Income inequality: causes, consequences... and politics (2/4)

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In this second part of the series dealing with income inequality, I focus on some of the *consequences* of the rise in income inequality in the aggregate. Since the early 1980s redistributional effects have taken place at a macroeconomic level that further exacerbate price stability and high unemployment. This implies that the increase in wealth an income inequalities are also self-generated mechanisms. Comments are welcome.

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. (For the discussion see here)
- **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. (Special attention is here given to long term trends and inequalities among countries).**
- 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.

Low inflation is (also) a consequence of growing income and wealth inequality, within and among countries

There is hardly any doubt that income and wealth inequalities have risen in the past forty years, and the consequences that emanate from this are dire. At a macroeconomic level, inequality across households translates in that the rich have a high propensity to save, whereas the poor have a high propensity to spend. This in turn implies that (1) aggregate savings exceed aggregate investment, and that (2) this gap has to be filled by the foreign sector.

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Before delving with these two points, let us first take a small detour and take a look at the link between the exchange rate and the inflation-unemployment trade-off, which are major determinants of currency values, and indirect determinants of inequality among countries.

When prices of goods and services are rising rapidly and constantly, the demand for money increases fast, and if supply grows even more than this demand (say, because of miscalculations from the central bank) then money becomes more abundant with respect to the amount the economy needs. In this case the currency loses value. Furthermore, in the absence of any change in exchange rate policy of partner countries, the currency of the country depreciates, which in turn worsens the capital account, but improves the trade balance and facilitates employment creation at home.

On the contrary, when the evolution of prices stagnates money demand slackens. Furthermore, in this case money supply is curtailed because when it is excessive it is associated with inflation. Therefore, money demand is likely to exceed money supply and the home currency gains value against other currencies. Again, in the absence of any change in exchange rate policy from partner countries, this implies that the home currency appreciates, which in turn worsens the trade balance and hinders economic growth at home, whereas it improves the capital account (demand for domestic financial assets increases).

Bearing this in mind, let us now see what were the major macroeconomic consequences of going from high inflation (mainly the 1960s and 1970s) to low inflation (1980s on) and how these relate to the consequences of the rise in income and wealth inequalities.

Following the second major oil shock of early 1979, the Federal Reserve raised the leading interest rate. This had the expected effect of lowering the inflation rate and keeping it low since then. This economic policy prescription was also carried out in several advanced countries, partners of the United States.

During the 1960s and 1970s inflation was high, unemployment was low and wealth and income inequalities existed, but were lower than today. With high inflation rich households saved small amounts at home as compared to what they saved abroad (where inflation was lower), whereas less well-off households enjoyed high employment rates, growing wages and lower debt loads than it is the case nowadays. On the international front, this meant that the trade balances of these economies were improving, given that their currencies were depreciating.

All this reversed since the 1980s. Inflation has since remained low, unemployment high and wealth and income inequalities increased. With low inflation rich households started saving larger amounts at home than abroad, and less well-off households were affected by less employment, stagnant wages and heavy debt loads. On the international front, this also meant that the trade balances of these economies were worsening, although their capital accounts were being replenished, given that their currencies were appreciating.

Now, going back to points (1) and (2) raised above. A major consequence of these long term macroeconomic trends means that the low inflation rates that prevail today in Western economies have promoted more savings, thanks in part to currency appreciation (no wonder why London and New York became much more important financial centers than other places even past at least four major financial crises). Since inflation is low, debt loads are higher, which is good news for debt holders and bad news for borrowers.

Other than widening the gap between the rich and the poor, this means that non-financial firms must face more stringent financial conditions than when there is higher inflation. Investment is thus lower than in the past and savings in the present. Naturally, the trend was the opposite back in the 1960s and 1970s, and the opposite is also now taking place in other parts of the world.

Since production is deficient in Western countries, demand for foreign goods (notably from South and Southeast Asia) has to fill this gap.

So, what are the major consequences of the widening income and wealth inequalities that have increased since the 1980s? More income and wealth inequalities! At the core of this wealth/income-gap are low inflation (which makes debt loads heavier), high unemployment (which reduces workers' wage bargaining power), appreciating currencies (which reduce competitiveness), high savings (which raises financial profitability and financial sector influence), low private investment (which exacerbates unemployment and forces firms to replace human labor by machines and exploited outsourced workers) and low economic growth.