A BETTER DISTRIBUTION OF INCOME MAY BE NEEDED FOR GLOBAL RECOVERY

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As the global recovery loses steam, it's perhaps time to "break out" of the traditional narrow framework of the debate on monetary and fiscal policy and look at the more long-term and structural features of the global economy that may be preventing a return to sustained growth. The global jobs crisis and the faltering recovery are bringing together the International Monetary Fund and the International Labour Organization in Oslo on September 13 at a unique event hosted by Norwegian Prime Minister Jens Stoltenberg to discuss both short-term and longer-term policy options, with a focus on jobs.

Critical for the pace of growth are supply side factors such as capital accumulation, the creation and diffusion of technology, and the development of skills. These determine how fast "potential" output can grow. But whether actual output equals potential output depends on whether there is sufficient demand for that output. This is the fundamental part of the Keynesian insight which is widely accepted: supply does not necessarily create its own demand.

When there are demand deficiency problems, economists have argued that monetary policies – low enough interest rates – and fiscal policies – more government spending and less taxes - can bring effective demand closer to potential output, reducing unemployment and idle capacity in the process. There has generally been more agreement on monetary policy than on fiscal policy, as many believe that an increase in government deficits generates expectations of future taxes, weakening the demand generating impact of these deficits, although few argue that this renders fiscal policy totally powerless. The debate is more on the degree of effectiveness of fiscal policy.

The current outlook for the world economy – and for the US economy in particular - is disconcerting and worrisome. There is little doubt that the massive fiscal stimulus and the very expansionary monetary policy that accompanied it were successful in leading to a recovery in output in late 2009 and early 2010. But the recovery is now losing steam. Arguing that there should be continued short-term fiscal stimulus but at the same time that governments should announce serious medium-term fiscal retrenchment raises the question of why consumers, who are being told they will be hit by higher taxes in the near future, would spend much more today. And continuing to use the balance sheets of the Fed and the ECB will also reach a limit.

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Yet there is no reason to believe that the underlying potential of the world economy to grow rapidly is less than it was. Technological know-how is increasing and the diffusion of that know-how is easier than it has ever been. Moreover the world seems to be awash in financial resources and savings that could finance the capital accumulation needed to translate technical know-how into growth. The problem seems to be a lack of confidence that there will be sufficient effective demand to make it happen, at least in many of the critical economies.

Could it be, therefore, that effective demand is hampered by the degree of income concentration at the top, that started to increase in the 1980s, and continues unabated? The top 1 percent of Americans commanded about 8 percent of total income in the late 1970s; they now earn 24 percent of national income – a breathtaking increase. Median incomes have hardly increased over the last three decades. In China, a very different economy, something similar has happened. While the income distribution statistics are less reliable and while there is still overlap between private and public control over resources in the state and local enterprise sector, the share of wages has fallen to below 40 percent of GDP. When there is such concentration of income a the top, demand has to be propped up, either by extremely low interest rates, irresponsible subprime mortgage practices and staggering credit card debt, as was the case in the US for most of the last decade, or by excessive focus on export markets, as happened in China over the same period.

The fear of insufficient demand at "normal" interest rates and sustainable household debt was not a problem when a large and growing middle class shared in the fruits of productivity growth. It was then easier for macroeconomic policies to fine tune the economy and balance aggregate demand and supply. But the deteriorating income distribution may have created a new, more structural problem for macroeconomic management. Some will argue that the US seems to suffer from excess consumption, not insufficient demand, as reflected in its current account deficits. But the question is whether there can be enough effective demand in the US economy, without the record low interest rates and the huge fiscal deficit which create other problems, such as asset bubbles and too much debt. In China the question is whether internal demand can be strong enough for the economy not to need large trade surpluses.

Less extreme inequality in income distribution may not only be ethically desirable – it may be a necessary condition to resolve global macroeconomic fragility and ensure more sustained growth.

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