestall the correction indefinitely, what will it take for the markets to turn against it? Q: What will that look like?

Source of the Trouble — Q: What part of the damn is going to break first? Q: Will it be a series of failed UST auctions? Q: Is the breakout in BTC the signal that the bond market has been unable to deliver?

Source of the Trouble — Q: What is your view when it comes to CBDC’s and China’s NDCP? Q: How will monetary policy operate in such a world?
QUOTES:

The Fed must understand that the way it judges employment, price stability, and prosperity relies on aggregates and averages that obscure the reality for most American families. Relying on different data may seem like a pedestrian solution, but bad data means bad policy with unintended consequences. The Fed doesn’t want to make America less equal, but it did so in part because it mistook the mean for the median. — Karen Petrou

The reason that the Fed can’t quickly raise rates or reduce its huge portfolio underscores why it should: financial markets are now so dependent on the Fed — rather than economic fundamentals — that any monetary-policy change badly rattles the financial system. Forward guidance needs to alert financial markets to a gradual, measured shift to a more normal system in which the Federal Reserve supports the market instead of being the market. — Karen Petrou

It may seem geeky to talk about statistical mistakes, but bad data make bad policy. — Karen Petrou

Monetary policy, both conventional and the post-2008 unconventional policy, is premised on two things that don’t exist anymore: one, banks as the sole driver of how money moves through the private sector and, two, a middle class that when interest rates drop takes out more debt to buy something like a car or a house that then fuels employment and promotes economic growth. Instead, leaving the question of what the banks do aside for the moment, when the middle class is already way over its head in debt, and can’t afford a new car or is not eligible for mortgage refinancing because their credit scores are too low, those traditional signals of that theoretically resilient middle where there’s a strong “marginal propensity to consume” don’t work. — Karen Petrou

When the federal government briefly shut down, federal employees who on average make $85,000-plus a year, almost two-thirds of them couldn’t pay their rent or the mortgage after missing a paycheck. People live on the edge. And the Fed’s data do not reflect that. — Karen Petrou

Income inequality in 2019 was even worse in the US than it was during the Great Depression. Reflecting this, 37 percent of the US was at grave financial risk after only a $400 unexpected expense. Clearly, unexpected expenses poured down in waves after COVID hit, increasing the percentage of Americans who couldn’t pay their monthly bills in full by 12.5 percent between just late 2019 and April 2020. — Karen Petrou

In 2019, the average net worth of millennials was still just $8,000, far less than earlier generations at their age. When COVID hit millennials yet again, some called them the “unluckiest generation ever.” This might not be historically true, but anger across the entire US political spectrum tells us that it’s how millions feel. Even relatively wealthy Americans said that their financial position was a cause of acute stress, and that was before COVID. — Karen Petrou

Something happened after the 2008 crisis ebbed that turned inequality into a faster and still more corrosive force running through the fabric of American social and political thought. This book will show that this something wasn’t the great financial crisis itself — painful though it was, the years
between 2008 and 2010 were actually more equalizing than those that preceded them due in large part to the short-term decrease in the value of assets held by the wealthy. What happened starting in 2010 is that federal financial policy makers tried to boost the economy and redesign American banking through a series of unprecedented market and regulatory interventions. All were well intentioned but most were nonetheless still directly and demonstrably destructive to US income and wealth equality. — Karen Petrou

Assume a parent saving for a child’s education puts $2,000 a year in a savings account paying a 5 percent compound rate of interest for 20 years. At the end of 20 thrifty years, he or she has $69,438 to show for this in nominal terms. After accounting for 2 percent annual inflation, he or she has $49,598. As a result, $40,000 has earned an additional $9,598, or 24 percent. Now take that same $2,000 for the same 20 years – $40,000 – and the same 2 percent inflation. But instead of a 5 percent interest rate, the parent earns only the half of one percent interest rate paid on small savings since the financial crisis. Instead of $69,438, this parent has only $42,168. After accounting for inflation, that is only $30,120, almost 25 percent less. — Karen Petrou

Post-crisis rules may well have made US banks safer, but they have also changed the bank business model to one focused on wealth management, corporate and commercial real-estate lending, and other activities with little equality impact. Given the depth of the great financial crisis in 2008 and how close we then came to another Great Depression, it’s easy to say that banks deserve every rule they got. But no matter how justified all of this regulatory retribution, quashing the capacity of banks to take deposits, make loans, and to operate the overall financial system leaves America with two choices: do without banks and the economic growth that depends on them, or rely instead on nonbanks, including giant technology companies such as Facebook and Amazon. — Karen Petrou

The first fix is for the Fed to see America as it is, not as it was. Top Fed officials came of age in the 1970s and 1980s when America was among the most equal nations in the world. At that time, monetary-policy theory could rightly assume that aggregate data about income and wealth represented the vast majority of Americans. Now, due to American inequality, the country as a whole no longer buys goods and services or invests as old models predict. — Karen Petrou

Polarized like so much else in American discourse, the current financial-policy debate contrasts two ends of the policy extreme: government intervention in the financial market or a wholly market-driven financial system. This is indeed the contrast between socialism in full flower and capitalism red in tooth and claw. John Kenneth Galbraith once observed, “Where the market works, I’m for that. Where the government is necessary, I’m for that.”50 This is insightful, but of course also facile – it’s not hard to be for working markets and an effective government; it’s hard to know which is which. — Karen Petrou

Before COVID created its own economic catastrophe, student debt exceeded 100 percent of income for US millennials with student debt and is an astounding 372 percent of income for the least well-off. — Karen Petrou

…two young people beginning their working careers might look similar in terms of income, but the one given a large house down payment by his or her parents is a good deal wealthier and has far better long-term equality prospects than the other, who not only lacks parental support, but may well also pay large student-loan bills that cut deeply
into consumption capacity and long-term wealth accumulation. Affluent parents are a great comfort to their relatively wealthy millennial offspring, with 63 percent of them saying that their own retirement security depends on inheritance from parents, grandparents, and even friends. — Karen Petrou

37 percent of American adults (almost 100 million) feared that they could not handle an unexpected bill of only $400 no matter the seeming prosperity of late 2019. Even a small rainy-day fund is essential for household resilience, but as COVID hit in April 2020, almost one-third of Americans lacked a rainy-day fund of more than three months. — Karen Petrou

In 2007, half of all households that were in the top 5 percent of income were also in the top 5 percent of households in consumption and wealth. By 2016, 60 percent of the households with top 5 percent wealth were also in the top 5 percent of consumption or income. These gains for the top 5 percent in income, consumption, and wealth came at the expense of almost everyone else – the bottom 80 percent of households saw their share of income, consumption, and wealth fall still farther. — Karen Petrou

In 1989, the top 1 percent of Americans had 24 percent; by the end of 2019, their share was 33 percent of US wealth, with top 1 percent wealth growing nearly $3 trillion in just the first half of 2019. The bottom 50 percent did grow its infinitesimal share of the national wealth pie, bringing it up to 1.5 percent, a negligible share and a tiny increase highlighted by President Trump and the Fed even as the wealth of the top 1 percent and the 90 to 99 percent group each grew over the first half of the year by more than the total wealth of the entire bottom 50 percent. Before COVID, households in the bottom 50 percent of US wealth had about as much debt as assets, with the bulk of what wealth they have often to be found parked on the street. In 2016, the bottom half of the US had less real wealth than it did in 1971. — Karen Petrou

From the US perspective, the most interesting aspect of the global data is the divergence between Western Europe and the US. Although both were about equal from 1950 to 1980, the income divide has grown dramatically and differently ever since. As Figure 2.1 shows, in 1980, the top 1 percent in both regions controlled about 10 percent of income. By the latest data from 2016, the 1 percent's share in Western Europe was 12 percent. In the US, it was 20 percent. — Karen Petrou

“And this is where we adjust the interest rate.”
In 2008, the financial system collapsed suddenly and, to many regulators and central bankers, seemingly without warning. The “great financial crisis” that ensued wrought havoc, but by 2010 the financial system stabilized and stock markets began their upward climb. By 2013, the Federal Reserve was confident that the “Great Recession” that followed the great financial crisis had ended, with financial markets also well on their way to becoming bulletproof thanks to tough new banking rules. The US central bank thus proclaimed that all was right with the national economy and financial system even though only a tiny percentage of Americans benefit from rising financial markets, underemployment was endemic, and anyone who tried to save his or her way to a better life lost ground every day due to ultra-low interest rates.

The Obama Administration also congratulated itself on the sound economy and resilient financial system, Hillary Clinton campaigned on renewed prosperity, Americans knew more than economists about their own struggles, Donald Trump won, markets climbed higher, economic growth remained weak, and America grew ever angrier as economic inequality rose even higher. By 2020, COVID blew away every one of the foundations on which the Fed thought the economy and financial system so securely rested. A decade of rising financial markets atop acute economic and racial inequality made the US as vulnerable to an economic shock as an ill-kempt nursing home to the coronavirus.

I’m among the Americans who got angrier and angrier from 2010 to 2020 as America became increasingly unequal while well-intentioned policy-makers assured us that, as the Fed likes to say, the US economy was in a “good place.” In my day job, I analyze monetary and regulatory policy to assess its strategic impact on financial-services companies and markets, doing so for major corporations, central banks, and those elsewhere in the financial market who make or lose money based on what policy-makers do. This isn’t exactly a job in the inequality trenches, but it does afford a unique perspective on the totally perverse effect of post-2008 financial policy: acute inequality and resulting risks to both growth and financial stability.

As the 2016 campaign began, I also saw another consequence of post-crisis financial policy: voter fury about the deaf ear most financial decision-makers gave to the warp-speed disintegration of the American middle class, economic despair in communities of color, and profound distrust across what was once the US’s manufacturing and agricultural heartland. Calls resonated for policies founded on populism, nativism, and even racism – calls that turned out to be clarion to all too many because vast swaths of the US were in acute economic distress no matter the aggregate growth and employment numbers with which the Federal Reserve comforted itself.

Because my nature is one of an analyst, not an advocate, I dove into the data. As you’ll see from all of it in this book, the more one knows the hard facts of financial policy’s inequality impact, the angrier one becomes. I thus switched into advocate mode.

In 2016, I told a group of global central bankers that income inequality is the battlefield casualty of post-crisis reform, urging them to clean up their own mess, not count on changes to taxation, spending, technology, or other policies somehow to do it for them. The central bankers were receptive, but none acted. Inequality then climbed higher as post-2008 monetary and regulatory policy continued unchanged, leading me in another speech to central bankers in 2018 to make a
still more forceful case for rapid financial-policy reform. Again, central bankers listened but did no more.

This book is my answer to all that inaction, an answer made still more angry and urgent by America in the wake of the pandemic. If more small businesses had been able to access sound credit before COVID, then many fewer would have closed and many more lower-income jobs would have survived. If most Americans had been able to put aside some savings, then families wouldn’t have run to food pantries in still-untold numbers. If policy-makers had seen the extent to which the Fed’s vaunted recovery stopped far short of people and businesses of color, then the fury following George Floyd’s murder would have focused solely on racial justice, not also on demands to “eat the rich.” If financial institutions – not just banks – had been properly regulated, then Americans wouldn’t have been so deeply in debt and the financial system wouldn’t have crumpled the first day COVID’s force was felt. And if the Fed hadn’t immediately rushed in to rescue all this risk-taking, then Americans of wealth wouldn’t have become so much richer so much faster even as US unemployment numbers reached heights not seen since the Great Depression.

Economic inequality is not a curse that afflicts America because some people just don’t try hard enough or even because some politicians just don’t care enough. This book – the first to do so – will show that US income and wealth inequality grew worse faster than ever before after 2010 due to the one thing that dramatically changed that year: the way the Federal Reserve set monetary and regulatory policy. As you will see, there is a clear and causal connection between financial policy and economic inequality and breaking it is desirable, feasible, politically achievable, and meaningful as a near-term equality remedy.

It might seem fanciful to target financial policy – after all, most of us don’t even follow financial policy, let alone feel its impact in our daily lives. However, the interest rates we get at the bank or pay on our debt, the returns some of us achieve in the stock market, the financial companies we choose or are forced to do business with, and even the wages we get are the result of financial policy. As a result, financial policy controls key turbines in the inequality engine.

Financial policy is the combination of the monetary policy dictated by the Federal Reserve Board and the rules written by the Fed and financial regulators. Although ignored by most assessments of economic inequality, financial policy sets the speed and direction of the inequality engine because the inequality engine’s fuel is money and no policy moves money with more force than financial policy. When the US economy largely depended on manufacturing and agriculture, financial policy moved the inequality engine, but only a little in comparison to other causes of American economic inequality such as tax or trade policy. But when an economy is “financialized” – i.e., when growth depends in large part on financial activities, not real production – financial policy is an inequality engine unto itself: The US is a financialized economy and financial policy is thus a potent inequality force.

In the US, money thus moves where monetary and regulatory policy drives it. And ever since the great financial crisis, policy drove money to take ever more speculative bets in financial markets that know neither
risk nor bounds thanks again to financial policy. How could it have been that, the day in April 2020 that the US announced then-record COVID deaths, the S&P 500 finished its best week since 1974? As this book will show in detail, one need look no farther than the Fed, which that day also stepped in with trillions to backstop even the riskiest investments.

It’s thus clear that money determines an economy’s haves and have-nots, but how does the inequality engine powered by money work? First, the engine analogy encapsulates the lesson in the Gospel of St. Matthew: “For unto every one that hath shall be given, and he shall have abundance: but from him that hath not shall be taken away even that which he hath” (Matthew 25:29).

This scriptural injunction is in a parable some scholars read as an assessment of spiritual growth, but it aptly describes the critical finding in Thomas Piketty’s magisterial analysis of economic inequality: when financial rates of return are above that of broader economic growth, inequality speeds up in a cumulative way, just like a gassed-up engine driven by someone with a heavy foot on the pedal.

The second reason to think of inequality as a financial-policy engine is that it helps us reckon with the critical importance of taking actions that put it into reverse or even turn it off. Letting an engine continue on its course even though the course is wrong only gets us farther from our goal at speeds set ever faster by the engine’s cumulative force. To make a difference in inequality, we thus need to pick policies that make a difference as quickly as possible.

This book thus not only details how financial policy made America increasingly unequal faster and faster, but also lays out changes we can make to the engine under current law with remarkably little controversy that will quickly slow the engine and recalibrate its direction toward renewed economic equality.

Much inequality thinking proposes far grander repairs, but most are controversial, costly, and—most importantly—slow-acting. For example, reforming the nation’s educational system is indeed an important inequality fix, but it will take years before kids in a better primary school graduate from institutions of higher education and decrease family inequality. We can’t wait that long.

Because inequality is an engine with cumulative force that chews up low-, moderate-, and even middle-income families, meaningful solutions must not just be fast-acting, but also politically plausible. Changes to US fiscal policy — i.e., to taxation and spending — such as a “wealth tax” or “guaranteed income” are appealing to some in macroeconomic and social-justice terms but face long, long political odds. Financial-policy fixes to the inequality engine aren’t always optimal, but practical policy solutions to income and wealth inequality slow down the inequality engine and give us time also to make more profound structural repairs. So, what are these fast-acting, politically plausible, and high-impact financial-policy fixes? The first recrafts US monetary policy so it sets interest rates at levels I call a “living return” and retracts the Fed’s safety net from beneath financial markets. Ever since the mid-2000s, the prime directive of US monetary policy is what the Fed calls the “wealth effect,” which as its name clearly implies assumes that the wealthier a few people get, the more money trickles down to the rest of us. The wealth effect worked in one
sense – wealth has grown to prodigious heights in fewer and fewer hands – but it’s done nothing for broader, shared prosperity. This book thus posits a set of monetary-policy actions premised on an equality effect derived from ground-up Fed interventions, not top-down largesse.

You’ll see that one reason the Fed thought the “wealth effect” created a “good place” is because the Fed measures America as it was decades ago, not as it now is. When it measured employment, the Fed missed the millions holding only part-time jobs or those out of the workforce due only to lack of hope, not lack of desire to work. The Fed said that American households had growing wealth, but it ignored the fact that most of this wealth was held in fewer and fewer hands. Wage gains in which the Fed took pride resulted from more people in more families having to work more jobs, not from higher wages allowing one wage-earner to support his or her family in reasonable comfort as many of us assumed when we were kids.

And the Fed missed the fact that most American families lived paycheck to paycheck, making ends meet only via high-cost debt. The central bank touted its ultra-low interest rates as a boost to the wealth effect, but all they meant to the vast majority of American households was no hope of saving for the future. Most of the debt they used to get by also remained very, very expensive.

As we’ll see, this high debt burden, combined with the challenges to robust employment, hit America hard when COVID pulled the rug out from under all the Fed’s mistaken expectations. Still, when the pandemic struck, the Fed created two huge facilities to backstop giant corporate debt and opened a “Main Street” bank that in fact did business with companies able to repay loans greater than $250,000 because their annual revenues were as much as $5 billion. The Fed could and should instead have opened a Family Financial Facility that provided ground-up – not trickle-down – emergency economic support.

However, it’s not enough for the Fed first to fix monetary policy based on a true reading of America’s unequal economy and also to aid those truly in economic need under acute stress. We cannot have shared prosperity if the US financial system crashes disastrously every decade or so.

The third fix to the inequality engine in this book thus redesigns US financial regulation not by removing all the costly rules imposed on banks after 2010, but instead by realigning rules so that like-kind financial activities come under like-kind rules. When only banks are under tough safety-and-soundness and consumer-protection rules, finance moves outside banks and thus outside a lot of equality-critical regulation. This it did from 2010 to 2020 and we know what happened then.

Fixing the financial system means not just new rules, but also new institutions. We can fix the unequal allocation of affordable credit in part by fixing how financial institutions are constructed. Equality Banks are thus among my fixes for a more equal financial system.

Finally, we can’t forget the inequality engine’s fuel: money. Companies such as Facebook and Amazon aren’t just dominant in social media and retailing – they plan to issue new forms of money on a redesigned payment system. This could give them control not only over with whom we associate, what we buy, what we read, and even how we vote, but also over how much money we

“I’m getting subtle hints of what the Fed might do.”
have and to whom it goes how. We are used to thinking about money as the bills in our wallets or the numbers in our bank accounts, but a quiet revolution redefining money is well under way. If it proceeds without appropriate controls, then the inequality engine’s fuel will go still faster and in even larger amounts to those who need it least.

Thus, the last fix I detail crafts a new, digital money system under Fed control along with controls on the Fed to ensure that its new money enhances equal access and secure transactions, not just for the wealthy but also for the rest of us. Much in this book lambasts the Fed, but I still trust it with my money more than Facebook.

In the sixties, a social philosopher said, “In the same way as men [sic] cannot for long tolerate a sense of spiritual meaninglessness in their individual lives, so they cannot for long accept a society in which power, privilege, and property are not distributed according to some morally meaningful criteria.” When so much wealth is in so few hands, its morality is elusive and the fury this engenders becomes widespread.

To address the defining economic, social-justice, and moral questions of our time requires a fast-acting, targeted, and politically-plausible action plan aimed at the policies that exert the most force in the inequality engine. This book will prove that financial policy is this inequality engine and also that it can first be reversed and then shut down. If we fail in the 2020s as badly as we failed in the 2010s to fix financial policy, fury will indeed be loosed and financial policy-makers will deserve it. The rest of us, not so much.

US ECONOMIC OUTPUT AND MONETARY POLICY UPDATE:

It has been one year since the first wave of the COVID-19 pandemic hit our shores—a year marked by heartbreak and hardship. We are all looking forward to a brighter time ahead, when vaccinations are widespread, the recovery is broad based and inclusive, and services, schools, sports, and social life are in person. The expected path of the U.S. economy has strengthened with the prospect of widespread vaccinations and additional fiscal stimulus, but risks remain, and we are currently far from our goals.

Current Situation

After a dark winter with elevated case counts and setbacks on service-sector jobs, case counts have come down and spending is picking up. Economic forecasts for growth during the first quarter have been significantly upgraded in response to the better-than-expected data. January data for household spending overall came in strong—confirming that the renewal of fiscal support at the end of the year provided a much needed boost to household incomes and spending at the turn of the year. The income support provided by fiscal authorities to hard-hit workers, households, businesses, and states and localities, as well as the actions of the Federal Reserve to promote orderly functioning in financial markets and low borrowing costs for households and businesses, have been providing vital support for the economy.

In recent weeks, vaccinations have been increasing, while weekly cases, hospitalizations, and deaths have decreased. The seven-day moving average of daily COVID deaths, which peaked in
mid-January, declined about 35 percent during the month of February, although sadly it is still at high levels. As of yesterday, nearly 77 million vaccination doses had been administered.

While the progress on vaccinations is promising, jobs are currently down by 10 million relative to pre-pandemic levels. Improvements in the labor market stalled late last year after rebounding partway in the summer and fall of 2020. When we take into consideration the more than 4 million workers who have left the labor force since the pandemic started, as well as misclassification errors, the unemployment rate is close to 10 percent currently—much higher than the headline unemployment rate of 6.3 percent.

Labor force participation by prime-age workers stands lower now, on net, than it did in June after it had bounced back partway from the decline in April. The decline in labor force participation relative to last June is largely a result of lower participation by prime-age women, which, in turn, partly reflects the increase in caregiving work at home with the move to remote schooling and the shutdown of daycares due to COVID. On average, over the period from November 2020 to January 2021, the fraction of prime-age women with children aged 6 to 17 who were out of the labor force for caregiving had increased by 2.4 percentage points from a year earlier, while for men the fraction had increased by about 0.6 percentage point. If not soon reversed, the decline in the participation rate for prime-age women could have scarring effects, with longer-term implications for household incomes and potential growth.

Roughly 90 percent of the shortfall in private payroll employment relative to the pre-COVID level is concentrated in service-providing industries, with half of these service job losses in leisure and hospitality. The concentration of job losses in services has had a disproportionate effect on the lowest-wage workers. Workers in the lowest-wage quartile face an extremely elevated rate of unemployment of around 23 percent. The advent of widespread vaccinations should revive in-person schooling and childcare along with demand for the in-person services that employ a significant fraction of the lower-wage workforce.

Realized inflation remains low, although inflation expectations appear to have moved closer to our 2 percent longer-run target. Both core and headline measures of 12-month personal consumption expenditures (PCE) inflation were 1.5 percent in January, well below our longer-run 2 percent inflation goal. Longer-term inflation expectations appear to have moved up in recent months, consistent with the Federal Open Market Committee’s (FOMC) new commitment to achieving inflation that averages 2 percent over time. Market-based indicators of inflation expectations increased over recent months, with Treasury Inflation-Protected Securities-based measures of inflation compensation over the next 5 years and 10 years rising about 40 and 30 basis points, respectively, since the end of last year. Some survey measures of inflation expectations have also moved up in recent months, although, on balance, they have only moved up toward their pre-COVID levels.

In many foreign countries, growth moderated at the end of 2020, as a spike in COVID hospitalizations and deaths led to tighter public health restrictions in many economies. Retail sales and measures of services activity weakened even as manufacturing and exports remained more resilient. Foreign activity should strengthen later this year as vaccinations rise, COVID case counts decline, and social
distancing eases. It should also be aided by some rundown in the stock of excess savings, continued fiscal and monetary support, and strong U.S. demand. The turnaround in growth in each country will hinge on success in controlling the virus and limiting economic scarring from the past year's downturn, as well as on available policy space, and underlying macroeconomic vulnerabilities.

**Outlook**

So, what do these developments suggest for the U.S. outlook? Increasing vaccinations, along with enacted and expected fiscal measures and accommodative monetary policy, point to a strong modal outlook for 2021, although considerable uncertainty remains. It is widely expected that we will continue to make progress controlling the virus, reducing the need for social distancing, but variants of the virus, slow take-up of vaccinations, or both could slow progress.

Additional fiscal support is likely to provide a significant boost to spending when vaccinations are sufficiently widespread to support a full reopening of in-person services. Various measures of financial conditions are broadly accommodative relative to historical levels and should remain so. The labor market should strengthen, perhaps significantly, as the virus recedes, social distancing comes to an end, and the service sector springs back to life.

Inflation is likely to temporarily rise above 2 percent on a 12-month basis when the low March and April price readings from last year fall out of our preferred 12-month PCE measure. Transitory inflationary pressures are possible if there is a surge of demand that outstrips supply in certain sectors when the economy opens up fully. The size of such a surge in demand will depend in part on the effects of additional fiscal stimulus, along with any spend-down of accumulated savings, which are uncertain. But a surge in demand and any inflationary bottlenecks would likely be transitory, as fiscal tailwinds to growth early this year are likely to transition to headwinds sometime thereafter. A burst of transitory inflation seems more probable than a durable shift above target in the inflation trend and an unmooring of inflation expectations to the upside.

When considering the inflation outlook, it is important to remember that inflation has averaged slightly below 2 percent for over a quarter-century. In the nine years since the FOMC's announcement of a 2 percent inflation objective, 12-month PCE inflation has averaged under 1-1/2 percent. Readings of 12-month inflation have been below 2 percent in 95 of those 109 months. According to recent research, statistical models estimate that underlying core PCE inflation ranges from one- to four-tenths of 1 percentage point below our 2 percent longer-run target. Recall that at the end of 2019, with unemployment at a multidecade low and after the addition of almost 1-1/2 million workers to the labor force during the previous year, PCE inflation was 1.6 percent for the year.

**Monetary Policy**

With that outlook in mind, let me turn to monetary policy. After an extensive review, the FOMC revised its monetary policy framework to reflect important changes in economic relationships characterized by a low equilibrium interest rate, inflation persistently below target, and low sensitivity of inflation to resource utilization. The new framework calls for monetary policy to seek
to eliminate shortfalls of employment from its maximum level, in contrast to the previous approach that called for policy to minimize deviations when employment is too high as well as too low. It emphasizes that maximum employment is a broad-based and inclusive goal assessed by a wide range of indicators. In addition, in order to keep longer-term inflation expectations well anchored at our 2 percent goal, monetary policy will seek to achieve inflation that averages 2 percent over time. Consequently, following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time.

These changes mean that we will not tighten monetary policy solely in response to a strong labor market. The long-standing presumption that accommodation should be reduced preemptively when the unemployment rate nears estimates of the neutral rate in anticipation of high inflation that is unlikely to materialize risks an unwarranted loss of opportunity for many of the most economically vulnerable Americans. It may curtail progress for racial and ethnic groups that have faced systemic challenges in the labor force. Instead, the shortfalls approach will enable the labor market to continue to improve absent clear indications of high inflationary pressures or an unmooring of inflation expectations to the upside.

The FOMC has set out forward guidance on the policy rate and asset purchases that implements the new framework. The guidance indicates an expectation that it will be appropriate to maintain the current target range of the federal funds rate until labor market conditions have reached levels consistent with the Committee’s assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time. Even after economic conditions warrant liftoff, changes in the policy rate are likely to be only gradual, as the forward guidance notes that monetary policy will remain accommodative in order to achieve inflation moderately above 2 percent for some time so that inflation averages 2 percent over time. In addition, asset purchases are expected to continue at least at their current pace until substantial further progress has been made toward our goals.

In assessing substantial further progress, I will be looking for realized progress toward both our employment and inflation goals. I will be looking for indicators that show the progress on employment is broad based and inclusive rather than focusing solely on the aggregate headline unemployment rate, especially in light of the significant decline in labor force participation since the spread of COVID and the elevated unemployment rate for workers in the lowest-wage quartile and other disproportionately affected groups.

Likewise, while I will carefully monitor inflation expectations, it will be important to achieve a sustained improvement in actual inflation to meet our average inflation goal. The past decade of underperformance on our inflation target highlights that reaching 2 percent inflation will require patience, and we have pledged to hold the policy rate in its current range until not only has inflation risen to 2 percent but it is also on track to moderately exceed 2 percent for some time.

Of course, we will be vigilant in parsing the data. Given the path of inflation to date, our framework calls for inflation moderately above 2 percent for some time. If, in the future,
inflation rises immoderately or persistently above target, and there is evidence that longer-term
inflation expectations are moving above our longer-run goal, I would not hesitate to act and believe
we have the tools to carefully guide inflation down to target.

Today the economy remains far from our goals in terms of both employment and inflation, and it
will take some time to achieve substantial further progress. Jobs are still 10 million below the pre-
COVID level, and inflation has been running below 2 percent for years. We will need to be patient
to achieve the outcomes set out in our guidance.

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Two senior Democratic lawmakers—Elizabeth Warren and Sherrod Brown—have warned the
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requirements that were introduced for US banks at the start of the pandemic.

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