Did Income Inequality Cause the Crisis?

By Editor Test *Wed, Mar 30, 2011*

Those with surplus money naturally lend to those who need money. But, as two IMF experts show, disaster can occur when too much money is lent for consumption and the process goes on too long.

The disparity between the incomes of the wealthiest Americans and the incomes of the rest—especially the 180 million folks in the lowest three wealth "quintiles"—has widened over the past three decades. Lots of evidence shows this.

That widening has coincided with: a) bull markets in equities and bonds; b) ballooning public and personal indebtedness; c) a halving of the marginal tax rates on the highest earners (69.125% in 1981 to 35% in 2003).

Hmm. Are there causal links among those phenomena, or just associations? Lately, as the country has struggled to find solutions (or scapegoats) for its massive debt and deficits, that question seems worth asking.

A recent paper, "Inequality, Leverage and Crises," by Michael Kumhof and RomainRanciére of the International Monetary Fund, provides some answers. The authors describe a mechanism whereby, just as the cycle of freezing and thawing splits pavement, a cycle of lending and borrowing worsens income disparity.

Here's how Kumhof and Ranciére explain our recent economic history:

> "The key mechanism is that investors use part of their increased income to purchase additional financial assets backed by loans to workers. By doing so, they allow workers to limit their drop in consumption following their loss of income, but the large and highly persistent rise of workers' debt-to-income ratios generates financial fragility which eventually can lead to a financial crisis," they write.
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> "Prior to the crisis, increased saving at the top and increased borrowing at the bottom results in consumption inequality increasing significantly less than income inequality. Saving and borrowing patterns of both groups create an increased need for financial services and intermediation.
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> "As a consequence the size of the financial sector, as measured by the ratio of banks' liabilities to GDP, increases. The crisis is characterized by large-scale household debt defaults and an abrupt output contraction as in the 2007 U.S. financial crisis."

Sounds familiar, doesn't it? The downward spiral was also driven by our economy's dependence on personal consumption and the country's failure to put borrowed money to more productive uses:

> "With 71% of the economy's final demand coming from workers' consumption, this output cannot be

> sold unless a significant share of the additional income accruing to investors is recycled back to workers by way of loans. With workers' bargaining power, and therefore their ability to service and repay loans, only recovering very gradually, the increase in loans is extremely persistent.
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> "If a large share of the funds is invested productively, higher debt is more sustainable because it is supported by higher income. If instead the majority of the funds goes into investors' consumption, or into loan growth, in other words an increasing "financialization" of the economy, the system becomes increasingly unstable and prone to crises."

The least effective solution to the crisis, the authors claim, would be the bailouts that we've seen, because they perpetuate the conditions that caused the crisis. A better long-term solution, they say, would be to reduce the debt load and increase the purchasing power of rank-and-file citizens. Inequality of income hurts the rich, the poor, the economy and the country.