Investment Themes & Strategy

Central banks can make inequality worse

Stefan Hofrichter | 28/09/2018

Summary

Economic inequality has been steadily rising thanks to the rise of automation, declining unionisation and the growth of the financial sector. But loose monetary policy also plays a role. For decades, easy money has significantly increased wealth and income inequality on a structural level, fundamental changing how the global economy operates.

Key takeaways

- Economic inequality drags down economic growth, destabilises social systems and stresses government finances
- Central banks generally view inequality as something beyond their control – exacerbated by factors such as technological change and globalisation
- We believe monetary policy has made inequality worse by overstimulating prices of risk assets, increasing debt levels and disproportionately benefiting the financial sector
- Ultra-low rates have led to a misallocation of resources and increased the share of "zombie companies"

Steadily rising for decades, economic inequality has become a pressing global issue. In addition to its human cost, it drags down economic growth and destabilises social systems, and it stresses government spending and revenue streams.

Most academics and central banks attribute the spread of inequality to the rise of automation and the growth of the financial sector. While this is true, we believe decades of too-loose monetary policy have also played a major role, significantly increasing wealth and income inequality on a structural level.

The conventional explanations for rising inequality

Although inequality has increased worldwide since the early 1980s, both in developed and emerging countries, the trend in the United States is particularly striking: the Gini coefficient – a common statistical measure of inequality – is at its highest level since the 1930s.

Academics largely attribute this growing divergence to the rise of automation. With machines and new technologies taking over many manual and repetitive activities, the wages of lowskilled employees and the ranks of middle-income earners have fallen. Many academics also cite the declining unionisation of employees and the rise of the financial sector as additional reasons for increased income divergence.

Central banks, for their part, generally view inequality as something created by factors beyond the control of monetary policy – namely technological change and globalisation. They believe that if monetary policy is symmetrical – that is to say, if the stimulation and tightening phases of monetary policy are equally pronounced – then the positive and negative distributional effects should balance out over time.

Our view: asymmetrical monetary policy is making inequality worse

But it is precisely this assumption that must be called into question: we believe monetary policy has been asymmetrical for several decades. According to our estimates, monetary policy in the US and Europe has been somewhat too loose on average since the 1980s and below the estimated "neutral" value at which the economy is neither stimulated nor slowed down.

There are three primary ways in which too-loose monetary policy contributes to economic inequality:

1

Higher prices for risky assets

Structurally over-expansionary monetary policy stimulates prices of risky assets, as market participants discount stronger economic activity in the future. Indeed, equities have generated above-average returns worldwide since the mid-1980s. During this time, asset owners benefited from an unprecedented rise in asset prices and capital incomes – and wealth and income inequality has risen structurally.

2

Significant increase in debt

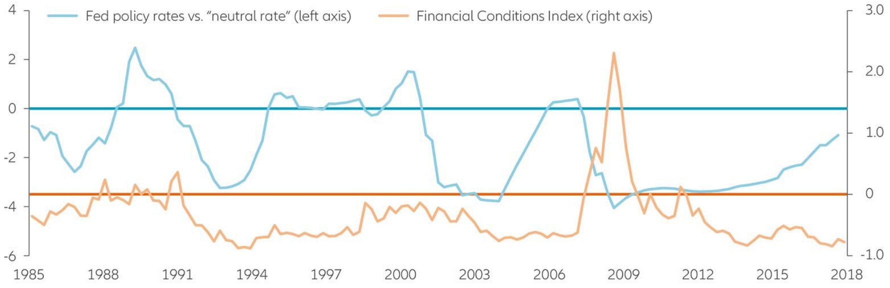
While low interest rates can certainly provide an initial boost to economic activity, they can also significantly raise debt levels. This has been the case in recent decades: relative to GDP, debt among companies and households has reached an all-time high of 150%. This has helped lower productivity and increase inequality because cheap financing lowers the profitability hurdle for investments: with ultra-low rates, even less-efficient investment projects become worthwhile. In recent years, this has led to a misallocation of resources and increased the share of "zombie companies" – firms with interest expenses that exceed their operating profits. This means less financing for younger, more productive companies – further dragging down economic growth and productivity, and worsening inequality.

3

Growth of the financial sector

The financial sector benefits from asymmetric monetary policy in several ways. First, it invests directly in those risk assets that are positively influenced by low rates – more financial assets than productive ones. Second, financial firms achieve above-average increases in commission and interest income in a favourable financial market environment. This has been the case in the US, where banks' and insurance companies' share of GDP has increased significantly since the mid-1980s. It has also held true since the financial crisis in Canada, Sweden, Australia and China. As the financial sector takes up a larger share of GDP, the relative compensation of its workers also increases – which by definition means the rest of the economy earns less.

Monetary policy has been too loose since the 1980s
US Federal Reserve interest rate relative to the neutral rate vs. the Chicago Fed's National Financial Conditions Index.



Source: Thomson Reuters Datastream, AllianzGI Economics & Strategy. Data as at 13 August 2018.

The monetary framework matters for productivity, growth and equality

Our view of monetary policy in the debate over wealth and income distribution and productivity is very different from the mainstream view. We accept that monetary-policy distortions are not the only explanation for low productivity growth and rising inequality; other factors such as competition policy, banking regulation and tax policy are also relevant. However, the monetary framework can itself trigger negative effects on productivity, growth, and the distribution of wealth and income.

Further reading

For a more in-depth look at this topic, read "How to repair economic inequality" and "To reduce inequality, focus on inclusive growth".

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Will US yields break out of their range?

Mona Mahajan | 09/10/2018

Summary

After staying stuck in a narrow band for much of 2018, 10-year Treasury yields have only recently stayed above the 3.05% barrier for a prolonged time. This could be the beginning of a sell-off in Treasuries that pushes yields higher, though other factors are putting downward pressure on yields as well.

Key takeaways

- Investors are watching the 10-year Treasury to see if it can remain above 3.05% for an extended time
- Inflationary pressure, tariffs, shrinking liquidity and rising debt levels may support a breakout, but increased demand for income and shifts in consumption and globalisation may keep yields down
- The market may be underestimating how many times the Fed will raise rates in 2019 and 2020
- As shorter-term rates have moved up and longer-term rates appear range-bound, the yield curve has flattened