Benoît Cœuré: What can monetary policy do about inequality?

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the International Day for the Eradication of Poverty, Intergroup "Extreme poverty and human rights, Fourth World Committee" event, European Parliament, Brussels, 17 October 2012.

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Members of the European Parliament, Professor Banerjee, ladies and gentlemen,

I would like to thank the European Parliament for inviting me to participate in this panel.

Economic growth has sharply reduced the incidence of poverty in "developed" economies. In Europe, it is one of the great achievements of the Single Market and of Economic and Monetary Union (EMU) to have delivered growth and job creation over a prolonged period, contributing to this objective. The euro area has created about 14.4 million new jobs since 1999, compared with approximately 10.7 million in the United States. Nevertheless, the past five years have been a time of hardship, owing to the financial and economic crisis. The Great Recession of 2008–09 and the subsequent crisis in the euro area have dented growth in our economies, pushing millions of workers into unemployment or forced inactivity, and adversely affecting living standards for our entire population. Moreover, they have left a shadow of uncertainty over long-term growth prospects and run the risk of creating a lost generation.

I would like to bring to this discussion a central banker's perspective on the theme of inequality. Inequality is a cause for concern for all European institutions, since social cohesion is one of the statutory objectives of the EU. For the ECB, the question naturally arises as to whether monetary policy can make a difference, and whether it is mandated to do so. Musgrave and Musgrave's traditional description of the functions of economic policy[1] can help to explain the role of monetary policy in the economic constitution of EMU. The task of the ECB under the Treaty on the Functioning of the European Union is to ensure price stability in the medium term. It thus focuses on income and wealth stabilisation rather than on the allocation of economic resources, or on redistribution. In Tommaso Padoa-Schioppa's concise words, monetary policy is focused on stability rather than on efficiency or equity. This should be the starting point of any discussion of the role of monetary policy in addressing inequalities.

Does this imply that inequalities are irrelevant for central bankers? Not at all, as first, monetary policy may have an impact on inequalities, and second, stability is conducive to equity. To the extent that it stabilises economic activity, monetary policy can help shield from poverty the lowest income classes of society, especially during recessions.

I will address these two issues in turn, starting from a few facts on the rise of inequality in recent years. I will maintain that preserving price stability over the medium term is the best contribution that monetary policy can make to economic stability. The ECB has achieved this goal throughout the crisis, thanks to its standard and non-standard monetary policy measures. Our recent decision to undertake Outright Monetary Transactions can also be seen in this context, to the extent that it helps to restore confidence in the integrity and irreversibility of the single currency.

1 Musgrave, R. and Musgrave, P. (1989), *Public Finance in Theory and Practice*, McGraw-Hill.

Inequality/poverty is a cause for concern also in the euro area

It is well known that the relationship between inequality and growth is complex and not necessarily monotonic.[2] On average, inequality in developed economies has increased in recent years. The Gini coefficient, a standard measure of income inequality that ranges from 0 (when everybody has identical incomes) to 1 (when all income goes to only one person), stood at an average of 0.29 in OECD countries in the mid-1980s. By the end of the last decade, it had increased by almost 10% to 0.32. It rose in 17 of the 22 OECD countries for which long-term data series are available. Of the eight euro area countries for which we have data, inequality increased in five, changed little in two and declined in one. Thus, although incomes remain more unequally distributed in the United States, the data suggest that inequality is also on the rise in the euro area.

The increase in inequality since the 1980s largely reflects a faster increase in household incomes at the top of the income distribution.[3] More precisely, greater inequality in labour income, which represents about three-quarters of total income across the working age population, emerges as the most important driver of household income inequality. In particular, most of the microeconomic studies find a continuous and sharp increase in wage dispersion in Anglo-Saxon countries over the last 30 years.

Microeconomic evidence is, however, mixed across countries. In countries such as Sweden and Spain, inequality has followed a downward trend over the same period of time. In Germany and Italy, the changes in wage distribution are more erratic and do not show a clear upward or downward trend.[4]

Developments in labour participation, which also affects labour income, are more heterogeneous across countries. It is also difficult to find clear patterns in developments in capital income inequality, owing to measurement difficulties.

How wages evolve over the business cycle depends both on the reasons why growth moves up and down, and on the way the labour market is organised.[5] At first sight, a rigid labour market may appear to shield the poorest from economic shocks, as wages will not easily adjust downwards in a recession. However, the lack of reaction of wages is a clear symptom of an ill-functioning labour market, leading to a costly and prolonged adjustment in employment. Taking into account fluctuations in wages and unemployment, a typical finding in several countries is that inequality in earnings at the bottom of the distribution tends to rise during recessions.[6] Moreover, households that do not receive labour income face even higher hurdles when labour markets do not function well and protect insiders at the expense of outsiders. What this means is that the poor suffer most in relative terms in and after a recession. In fact, the pain they suffer does not fully disappear once the recession is over owing to the persistence of unemployment and the malfunctioning of labour markets.

With regard to developments since 2007, recent research finds marked differences across countries depending on whether they have also experienced large corrections in house

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[2] See Simon Kuznets (1955), “Economic Growth and Income Inequality”, *American Economic Review*, 45: 1–28.

[3] See OECD (2011), *Divided We Stand: Why Inequality Keeps Rising*.

[4] See, for example, a number of recent country studies published in a special issue of the *Review of Economic Dynamics* on “Cross Sectional Facts for Macroeconomists” (see *Review of Economic Dynamics*, 13(1), 2010).

[5] See, for example, Blanchard, Olivier and Wolfers, Justin (2000), “The Role of Shocks and Institutions in the Rise of European Unemployment: The Aggregate Evidence”, *Economic Journal*, Royal Economic Society, Vol. 110(462), pages C1-33, March.

[6] See Fatih Guvenen, Serdar Ozkan and Jae Song, (2012), “The Nature of Countercyclical Income Risk”, *NBER Working Papers* 18035, National Bureau of Economic Research, Inc., for new evidence from the United States.

prices.[7] Nevertheless, for most OECD countries for which data are available, there is thus far little evidence of changes in household income distribution in the two years following the start of the downturn, from 2007 to 2009. Once more data become available, however, larger changes can be expected over the coming years, especially in countries like Spain that suffered a severe slump in the housing market and massive job losses in the construction sector, mostly for temporary workers.

Taken together, these factors suggest that unemployment remains a crucial determinant of inequality and poverty. There is a need for a comprehensive strategy to support job creation and ensure that the unemployed are employable. In the global economy, the comparative advantages of European economies rest very much on human capital and skills. Active labour market policies and investment in higher education are the most powerful instruments at the disposal of governments to counter rising inequality and to foster employment.[8] This leads to a simple policy message. At a time when fiscal policies are being reorganised in European countries, reflecting the crucial need to restore the sustainability of public finances, it is essential that the composition of fiscal adjustment preserves governments' ability to invest in skills and recreate comparative advantages in their economies, and that they are supported by mobilisation of EU instruments.

Can monetary policy affect inequality and poverty?

But let me now return to the contribution that the central bank itself can make to reducing inequality and poverty. Is there evidence that monetary policy affects inequality? I will discuss this question from two perspectives: first, the immediate distributive effects of monetary policy and inflation; and second, the benefits of macroeconomic stability for the more vulnerable.

Because monetary policy is transmitted through many channels, direct and indirect – interest rates both current and expected, credit extension, asset prices – and because households differ in many respects – with regard to socio-demographic factors, such as age and education, as well as economic variables, such as income, wealth, employment status and housing status – monetary policy does not affect all households in the same way. Many channels through which monetary policy affects individuals in different ways may be at work, and it is a daunting task to disentangle and quantify these channels empirically.

Inflation has a direct effect on income inequality through changes in the real (i.e. consumer price-adjusted) valuation of financial and non-financial assets. Clearly, an unexpected fall in interest rates and an increase in inflation tend to hurt savers and benefit borrowers – the mechanism John Maynard Keynes referred to as the "euthanasia of the rentier".[9] Careful studies based on US data demonstrate that inflation hits in particular richer and older households, which hold the bulk of the economy's wealth and whose asset holdings are typically imperfectly insured against surprise inflation.[10]

Can this evidence be interpreted as suggesting that the higher inflation is, the lower income inequality will be? Or that higher inflation should be pursued as a way to reduce income inequality? My answer is no, because inflation is also particularly harmful to the poorest parts of the population. First, poorer households tend to hold a larger fraction of their financial wealth in cash, implying that both expected and unexpected increases in inflation make them

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[7] See also Stephen P. Jenkins, Andrea Brandolini, John Micklewright and Brian Nolan (forthcoming), *The Great Recession and the Distribution of Household Income*, Oxford University Press.

[8] OECD (2011), op. cit.

[9] See John Maynard Keynes (1936), *The General Theory of Employment, Interest and Money*, Chapter 24.

[10] See Matthias Doepke and Martin Schneider (2006), "Inflation and the Redistribution of Nominal Wealth", *Journal of Political Economy*, University of Chicago Press, vol. 114(6), pages 1069–1097, December.

even poorer. In addition, monetary policy shocks and surprise inflation can have an impact on inequality through other sources of income. Income from labour and the unemployment of less-skilled workers tend to be adversely affected to a disproportionate degree during recessions. All in all, recent studies suggest that a higher inflation rate is accompanied by greater income inequality.[11] At the same time research on the US data finds that also contractionary monetary policy actions appear to increase inequality in earnings and total income.[12] A stability-oriented monetary policy, which aims to smooth the cycle and reduce its amplitude, ought therefore to cushion the impact of negative shocks on poorer households.

However, it is not only the extent of income and wealth shocks that affects consumers' welfare, but also the fluctuation in their consumption expenditure. All households are not equal in this respect. Some of them are able to insure against wealth shocks and can thus mitigate the adverse consequences of such shocks for their well-being. But poorer households have limited or no access to the financial system (let alone to financial markets) and do not have adequate buffers in the form of precautionary savings. Consequently, their consumption and welfare are particularly vulnerable to adverse shocks. Even if all households were hit by negative shocks to the same extent, poorer, less-insured households would suffer from more volatile consumption and lower welfare.

Studies of these effects have so far focused almost exclusively on the United States and their findings may not be applicable to the euro area, where countries are characterised by different tax/benefit systems and different institutions, and where households do not access financial markets in the same way. We in the Eurosystem are aware of the need for more empirical research at the household level and, partly for this reason, we have been collecting such data. Our "Household Finance and Consumption Survey" (http://www.ecb.int/home/html/researcher_hfcn.en.html) documents the extent of wealth heterogeneity and the structure of household balance sheets across the euro area member countries. To enhance the analysis and understanding of issues such as whether and how different households react to shocks in different ways, the data will be made available to researchers in early 2013 together with a detailed public report on the results.

Finally, it should be mentioned that monetary policy can impact geographical inequalities, insofar as it contributes to smoothing unevenly distributed shocks to households' wealth and income across countries or regions. The ECB's non-standard measures, as described below, have limited the risk of negative feedback loops at country level within the euro area, arising in particular from the tight link between the creditworthiness of banks and of sovereigns, and more recently from the unjustified perception of a risk of euro break-up. To this extent, monetary policy has helped cushion the impact on the crisis on the less well-off households in jurisdictions under financial stress.

Price stability and economic stability: the role of ECB measures

There is a broader point on the relationship between monetary policy and the fight against poverty, a point that I would like to stress now. Social equality is better served by economic stability. A large body of theoretical and applied academic literature and the experience of the past decades indicate that monetary policy's best contribution to economic stability is to maintain price stability. Moreover, credible central banks have a comparative advantage in

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11 See Albanesi, Stefania (2007), "Inflation and inequality", *Journal of Monetary Economics*, Elsevier, Vol. 54(4), pages 1088–1114, May, for evidence from 47 advanced and developing countries.

12 See Olivier Coibion, Yuriy Gorodnichenko, Lorenz Kueng and John Silvia (2012), "Innocent Bystanders? Monetary Policy and Inequality in the U.S", *NBER Working Papers* 18170, National Bureau of Economic Research, Inc.

this area, as the return to price stability becomes possible at lower costs in terms of output volatility.[13]

The available empirical evidence supports the view of a complementarity between price and economic stability at the aggregate level. Price stability appears to be conducive to economic growth, low unemployment and subdued income volatility. Recent developments in the main advanced economies in terms of volatility of inflation and GDP growth confirm this insight and show that there has been no trade-off between the two variables.[14] Volatility has been low in both variables in the euro area by comparison with other major economies.

The crisis period is illustrative of this complementarity. After 2007, output and inflation volatility increased everywhere, but the combination remained more favourable in the euro area, which suggests that the recent policy easing aimed at checking deflationary risks also helped to sustain the economy. The ECB responded boldly to the bankruptcy of Lehman Brothers and to the subsequent crisis with a sequence of cuts in the policy interest rate and a range of measures such as fixed rate liquidity provision with full allotment, the extension of the list of eligible collateral, very long-term refinancing operations and, most recently, the Outright Monetary Transactions. The ultimate justification for such measures was the need to pre-empt negative inflationary pressures and avoid a collapse in money and credit creation. By achieving this goal, the measures helped to cushion the effects of the financial crisis on the real economy.

Existing studies are consistent with the hypothesis that ECB measures were instrumental in preventing deflation and in containing the fall in economic activity at the height of the recession.[15] Among our early non-standard measures, the switch to fixed rate tender procedures with full allotment appears to have been especially effective. Had the unprecedented increase in the demand for liquidity following the financial crisis not been accommodated by unlimited liquidity supply from the ECB, money market rates would have increased strongly. A larger fall in credit growth would have ensued. Estimates suggest that the euro area inflation rate would have been about 1 percentage point lower and the GDP level would have been more than 2% lower by the first half of 2010.

From a broader perspective, our non-standard measures have prevented more adverse economic outcomes by helping in particular the euro area countries which were most affected by the crisis, and by preventing a halt in the flow of credit especially to small and medium-sized enterprises (SMEs). According to the latest survey conducted by the Eurosystem, in the second and third quarters of 2011 access to finance remained one of the most pressing problems for SMEs, which continue to rely mostly on banks for external financing. Maintaining a flow of credit to SMEs was particularly important because they employ 72% of the euro area's labour force and have significantly higher gross job creation (and destruction) rates than large enterprises.

Conclusions

Let me conclude.

I have focused on the narrower question of whether inequality can be affected by monetary policy. More evidence has to be collected before we can produce robust stylised facts.

[13] See, for example, Richard Clarida, Jordi Gali and Mark Gertler (1999), "The Science of Monetary Policy: A New Keynesian Perspective", *Journal of Economic Literature*, American Economic Association, vol. 37(4), pages 1661–1707, December.

[14] See Stephan Fahr, Roberto Motto, Massimo Rostagno, Frank Smets and Oreste Tristani (2011), "A monetary policy strategy in good and bad times: lessons from the recent past", *Working Paper Series*, No 1336, European Central Bank.

[15] Fahr et al. (2011), op. cit.

However, it is clear that, by ensuring price stability over the medium term, monetary policy also contributes to broader economic stability. During recessions, it also has stabilising effects on employment and poverty.

This role of monetary policy has been especially important during the crisis. An increase in the overall demand for liquidity by banks – when unmatched by the central bank – can cause a downward spiral in asset prices, a credit crunch, bank failures and a severe recession. Deflation accompanies these phenomena. The Great Depression – a combination of recession, deflation and bank failures – is a clear historical example of what can happen if central banks fail to provide liquidity to the financial system. The monetary policy measures taken by the ECB have helped to avoid a collapse in money and credit and to eliminate the spectre of the Great Depression. They have not only avoided a collapse of the financial system, but also, and more importantly, prevented a surge in unemployment and poverty in the euro area. In so doing, we have proven that the three objectives of stability, efficiency and equity are mutually supportive, and that the ECB can effectively contribute to containing inequalities within its Treaty mandate.

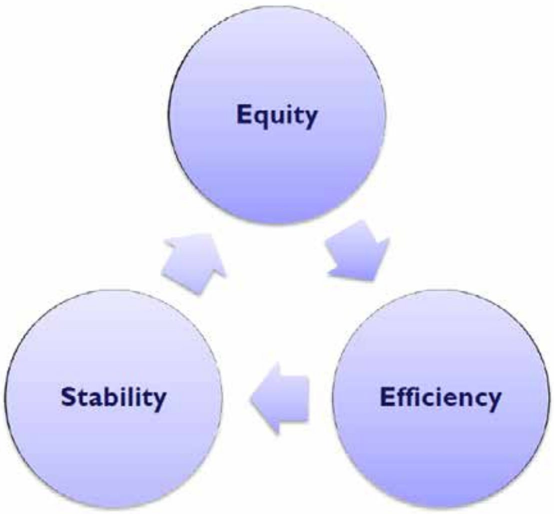
I thank you for your attention.

1. ECB mandate
2. Inequality and poverty in the euro area
3. Impact of monetary policy
4. Price stability and economic stability

EUROPEAN CENTRAL BANK 2

1. ECB mandate

- ECB Treaty mandate: medium-term price stability



EUROPEAN CENTRAL BANK 3

2. Inequality and poverty in the euro area

- Inequality on the rise in the euro area
  - Gini coefficient of income distribution rose from 0.29 in mid-1980s to 0.32 end 2000s in OECD countries
  - Of the 8 euro area countries for which data is available, inequality increased in 5, changed little in 2 and declined in 1
  - Trend in labor income inequality less clear in the euro area than in Anglo-Saxon countries
- Sources of economic shocks (e.g. housing market bubble) and labour market functioning do matter
- Need for policies focused on human capital and skills; quality of fiscal adjustment will be key

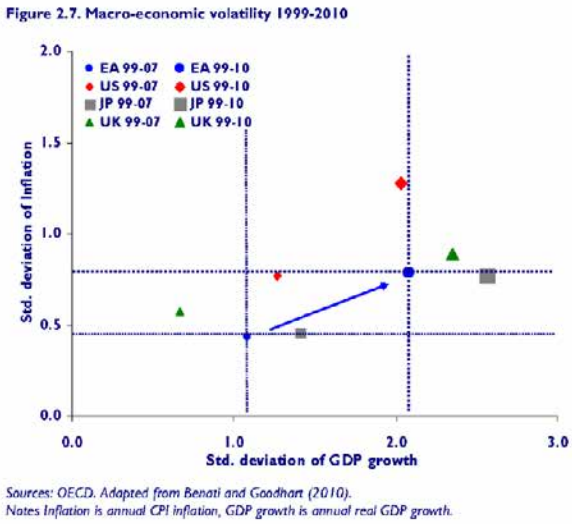
EUROPEAN CENTRAL BANK 4

3. Impact of monetary policy

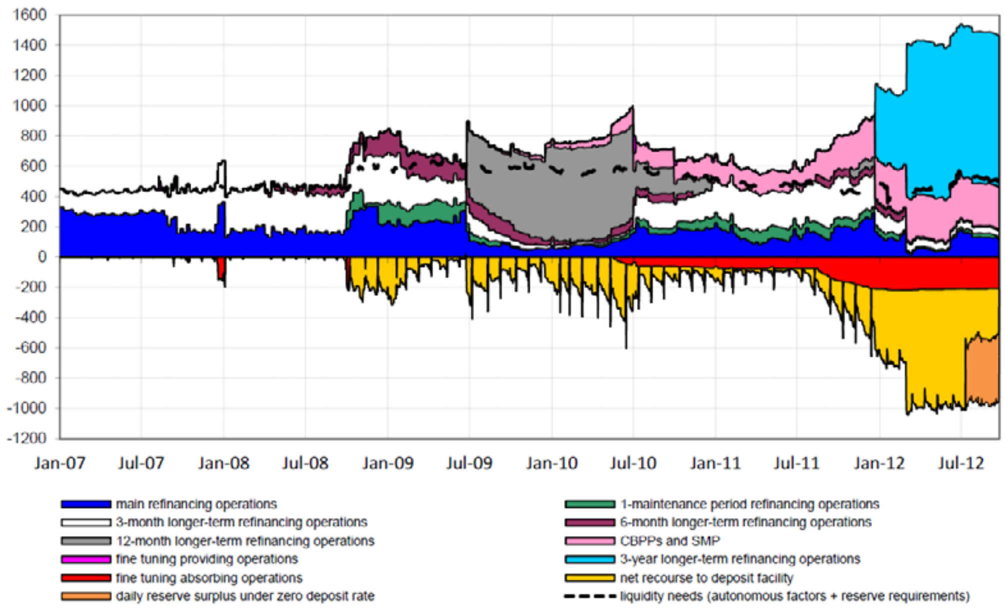
- Complex transmission channels
  - Asset return dependent on level of interest rates (Keynes' "euthanasia of the rentier")
  - Poorer people less well protected from inflation (cash holdings, labour income only)
- Mixed empirical results
  - On average, a higher inflation rate is accompanied by greater income inequality; but in the US, contractionary monetary policy has increased inequality in earnings and total income
- Euro area heterogeneity
  - Monetary policy can cushion rise in inequality in countries under financial stress

EUROPEAN CENTRAL BANK 5

4. Price stability supports economic stability



ECB crisis measures



Conclusion

- Non-standard monetary policy measures have helped to avoid a collapse in money and credit
- They have prevented a surge in unemployment and poverty, particularly in stressed countries
- Stability, efficiency and equity are mutually supportive, implying that the ECB can contribute to containing inequalities within its Treaty mandate

EUROPEAN CENTRAL BANK 8