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Income Inequality: New Worry Over Impact of QE

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Synopsis

While the policy of easy money known as quantitive easing (QE) has saved the US financial sector from collapse, it has also been criticised for causing various problems. One recent criticism: QE could worsen the already worrisome global trend of increasing income inequality.

Commentary

THE US Federal Reserve has actually terminated the quantitative easing or QE. It is basically a programme for repeated purchase of assets – mortgage-backed securities and bonds – for an unspecified period by the Fed. QE was launched as part of efforts to fight against the credit crunch that became contagious since the bankruptcy of Lehman Brothers in 2008.

The programme was implemented in three stages. The last one (QE3) launched in September 2012 involved a monthly purchase of securities of US$40 billion (later raised to US$85 billion). When some economic indicators showed improvement the Fed decided to end the programme. This was done through the tapering-off or reduction of the monthly purchase by US$15 billion first announced in May 2013. It proved to be quite a controversial move.

QE and income inequality

The announcement caused some market turmoil in emerging economies leading to what has since been dubbed as ‘taper tantrum’. However, since the Fed was not sure about the economic improvement in addition to the market turmoil, the tapering was started only seven months after the announcement. The implementation of the taper had reduced the monthly purchase to zero by the end of October. As the Fed had implemented the programme according to schedule, QE was terminated accordingly by the end of October.

However, the termination of asset purchase by the Fed does not mean the end of QE as a whole. Despite differing in variation the Bank of England also implemented quantitative easing in 2009 and Bank of Japan (BoJ) did so in 2013. The BoJ’s programme is still continuing. Lately there has also been pressure for the European Central Bank (ECB) to do likewise to avoid the ‘Japanification’ of

Europe – namely deflation and its associated phenomenon of prolonged weak or even stagnating economy.

Basically under the QE the central banks create hundreds of billions of US dollars, British pounds and Japanese yen respectively to buy bonds and mortgage-based securities. The addition of trillions of dollars of liquidity saved global markets for not just bonds, but equities from collapsing as it was indeed the case. For sure, this was also the objective of the programme when the scheme was introduced.

Meanwhile the ownership of equities is mostly by high income groups or the rich as the poor do not own stocks. The QE which was aimed at suppressing long term interest rates had also an additional impact of raising prices of equities. As a result the return on investment in equities had become better than the return of investment in fixed assets (bonds).

The above development has been used to criticise QE as ultimately hurting savers including fixed income earners and pensioners. In addition QE has been criticised for lopsidedly benefiting the rich at the expense of the poor, and thus increasing income inequality.

A global phenomenon

Increasing inequality has become a global phenomenon. This was also the view from the World Economic Forum in its report about the global risks in 2011 which mentioned the consequent social risk from increasing inequality. Early this year this forum, known as the Davos Group, issued a resolution that put increasing income inequality at the top of global risks that could trigger social unrests.

Dr. Olivier Blanchard of the IMF stated in introducing *The World Economic Outlook 2015* that “as the effects of the financial crisis slowly diminish, another trend may come to dominate the scene, namely, increase income inequality”. In a new book *Capital in the Twenty First Century*, Professor Thomas Piketty of Paris School of Economics disputes the validity of established theories in economic growth and income distribution proposed by Nobel Laureates in Economics Professor Simon Kuznets of Harvard University and Professor Robert Solow of MIT respectively.

The well-known Kuznets curve showed that income distribution is bell-shaped; it is increasing in the early stage of development but decreasing as an economy developed. Professor Solow proposed ‘the balanced growth path’ which also showed that income distribution will ultimately balancing toward more equal distribution.

In contrast Dr. Piketty showed that inequality of income has historically been increasing in both the US and Europe. The main reason is that the rate of return on capital significantly exceeds the growth rate of the economy. This had been the case through much of history until the 19th century and is likely to be the case again in the 21st century. Capital and wealth had been unequally distributed at the outset.

Debates about income inequality

Actually the debate about inequality of income has become more prominent since the financial crises that the world had been experiencing, especially the Global Financial Crisis of 2007-2009. Some writings by academics like Professors Joseph Stiglitz and Jeffrey Sachs are all testimonies of the concerns regarding increasing income inequality.

Amidst the debates about the global spread of income inequality, Fed Chairperson Janet Yellen recently made a presentation at a conference in Boston stating her great concern of the rising income and wealth inequality, and asking whether this is compatible with American values. Curiously though in her detailed presentation, Dr Yellen did not touch on the issue of whether QE contributed to the inequality.

The rise of income and wealth inequality could threaten the social fabric of economies harbouring them. This is too important an issue to be ignored, even in monetary policy, no matter how unconventional it is.

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