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The inequality trifecta

Mohamed El-Erian | Allianz | 24 October 2014

There were quite a few disconnects at the recently concluded Annual Meetings of the International Monetary Fund and World Bank. Among the most striking was the disparity between participants' interest in discussions of inequality and the ongoing lack of a formal action plan for governments to address it. This represents a profound failure of policy imagination – one that must urgently be addressed.

There is good reason for the spike in interest. While inequality has decreased across countries, it has increased within them, in the advanced and developing worlds alike. The process has been driven by a combination of secular and structural issues – including the changing nature of technological advancement, the rise of "winner-take-all" investment characteristics, and political systems favoring the wealthy – and has been turbocharged by cyclical forces.

In the developed world, the problem is rooted in unprecedented political polarisation, which has impeded comprehensive responses and placed an excessive policy burden on central banks. Though monetary authorities enjoy more political autonomy than other policymaking bodies, they lack the needed tools to address effectively the challenges that their countries face.

In normal times, fiscal policy would support monetary policy, including by playing a redistributive role. But these are not normal times. With political gridlock blocking an appropriate fiscal response – after 2008, the US Congress did not pass an annual budget, a basic component of responsible economic governance, for five years – central banks have been forced to bolster economies artificially. To do so, they have relied on near-zero interest rates and unconventional measures like quantitative easing to stimulate growth and job creation.

Beyond being incomplete, this approach implicitly favors the wealthy, who hold a disproportionately large share of financial assets. Meanwhile, companies have become increasingly aggressive in their efforts to reduce their tax bills, including through so-called inversions, by which they move their headquarters to lower-tax jurisdictions.

As a result, most countries face a trio of inequalities – of income, wealth, and opportunity – which, left unchecked, reinforce one another, with far-reaching consequences. Indeed, beyond this trio's moral, social, and political implications lies a serious economic concern: instead of creating incentives for hard work and innovation, inequality begins to undermine economic dynamism, investment, employment, and prosperity.

Given that affluent households spend a smaller share of their incomes and wealth, greater inequality translates into lower overall consumption, thereby hindering the recovery of economies already burdened by inadequate aggregate demand. Today's high levels of inequality also impede the structural reforms needed to boost productivity, while undermining efforts to address residual pockets of excessive indebtedness.

This is a dangerous combination that erodes social cohesion, political effectiveness, current GDP growth, and future economic potential. That is why it is so disappointing that, despite heightened awareness of inequality, the IMF/World Bank meetings – a gathering of thousands of policymakers, private-sector participants, and journalists, which included seminars on inequality in advanced countries and developing regions alike – failed to make a consequential impact on the policy agenda.

Policymakers seem convinced that the time is not right for a meaningful initiative to address inequality of income, wealth, and opportunity. But waiting will only make the problem more difficult to resolve.

In fact, a number of steps can and should be taken to stem the rise in inequality. In the US, for example, sustained political determination would help to close massive loopholes in estate planning and inheritance, as well as in household and corporate taxation, that disproportionately benefit the wealthy. Likewise, there is scope for removing the antiquated practice of taxing hedge and private-equity funds' "carried interest" at a preferential rate. The way home ownership is taxed and subsidised could be reformed more significantly, especially at the top price levels. And a strong case has been made for raising the minimum wage.

To be sure, such measures will make only a dent in inequality, albeit an important and visible one. In order to deepen their impact, a more comprehensive macroeconomic policy stance is needed, with the explicit goal of reinvigorating and redesigning structural-reform efforts, boosting aggregate demand, and eliminating debt overhangs. Such an approach would reduce the enormous policy burden currently borne by central banks.

It is time for heightened global attention to inequality to translate into concerted action. Some initiatives would tackle inequality directly, others would defuse some of the forces that drive it. Together, they would go a long way toward mitigating a serious impediment to the economic and social wellbeing of current and future generations.

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