Demetri Kofinas:	00:00	The Hidden Forces Podcast features long-form conversations broken into two parts, the second hour of which is made available to our premium subscribers, along with transcripts and notes to each conversation. For more information about how to access the episode overtimes, transcripts, and rundowns, head over to patreon.com/hiddenforces. You can also sign up to our mailing list at hiddenforces.io. Follow us on Twitter @HiddenForcesPod and leave us a review on Apple Podcasts. With that, please enjoy this week's episode.
Demetri Kofinas:	00:54	What's up, everybody. My name is Demetri Kofinas and you're listening to Hidden Forces, a podcast that helps investors, entrepreneurs, and everyday citizens get an edge by equipping themselves with the knowledge needed to anticipate the challenges and opportunities of tomorrow. By sharing my critical thinking approach and by challenging consensus narratives about the power structures shaping our world, I help you make the connections to see the bigger picture, empowering you to make smarter decisions.
Demetri Kofinas:	01:28	On this week's episode, I speak with Karen Petrou, Co-founder and Managing Partner of Federal Financial Analytics, a consultant firm that provides analysis and advisory services on legislative, regulatory, and public policy issues. She is also the author of a new book titled Engine Of Inequality, in which she argues that Fed policy is one of the primary drivers of wealth inequality in America, and puts forward several solutions to fixing the problem, including a reversal of interest rate policy, balance sheet management, and forward guidance.
Demetri Kofinas:	02:02	We are living through the most extraordinary monetary experiment in US financial history. If you'd graduated with a Ph.D. In monetary economics from Harvard in 2008, and someone dropped you into the middle of this week's FOMC meeting, you'd have absolutely no idea what was going on. That's how much monetary policy has changed in the intervening years and how far the goalposts have moved from anything that would have been considered normal, And I would argue possible in the world of money.
Demetri Kofinas:	02:36	My objective in bringing you this conversation today is to help you better understand not only how monetary policy and financial regulations have changed in the year since the great financial crisis, but also how those changes have destabilized society and impaired financial markets by transferring risk from the more tightly regulated banking sector, which was the source of the '08 panic, to other parts of the system. In the subscriber overtime, Karen and I discuss solutions to the current predicament and what would be needed in order to make those changes possible.
Demetri Kofinas:	03:10	We also discuss limits to the current policy and how much more room policymakers have to stimulate the economy before inflation finally begins to pick up or before we start seeing yields in the treasury market begin to rise precipitously. We may already be there. With that, please enjoy this thought-provoking and important conversation with my guest, Karen Petrou.
Demetri Kofinas:	03:39	Karen Petrou, welcome to Hidden Forces.
Karen Petrou:	03:42	Thank you, Demetri.

Demetri Kofinas:	03:44	It's great having you on the program.
Karen Petrou:	03:46	It's a pleasure. It's a great program.
Demetri Kofinas:	03:48	Thank you very much. Where do you live? Where are you located?
Karen Petrou:	03:52	Washington D.C.
Demetri Kofinas:	03:53	How long have you been there?
Karen Petrou:	03:55	Long time. I'm old. I've been here since 1979.
Demetri Kofinas:	03:58	Wow. You've seen a lot of changes in DC. I lived in DC between 2011 and 2013 in Dupont Circle.
Karen Petrou:	04:05	Oh, that's not far from where I live. I live up right by Rock Creek Park.
Demetri Kofinas:	04:08	Okay, cool. Yeah. It's a beautiful town. It's unique in many ways. It really changed a lot after 9/11, with all of the spending by the Bush administration, and subsequently it feels, in many ways, like it's bursting at the seams. It doesn't have the infrastructure or capacity, both in the private and public sector to really service... Well, public sector, it does. It most certainly does, to service the needs of the people.
Karen Petrou:	04:34	Yeah. It just keeps changing. I mean, now, of course, after the Capitol riots and the attack on January 6th, all of Capitol Hill is just a war zone. The city is a very different place once you get over across town.
Demetri Kofinas:	04:46	Oh, that's interesting. I hadn't considered that. For people that aren't familiar with you, Karen, can you give my listeners a sense of your background and your journey and what brought you to the place you are today, where you are someone who talks about, thinks about, and writes about the Federal reserve and issues like inequality?
Karen Petrou:	05:05	Oh, sure. Yeah. I started my career a long time ago, going to Wellesley College, Massachusetts Institute of Technology. And then I was finishing a doctorate at the University of California at Berkeley in political science when I realized, and I probably should have figured this out sooner, but I realized, looking around the faculty where there were 40 or 45 men and one woman adjunct lecturer, that may be academic life might not be a swift path to success for a woman.
Karen Petrou:	05:39	At the same time, I interestingly was offered a position as the chief, the only political scientist looking particularly at financial political risk affecting countries at Bank of America. So I thought, "I don't know anything about banking, but I know a little bit about political risk. That sounds interesting. And it might pay some more, so sure. I'll give it a try." I joined Bank of America and I got quickly caught up just because of the issues at the time, in questions of regulatory policy and monetary. What does the Fed do? What do banks do? What are the rules, and how do the rules change the way banks work?

Karen Petrou:	06:20	Banks as a regulated business are deeply, directly strategically affected by political decisions. So it really was very interesting to me. The bank moved me to Washington and I represented the bank in this town before the regulatory agencies and Congress. And then, in 1985, I had moved up through the ranks of the bank very fast. But the then CEO of the bank said he didn't feel good about making a young woman a senior vice president. I hoped to get older, but I was not going to stop being female.
Karen Petrou:	06:55	So I started my own company, which we now call Federal Financial Analytics. That's what I've been doing ever since, working with large financial institutions, central banks, US regulators, investors, understanding how financial institutions work, and most importantly, how political and regulatory and monetary decisions change the way the financial system functions.
Karen Petrou:	07:22	I've looked at this over the years, really, in terms of who wins and loses in terms of profits, what kind of activities should banks get in and out of if an investor buys a bank, how much money is it likely to make? Those are the kinds of questions I looked at. But after the 2008 financial crisis, which really changed all of the rules, it became quickly clear to me starting in 2011 when I wrote some papers on our own for ourselves, not for clients, about how the financial system was changing, that reforms, we needed reforms.
Karen Petrou:	07:56	The financial system, obviously, the crash in 2008 was cataclysmic with tremendous macroeconomic damage. But I thought some of the intersection between monetary and regulatory policy was going to lead to unintended consequences. And then 2015 and 2016, it became clear as I worked on the intersection of those unintended consequences and complicated areas like liquidity, risk management, and how the government securities bond market works in those areas, that there was another really serious issue, which was economic inequality, that the rules combined with monetary policy were changing the way the financial system worked. And that those changes not only made the financial system as a whole more fragile, but also America a lot less equal.
Karen Petrou:	08:48	That's when I started thinking about these issues. Then as the 2016 election came along, it seemed to me that America was not only getting a lot more unequal and the financial system more fragile, but Americans were getting a lot angrier. That was a very visceral, vicious election. What struck me was Hillary Clinton ran on the position of the Fed and the Obama administration, which was that the economy was in what the Fed likes to call "good place", that the recovery, the Obama administration Democrats had brought the country out from the crisis, out from the crash, and the country was in pretty good economic shape.
Karen Petrou:	09:30	A lot of voters, especially African-Americans stayed home because the place they were in wasn't good. Donald Trump said, "You know, this place isn't good, not if you're a high school educated White man, not if you're a couple that used to have one worker in the household. Now you need two that used to work full-time. Now you're holding down two or three part-time jobs. The economy isn't a good place." He was right. For low, moderate, and middle income households in 2016, the economy wasn't working well. It wasn't a good place.

Karen Petrou:	10:06	The anger and the destruction that wrought really is what led me to write my book. This has to change. Financial Policy is complicated, and nobody really thinks about it when you talk about equality. But the fuel, the engine of inequality, is money. And so, you have to think about money, and that's why I wrote my book. Nights and weekends.
Demetri Kofinas:	10:30	You should have called it "Nights And Weekends." "The Fed Nights and-
Karen Petrou:	10:33	No, the book is called "Engine Of Inequality."
Demetri Kofinas:	10:34	No, I know. I know. I know.
Karen Petrou:	10:36	Should have called.
Demetri Kofinas:	10:36	You should have called it "Nights And Weekends At The Fed." Take me back to when you began your career. You said that B of A hired you as a political risk analyst?
Karen Petrou:	10:45	That's right.
Demetri Kofinas:	10:46	Did I hear that right? But you weren't qualified to do that. Did you say that you didn't-
Karen Petrou:	10:50	No.
Demetri Kofinas:	10:50	Interesting.
Karen Petrou:	10:51	I like to think I was.
Demetri Kofinas:	10:52	Okay. I thought you said something to the contrary. When was that? Can you give me a timeframe? Are we talking about mid 1970s here?
Karen Petrou:	10:59	You were talking 1977. I was qualified to do that, but what happened was the chairman of the board of the bank was called to testify before Congress, and they were on a question of international financial security. And so, they said, "We need somebody to write this testimony for him." And I, "I don't know anything about banking, but I do know about international financial security." And they said, "Well, somebody will write the banking parts. You just write the testimony." And I did, and he went to Washington and he thought it went very well. So I got promoted.
Demetri Kofinas:	11:30	Well, it's interesting because the 1970s was the textbook period for not just regime change in markets, but political instability, both domestically and geopolitically, with the oil shock, with Nixon, with Ford. The end of Bretton Woods in the early 1970s led to a dramatic transformation of international capital flows and foreign exchange markets. That speaks to your point about regulation and how regulation... I mean, Bretton Woods shaped the international monetary system.

Demetri Kofinas: 12:04 I'm curious how much that experience informs or you pull from today when you look at how the system is changing as a result of 2008, and the regulatory changes that went into effect after that.

Karen Petrou: 12:18 Right. The system is so different, Demetri, that the rigor and the understanding that in a regulated business, rules are strategic events, has carried my thinking through from that day to now. That might sound obvious, but it wasn't then and it still isn't, where people think banks make money based on brilliant CEOs, or that decision to move it and to open branches in Texas and all of that matters.

Karen Petrou: 12:46 But the be all and end all of a regulated industry is its rules. Particularly in a business where there are unregulated competitors with formidable resources, the rules really define winners and losers, and also how safe or dangerous a financial market is to customers in terms of safe and sound banking, predatory lending, and to the economy as a whole.

Demetri Kofinas: 13:12 Yeah. I mean, no doubt about it. I mean, the thing that comes to mind is how the banking system has changed.

Karen Petrou: 13:19 Absolutely.

Demetri Kofinas: 13:19 I mean, the end of Bretton Woods had an enormous effect on banking. One could argue that... I don't know that I would be educated enough to compare the changes in the banking system post 2008 with those post Bretton Woods, but certainly the banking system itself has dramatically changed. I mean, the way in which monetary policy is conducted and the way in which the Fed is able to influence credit in the economy is dramatically different today than it was before 2008, certainly before the end of Bretton Woods. I mean, that has evolved over the years.

Demetri Kofinas: 13:51 Maybe the appropriate question to ask you, and this would be helpful for, I think, myself and especially for people that maybe aren't as familiar with monetary policy, how does monetary policy work? First of all, how did it work? Well, I first learned about monetary policy by reading William Greider's book, The Secrets Of The Temple. It's dramatically changed from that period under Volcker.

Karen Petrou: 14:13 Oh yeah.

Demetri Kofinas: 14:13 Forget even 1913. Can you explain to people how monetary policy has traditionally worked and how it works today?

Karen Petrou: 14:21 Sure. I think it's important to know that monetary policy works in the banking system and it works in the economy. Excuse me. We've had a lot of things changing at the same time. One is the banking system. The basic mechanism of monetary policy used to be reserve requirements. Banks were required to hold a certain amount of money at the Fed in reserve, based on how much people had in various transaction checking and savings accounts.

Karen Petrou: 14:56 When the Fed wanted to tighten monetary policy, i.e. to make it more restrictive to slow the economy down, it raised those reserve requirements. So banks had to hold more at the Fed. They could put less into the economy, and things slowed down. Conversely, when the Fed wanted accommodative policy, easy money, it reduced the reserve requirements. Banks had more money. They lent that out and the economy theoretically improved. The idea was very much that when the cost of money goes down, reserve requirements go down because banks now can lend more.

Karen Petrou: 15:33 Borrowers say, "Hey, that's cool. I'll go buy a car or a house." The act of using that easy money stokes demand, which stokes employment, which stokes growth. And if you want to slow the economy down, you turn the knob in the other direction. First, we had the S&L crisis in the 1980s. We had a banking crisis in the early '90s. And then we had the growth of non-bank organizations, particularly the asset management companies, and bit by bit banks became less and less important in the financial system.

Karen Petrou: 16:11 So the Fed went to plan B. It still had the reserve requirements and it tried to set monetary policy through the reserve requirements. But it got more engaged in open market operations. The committee that sets policy at the Fed is called the Federal Open Market Committee. The Fed went into what's called the Fed funds market and traded in that market also to raise or lower short-term rates as it thought best.

Karen Petrou: 16:37 That worked relatively well, but the system was beginning to fray at the seams into the early 2000s, when Alan Greenspan talked about the great moderation and he lowered interest rates, and he said there would never be another financial crash. It was fraying because banks were less important, and therefore, monetary policy working through the banking system worked less well, and because America was getting more and more unequal.

Karen Petrou: 17:06 In the 1970s, we had a very equal country. I mean, we had rich and poor people. But when I graduated from college in 1975, poor people earned their share of GDP of national production. Rich people had more of it, but we all got an equal share. So poor people got the rewards of their labor and middle-class households did quite well. In the last year for which data are available, 2018, rich have topped 1% of Americans got 300% of the share that they got in 1975.

Karen Petrou: 17:46 Growth is distributed very differently in this country. And so the signals the Fed tried to send stoking borrowing, which was then supposed to stoke demand and then stoke employment, don't work the way they did because rich people don't need new cars. They've got lots. They save their money instead. They do different things with their money than a middle class does. And without a middle-class, monetary policy doesn't work. And we've seen that particularly in the last 10 years.

Demetri Kofinas: 18:16 One of the things that you talk about in your book is that one of the issues that the Fed has had when it conducts monetary policy, sets interest rates, and tries to "fine tune" the economy, is that it's measuring its targets incorrectly. You mentioned the great moderation now in Greenspan. How much was the Great Moderation simply an illusion or a manifestation of the imagination of policymakers who were measuring inflation in the wrong places, and who were using the wrong indicators in order to determine economic growth, inflation, employment, etc.?

Karen Petrou: 18:55 I think the fundamental mistake that was made in the Great Moderation by Alan Greenspan, that the Fed continues to this day is to think of prosperity in terms of the "wealth effect". I call this trickle-down monetary policy. If you create more wealth, theoretically, you have a prosperous country because there is demand, there is employment. That wealth is going somewhere. But we've seen over the last decade in particular that we have a very powerful wealth effect. Rich people are getting very, very rich. But it's not generating strong economic growth.

Karen Petrou: 19:34 The recovery since 2010 is the weakest since the second world war and it's making America more and more unequal. It's a different economy in which a wealth effect backfires.

Demetri Kofinas: 19:47 Walk me through that. How does Fed policy and how has Fed policy as it's been conducted over the last, what, two decades... Do you begin the clock towards the end of the tech boom in the late '90s till today? How has Fed policy, in the way it's been conducted, driven inequality over this period? And tell me what period you are looking at.

Karen Petrou: 20:12 Yeah, I'm really looking at the period from 2008 to today because in the 2008 crisis, Ben Bernanke, the chairman of the Fed at the time, realized that the old approach to driving monetary policy through the banking system and also through the Fed funds market had blown up. It really wasn't working in the traditional way. That's when he launched what this called unconventional monetary policy.

Karen Petrou: 20:41 It does two things very differently than the Fed had ever done before. One, using the reserve tools, including some new ones, paying interest. The banks were holding reserves, but the Fed created incentive for banks to hold trillions in reserves at the Fed, by paying them interest. Created interest on excess reserves and use those to drive rates. And it built a huge portfolio.

Demetri Kofinas: 21:09 They moved from a corridor to a floor system.

Karen Petrou: 21:12 That's correct, except the floor has always been rather soft. I was trying not to be technical, but technically, you're correct.

Demetri Kofinas: 21:18 Sure. For listeners who are interested, I know you were recently interviewed by George Selgin. He's written a book called Floored where he discusses this, and we had him on the program as well. I think that was episode 128 or thereabouts. But go ahead.

Karen Petrou: 21:33 Well, that's exactly right. That policy, ultra-low interest rates, rates that since 2010 have been mostly below zero after taking inflation into account, very low real rates, and a huge Fed portfolio, changed the way the markets work. They combined with the Fed's unwillingness to support, to see any kind of market volatility. One of the points in my book is I really think the Fed has confused financial markets for the real economy. It was so focused on financial market stability.

Karen Petrou: 22:10 It missed the fact that we didn't have shared prosperity or even strong economic growth for a few people. We had weak growth and inequality. But anybody who had money in the markets did very, very well. Anybody who tried to save by putting money in the bank lost money. That never used to happen. That's new. Savings used to be in the bank was supposed to be a good idea.

Demetri Kofinas: 22:34 I think it was Richard Koo that coined the phrase balance sheet recession.

Karen Petrou: 22:39 Right.

Demetri Kofinas: 22:39 Or he certainly popularized it. How much is the phenomenon of a balance-sheet-driven recession? i.e., large outstanding amounts of private sector debt. How much of that is part and parcel of what you're describing when you talk about inequality, and how much does all of that fit into explaining why, as you mentioned, Bernanke saw that monetary policy, as it was traditionally practiced, didn't seem to generate the types of results that they were looking for. And so they went and they pursued to change the operations in order to try and effect a different outcome.

Karen Petrou: 23:16 Right. Richard Koo's theory is I think really important, but the Fed has never agreed with it. And so, from Ben Bernanke's thinking, I don't think that entered into it, particularly in 2008, 2010, or for that matter, since the Feds approach to thinking about the economy has historically, and really is... Even though the Fed changed its monetary policy construct a little bit last year, the Fed's thinking is still very conventional. This much wage growth equals that much inflation, that sort of thinking, as opposed to understanding that when there is a significant amount of debt, private debt, as you said, people behave differently.

Karen Petrou: 23:57 Where I would refine Richard's model to look at debt distributionally, not just to look at the aggregate amounts of debt, but to see who has the debt. Because if you do that in the United States, and the US is very different than Japan or to Europe, you see that all but the top 10% have more debt than assets. This is a very indebted country. And so, under any kind of stress, we have a significant amount of financial fragility.

Demetri Kofinas: 24:26 Does that, if anything, only exacerbate the tendency for new money to push asset prices up in relation to consumer prices?

Karen Petrou: 24:36 I think it does because where else would you... If you have exit savings and the top 10%, particularly the top 1% has a lot of savings, what are you going to do with it?

Demetri Kofinas: 24:47 Right.

Karen Petrou: 24:48 It's got to go somewhere.

Demetri Kofinas: 24:50 Yeah. Yeah. I think one way that people can think about this is that if you're wealthy enough, you have no marginal propensity to consume with additional income. And you're in an environment where money is free and there are concerns about inflation. Then not only are you going to put your incremental dollars into investments that you think are going to perform better in an inflationary environment, but you have no reason to sell them, because if you sell them, what are you going to put them into? Cash? It generates a Ponzi-like asset investment climate.

Karen Petrou: 25:27 We see that. Look at Bitcoin, look at these blank check companies that have $156 billion right now to spend on woohoo, anything.

Demetri Kofinas: 25:36 Yeah, tech stock, story stocks. That, of course, goes back to your point about the wealth effect. This was, in some ways, a conscious decision by the Greenspan Fed, certainly after the 2001 9/11 attacks, to generate, certainly in the housing market, a wealth effect that could help drive the economy.

Karen Petrou: 25:57 Oh, that's right. You may recall that Alan Greenspan said there was no risk to that because the US housing market could never fail.

Demetri Kofinas: 26:06 Nationally, yeah.

Karen Petrou: 26:07 Nationally, yeah. He said, "We might have regional housing market failures, but Texas is different than Massachusetts, and there'll never be a coast to coast housing crisis." What he didn't understand, there was a national housing market. The world had changed. We were not dealing with little S&Ls anymore wending 10-block area in New York City. This was a national market, and national lending practices led to a national crisis.

Demetri Kofinas: 26:34 Do you think, knowing what he knows now, that Alan Greenspan would have either not lowered rates as dramatically after 2001, and been tighter on regulation in the mortgage market during that period, or at the very least raise them faster and kept them higher after that initial cut?

Karen Petrou: 26:58 Well, I think the really important point in your question is regulation. One of the key points I think is ill understood, and I really tried to explain this in my book, is the interplay between monetary policy and financial regulation, bank and non-bank. People think about banks and huge banks and JP Morgan with great big buildings on park Avenue. Actually, by financial assets, the United States non-banks have more financial assets than banks. So this is not a financial system control the banks.

Demetri Kofinas: 27:30 The shadow banking market.

Karen Petrou: 27:32 Exactly. Except it's not so shadow. It's kind of out there. Yeah. That is particularly true in housing, going back to 2003, through 2008, in that crash where you had a huge growth of non-bank lenders, subprime lenders. They were "democratizing mortgage finance". But actually, many of their practices were not only very high risk, but even predatory as we saw. They had a government system, Fannie Mae, Freddie Mac, and the Federal Housing Administration, creating essentially a no-risk system for high-risk lenders because those government agencies bought the mortgages directly or through mortgage-backed securities that very speculative, often unscrupulous mortgage lenders originated.

Karen Petrou:	28:21	I testified in 2003 that this was going to be a dangerous proposition and told Congress that we worked hard in my firm, trying to identify the causes of the housing crisis at the time and bring them to policymakers' attention. But there was a strong view, both from the leftover from the Clinton administration, and then in the George W, was that light touch regulation. This is the free market, that we can have a national housing crisis. Therefore, this is generating economic growth. Monetary policy I think was less important than regulatory policy. Although, the two, again, Fed off of each other.
Demetri Kofinas:	29:01	You said monetary policy was less important than regulatory policy?
Karen Petrou:	29:04	In terms of driving up the housing boom. The ultra-low rates played a role. I mean, again, both monetary and regulatory policy interact. But had the rules been tighter and borrower protections been better, and the government sponsored enterprises, less profit focused and more stability minded, I don't think we would have had the crisis.
Demetri Kofinas:	29:26	How much of a role did the Fed put what would have been at that time, I guess, almost two decades of leadership under Alan Greenspan, where the market believed, and he certainly stoked, this idea that he, and I guess, well, the cover story of Time Magazine in 1999, and when was it, or 1998, committed to save the world with him and then treasury secretary, Lawrence Summers, or Rubin was treasury secretary. Lawrence Summers, I guess, then was deputy secretary.
Demetri Kofinas:	30:00	Regardless, this idea that we can just go and take reckless amounts of risk because the Fed's got our back, it's intangible and difficult to quantify. But I often wonder if that was not more important than both regulation and interest rate policy.
Karen Petrou:	30:19	It's huge. And that's why in my book, I talk a lot about the Greenspan. They call it the so-called Greenspan Put in that the market will never drop. I say there's been a Greenspan Put, a Bernanke, a Yellen Put. Now we have a Powell Put.
Demetri Kofinas:	30:33	Well, people forget. CNBC used to have the briefcase indicator. They used to look at Alan Greenspan's briefcase when he used to go into work to see... If it was bigger at an FOMC meeting, that somehow hinted at something. I mean, crazy.
Karen Petrou:	30:52	No, but still true. Everybody listens. You just watch the financial press. Every utterance from every Federal reserve bank president, from every Federal reserve bank governor, from every Federal reserve bank janitor, every Federal reserve bank official, has an immediate impact on the market. It determines the market because the markets are operating knowing, again, that that could exist. So as long as they operate within the parameters of what they think the Fed is going to do, they can't lose, and they haven't.
Demetri Kofinas:	31:27	Let's go back to two things because you actually highlight them in the book. But we talked a little bit about statistics, which is very important because that's the

sensorium through which the Federal reserve perceives the world, perceives the market upon which it acts. But you really make a point to emphasize both the transmission mechanism of monetary policy from the supply side, and then the demand side of that equation, which is the marginal propensity to consume, or lack thereof, of the middle-class, and the reliance on that assumption models that in many ways, are informed from the period of the 1970s, to actually stimulate the economy.

Demetri Kofinas: 32:09 So let's take each of those in turn, with respect to the banking system. Because, I mean, we saw this in the recent pandemic crisis. The Fed has now set up liquidity facilities directly purchasing corporate bonds. It's only a matter of time, in my view, before they start purchasing indices and God forbid, individual stocks. Can you walk me through both of these, beginning first with the transmission mechanism on the supply side?

Karen Petrou: 32:35 That's a lot, Demetri. There's a lot in there. But I think the key is these facilities, because the Fed's understanding of the economy is through the financial markets. And so, the view is if you save the financial markets, you save the economy. Certainly, financial crashes are not good for the economy. That's why central banks exist with their long-standing discount window authority to lend during liquidity crises. But the problem with these market rescues, the so-called puts, is that it's very hard to determine. And often, in fact, the Fed steps in when there are solvency crises as well.

Karen Petrou: 33:19 The banking system was rescued, AIG was rescued, Fannie and Freddie. A lot of insolvent entities were rescued in 2008. That was a different form of put. And then in 2020, as you say, we rescued everything up to and including the junk bond market. Wild risk, corporate bonds for companies with no earnings, were selling at premium prices. When the COVID hit and everybody said, "Oh my God, the real economy might suffer," the Fed stepped in and rescued pretty much anyone across the financial system.

Karen Petrou: 33:56 I do know, the markets had a few bad days, and then they took back off again, even as unemployment climbed to record numbers. I think what's fundamentally wrong with the market put and the so-called moral hazard, you can never lose psychology that develops, is that any American who's not in the market, which is in terms of real wealth, virtually all Americans, loses. These markets enrich wealthier households.

Karen Petrou: 34:31 I know a lot of Americans have 401k plans and it's very important, but the top 1% has 53% of American financial assets. The top 10% has 88% of the assets. It's not shared wealth. When you have the kind of debt that most households had going into 2020, the Fed rescued the financial market and households were put at grave risk.

Demetri Kofinas: 34:57 Yeah. I have a few thoughts here. One, the reason I brought up the corporate bond market is for the same reason that I would mention the hiccups that we saw in the repo market with treasury collateral, because both of those reflect regulatory changes on the banking side, which have distorted and sent, for example, in the corporate bond market... Made the corporate bond market a more important funding mechanism or platform for corporates than it was prior to 2008. That speaks to your point about regulation.

Demetri Kofinas: 35:29

Another thing that comes to mind, which is so interesting, is how interest rate policy and monetary policy and what they call financial repression has turned index investing into basically the equivalent of a savings vehicle, and in many ways has destabilized, created a lot of instability, underlying instability in financial markets, because the way in which people view their investments is no longer as a speculation, is certainly when you're investing in an index, you're told that this is basically the equivalent of savings. It's how you generate yield. In other words, people still need yield and they're willing to do increasingly insane things in order to get it.

Karen Petrou: 36:14

Oh yeah. That's right. The wealthier you are, the more you can manage your portfolio and balance sheet. Look at what happened in the game stop case. Most of those people were not wealthy. They were gambling because it was their only way to save.

Demetri Kofinas: 36:36

Right.

Karen Petrou: 36:37

Or so they thought.

Demetri Kofinas: 36:38

Right. I'm curious to get your views on that because that has become, I think, one of the most important logical leaps that I think a lot of people fail to make, which millennials have made, which actually explain... I use millennials in particular here because they are, in some ways, the most disenfranchised generation in a hundred years. But it explains behavior that would otherwise seem illogical because of the fact that costs, the cost of tuition, student loans, housing, etc., have gone up so much that in order to actually make a dent, you can't save your way to prosperity. You have to gamble your way to prosperity.

Demetri Kofinas: 37:23

Do you think at all about how monetary policy certainly has contributed to this? But overall, how this phenomenon has damaged what it's supposed to be the most vital generation in America today, which are millennials, and the generation which is going... To the point that we started with this conversation about political risk, that is set to take power in this new decade and how that's going to shape policy in the 2020s.

Karen Petrou: 37:52

These are great, great... Again, really hard, but great questions. And I do think a lot about them. There's a lot in the book on exactly these questions, the inability to save and what that does to both financial markets in terms of creating asset bubbles, Bitcoin, speculative stocks, housing prices even, with the impact of the pandemic. There was lot of debate about whether housing prices have become a new bubble back as we saw a debt more over a decade ago.

Karen Petrou: 38:20

But the Fed's view of price stability, as you... You said the cost of being middle class has gone up enormously, and yet the Fed thinks there's price stability. Well, there may be in the measures it looks at, but not in terms of what it costs to try to run a household, have kids. Now that with wage growth, middle-class wage growth in 2019 was the same in real terms as it wasn't 2001. And with all those cost increases, now most of millennial households have two wage

		earners. People often are working more than two jobs, are working more hours. That means they need childcare.
Karen Petrou:	38:59	It's astonishing. When you think we have a middle class, well, the people who fall into the middle of the income spectrum, 24% of the "middle class" in 2019 skipped medical payments because they couldn't afford them. When you think about, now will people make decisions? Well, I would be very angry.
Demetri Kofinas:	39:19	I think we've seen that.
Karen Petrou:	39:20	Yeah.
Demetri Kofinas:	39:22	It's not fair. It isn't fair.
Karen Petrou:	39:24	Yeah. Well that goes to the point about... We didn't really talk about it explicitly. It's something that I talked about in an episode with Katharina Pistor, which has to do with how regulations actually shape the playing field, regulations and regulatory choices. I mean, policy actually has a huge impact on wealth distribution without even taking into account redistributive policies through taxation.
Demetri Kofinas:	39:50	Absolutely.
Karen Petrou:	39:51	The reason I call the book Engine Of Inequality is that if you look at Thomas Piketty's book on capitalism and inequality, what he shows really clearly is that inequality is cumulative. The richer you are, the richer you get, the poorer you are, the poorer you get. And you hollow out the middle class by wealth moving up and out of all but the richest households, unless policy intervenes. That policy can be... His focuses on inheritance taxes and wealth taxes. Mine is on monetary and regulatory policy.
Karen Petrou:	40:28	There are certainly others like education policy, the cost of college and student debt. Each of them plays an important role. But if you don't have equitable policy, you will have cumulative economic inequality because of the power of that engine.
Demetri Kofinas:	40:45	Yeah. It's funny. As you were saying that, I oftentimes, certainly for episodes like this, I go into cartoonstock.com and I buy cartoons and I put them into the rundown. There's this one here where the hotdog vendor and he's priced hotdogs at 25 cents. And there are two bankers walking by, and the guy goes, "I told you the Fed should have tightened." But that's a little side note.
Demetri Kofinas:	41:09	You mentioned Bitcoin, and you talk a little bit about central bank digital currencies in the book. One, what is your view on CBDCs, and two, how would monetary policy work in a world like that, where money is going directly into people's wallets without necessarily having to enter the banking system?
Karen Petrou:	41:33	If you think about what is money, and money used to be goats and chickens. I have a chapter about this in my book. We all know now, for most of us, money is digits along with some cash. Interestingly, the lower income you have, middle, moderate, and lower income, the more cash you use. Everybody says, "This is

going to be a cashless society." Well, maybe up where I live in Washington DC, but not for most American household. But that's what cash is. We have "token cash", which is fiat currency, dollars and coins, physical.

Karen Petrou:	42:08	Then we have the digits that are in our bank accounts that we never see. You get your paycheck not in coins or dollars. It's just a statement dollars that are in an account. The revolution of digital money is like the revolution of digital everything else, which is that, why not create new forms of money that aren't fiat currency, not the money the Fed creates, that our money, whether Facebook creates it or Bitcoins create it, that we just all choose to use?
Karen Petrou:	42:42	They're faster. For example, the current payment system is very slow. In Bitcoin's case, you can get rich as opposed to dollars, and you put the dollars in the bank, back to what we were talking about. You lose money. If you put your dollars into Bitcoins, you think you're going to make money. So you have money that isn't money in the sense of what we think of money as. Do you want to get paid in Bitcoins? Can you go buy that hotdog in Bitcoins? Could you go buy a car?
Demetri Kofinas:	43:11	Certainly not at 25 cents.
Karen Petrou:	43:12	No, exactly. But what's money? It's a medium of exchange so that you get paid in it and then you buy things in it. I can sell you a car and you give me money. It's a medium of exchange that I'm willing to accept. And then I take the dollars you give me and I go buy a house. The medium of exchange is stable across all these transactions. And money is a store of value. That's what we expect it to be. If I put a hundred dollars in the bank, I get a hundred dollars back.
Karen Petrou:	43:46	Digital money is pushing at all of those concepts of money. But because the system is so digital, it certainly is, I think, increasingly true that there will be less and less cash, less and less token currency. And we're going to need a faster, better digital currency to support a payment system. So the key, when you talk about central bank digital currency is, does the Fed create that digital currency? Basically an electronic dollar.
Karen Petrou:	44:21	If it does that, how does that digital dollar, which is what members of Congress now are talking about, move through the financial system? Congressional Democrats are talking about creating Fed accounts in which you would deposit your pay at the Fed, not at the bank. In the Fed accounts, then you would write checks, the equivalent of checks, or a clicks, taps transactions against that Fed account into the payment system, which the Federal reserve now largely controls. That's one option.
Karen Petrou:	44:55	It's similar to our system right now, but different in that the Fed would become basically not just the central bank, but the national bank as well for all of our accounts.
Demetri Kofinas:	45:07	Why do you think that Western central banks have been so late to the game on this one?

Karen Petrou: 45:13 First of all, they're not exactly innovative. Secondly, any institution that are used to being as powerful as they are, haven't thought that anyone could challenge their hegemony. Secondly, I think things have changed really, really fast. I mean, two, three years ago, we wouldn't be talking this way because the digital currencies were very marginal. What really changed the debate was Facebook's proposal in 2019 to create Libra, its own digital currency.

Karen Petrou: 45:42 When you have a company with I think three and a half billion customers, all of a sudden banks said, "Maybe we're not as important as we thought. We have competition."

Demetri Kofinas: 45:52 Yeah, that was a bit of a shock to the system at the time.

Karen Petrou: 45:55 And it still is. It really shook up the concept of currency, and the concept of central banking, and the concept of payment systems.

Demetri Kofinas: 46:04 How familiar are you with Stablecoins?

Karen Petrou: 46:06 Reasonably.

Demetri Kofinas: 46:08 We did an episode with Rohan Grey, who was one of the prime authors of the STABLE Act. He actually made an interesting point about how... In a way that I hadn't really thought about, which was that Stablecoins effectively piggyback off of the stability created by the national currency, in this case, the dollar. And in that way, they effectively operate as promissory notes made by private entities that at the limit are not able to actually honor those pledges, and that they would effectively...

Demetri Kofinas: 46:41 If a situation like Facebook's Libra were to grow and scale in order to service the US economy, that it would quickly become too big to fail in the deepest sense of the word, in a way that we really haven't been familiar with in the past. And that, that simply would be really bad policy. And that the US should legislate against that. I'm curious what your view is on that.

Karen Petrou: 47:03 I agree with that, in broad terms. Bitcoin isn't a Stablecoin, Bitcoin is bits and you just trade in and out of it through the various Bitcoin mining machines.

Demetri Kofinas: 47:15 Definitely not stable.

Karen Petrou: 47:16 No. And the idea that Facebook came up with Stablecoin is that you have a Libra, now they're calling it Diem, that's stable like a dollar because it's based on a basket of currencies. Then there are a lot of new Wyoming-ish chartering cryptocurrency, Stablecoin banks, and things like that. The idea is, again, that you have this thing, this token, this currency that is based on a basket of assets or currencies. But Facebook has never made clear what kind of currencies it will have in there, and currency values change. There's a huge foreign exchange market, that the price goes up, the price goes down.

Karen Petrou: 47:56 Will Facebook be trading in the currencies in this basket? Who makes the money when it trades in the basket? Is there going to be enough in the basket? The payment system is run through the Fed through banks because banks hold, as I said before, reserves, and banks have capital requirements, and banks are highly regulated, so that when you put your money into a checking account and you go to write a check, you don't really worry that the hundred dollars you put in is still there, or maybe it's $85 because something happened overnight.

Karen Petrou: 48:28 So we really need a regimen for Stablecoins that ensures that that basket of currencies is put only into sterile assets, i.e., assets that Facebook can't touch, that are always going to be there and are easily liquid to ensure payment system finality. It's a very risky proposition if that basket backing the Stablecoin is as it currently is constructed in many cases, just something else cool that the offerer of the Stablecoin gets to make money with.

Demetri Kofinas: 49:01 Yeah. It's a bit of a complicated situation, also because, again, central banks have been late to the game.

Karen Petrou: 49:06 That's right.

Demetri Kofinas: 49:07 And so, a lot of these private sector players are filling a market need. Now, there's a huge speculative component of it, tons of fraud. I don't mean specifically in Stablecoins, I mean across the entire industry. But in some ways, they're responding in a way that central banks have not. While I'm sympathetic to the arguments put forward by Rowan, and I think there's actually a lot of merit to it, and I do think that a Stablecoin at scale would be too big to fail. Then that would be very dangerous and unfair for those of us that would have to bail it out.

Demetri Kofinas: 49:43 At the same time, Janet Yellen recently, it was like a month ago, not even, not even a month ago, where she said that they're beginning to think about central bank digital currencies. I mean, I think that literally is what you said. And I find that stunning. I find that stunning similar to how I'm stunned that Federal Reserve policy officials and people in government couldn't understand that the Fed was creating actually a driver in equality. I mean, your thesis to me is absolute common sense, and that's something that I've personally understood for a very long time.

Karen Petrou: 50:21 Great.

Demetri Kofinas: 50:22 It's plainly obvious, simply in the levitation of asset prices and recognizing who owns assets. I mean, it's commonsensical. So I find it similarly tone deaf. I want to ask you one more question, Karen, and then I'm going to move us into the overtime, where we'll continue this conversation and get into solutions. That question has to do with the fact that the Federal Reserve's liability, which is the US dollar, is not a national currency. I mean, it's a national currency, but it's a global reserve currency.

Demetri Kofinas: 50:52 Of course, we know that whenever there's a large liquidity draw-down in US financial markets or globally, the Fed rushes into set up swap lines. Why? Because so much credit and leverage is generated in dollars outside of US financial system. Therefore, Fed policy and monetary policy in the US isn't just a domestic affair. It has impact on the globe. And of course the globe comes back and impacts the US. So how much can the Fed really afford to focus solely on

America's economy? Because I think in your book, it almost seems as though you exclude the rest of the world, when you think about, or you have in your assumptions.

Demetri Kofinas: 51:30 How much can it afford to focus on America's economy when thinking about monetary policy, considering how integrated the world is and how dependent the global economy is on the US dollar?

Karen Petrou: 51:41 Well, I focused on the US because there are only so many pages I could write in one book. And my real call is what you said before, maybe common sense. But a lot of people didn't understand how monetary policy... Particularly through driving up asset prices and ultra-low rates in the role of the Fed's huge portfolio. That's very controversial. The Fed strongly disagrees with what's in my book. They say economic inequality is solely the fault of fiscal policy, tax policy. And they're not doing anything that anybody could argue with.

Karen Petrou: 52:12 So I really felt I needed to spend time in the book, laying out all of what you say, to try most importantly to get the Fed to change, because this country cannot take continuing economic inequality. Again, the political instability, the human costs. Look at what happened in COVID and how damaging it was to communities of color and low-income households. We just can't keep doing this. That's wrong.

Karen Petrou: 52:37 Now, the Fed is really conscious of its impact as to the reserve currency. Every time it did this in 2008, it did it again last year in 2020, it sets up dollar swap facilities to help other central banks deal with the impact of financial instability. It is really aware of how US low rates create high-risk emerging debt markets and so forth. We're related in the sense that problems, as we saw in 2011, problems in Greece can all of a sudden mean problems in the United States in terms of financial stability.

Karen Petrou: 53:11 But Fed policy is first and foremost about domestic economic growth, prosperity, and financial stability. If we start there, I think these other issues will follow in good order.

Demetri Kofinas: 53:22 I'm going to move us into the overtime, Karen. In the overtime, I wanted to discuss, one, how the Fed can change the measuring sticks that it uses to determine the efficacy of its policy, whether we're talking about measuring employment, whether we're talking about measuring inflation. I also want to discuss political instability because some of your solutions, I want to understand better, because right now I kind of disagree with some of the outcomes that I think would be generated from them. And that's because I think there are political dynamics at play with some of the things you suggest. While I would love to live in the world that you describe in the book, let's see if you can help me get there.

Karen Petrou: 54:03 Sure.

Demetri Kofinas: 54:03 I also would love to get your projections. Not your forecasts, but when we're talking about things like balance sheet growth, I think one area where I myself have been surprised, I will acknowledge this, if you had told me in 2008 that the

Fed was going to move from a $900-billion balance sheet to, what is it, like $10 trillion today, some enormous number... I don't even know off the top of my head what it is.

Karen Petrou: 54:30 It's right now, as we speak, it's 7.4 trillion, heading to 10. Heading to 10.

Demetri Kofinas: 54:35 It feels like 10. It feels like 20.

Karen Petrou: 54:38 Yep, it's a lot.

Demetri Kofinas: 54:39 I wouldn't have believed you that we would have been able to do that without generating inflation. And I was aware of Japan's case. But at the time, I think, when I had thought about the case of Japan and they were finishing up their second lost decade at that time. Somehow I saw Japan as being fundamentally different, and the reasons that Japan wasn't able to generate the consumer price inflation I thought was different. But I was wrong on that.

Demetri Kofinas: 55:04 So I'm curious to hear your view on how long you think the Fed can continue along its current trajectory, how big the balance sheet can get, and what it's going to try to buy before it can actually finally break markets. For anyone who is new to the program, Hidden Forces is listener supported. We don't accept advertisers or commercial sponsors. The entire show is funded from top to bottom by listeners like you.

Demetri Kofinas: 55:29 If you want access to the second part of my conversation with Karen, as well as the transcripts and rundowns to this episode and every other episode we've ever done, head over to hiddenforces.io to check out our episode library, or subscribe directly through our Patreon Page at patreon.com/hidden forces. There's also a link in the summary page to this episode with instructions on how to connect the overtime feed to your phone so that you can listen to these extra discussions just like you listen to the regular podcast. Karen, stick around. We're going to move the rest of our conversation into the subscriber overtime.

Karen Petrou: 56:05 Sure.

Demetri Kofinas: 56:07 Today's episode of Hidden Forces was recorded in New York City. For more information about this week's episode, or if you want easy access to related programming, visit our website at hiddenforces.io and subscribe to our free email list. If you want access to overtime segments, episode transcripts, and show rundowns full of links and detailed information related to each and every episode, check out our premium subscription available through the hidden forces website or through our Patreon page at patreon.com/hiddenforces.

Demetri Kofinas: 56:44 Today's episode was produced by me and edited by Stylianos Nicolaou. For more episodes, you can check out our website at hiddenforces.io. Join the conversation at Facebook, Twitter, and Instagram @HiddenForcesPod, or send me an email. As always, thanks for listening. We'll see you next week.