Growing Inequality: Cause and Consequence of Financial Crisis

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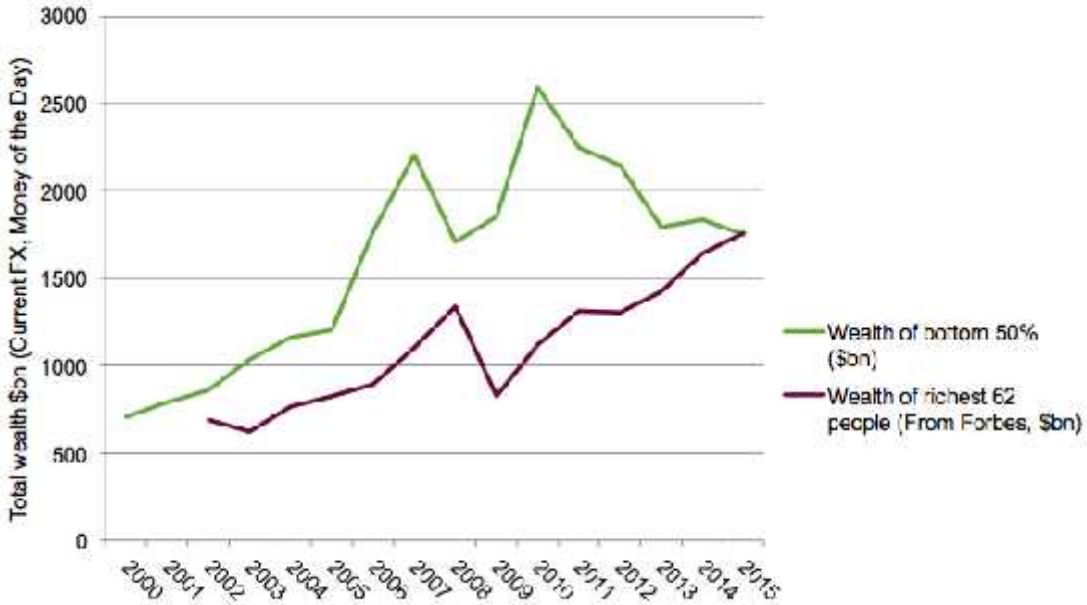
Inequality in most societies, both developed and less developed, has been rising with the onslaught of neoliberalism since the 1970s. After decades of either neglect or denial by mainstream economists, almost everyone now, including the super-rich and high establishment, has recognised this worrying trend. For example, Li Ka-shing, Asia's wealthiest man, said widening inequality keeps him awake at night. US Federal Reserve chief Janet Yellen weighed in on this issue and was admonished by conservatives for straying from the Fed's mandate. Rising inequality has also captured attention in the World Economic Forum meetings of the global elite.

According to a report by the international NGO Oxfam, just 62 individuals owned as much wealth as 3.6 billion people in 2015, down from 388 in 2010. The wealth of these 62 rose 44% in five years while that of the bottom half of the world's population dropped 41% (Figure 1).

Figure 1: Wealth of 62 richest individuals and of poorest half of world population



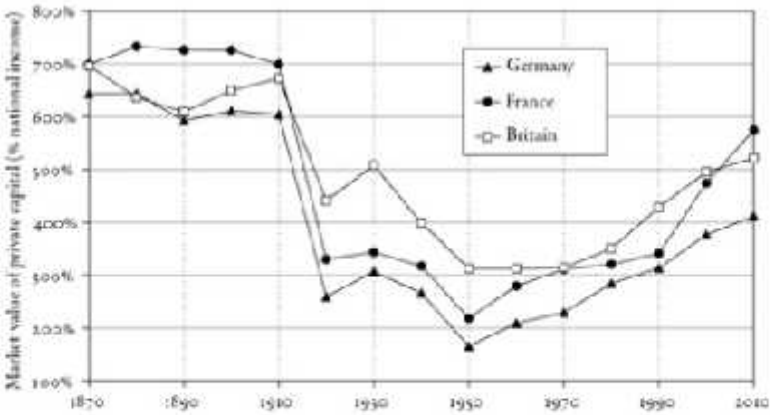
Source: Oxfam (2016)

In the US, inequality is reported to have reached its highest level since such records were kept in the 1910s. The income of the top 1% exceeded 25% of total income for the whole society.

Taking a long historical view, economist Thomas Piketty, in his path-breaking book, *Capital in the Twenty-First Century*, showed that inequality, as measured by

a country's ratio of stock of wealth to national income, was extremely high in 19th-century Europe, took a dip in the period between the two world wars of the 20th century, and started to rise again after the 1970s. Figure 2 shows the U-shaped inequality (wealth/income) ratio. The basic driver for this, Piketty explains, is that, as the rate of return to capital is greater than the rate of economic growth, more and more income accrues to those who own capital unless there are stronger countervailing forces against this trend.

Figure 2: The capital/income ratio in Europe, 1870-2010



URE 1.2 The capital/income ratio in Europe, 1870–2010

gregate private wealth was worth about six to seven years of national income in Europe in 1910, betw
o and three years in 1950, and between four and six years in 2010.

urces and series: see piketty.pse.ens.fr/capital21c.

Causes of inequality

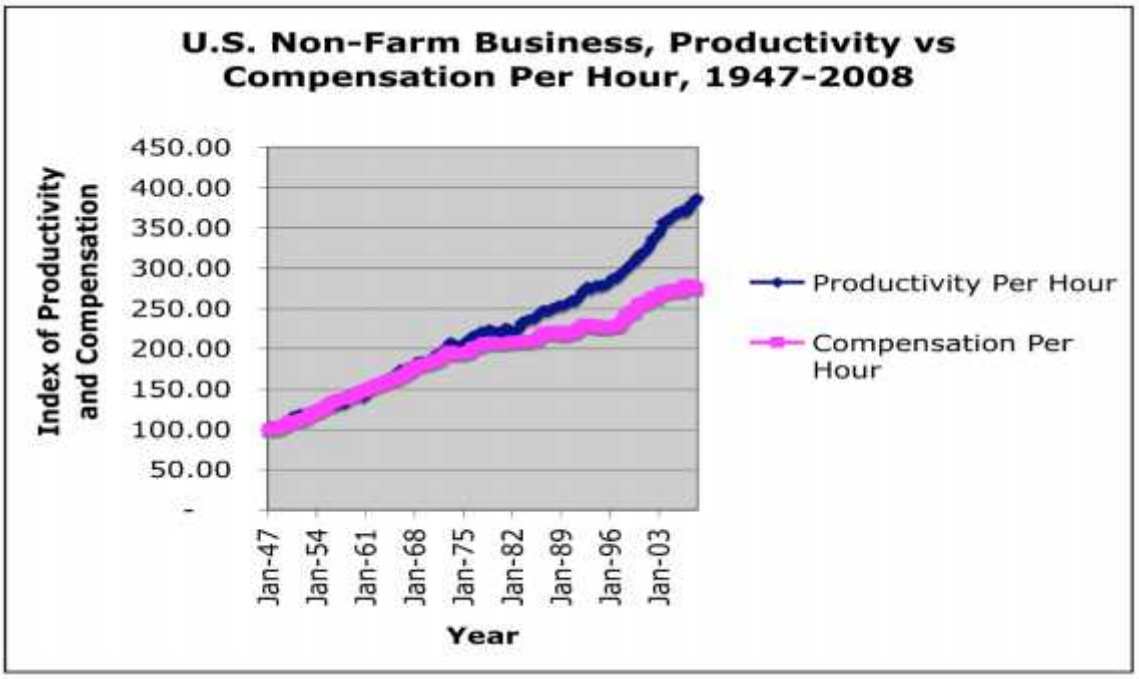
For a long time, mainstream economists were fixated on growth, ignoring the issue of distribution, believing in the theories of trickle-down growth and that 'a rising tide lifts all boats'.[1] Faced with irrefutable evidence to the contrary, they, except for the die-hards, now admit inequality has been rising.

Their focus, however, is on distribution of personal income as measured conventionally by the Gini coefficient. Inequality is seen mainly as inequality of opportunities in education, health and other endowments. Technological causes are also given prominence; people with skills and ability who take advantage of technology reap benefits of higher productivity. The theory of marginal productivity features centrally in their explanation of inequality: people with higher marginal productivity are accorded higher income.

However, this theory of marginal productivity has encountered an anomaly, as was admitted by Alan Greenspan, a former chairman of the US Federal Reserve. Noting the significant and stubborn divergence between growth of labour productivity and growth of labour compensation, he admitted that profits are much higher than they should be in a competitive world. He said that from an accounting perspective, he understood this divergence, but that he did not know

in an economic sense what the processes are that cause this divergence. He professed concern that if wages for the average US worker do not start to rise more quickly, political support for free markets may be undermined [cited in Guha (2007)].

Figure 3: Productivity vs Wage Growth in the U.S. (1947-2008)



Source: Lim and Lim (2010)

While heterodox economists would agree that inequality of opportunities and skills contributes to inequality, they devote more focus to macro-structural, political and economic factors that worsen inequality. Central to this is the unequal distribution of economic resources and political power, their shifting realignment, and the redistribution of profits and rents versus labour income. Are wages determined more by marginal productivity or by political and economic forces that influence the bargaining power of capital over labour? What are the global and national forces that influence this realignment of bargaining power? How does technology factor in this process?

At the top of the agenda is globalization – the increasing movement and integration of goods, capital, labour and technology at a global level that has brought higher growth but also greater inequality, resulting in winners and losers. Associated with globalization are two related processes – financialization and the international relocation of production – that weakened the bargaining power of labour in developed and less developed countries.

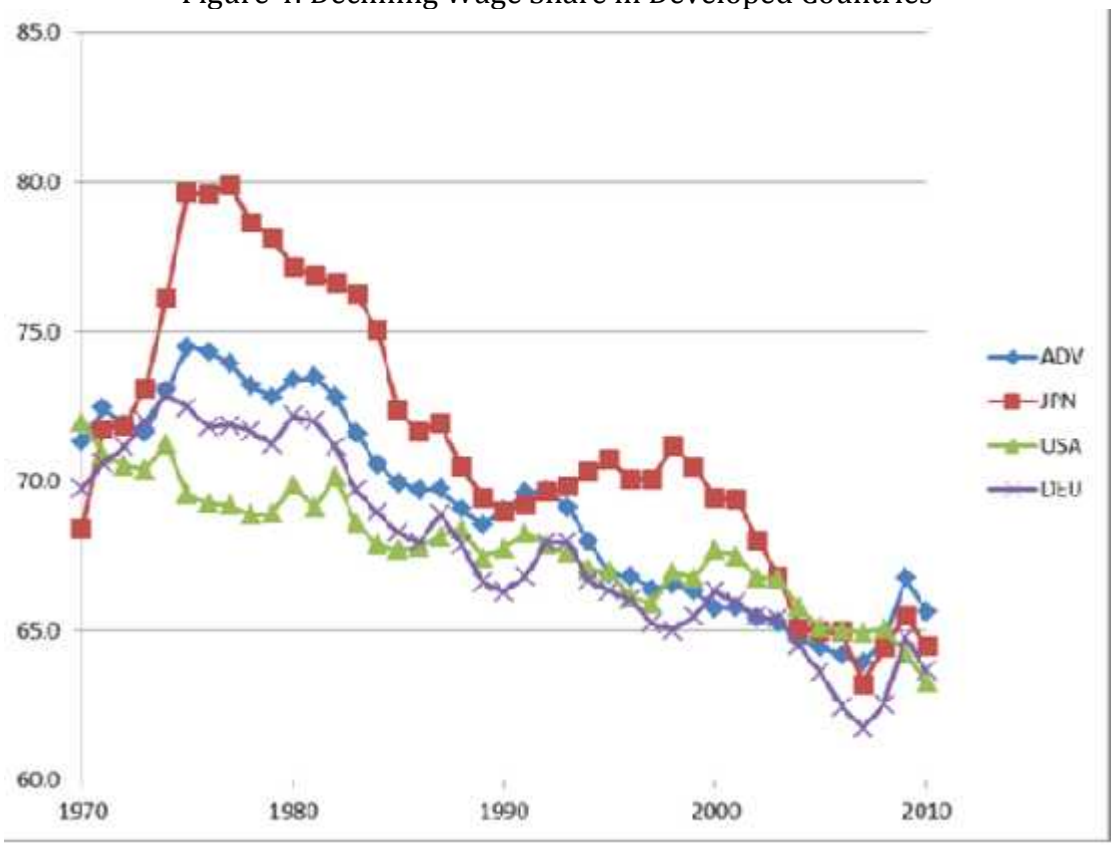
With the collapse of the Bretton Woods Agreement in 1971, the international monetary system went off the US dollar-gold standard, and from a fixed to a floating exchange rate system. With the latter, banks started to trade in foreign exchange in a big way such that trading income soon exceeded income from lending for many banks.

Financial liberalization, the economic counterpart of political neoliberalism, also ushered in an era of free international capital flow. Capital can now flow freely, without political constraints, in search of the highest profit. Together with significant changes in technology and business organization, multinational corporations can now freely invest and relocate production to any part of the world, pitting one country against another. Economic liberalization in Asia, the introduction of economic reforms in China, and the collapse of the Berlin Wall unleashed billions of unemployed or underemployed workers from these regions into the global workforce, making possible the global arbitrage of labour. That is, capital is now able to move freely in search of countries with the lowest costs.

This, aided by national policies that repressed labour, reduced labour's bargaining power in both developed and developing countries. In the US and the UK, the Reagan and Thatcher regimes broke the back of organized labour. Governments in many Asian countries openly repressed labour and wages in order to compete for foreign direct investments. All these put a brake on wage rise in both poor and richer countries.

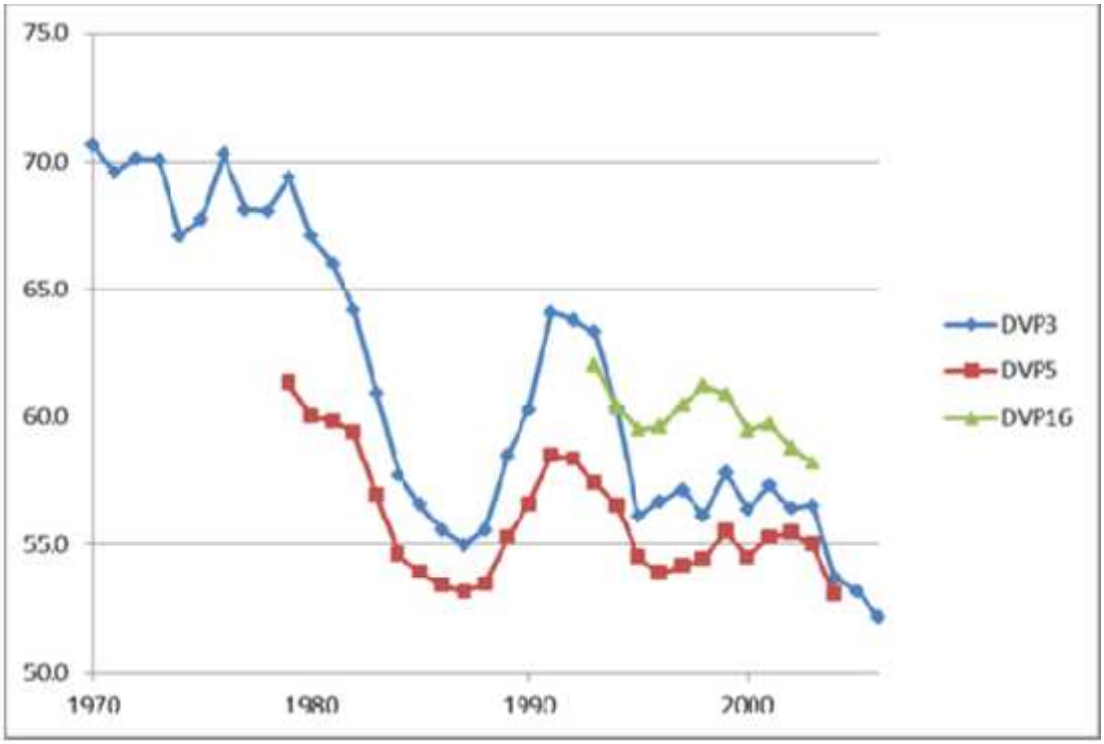
It is no coincidence that this period saw a decline in labour's share of gross domestic product (GDP) and a rise in inequality.

Figure 4: Declining Wage Share in Developed Countries



Source: Stockhammer (2013)

Figure 5: Declining Wage Share in Developing Countries



Source: Stockhammer (2013)

Another way of looking at this is by considering the divergence between wage and productivity growth alluded to by Greenspan. Wage growth lagged behind productivity growth not because of marginal productivity but because capital was able to claim a greater share of the income growth due to the weaker bargaining power of labour.

Financial crises are periods when capital and labour contest for the distribution of income. Such crises often offer opportunities for capital to restructure to its advantage, as in the case of South Korea. Prior to 1998, economic growth in South Korea was accompanied by declining inequality where not only the Gini coefficient fell but also the wage share of GDP rose. This trend reversed following the Asian financial crisis that hit the country in 1997-98 after a decade of financial liberalization. The International Monetary Fund (IMF) stepped in to rescue the economy and major structural changes were introduced that, among other things, increased "labour market flexibility" (read: reduced labour's bargaining power). There was massive retrenchment of workers, a surge in part-time and temporary employment, and greater wage restraint.

Consequences of inequality

Public health researcher Richard Wilkinson has explained at length the social and political consequences of inequality, which include social tension, rise in crime rates, mental illness, suicides and social exclusion. Greenspan has alluded to the political alienation and risks of rising inequality.

Beyond political and social instability, rising inequality is also not good for financial stability and economic growth. A recent IMF study (…) shows that

inequality is not good for long-term growth. While it is possible to produce growth spells irrespective of inequality, the study finds that income distribution is one of the most robust predictors of sustained growth. Furthermore, extreme inequality misallocates human resource development and is often associated with weak institutions and governance. The study also concludes that redistribution of income does not negatively affect growth.

Finally, inequality is related to financial instability. The recent global financial crisis is not simply the result of greedy bankers, poor corporate governance and lax banking regulation, although these problems must be addressed. There are even more serious underlying structural causes for the crisis, one of which is rising inequality (see Lim and Khor, 2011).

It is widely recognized that global trade imbalances contributed to the crisis, i.e., China and other Asian countries have enormous trade surpluses that funded the US' huge trade deficit. But behind this trade imbalance is wealth and income imbalance. China's declining wage share of GDP is reflected in its drastic drop in personal consumption (from over 50% to 35% of GDP in the last four decades) and the concomitant rise in its savings rate (from about 30% to 50% of GDP). This excess of savings over investment, which is the current account surplus, is recycled through the international financial system to fund consumption in the US, which reached 72% of GDP in 2007.

How was it possible for consumption in the US to rise when real wages were either stagnating or even declining? Essentially consumption was supported by debt rather than income. Between 1960 and 2006, the US GDP rose 26 times but household debt 64 times, reaching close to 100% of GDP in 2006. Much of this was housing debt that eventually imploded in 2007.

Wages are not simply a cost factor; they are also an important factor driving aggregate demand. If wages are repressed, then aggregate demand and economic growth are negatively affected unless there are compensating mechanisms to prop up aggregate demand. Debt is one such mechanism. However, there are risks and limits to pumping up consumption through debt, as amply demonstrated in the US and global financial crisis in 2007.

A number of Asian countries are exhibiting similar tendencies. In South Korea and Malaysia, where the wage share is declining due to wages falling behind productivity growth, household consumption and debt have been climbing to dangerously high levels. The ratio of household debt to GDP reached 89% in South Korea in 2010 and 89% in Malaysia in 2015. Even more alarmingly, the ratio of household debt to disposable income is 164% in South Korea (2012) and 140% in Malaysia (2010). The lesson from the US debt-driven consumption and financial crisis because of rising inequality and declining wage share should serving as a warning to these countries.

Quantitative easing and inequality

Governments in the US and elsewhere unleashed massive fiscal and monetary stimulus programmes to contain the 2007 global financial crisis. Trillions of dollars were pumped into the economy, much of it from government borrowing which pushed public debt to even higher levels. Since 2008, total public and private debt in major economies reached $200 trillion or about 300% of global GDP, an increase of 20%.

On the monetary front, central banks all over the world not only reduced interest rates. Those of major economies the US, the European Union and Japan embarked on rounds of quantitative easing (QE). This consists of central banks buying long-dated securities to bring down long-term interest rates, pumping liquidity into banks and financial institutions to boost lending, and encouraging higher financial risk appetite and investments in financial markets.

There are three main ways by which QE can impact on inequality – through portfolio rebalancing and asset prices, employment creation and mortgage financing. The first exacerbates inequality, while the latter two are said to be countervailing factors. Ben Bernanke, former chairman of the US Federal Reserve, argues that the latter two work to contain the inequality effect of QE, but two other former Fed members differ.

Employment creation spreads income more widely. However, this effect has been weak as many of the jobs created are low-paying and, moreover, the structural factors explained above work against wage increases. Thus it has been dubbed a job-rich but pay-poor recovery.

Theoretically QE and excess liquidity should translate into availability of cheaper mortgage financing. However, people who are able to take advantage of this are the better off, while the poor and those whose house equity are under the water are unable to get refinancing and those with low incomes are unable to get new loans as banks become more cautious of lending after the global financial crisis.

As for the first factor above, when central banks buy securities and financial assets, they inject liquidity into banks and financial institutions. The objective is for them to lend the money for productive investment and to boost economic activities. However, much of it is used for buying equities, bonds and for speculative purposes. Financial institutions and fund managers are now able to borrow at near-zero interest rates to invest in the financial markets. There was also a surge in corporate borrowing; instead of investing in production, much was ploughed into share buybacks and mergers and acquisitions.

The upshot of this was a huge run-up in financial asset prices. The prices in bond, stock and property markets have exceeded the levels in the pre-crisis period. As pointed out, ownership of wealth is highly unequal and concentrated, even more so than income distribution. Hence the people who are best placed to take advantage and reap the benefits of this financial asset repricing are the rich.

As Table 1 shows, taking the example of the UK, the share of stocks directly owned by the top 1% of households rose from 32% to 53% between the pre- and

post-financial crisis periods, while that of the bottom 80% dropped from 13% to 7%.

Table 1: Ownership of stocks in the UK before and after the global financial crisis

	Percentage share of total stock wealth	
	2006-08	**2010-12**
Top 1%	32.1	53.1
Top 10%	77.0	86.2
Bottom 80%	12.7	7.0

Source: Standard & Poor's (2016)

Unlike the conventional monetary policy of cutting interest rates, which works through the "credit channel", QE as a policy, according to former US Federal Reserve Board member Kevin Warsh, works purely through an "asset price channel", enriching the few who own stocks or other financial products (and not the 96% of Americans who receive the majority of their income through labour).

Another former Fed Board member, Richard Fisher, put it in stronger terms, describing QE as a "massive gift" to the elite of the financial world (Soni, 2014). In another article, he called this the "Everything Boom" and stated: "I believe the root cause is the hyper-accommodative monetary policy of the Federal Reserve and other central banks" (Fisher, 2014). With interest rates forced down, fund managers and investors were encouraged to invest in other financial assets, pushing up prices, and the purchase of these made them richer.

Conclusion

Rising inequality is among the root causes of the recent global financial crisis. Aggressive loose monetary policies and quantitative easing is the cure to resuscitate the economy. These policies have pushed interest rates to near zero and in some places to negative levels. But like pushing on a string, the real economy has not recovered to pre-crisis levels. Growth is desultory and patchy, but inequality has worsened because of quantitative easing. The pill that was supposed to be the cure not only has not been effective but also has produced unintended consequences of rising inequality. Will this add fuel to the fire? Time will tell.

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Endnote

1. Robert Lucas, a Nobel laureate in economics, wrote, "Of the tendencies that are harmful to sound economics, the most seductive, and in my opinion the most poisonous, is to focus on questions of distribution."

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