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

Luis Reyes*

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In this fourth part of the series, I highlight some of the inconsistencies of reducing income and wealth inequalities as well as unemployment in a globalized world. Despite these inconsistencies, I make some macroeconomic policy recommendations to reduce them. 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 given to long term trends and inequalities among countries, see the discussion here).
- The strong increase in income inequality has often been present in political campaigns. Surprisingly, however, recent U.S. and French elections focused very little attention to this issue. (See the discussion here)
- **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.**

Income and wealth inequality persistence in a globalized world

Despite the celebrated achievements of globalization, we must recognize that there have also been several negative consequences of this phenomenon. By focusing exclusively (or mostly) on the advantages and on some success stories of the winners of this game, we may be paying a blind eye to its drawbacks and our capacity to act in a convincing way to diminish the latter.

As argued in this series of notes, globalization (together with unemployment) is here seen as a major determinant of growing income and wealth inequalities. These have grown across and

*Centre d'Économie Paris Nord: luis.reyes.rtz@gmail.com, https://luisreyesortiz.org/

among countries, with the result that those at the bottom of the distribution find it harder to climb up, whereas those at the very top find it easier. As an almost natural byproduct, poverty rates have increased.

Income and wealth inequality is a self-reinforcing mechanism. At a microeconomic/behavioral level this can be seen as a hierarchical issue or as a self-legitimating mechanism. At a political level, existing inequalities could reflect the dynamics of public opinion that end up translating into actual policy-making that further widens inequalities.

At a macroeconomic level, the dynamics of the international monetary system and government ideology are key determinants of this self-reinforced trend. In the remaining of this note, I focus on the latter and I propose a policy measure to counter inequalities. Let us begin with a small historical detour.

A major historical economic event we have witnessed over the past sixty years, that is perhaps at the *origin* of the stark rise in income inequalities worldwide, is the second oil shock. This was the consequence of the overthrowing of a pro-American government in Iran (a major supplier of oil for the U.S. back then) and its replacement by a strongly anti-American one in January of 1979. Beyond the important structural changes that took place in Iran itself, this brought about the strong rise in oil prices worldwide that translated into a higher and higher general price level of goods and services.

Despite the inflationary pressures of the period, the then Federal Reserve chairman William Miller did not consider creating a recession as a viable solution (which would come from a rapid and sustained rise in the Treasury rate, see p. 142-144 of Romer and Romer, 2004). This changed in October of the same year when the strong inflationary pressures had already caused wide discontent, particularly so for financial actors who were concerned for the dollar depreciation that discouraged financial investors from holding financial instruments denominated in that currency.

With the lead of the newly appointed Fed chair Paul Volcker, the Federal Reserve provoked a recession by raising the interest rate in October 6, 1979 that ended once and for all the inflationary problems of the decade and thereafter (the so-called Great Moderation). Since then, inflation rates have remained low and relatively stable, whereas inequalities have not ceased to increase.

When this was happening, financial capital markets were already *globally integrated*, so that a strong appreciation of the dollar created a capital inflow in the U.S., and a corresponding capital flight from other countries (mainly, Central Europe). In order to stop the capital drain, central banks of major industrial countries were forced to raise their interest rates too, thus creating a recession, taming inflation and widening economic inequalities in their countries as well. The Great Moderation turned global.

Low inflation has since been coupled with high unemployment, high debt-to-GDP ratios, important trade deficits and growing inequalities in industrial countries, with the important exceptions of Japan and Germany (at least with respect to trade deficits). This contrasts with dynamic (though precarious) labor markets and productive sectors in emerging economies (most notably China) with strong levels of inequality as well.

Because low inflation is a global process, high unemployment, high indebtedness and sharp economic inequalities are also (at least in part) consequences of globalization.

As mentioned above, inequality is a self-reinforcing mechanism also at a macroeconomic level. An example of this is the fact that international organizations (IMF, World Bank, OECD) often make policy recommendations that (when and if these are followed) tend to enhance inequalities across and among countries. This is the case of the now popular 'small government' doctrine that forces governments to reduce their debt (and, as a consequence, their spending) at a level that is incompatible with the high employment levels witnessed in the immediate post-war period.

An interesting example of this is the infamous austerity measures promoted and strongly encouraged by the European economic authorities (ECB and European Commission, mainly) that have kept Southern Europe from recovering from the global financial crisis, and that has impeded the so-expected 'catching-up' with respect to its Northern European peers.

The small government doctrine has existed for a long time, but it gained further strength since the early eighties thanks in part to the fact that it is meant to limit corruption in governments that were financed by money creation, thus undermining the ability of governments to amortize their debt by creating inflation via public spending. Money creation is now banned, thanks to the fact that central banks are independent. Inflation is currently low, but (alas!) the economy is doing much more poorly than back when governments could finance their expenditure via central bank money.

The global fight against inflation led to high unemployment and inequalities, as well as limited government spending at a global scale. Perhaps the solution to counter this trend is to push policy in the opposite direction, which would imply higher (not lower!) government expenditure that would allow the world economy to pull itself out of deflation. This would perhaps need to be coupled with a loss of independence of central banks and the printing of helicopter money.

Now, more public debt (instead of less) may sound as a counter-intuitive proposal at a time when debt-to-GDP ratios are already high. However, more public indebtedness would also finance more public spending (which buys goods produced by private firms) and, consequently, bring about lower debt-to-GDP ratios (public and private). For it would boost both inflation and economic growth, both of which would make the denominator of this macroeconomic indicator increase via Keynesian multiplier effects.

Needless to mention, more growth and more inflation would reduce unemployment, and this combination would be ideal to reduce income and wealth inequalities.

References

Romer, Christina and Paul Romer (2004) *Choosing the Federal Reserve Chair: Lessons from History.*