Andrew G Haldane: Unfair shares

Remarks by Mr Andrew G Haldane, Executive Director, Financial Stability, Bank of England, at the Bristol Festival of Ideas event, Bristol, 21 May 2014.

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Inequality has become the issue *du jour* – especially, it seems, when it is expressed in French. Yet until recently, inequality was a deeply unfashionable topic among academics and policymakers. Until the crisis, it is difficult to identify a period in the past 50 years when inequality was close to the top of the public policy or academic agenda (Stiglitz (2012)).

The past few years have changed all that. Key milestones include:

- The emerging facts. As ever, dispute rages about the precise statistics. But the long-term patterns are clear enough – and remarkable. Almost half of the growth in US national income between 1975 and 2007 accrued to the top 1% (OECD (2014)). In the UK and US, the top 1%'s share of the income pie has more than doubled since 1980 to around 15% and their share of the wealth pie has been estimated at up to a third – more than the whole bottom half of the population put together (ONS (2014), Wolff (2012)). The five richest households in the UK have greater wealth than the bottom fifth of the population (Oxfam (2014)). Even among the 1% there has been a striking polarisation. In 1990, a similarly-skilled banker, lawyer and accountant were paid roughly the same. By 2006, the banker was earning between three and four times as much (Philippon and Reshef (2009)).
- The global financial crisis. On standard metrics, the crisis probably reduced wealth inequalities because the collapse of asset values hit hardest existing asset-owners. But the global financial crisis also shrunk the global income and wealth pie, in some countries materially so. This added momentum to the squeeze on real incomes at the very bottom end of the income scale experienced in a number of Western countries (Economic Policy Institute (2012), Joyce et al (2010)). Financial crises are known to disadvantage disproportionately the poor because they are least able to absorb income shocks (Honohan (2005)). This crisis appears to have been no different. Meanwhile, the crisis-induced narrowing of wealth inequalities has been at least partially reversed as asset prices have reflated rapidly over recent years.
- The Occupy movement. They took up the baton for the 99% in 2011. At least at first, Occupy were treated with all of the seriousness of a local student protest. But rather remarkably Occupy became a global outfit, albeit a rather loosely-fitting one. Occupy touched a moral nerve among the many. The 1%ers in Davos had inequality as their main theme this year. In the words I used when addressing Occupy in 2012, there is now a broader acceptance that "they were right" in their diagnosis (Haldane (2012)). Criticism of Occupy today tends to focus not on their diagnosis, but on their lack of prescription for curing the ills of inequality.
- Bill de Blasio. He was elected Mayor of New York in November 2013 on a signature theme of tackling widening inequality in the city. His campaign slogan was "a tale of two cities". And this was no ordinary victory. Bill de Blasio won with a remarkable 73% of the popular vote.
- And finally, Thomas Piketty. Enough has already been said and written about a book bought by many, read by few and understood by even fewer (Piketty (2014)). I am guilty on all three charges. I suspect never, in the field of human endeavour, has so

simple a line chart done so much to fuel the debate among so many, not just in the salons of Paris but in the Starbucks of London and New York.

Suffice to say, the inequality issue seems unlikely to be a French fashion. It is a global public policy trend and a rising one. Inequality is emerging after a half-century in the wilderness. The surprise may be that it has taken so long. It is well-known, from survey and experimental evidence, that a sense of "fairness" is a deeply-held and richly-valued psychological trait in humans (Bowles (2012)). And if Piketty is right, inequality trends are self-perpetuating as wealth begets wealth.

Economic and financial stability

That naturally begs the question of whether anything should be done. On the face of it, this is not the business of a central banker. There is considerable truth in that. The tools at the disposal of a central bank – interest rates, the money supply, regulation – have an impact on inequality which is, at best, indirect, inadvertent and transient. Central banks can do nothing, durably, to reshape long-term structural trends in the economy, much less in broader society.

Yet inequality has appeared on central banks' radar during the course of the crisis, sometimes flashing red. That is because, at least over the shorter-term, central bank policies can and probably have reshaped patterns of inequality. Some have gone further, arguing that central bank policies of extra-ordinary monetary accommodation have, by boosting asset prices and wealth, exacerbated inequalities (Saiki and Frost (2014)). In effect, central banks stand accused of having provided an extra spin to the Piketty cycle. It is worth viewing this claim in context.

In response to the Great Recession, monetary policy globally went into overdrive. Interest rates fell to the floor and central bank money supply rose to the ceiling – so-called quantitative easing or QE. Interest rates have never been so low, nor central bank money supply so high (relative to money spending), in the Bank of England's 320-year history. Extraordinary times heralded truly extraordinary measures.

This action was taken with the best of intentions: to cushion the economy from the sharpest downturn in economic activity since the Great Depression. Monetary policy aimed to do so by lowering borrowing costs for debtors whose income and employment prospects were squeezed and by boosting risk-taking, and hence asset prices, otherwise held back by fearful investors.

It is impossible to know for sure how the economy would have performed in the absence of this monetary action. But it seems near-certain the economy would have been materially smaller, and asset prices materially lower, had this action not been taken. On the Bank's own estimates, the UK economy today would have been at least 6 percentage points smaller today without the combined effects of lower interest rates and large doses of QE. Or, in money terms, we as a nation would have been perhaps £80–100 billion poorer. The income pie would have been materially smaller.

It is harder still to gauge the impact of monetary policy measures on asset prices. But the facts are striking. Equity prices are almost 90% higher than in 2009 when QE commenced in the UK. Corporate bond prices are over 40% higher and government bond prices 15% higher. In the US, the numbers are 120%, 30% and 12% respectively. In other words the wealth, as well as the income, pie would most probably have been materially smaller absent extra-ordinary monetary stimulus.

During this reflationary process, shares of the income and wealth pie have not remained constant. All public policy is re-distributional and monetary policy is no exception. *Relative* winners have included debtors, whose borrowing costs have collapsed. *Relative* losers are likely to have included savers reliant on bank deposits for income, due to falling bank deposit rates. Studies have tended to confirm that distributional pattern (McKinsey Global Institute (2013)).

But these relativities need to be seen against the backcloth of a rising, not retreating, income and wealth tide. The majority of people – savers and borrowers, old and young – appear to have been made better off *absolutely* as a result of extraordinary monetary measures. For what it is worth, the Bank's own research points firmly in that direction (Bank of England (2012)).

Of course, some of the losses may be more visible than the gains and some of the relative losers more audible than the gainers. For example, low yields have reduced annuity rates for some pensioners, lowering income streams. But those same low yields have boosted asset prices, raising the value of pension pots. The net effect appears on average to have been positive. And extra-ordinary monetary measures will of course not last forever. When they unwind, so too will any distributional effects. In others words, central banks' influence on income and wealth shares is likely to be temporary.

Yet even if, over the medium-term, central banks cannot influence inequality, the reverse may not be true. There is rising evidence that inequality can have an important bearing on the objectives central banks hold dear – the stability of the financial system and growth in the economy. Were inequality to jeopardise these public goods, it could make the everyday job of central banks somewhat harder. This means that, even if they cannot influence it, central banks have a strong vested interest in inequality issues too.

In his book *Fault Lines*, Raghu Rajan – now Governor of the Reserve Bank of India – dug up the deep roots of America's sub-prime crisis (Rajan (2010)). Many conventional crisis explanations have focussed on the combined effects of venal bankers, Byzantine risk models and somnambulating regulators. Rajan suggested these missed the deeper cause – rising US inequality. Facing this fault-line, US policymakers had chosen a policy of cheap and plentiful credit, expanded home-ownership and rising asset prices – a "let them eat credit" policy. Bank balance sheets grew to distribute this rapidly expanding credit cake, with banks taking their own healthy slice en route.

Interestingly, this would not be the first time rising inequality has preceded crisis. The self-same pattern preceded the financial crash of 1929 and the resulting Great Depression (Kumhoff and Ranciere (2010)). Between 1920 and 1928, the income share of the top 5% rose from little more than a quarter to more than a third. Household debt relative to GDP doubled. Inequalities widened and balance sheets fattened. And the upshot was the same: a huge economic contraction when the credit bubble popped.

If this is a fair reading of history, then inequality may have a direct bearing on the fragility of the financial system. And while of historical interest when describing the past, its greater significance may be in highlighting risks for the future. As in the 1920s and the 2000s, rising inequality could build pressure for a credit balm to sooth the symptoms. Yet temporary pain relief, through a credit boom, would risk sowing the seeds of tomorrow's crisis.

The good news is that central banks may, in future, be better placed to head-off these pressures by taking pre-emptive regulatory policy action. This is the essence of so-called macro-prudential policy. In the UK, it is the responsibility of the Bank of England's Financial Policy Committee (FPC). The FPC aims to curb excess credit at source. A large and growing number of other countries are putting macro-prudential frameworks in place, and taking macro-prudential actions, to serve similar ends (Haldane (2014)).

There is a second way in which inequality could affect central bank policy objectives. Based on a detailed cross-country study, IMF research has found that lower income inequality delivers faster and more durable growth (Ostry et al (2014)). Moreover redistributive policies, provided they are not excessive, have benign direct growth effects – and positive indirect effects by lowering inequality. Or, put differently, the IMF's research suggests that increasing inequality shrinks the pie.

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This link between growth and inequality is, at present, no more than an empirical regularity. The IMF's research does not tell us the channels through which inequality may have dented growth. And without an appreciation of those channels, it is difficult to know where public policy could make inroads into the problem. Nonetheless, it is useful to piece together evidence on possible channels of causation.

Growth is rooted in investment, specifically the accumulation of human capital by individuals (education, skills, experience) and physical capital by firms (research and development). Both boost productivity, the elixir of economic life. And both require inter-temporal sacrifice – patience, a willingness to defer gratification. This is a topic I have researched in recent years (Haldane (2010), Davies et al (2014)).

Individuals' patience, and hence human capital accumulation, is a complex process. But it is affected importantly by their financial environment. An important new book by psychologists Mullainathan and Shafir (MS) illustrates the impact of financial circumstances on decision-making (Mullainathan and Shafir (2013)). Solving everyday problems of scarcity – of time, money, friendship – absorbs huge amounts of the mind's energy. It taxes cognitive bandwidth. And this can have dramatic effects on behaviour.

In one experiment, two groups – one wealthy, one poor – are IQ-tested, asked to contemplate suffering a significant monetary loss and then re-tested. The remarkable finding is that merely *contemplating* monetary loss is sufficient to reduce significantly the measured IQs of the poor, lowering scores from "average" to "seriously deficient". This is a dramatic, environmentally-induced, loss of cognitive power, the direct result of minds being impoverished by financial insecurity concerns. Being poor taxes the mind every bit as much as the wallet.

It does not end there. Financial scarcity is also shown by MS to damage decision-making over time. The mind-absorbing effects of making ends meet can lead to an excessive focus on the present at the expense of the future – that is, financial insecurity generates impatience or myopia. This, too, can have damaging implications for life choices. As MS demonstrate, it may lead people to under-invest in education and skills and to over-borrow at high interest rates and short maturities.

MS call this a scarcity or myopia trap. It is a trap because it is self-fulfilling. Scarcity generates myopia and myopia is the enemy of human capital accumulation. For individuals, this means that scarcity traps may, over time, create poverty (lack of income) or unemployment (lack of skills) traps. And at the level of the aggregate economy, it means that scarcity traps, by taxing human capital accumulation, may generate lower growth and productivity.

Physical capital accumulation, such as research and development, also relies on patient decision-making. It requires a willingness to defer gratification, either on the part of managers of firms (for example, through lower salaries and bonuses) and/or shareholders in those firms (for example, through lower dividends and share buybacks). Unfortunately, the evidence suggests neither have found it easy to do so. Public companies suffer from "short-termism" (Kay (2012)).

One example is found in the high and smoothed payout ratios to both executives and shareholders of public companies even when underlying company profitability is low, perhaps even negative. Another is that longer-term cashflows from company projects appear to be "excessively" discounted (Davies et al (2014)). This can lead to projects which boost the long-run value of the company being wrongly rejected. Consistent with that hypothesis, privately-owned companies seem to invest more than otherwise-identical public companies (Davies et al (2014)).

There is some debate about where the blames for this corporate myopia problem may lie. Some place it at the door of shareholders, driven to demand short-term returns by short

holding periods. Others blame management for seeking short-term financial gain given their short tenure. This distinction may anyway be artificial. In a world where executive compensation is largely in stock, the two are one and the same, their incentives largely indistinguishable.

So how does all of this link to inequality? If impatient (money-scarce) individuals are failing to invest sufficiently in skills, and impatient (short-termist) companies are failing to invest sufficiently in capital, this is a recipe for weak (human and physical) capital accumulation. This will show up in weak long-term investment and skills deficits. The most likely casualties from this are productivity and growth.

If there are legs to this story, then one important element is corporate governance. This defines decision-making within firms – how much to invest, how much to distribute, and to whom. Company Law in a number of countries, such as the UK, gives primacy to the interests of shareholders when defining the objectives of a company and its decision-making. The objectives and rights of a broader set of stakeholders, including workers, suppliers and wider society, tend to be secondary (Mayer (2013)).

This governance structure has stood the test of time. But it is not without distributional consequences. If power resides in the hands of one set of stakeholders, and they are short-termist, then we might expect high distribution of profits to this cohort, at the expense of ploughing back these profits (as increased investment) or distributing them to workers (as increased real wages). To some extent, this matches the stylised facts on rising inequality – rising executive and shareholder compensation and faltering real wage growth. The shareholder model may, ironically, have contributed to unfair shares.

If so, this suggests that one avenue worth considering further is corporate governance reform. A set of corporate incentives which had as its fulcrum long-term company value and which more fully reflected the interests of a wider set of stakeholders might help rebalance the scales – for example, towards investing rather than distributing. Such an alternative model is certainly not without precedent. It is found in a number of countries around the world (Mayer (2013)).

Inequality and corporate governance are deep, structural issues. Central banks do not have many, perhaps any, of the solutions to these problems. But the stakes – a more stable, faster-growing, fairer society – could not be higher. There is a collective public policy interest in getting them right.

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