Interview with Dr. Mark Zandi, Chief Economist, Moody's Analytics

Income Inequality Destabilizes Business Cycle & Lowers Growth

By *Japan SPOTLIGHT*

What are the implications of income inequality for macroeconomic prospects? Dr. Mark Zandi, chief economist of Moody's Analytics and a distinguished macroeconomist working on economic forecasts, talks about the connections between income inequality, growth and business cycles in the following interview.

(Interviewed on Sept. 3, 2019)

Assessment of the Current Global Economy

JS: There is a lot of talk about the growing risk of a recession. How do you assess the possibility of a recession in the current global economy?

Dr. Mark Zandi

Zandi: The global economy is struggling, and global recession risks are rising and are uncomfortably high. Parts of the global economy are already close to recession. In Europe, Germany, Italy and the United Kingdom are near recession. In Latin America, Brazil and Mexico are barely growing. And in Asia, Hong Kong, Singapore and South Korea have weak economies. The escalating trade war between the United States and China and other trading partners is having a negative impact on global trade, and making the global economy vulnerable to a downturn.

JS: Do you think a trade war between the US and China is the principal reason why you consider the risk of a recession to be so high?

Zandi: Yes, I think that the trade war is doing significant damage to the global economy; not only weighing on global trade but also affecting business investment. Global businesses are very uncertain and do not know how this is going to play out, and as such they have pulled back on their investment and are turning more cautious in their hiring. There are other reasons to be nervous, such as Brexit, which could contribute significantly to the risk. Even in Japan there is a VAT increase coming that will have some negative consequences. Growing tensions in the Middle East and the impact on global oil prices also poses a threat. But while there are many things to worry about, the trade war poses the greatest concern.

Income Inequality & Economic Growth

JS: Income inequality would seem to be one of the main drivers of rising populism around the world. How do you think income inequality affects your assessment of economic growth globally?

Zandi: The growing wealth and income inequality across many parts of the world is a corrosive on global economic growth. I do not think it is a reason for a recession this year, the next year or the year after, but I think it weighs on the economy's long-term growth, particularly in places in the world where the income and wealth distribution is very significantly skewed. Wealthy and high-income households are able to capture the political regulatory process and change rules in their favor, and this exacerbates the existing income inequality, and such an inequality is of a structural nature.

Given the fact that the global economy is already growing very slowly and long-term prospects are for continued slow growth given demographic trends and other factors, the skewing in the income and wealth distribution means that we are more likely to suffer economic downturns and recessions. That is a real problem because there aren't effective policy tools to navigate and manage through those downturns. Japan is a very good example of this. Monetary policy is now much less effective than it was in the past, and given the heavy fiscal debt burden, there is much less capacity for fiscal stimulus, so this makes the economy much more vulnerable and more likely to suffer periods of secular stagnation because there is no good policy response to it.

The skewing of the wealth distribution in itself is not a catalyst for an economic downturn but it certainly makes it a lot more difficult to avoid one and to navigate around a recession if it does actually hit. It is a very pernicious corrosive on long-term growth.

JS: You mentioned that in the short term, income inequality could have a limited impact, but could have a significant impact in the long term. What would the "channels" of such an impact be precisely?

Zandi: The first one is that high net worth households have the ability to capture the political and regulatory process where they do business. They can bend the rules in their favor and garner more of the benefits of government policy. So, it is more likely that they can collect the rents of protection that they receive, and these rents could increase.

This means that economic activity is not being allocated efficiently and that will weigh on long-term productivity growth and therefore long-term economic growth. This varies – in some parts of the world it is a significant problem, others less so – but as the income and wealth distribution becomes more skewed, it becomes more and more of an issue. It is very difficult to measure and quantify but is a very pernicious problem. You can see this in the industries of technology, media, telecommunications, and pharmaceuticals; these industries are dominated by very large companies that are owned by a very small number of people who do have a lot of political influence and are able to influence the government to create rules that work in their favor.

The second channel goes to the fact that the long-run potential growth of the global economy is much lower today and will be for the foreseeable future than has been the case since World War II. This is linked to demographic trends including aging populations. This affects not only the growth of the labor force but also productivity growth. So you have slower underlying growth, and the skewing in income and wealth distribution creates incentives for lower income households to take on debt leverage and greater financial vulnerabilities that make them exposed, and then when the economy goes into recession it is very difficult to get out of it because there is no effective policy response. So it is much more likely that we will see economies that are struggling to grow and to break free from these broader forces at work such as income inequality.

One final point is that it is difficult to explicitly connect the dots between income and wealth distribution and economic growth; the channels are more indirect and not as obvious as one might think.

Income Inequality & Business Cycle

JS: You also mentioned in your essay in *After Piketty: The Agenda for Economics and Inequality* published in 2017 that income inequality could destabilize the business cycle and that the debt problem in poor households would create this instability. Is that right?

Zandi: Exactly right. The crisis 10 years ago that emanated from the US was caused largely by the leveraging of lower- and middle-income households motivated in significant part by the skew in wealth and income distribution. These households had not experienced any significant increase in real incomes or wages or wealth for several decades and in the period prior to the financial crisis they had access to significant amounts of credit – mortgage debt, credit card debt, auto debt, and so forth. They took on a lot of debt and this was the main culprit for the downturn that followed. This kind of massive leveraging by households seems much less likely to happen today in the US given that in response to the financial crisis there were a lot of regulatory changes. It is now a lot more difficult for those households to take on that debt. But the risk exists in many other parts of the world – the economies where leverage has increased significantly and continues to increase significantly and in part probably due to the skewing in income and wealth distribution. Places like Australia and Canada, the Netherlands, the UK have all seen significant increases in leverage of debt and there are lots of reasons for that, but the fact that low- and middle-income households have not seen any increases in their wealth for decades may be one of the reasons.

JS: Not only poorer households, but also wealthy people seem to be depending significantly on asset prices. Would you agree?

Zandi: This is an excellent point. Wealthy households have significant assets and their spending and investment behavior is very much tied to the ups and downs in asset prices, much more so than in the past. Asset prices are highly volatile and in recent decades we have experienced significant bubbles in asset prices.

Something that also might be related to the skewing in income and wealth is that wealthier households have invested very aggressively in these assets that have appreciated significantly in value and at times into bubbles. This results in a more cyclical economy through so-called wealth effects in which high income and wealthy households change their spending behavior very sharply and dramatically in response to shifts in asset prices, including stock prices, housing values, commercial real estate values, bond prices, and so on. This makes the global economy much more cyclical and vulnerable. If interest rates are already low or negative, then the heightened volatility in the economy is much more dangerous as it makes it much more likely to fall into a recession and harder to get out of one.

JS: With regard to the impact of income inequality on the business cycle and long-term economic growth, could there be some differentiation among developed economies?

Zandi: The skewing of the income distribution varies substantially across the globe, and indeed has become less skewed among developing economies in recent decades. Globalization has lifted hundreds of millions of people out of poverty; China is the best example as the wealth and income distribution has become much less skewed. In the developed world, and in particular in countries like the US and European economies, income and wealth distribution has become much more skewed as a result to the globalization process. The US is probably the best example of the skewing in income and wealth as it is much more unlikely to use government policy to redistribute income and wealth. In many European countries, there are very progressive tax codes – wealth and estate taxes that work to mitigate the skewing of income and wealth, but much less so in the US. That may change; a lot of the presidential candidates on the Democratic side are focused on this issue and want to increase wealth taxes and mitigate the distribution in income and wealth, but as of now this is not the case, at least not as much as in Europe, Canada and other developed economies.

Differentiation of Income Inequality Among Nations

JS: Do you think that income inequality in the US has been expanding and diminishing in Europe?

Zandi: It has been widening – the skewing has becoming more significant in the US and to a lesser degree in the rest of the world. If you consider government policy, taxes, benefits and other forms of public support, the skewing of the distribution is less pronounced everywhere, but much less so in Europe and Canada compared to the US. But even in Europe you can see there is a lot of tension among lower-income households, and a lot of this has fueled the populist movements there.

JS: Income inequality is different between developed and developing nations. In the case of developing nations, income inequality is emerging as a "middle-income" trap; the shrinking middle class in developing countries could hamper long- or mid-term economic growth. How do you evaluate the different consequences of income inequality upon developing and developed economies?

Zandi: In general, in developing economies the distribution of wealth and income has become less skewed over the last quarter of a century, but that goes to the benefits of globalization on those economies. They have been able to reap the benefits of that globalization and have helped to lift everybody in their economy but in particular low-income households in the last few decades. At the same time, that is why lower- and middle-income households in the developed world have struggled, because they lost incomes, wages, and wealth to the developing world due to the globalization process, among other factors. Technology has also played a role in enabling globalization, but also the adoption of new technologies has been most pronounced in the developed world and that has significantly impacted lower- and middle-income households. This has been ongoing for much of the past half century.

Having said this, the impact of globalization on income and wealth distribution is about ready to turn, especially if the world doesn't pull away from globalization. Because of globalization, many developing economies now have large and quickly growing middle classes who are beginning to buy many of the high valued-added goods and services produced in the developed world. The developed world is on the cusp of selling much more to the developing world, which will create many jobs and ultimately work to reduce the skewing in income and wealth. It would be a dark irony if the developed world turned away from globalization now, just when globalization was set to benefit everyone, including lower income and less wealthy households.

JS: If China is suffering from the middle-income trap, its consumption would not grow so significantly and this would impede its economic growth, wouldn't it?

Zandi: Yes, it would and I think they realize that and are trying to address it. One potential solution to that problem is to strengthen their social safety net. Unlike many developed economies, they have very little in the way of retirement benefits or healthcare benefits or unemployment benefits, and therefore the population has to save a lot and does not spend very much; consumers and households bear all the risk. I think the Chinese understand that they need to harden their social safety net to address the problem and I believe they have been moving in that direction for the last decade. China is symptomatic of this problem in many developing economies.

Income Inequality & Policies

JS: Do you think this income inequality is the main driver of increasing populism today?

Zandi: It is a very significant factor, as lower- and middle-income households have not seen their wages or wealth increase for many decades. They now feel helpless and are worried that their children are going to do worse than they are financially and they are very upset by that. On top of that, massive global migration flows make them very nervous because they worry that immigrants will take their jobs and their incomes. So the combination of the skewing of income and wealth distribution and the very significant flows of people across borders has fuelled the populism that is evident across the globe, particularly in developed economies.

JS: Do you think that the capacity of the current fiscal and monetary authorities is good enough to stabilize the economy and business cycle by mitigating income inequality?

Zandi: I worry about it; I am not sure that policymakers are up to the task. I might have had a different view several years ago, but now I worry that populism is overtaking the political process and the resulting policy response is wrong-headed. Anti-globalization sentiment is not to anyone's benefit and will hurt everybody from the top to the bottom of the income and wealth distribution. We are also underinvesting in educating, training and re-training the workforce and we are not building the public infrastructure that is needed for economic development, especially in poor areas. I worry that policy is not moving in the right direction. On top of that, the fiscal health of many countries is deteriorating, reducing the resources available to address the skewing of income and wealth.

The political capacity for governments to address the income and wealth distribution is also eroding. Populist sentiment is overtaking the political process and we are unable to collectively deal with these serious problems and as such they are becoming self-reinforcing. I am as pessimistic about this as I have ever been, and I'm not at all sure we are going to be up to the task globally to address this problem. Something has to shift fundamentally before we can address these problems in a meaningful way.

JS: You mentioned tax policy and regulations in order to mitigate income inequality. Assuming that our government has serious constraints on fiscal and monetary policies, what kind of tax policies would be necessary to mitigate income inequality?

Zandi: In the US, there is increasing attention to the possibility of increasing existing estate taxes and implementing new wealth taxes on those at the very top of the wealth distribution. The tax revenues that would be generated would be used to finance policies that support lower- and middle-income households, including more affordable housing, increased childcare and health care, and greater educational opportunities. There are many open questions regarding the efficacy of wealth taxes, as these households have significant means to avoid paying them, but increasing thought is being put into how to design these taxes to address these issues. Other types of taxes being debated to address income and wealth inequality include carried interest taxes on private equity firms and financial transaction taxes. Finally, increasing the income threshold for the payroll tax that funds the nation's retirement system is also a possibility. The effective tax rate on high income and wealthy households is generally much lower than in other parts of the developed world.

JS: In the future, do you think it would be necessary to create a macroeconomic model taking income inequality's long-run impact on the economy into consideration?

Zandi: Yes, macroeconomic models need to catch up to the growing chasm between the wealthy and the poor in many parts of the world. Until recently, most macroeconomists, at least those focused on the economy's prospects, have all but ignored inequality in their thinking. Their implicit, if not explicit, assumption is that inequality doesn't matter much when gauging the macroeconomic outlook.

This is a mistake, as inequality makes the financial system less stable, as credit-constrained low-income households are potentially significant risks, and the economy more cyclical, as wealthier households that account for the bulk of the spending are sensitive to swings in increasingly volatile asset markets. This may not be a big deal if financial markets and the economy move in a more-or-less straight line, but it could be a huge deal if they don't.

This is especially true given that the economy's potential growth will be much slower going forward than in the past, suggesting that recessions will be more likely. With monetary and fiscal policy almost certainly rendered more impotent by the zero lower bound and tighter political fetters, future recessions could be more severe.

A critical lesson of the Great Recession is that recessions do permanent damage to the economy, diminishing its potential. Few, if any, macroeconomists have models that account for this in their long-term projections. Macroeconomists should thus not be comfortable that they have a good grip on what inequality means for our economic prospects. JS

Written with the cooperation of Joel Challender, who is a translator, interpreter, researcher and writer specializing in Japanese disaster preparedness.