Overview

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What is the link between monetary policy and equality? The Bank of England gives occasional briefing sessions to Members of Parliament. At those sessions our main message to the MPs is that when they arrive at the summit of their careers and enter the Cabinet, they will not wish to spend their time dealing with a macroeconomic crisis. Rather, they should devote time in the Cabinet to the discussion of the social objectives of the government, including, where relevant, policies to reduce inequality. In other words, by the consistent pursuit of price stability, the central bank provides a background against which politicians can discuss their political priorities. As Alan Greenspan put it in his opening remarks, "Sustaining a healthy economy and a stable financial system naturally permits us to take the time to focus efforts on addressing the distributional issues facing our society and on other challenging issues that may remain out in the cold."

The role of monetary policy was well described by one of my favorite American economists, Benjamin Franklin, in 1729:

> *"There is a certain proportionate Quantity of Money requisite to carry on the Trade of a Country freely and currently; More than which would be of no Advantage in Trade, and Less, if much less, exceedingly detrimental to it."*

So the central bank should do its job, and other people should do theirs. I shall return to Benjamin Franklin, and indeed to the MPs, in due course.

The discussion in the symposium covered six questions:

(1) Has inequality increased?

(2) If so, why has it increased?

(3) Should we care about the rise in inequality?

(4) What can be done to reduce inequality?

(5) Does inequality matter for monetary policy?

(6) What should central banks do about inequality?

Has inequality increased?

In short, the answer is yes. As Larry Katz explained, although there is a good deal of diversity with differences between countries and time periods, the big picture is of a rise in inequality compared with 20 years ago. Whether one looks at earnings, total income, or the incidence of unemployment, inequality has risen. Indeed, using simple measures such as the Gini coefficient, the rise is striking. In the United States and the United Kingdom, the Gini coefficient increased by between 1 percent and 2 percent a year between the late 1970s and the mid-1990s. The rise was smaller, but still positive in Germany, although wage inequality has not risen in continental Europe. Nevertheless, inequality did increase in 12 of the 14 countries in the 1996 Organization for Economic Cooperation and Development (OECD) study. And, as Kevin Murphy pointed out, the growth of inequality is a pervasive phenomenon, not just a story of the very rich or the underclass. So there is a real phenomenon to be explained.

Why has inequality increased?

In this symposium there was a clear consensus that a shift in labor demand away from the unskilled and disadvantaged, in favor of the skilled and socially adaptable, is the main reason for the rise in inequality. In other words, technology now favors brains rather than brawn. In part, this represents a shift in demand away from goods and toward services—the so-called weightless economy—and, in part, technological change. Of course, these two are related. The shift from brawn to brains was celebrated in the recent British film, "The Full Monty," in which a group of unemployed steelworkers in Sheffield become strippers—male strippers—in order to find an income and identity. In the film, brawn paid off. But in reality, it was the imagination and the skills of the film producers that made the money, not unemployed steelworkers in Sheffield.

Measures of inequality at a particular point in time are an inadequate measure of the underlying distribution. Mobility within the distribution also matters. And there appears to be rather little change in the degree of mobility. But a constant degree of mobility between the percentiles of a more unequal distribution means that the consequences of moving up or down the distribution are much greater than before. It is also likely that the shift in demand for skilled rather than unskilled labor will reduce the opportunities, and hence the mobility of the latter group.

Is the conventional supply and demand framework for analyzing changes in relative wages adequate? Dennis Snower and Joe Stiglitz argued that the answer was no. But even with their nonstandard models, which are extremely interesting, they explain inequality in terms of fundamental shocks such as "organizational change" or "skill-based technological change." So the causes of the rise in inequality in their models are rather similar to the conventional supply and demand framework, even if the consequences of that rise in inequality are different.

There is one other phenomenon to be explained. All studies show that there has been an increasing dispersion of incomes within

groups defined by similar characteristics. Consider the example of professional tennis. The winner of Wimbledon earns millions of dollars a year in endorsements and contracts. The number 100 player in the world earns a rather ordinary salary. Why? People pay a fortune to buy tickets to the Wimbledon Mens' Final, whereas the number 100 player can be seen free of charge in the qualifying tournament, held incidentally immediately prior to Wimbledon at the Bank of England Sports Club. The best has become the enemy of the good.

Similarly, professional soccer players have seen an extremely large rise in inequality within their own group. When I was a boy, soccer players in Britain earned wages not dissimilar to the spectators and, indeed, were subject to a maximum wage of £5 a week. Ultimately, the courts ruled that it was illegal for football clubs to impose a maximum wage. But it was the rise of television, with worldwide distribution, that led to an increase in average salaries and a concentration of earnings in a small number of clubs and a small number of players. Instead of £5 a week, they earn £50,000 a week. Sherwin Rosen's theory of tournaments tells us why the winner takes, if not all, then a great deal. But it was the shift in technology, plus deregulation of the relevant markets, that made the idea so relevant.

Should we care about the rise in inequality?

One view expressed by a number of people at this symposium is that inequality is not a matter of concern in itself; rather, we should focus attention on poverty and the plight of particularly disadvantaged groups in society. But there are some policy problems for which a wider view of inequality is necessary. In designing a tax system to raise money to finance public expenditure, the shape of the income distribution matters in determining the appropriate tax schedule. There is a large literature on the interrelation between attitudes toward inequality, the implied shape of the tax schedule, and the resulting distribution of post-tax incomes. Many distinguished philosophers have contributed to this question, and space does not permit any adequate treatment of the subject. But I would point out only that one does not have to be a "spiteful egalitarian," to use Martin Feldstein's phrase, to believe that the shape of the entire distribution is

relevant to certain policy issues. Rather little was said at the symposium about inequality of opportunity as opposed to inequality of outcomes (as measured, for example, by incomes). My earlier example of professional football players is one in which the abolition of the maximum wage greatly increased inequality within the group, but which also greatly increased the opportunities of soccer players and their average incomes.

What can be done to reduce inequality?

Assar Lindbeck's paper gave us a comprehensive guide to the range of policies that could be employed to reduce inequality. Such policies come under two general umbrellas:

– policies to increase the "human capital" of the disadvantaged; and

– policies of market interventions such as tax and subsidy schemes and statutory minimum wages.

Policies to increase the value of human capital of the poor inevitably come back to education and training. The great difficulty in practice is that education and training is an input with a rather imprecise relationship with output measured by the increase in human capital. On policies of market intervention, there seems no simple conclusion from the experience of countries that have tried minimum wages, and those that have adopted tax and subsidy schemes specifically designed to help the poor enter the labor market, such as the Earned Income Tax Credit in the United States, or more recently, the Working Families Tax Credit in the United Kingdom. There did seem to be general agreement that a number of cultural and social norms were highly relevant in dealing with poverty. These include family structure, attitudes toward work, the pervasiveness of drugs, and the history of unemployment within the local area. But there was a broadly based consensus that policies to promote a culture of work were extremely promising. Policies that attach people to the labor force, even if apparently expensive, may pay dividends if that attachment to work continues, thus promoting a culture of work.

Does inequality matter for monetary policy?

There are several reasons for supposing that the answer to this question is yes. Distributional effects can alter the appropriate monetary policy setting that is needed to achieve price stability. Representative agent models are inadequate. Joe Stiglitz drew our attention to the estimate of the cost of business cycles of $20 per person implied by the calculations of Bob Lucas. I should point out that the cost of the Bank of England is only $7 per person in the United Kingdom.

To the extent that changes in inequality move the natural rate of unemployment around, then a central bank will need to take that into account when setting monetary policy. Of course, in practice, the uncertainty about where the natural rate is means that the qualitative observation of the link between inequality and the natural rate is less helpful than further insights into the quantitative measure of tightness in the labor market.

I shall give two further practical examples of where distributional effects mattered for monetary policy. The first example concerns the nature of the recession in the United Kingdom in the early 1990s. Following a boom in the late 1980s, many households had taken out mortgages with a value in excess of the current value of their houses. When house prices started to fall in the early 1990s, many younger households found themselves in a position of negative net financial wealth, with the value of their houses at market prices falling short of their mortgage liabilities. This "negative equity" had a major impact on their consumption as precautionary saving rose and small changes in wealth led to large changes in consumption.

Why does precautionary saving matter? I believe it is related to the explanation of the sharp fall in consumption in the last recession. In both the United States and the United Kingdom, the last recession was characterized by a surprisingly large fall in consumption. In the early 1990s, falls in consumption in the United Kingdom were larger than in previous recessions—aggregate consumption fell for seven consecutive quarters and by 3.5 percent from peak to trough, the period in which real disposable income rose by 1.1 percent. In part, I believe

the fall in consumption in the early 1990s relates to the rise in debt burdens in the late 1980s. And that rise in debt burdens was not distributed evenly across households. In the United Kingdom, the particular problem was the combination of high debt burdens and falls in house prices. Too many households had portfolios dominated by one asset—their homes— and one liability—the mortgages on those homes. As the price of houses fell, there was no change in the nominal liability on the mortgage. Net worth held in financial assets became negative for a number of households. In the United Kingdom, house prices fell by 13 percent between May 1989 and February 1993. But there was a significant difference between the impact of changes in wealth on households that had experienced negative equity and those that had not. As an illustration of this, between 1989 and 1991, total consumption expenditure of households with a mortgage *fell* by about 2 percent, whereas for those without a mortgage it *rose* by almost 4 percent. There is, therefore, a case for thinking that the distribution of the shock to asset prices led to a larger impact on consumption than if that shock had been evenly distributed across the population as a whole.

The second example is much more recent. Indeed, it comes from the latest Monetary Policy Committee (MPC) at the Bank of England in August 1998. The government announced earlier this year that it would introduce a national minimum wage. The details of that minimum wage were announced in June and the provisions will take effect in April 1999. The minimum wage—£3.60 an hour for all workers over 21 years of age and a lower figure for those aged 18 to 21—is about 55 percent of median earnings. That is lower than the minimum wage (relative to median earnings) in France but higher than in the United States. An estimated 1.9 million employees, about 8.5 percent of the work force, will be affected directly.

Why should this matter for monetary policy? The immediate impact of the minimum wage will be to add around 0.6 percent to the aggregate wage bill. Will this be passed on in higher prices? Will it affect inflation expectations? Should monetary policy accommodate such a one-off change? The MPC of the Bank of England had to answer exactly those questions in its August meeting earlier this

month. Its analysis of the minimum wage was published in the August Inflation Report. In the course of putting together its quarterly forecast for inflation in the United Kingdom, the MPC came to a common view about the likely impact of the minimum wage, the uncertainty of its effect, and the nature of the risks around the central projection. That central projection was that the minimum wage would add about 0.4 percent to the price level, spread out over a period with the maximum impact on the inflation rate of 0.2 percentage points at any one time. The effect will, of course, be only temporary. That in itself is not a reason for accommodating the impact of the minimum wage because its effect was announced well in advance. It is not an unexpected supply shock. But the assessment of a structural policy of this kind did enter into the MPC's thinking, and affected its projection for inflation over the next two years.

All of this goes to show that structural policies that affect income inequality cannot be entirely separated from monetary policy, and the absence of distributional effects in standard macroeconomic models does not mean to say that policy either can or will ignore them.

What should central banks do about inequality?

There are two answers to this question. The first is technical; the second concerns political choice issues.

Technical issues

The impact of monetary policy on the poor varies with the time horizon over which the effects are calculated. As the paper by the two Romers shows convincingly, in the short run monetary policy could be adverse to the poor if, as part of the pursuit of price stability, unemployment needs to rise. Of course, what the poor lose when unemployment rises they gain when unemployment falls because, in the long run, unemployment will move around an average determined by the natural rate. So in the long run, there is no obvious deleterious effect on the poor of a pursuit of price stability. And the benefits to the economy as a whole from a stable price level and macroeconomic

performance more generally are likely to lead to at least some of those benefits accruing to lower income groups. In the long run, the volatility of the share of total income accruing to the poor will depend upon the volatility of unemployment around its natural rate. So the central bank can affect this by its choice between the volatility of inflation and the volatility of output when responding to shocks that hit the economy from time to time. No central bank pursues a rigid form of price stability in the sense that inflation is held to its target level month by month. That would lead to undesirable fluctuations in output, and in those countries with inflation targets, it is clearly understood that one important decision variable of the central bank is how quickly to return inflation to its target level after a shock has occurred. An interesting question raised by Alan Blinder is whether the tradeoff between the volatility of inflation and the volatility of output implied by any well-specified policy reaction function affects inequality in the economy. It is not at all clear that it should have any impact on the average share of any particular income group. But the volatility of that share might well depend upon choices made by the central bank about how far to absorb shocks in terms of movements of inflation or movements in output. But since those effects are likely to come through the volatility of unemployment, it is not obvious that inequality adds anything to the existing choice, which a central bank has to make and which is represented in its policy reaction function.

Political choice issues

I shall start by returning to the briefing sessions that we have with Members of Parliament. A frequent experience is that after a successful attempt to persuade MPs of the virtues of price and economic stability, their reaction is then to ask the Bank of England its views on the tax system, social security arrangements, and many other aspects of government policy. Our attempts to argue that these are not our responsibility meet with surprise. But this is a reflection of what George Shultz has described in the adage so common in political circles: "If an organization does one thing well, it gets asked to do other things." I am a firm believer in Shultz's belief in "limited purpose" agencies. Performance of an agency is improved by accountability,

which, in turn, requires a well-specified objective for the agency. Clearly, if governments would like to benefit from the economic expertise of the central bank, that can be made available in confidence. But our public job is the task of providing a stable macroeconomic environment, thus enabling politicians to do what they were elected to do.

Transparency is a necessary condition for accountability. So transparency of a central bank is a key element of a successful monetary policy. Benjamin Franklin, too, believed in transparency. Indeed, I am sure that he must have believed that central bankers were gentlemen, when he wrote:

> *"... there are among us several Gentlemen of acute Parts and profound Learning, who are very much against an Addition to our Money. It were to be wished that they would favor the Country with their Sentiments on this Head in Print; which, supported with Truth and good Reasoning, may probably be very convincing. And this is to be desired the rather because many People, knowing the Abilities of those Gentlemen to manage a good Cause, are apt to construe their Silence in This, as an Argument of a bad One. Had any Thing of that Kind ever yet appeared, perhaps I should not have given the Publick this Trouble. But those ingenious Gentlemen have not yet (and I doubt never will) think it worth their concern to enlighten the Minds of their erring Countrymen in this Particular, I think it would be highly commendable in every one of us, more fully to bend our Minds to the Study of What is the true Interest of Pennsylvania ...."*

I think that argument could be extended beyond Pennsylvania to the United States, and indeed, to the world of central banking as a whole.

Reference

Franklin, Benjamin. "A Modest Enquiry into the Nature and Necessity of a Paper Currency," Philadelphia, (1792).