Income inequality: causes, consequences... and politics (1/4)

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Key points:

- **Among the *causes* of income inequality (no longer mentioned in non-specialized discussions) there is the strong fall in the inflation rate in Western countries since the early eighties, which may play a major role in explaining this phenomenon.**
- Major *consequences* of income inequality are the well-known detrimental effects on consumer demand and its strong potential to increase savings, which in turn exacerbate inequality.
- The strong increase in income inequality has often been present in political campaigns since at least the 1990s. Surprisingly, however, recent U.S. and French elections focused very little attention to this issue.
- A possible reason why this is so may be that reducing income inequality is at odds with globalization (as it is practiced today) and the Great Moderation.

In this first part of the series dealing with income inequality, I focus on some of the *causes* of the rise in income inequality in the aggregate. Mainly, the low inflation rates and high unemployment rates that prevail across Western economies. The remaining points will be dealt with on a one by one basis subsequently. Comments are welcome.

Low inflation as a major cause of income inequality

Income inequality is a multifaceted phenomenon. In this note I focus on unemployment and inflation, which are perhaps major elements that explain it. Let us start with a long-term view of the so-called Phillips curve, that is, with the curve that negatively associates the unemployment rate and the inflation rate.

During the post-war period known as Bretton Woods (1945-1971) the unemployment rate in most Western economies was low, and this contrasted with a dynamic evolution of consumer prices, which increased at a faster speed than today thanks in part to growing demand for goods and services (this is known as demand-pull inflation). Today the picture is the opposite. The evolution of demand for goods and services is relatively low, therefore prices grow at a low

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pace, and there are higher unemployment rates than in the past.

Since the early 1980s high unemployment rates, low inflation rates and low economic growth rates have been coupled with a rise in income inequality for several reasons. One of these is the strong increase in unemployment itself. Looking first at the lower end of the distribution, an increase in the proportion of unemployed persons willing and able to work is equivalent to an increasing share of the population being economically less well-off, which translates into less dynamism in production and demand for goods, as well as aggressive advertising to cover for this lackluster demand.

Let us now focus on the upper end of the distribution. Despite the workers shortfall, firms have not stopped producing, mainly because they can outsource part of their production in places where labor is cheaper and more flexible than at home, invest in mechanization of otherwise manual tasks and/or pay less to non-replaced low-skilled workers. Because the inflation rate and welfare enhancing policies/institutions (that presumably cause inflation) have been greatly undermined, this period is known as the Great Moderation.

On the macroeconomic front, the second half of the seventies (the transition period between Bretton Woods and the Great Moderation) was *exceptionally* characterized by high unemployment and high inflation rates. Both problems were bad and both had to be solved, but only one persisted past the second oil shock (unemployment) because the authorities focused too much attention on the other one (inflation).

By taming the evolution of prices in the early eighties, economic authorities did society a favor. However, by insisting too much on keeping inflation below at or below a certain threshold (the now so famous 2%) in subsequent decades, the same authorities are now contributing to the growing gap between the well-off and the poor. Hawkish analysts/politicians/journalists often ignore the benefits of inflation and focus instead exclusively on its drawbacks.

Back in the Bretton Woods years inflation was higher than today, and this encouraged firms to borrow in order to fund their investment. This investment also meant more employment and production, so that inflation itself helped reduce unemployment and increase production. During this period debt-to-GDP ratios were lower than today because the real value of debt was being diminished by inflation and GDP was growing at a fast pace.

In contrast, in the period known as the Great Moderation inflation remained at lower levels, which in turn discouraged firms to borrow and encouraged banks to look for alternative borrowers: households and the rest of the world. Low inflation discouraged firms to keep on funding their investment by issuing debt, which in turn meant higher unemployment rates and lower economic growth. During this period debt-to-GDP ratios increased strongly because the real value of debt was being maintained by low inflation, and GDP was growing very slowly.

That is, the world in which we now live, where low inflation prevails, redistributes wealth from borrowers to lenders and increases debt liabilities, unemployment, low growth and inequalities in a loop. This is something inflation-phobic individuals forget when they defend their hawkish points of view against the evils of inflation (excessive or otherwise).