

# No surprises from the Fed\*

By Christine Riffart

Not surprisingly, at its meeting on 29 and 30 October the Monetary Policy Committee of the US Federal Reserve decided to maintain its unconventional measures and to leave the federal funds rate unchanged. Since the end of 2012, the Fed has been making massive purchases of securities (government bonds and mortgage debt) at a rate of \$85 billion per month. The aim is to put pressure on long-term rates and to support economic activity, including the real estate market.

The Federal Reserve, which is committed to a strategy of transparency and communication aimed at orienting investor expectations, also confirmed that it will hold the rate at between 0 and 0.25% so long as: the unemployment rate is greater than 6.5%; forecasts of inflation over 1 to 2 years do not exceed the long-term inflation target, set at 2%, by more than a half-point; and long-term inflation expectations remain stable. According to our forecast in October (see [The United States: capped growth](#)), the unemployment rate, which was 7.2% in September, could fall to 6.9% by end 2014. Finally, inflation, which was at 1.5% in the third quarter of 2013, should not exceed 1.8% in 2014. In these conditions, no rate increase is expected before the second half of 2015. Policy will thus remain particularly accommodating.

There is greater uncertainty about the withdrawal of the unconventional measures than about keeping long-term rates at artificially low levels. A cessation or reduction of these measures was announced last May and is thus expected by the markets, and in any case they were not meant to last. Between May and September 2013, foreign private and public investors had anticipated the beginning of their withdrawal and began offloading some of their securities. This influx of securities depressed prices and led to a one-point increase in long-term

public rates in just a few weeks. But the fragile character of growth, inadequate job creation and especially the public relations efforts undertaken by the central banks to reassure the financial markets led to putting off the actual date the purchases are to be curtailed. Long-term rates fell once again, and have continued to fall in recent weeks following the October budget crisis.

If, in retrospect, it appears that it was premature to anticipate an early withdrawal of the unconventional measures, the question of timing still remains. In its press release, the Committee stated that any decision will depend on the economic outlook as well as on a cost-benefit analysis of the programme. However, the economic situation is not expected to improve in the coming months. If Congress reaches a budget agreement before December 13, this will certainly be on the basis of cuts in public spending. This new fiscal shock will further dampen growth and penalize the labor market yet again. The issuance of new debt, which was compelled in 2013 by the statutory debt ceiling, might then grow very slowly in 2014 due to budget adjustments. Faced with this moderate growth in the supply of securities, the Federal Reserve could reduce its own purchases to the benefit of other investors. This could help maintain equilibrium in the securities market without a sharp fall in asset prices.

This normalization of monetary policy instruments should not be long in coming. But there are risks involved, and a sharp rise in long-term rates cannot be excluded. The markets are volatile, and the events of May and June have not been forgotten. But much of the movement has already been taken on board by the markets. The Federal Reserve will therefore have to beef up its communication strategy (by for example announcing in advance the date and scope of its decision) if it is to succeed the difficult balancing act of maintaining a highly accommodative monetary policy while gradually dispensing with its exceptional measures to maintain low

interest rates. Let us assume that the exercise will be a success. Long-term public rates, at 2.7% in third quarter 2013, should not exceed 3.5% by the end of 2014.

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\*This text draws on the study “Politique monétaire: est-ce le début de la fin ?” [Monetary policy: Is it the beginning of the end?], which is to appear soon in the OFCE 2013-2014 outlook for the global economy.

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# **Inequality and Global Imbalances: reconsidering old ideas to address new problems**

by [Jean-Luc Gaffard](#) and [Francesco Vona](#)

The main challenge of the Bretton Woods agreements was to reconcile social justice and full employment to be achieved through domestic policies with an international discipline and progress toward trade liberalization (Rodrick 2011). After more than six decades, such division of objectives between international and domestic policies has been questioned by the current economic crisis, characterized by high debt levels, remarkable global imbalances and low global demand. It can hence be useful to reopen an old debate by reconsidering ideas that were discarded in the past, such as the proposal of Keynes to create global demand stabilizers. Our suggestion is that a global stabilizer that prescribes surplus countries to gradually increase their wages can have both a direct positive effect on global demand, without increasing public debts, and an indirect one by favouring a reduction in income

disparities.

The structural lack of global demand represents unquestionably the key constraint to exit from the great recession. Worldwide, sluggish demand appears as the resultant of two quite independent factors, a *constraint* and a *political choice*. The choice is of those countries, especially emerging ones plus Germany, that build up their wealth on export-lead growth using a mix of wage moderation and clever firms' industrial strategies. The public debt constraint, instead, impacts upon the possibility to expand demand of the majority of developed countries. As these countries should enforce restrictive fiscal policies to prevent default, their only chance to expand demand impinges on redistribution in favour of poorer households who consume a larger fraction of their incomes.

The current debate on this matter is misleadingly at best, oscillating between the usual Scylla and Charybdis of more or less state intervention. From a standard Keynesian viewpoint, the bottleneck in global demand is the consequence of neo-liberal policies, which in Europe are worsened by the opposition of Nordic countries against large scale public funded EU programs, possibly financed with EU bonds. From an orthodox viewpoint, which relies upon the belief in a trickle-down mechanism (increase the wealth of the rich eventually benefit all), the crisis represents an opportunity to remove the last barriers to a full liberalization of labor and goods markets. These barriers would prevent EU economies to raise their competitiveness with respect to their new emerging competitors, the BRICS (Brazil- Russia- India-China- South Africa). While Keynesians are overoptimistic in their belief that more public expenditures will succeed in ensuring a fresh start to our feeble economies, orthodox economics neglects by assumption the problem of global demand. In particular, it ignores that a race for competitiveness based on further wage moderation and welfare state cuts would only amplify the

global demand constraint.

It is well documented that, in last thirty years, living conditions and real wages of both low and middle skilled workers decreased substantially while profits and, in general, earnings of top 1% earners increased impressively, especially since the 2000s (Piketty and Saez 2006, Eckstein and Nagypál 2004, OECD 2011). The widening in incomes has been especially large in the US and Anglo-Saxon countries where deregulated labour markets allow wage to adjust downward, but also affected European economies in other forms such as structurally higher unemployment rates and higher profit shares (Krugman 1994). The excessive decrease of the median wage with respect to the average productivity created a fundamental wedge between demand, which is more sensible to wage changes than to changes in profit opportunities, and supply, for which the opposite holds. Globalization plays a key role in increasing inequality between profits and wages as increases in capital mobility were not accompanied in parallel increases in international labour mobility (Stiglitz 2012). Only the joint working of increasing debt (both private and public) and of productivity improvements related to new information & communication technologies prevented the demand deficit to emerge earlier together with the dysfunctional role of excessive inequality (see Stiglitz 2012, Fitoussi and Saraceno 2011, and on the role of technical change Patriarca and Vona 2013). Global imbalances played a key role in maintaining high the level of global demand as long as savings of countries with commercial surpluses (e.g. China) were borrowed to households and governments in countries with commercial deficits (e.g. the US). By mitigating the consequence of on excessive inequality, they keep also under control the political pressure for redistribution. But, as we have seen, they are a source of macroeconomic instability. In fact, the saving glut in export-led economies creates a mass of liquidity in search of investment opportunities that increases the likelihood of asset price bubbles, especially in

presence of an inadequate and oversized financial sector (Corden 2011).

Leaving ethical considerations aside, the concern for rising inequality in western economies would have been irrelevant for overall growth provided the lower demand there was compensated by a growing demand in emerging and export-led countries, such as China. Unfortunately, the compensation did not and is not expected to take place soon for at least two reasons.

First, oligarchies in emerging economies (especially China) found it convenient to sustain global demand indirectly, rather than through wage increases proportional to productivity, by investing large current-account surpluses in the US financial market and so financing US consumers. The indirect empirical support for this argument is that inequality increased in China too since the market friendly reform started. Especially inequality in factor shares, i.e. between profits and wages, increased substantially since the 1995 with the labour share falling by between 7.2% and 12.5% depending on the accounting definitions used (Bai and Qian 2010).

Secondly, a historical comparison of catching-up episodes can help shed light on the origin of the global demand glut. Between the second half of the 19<sup>th</sup> century and the beginning of the 20<sup>th</sup> century, the economic catching-up of both Germany and the US with the UK was soon followed by convergence in living standards and wages (Williamson 1998). Nowadays, the economic catching-up of China is much slower in terms of convergence of wages and living conditions. By way of example, China's GDP per capita increased from 5.7% to 17.2% of US GDP per capita from 1995 to 2010 (source: World Penn Tables), while the hourly labour compensation cost is also increasing but reached only 4.2% of the US labour compensation cost in 2008 (source: Bureau of Labor Statistics Data). This gap between GDP per capita and unit labour cost in China clearly

shows that the catching-up in terms of workers' living conditions is far slower than the economic catching-up.

The reasons for this slow wage convergence deserve further investigations and have probably to do with factors affecting institutional changes that support redistribution from profits to wages, including culture and tax progressivity (Piketty and Qian 2009), in the catching up country. Certainly, the size of Chinese population relative to the world population did not help in fastening these institutional changes. By simple assumptions of standard bargaining theory, bargaining power depends on the outside option that, for workers, is limited by existence of a large 'reserve army' willing to work for extremely low wages. One can then argue that the larger the reserve army, the longer it takes to reduce the downward pressure on the workers' wages in the advanced part of the economy. De facto, the wage convergence has been much faster in previous catching-up episodes since the labour constraint becomes stringent sooner due to the smaller size of the population, allowing workers to fight for better conditions and higher wages. In a nutshell, an excessively large reserve army in the countryside prevents both wages to increase and democratic reforms to take off in China, thus creating a wedge between the timing of economic growth and the one of political reforms, required to rebalance demand and supply.

Not only the slow wage convergence of catching-up country causes persistent global imbalances between demand and supply, it is also the essential reason of the obstacles faced to reduce inequality in western countries. First, implementing redistributive policies and increases in real wages are likely to further reduce competitiveness and to bring about a substantial investment outflows. Second, the treat of delocalizing production abroad can have forced workers to accept lower wages; an effect that is difficult to correlate empirically with observable proxies of globalization such as trade or investment outflows.. While empirical analyses

looking at the last 30 years of the 20<sup>st</sup> century concur that globalization was not the main driver of inequality increases, recent evidence shows that: (i) Outsourcing had a negative impact of on middle and low skill wages and employment levels in developed countries, especially in the last decade (Firpo, Fortin and Lemieux 2011); (ii) The effect of trade on inequality can be underestimated due to production fragmentation (Krugman 2008).

Global imbalances are also likely to create political obstacles to policies aimed at reducing inequality. An oversized financial sector contributed to increase earnings of the top 1% of the population and so their lobbying power. This allowed these super-rich to heavily influence political decisions making their rents higher, especially through a massive reduction of tax progressivity (Fitoussi and Saraceno 2012) and other opaque channels (e.g. fiscal loopholes, Stiglitz 2012). Now, this lobby of super-rich makes it exceedingly difficult to limit the power of finance and restore fairer tax rates for financial rents and top incomes.

How to avoid the stalemate generated by global imbalances and global pressure for wage moderation? Are there in the system as it is endogenous forces that will eventually reduce global imbalances and inequality?

The first option is to wait for reforms in China. Politicians in western countries can hope in a speeding up of this process that will lead to a parallel increase in real wages and hence global demand. This will be the ideal market solution, but it is unlikely to occur in the short- and medium-run. A second possibility will consist in a large scale devaluation of western economies' currencies: Dollar, Euro and Yen. However, such a policy is likely to create a devaluation spiral, also increasing investment uncertainty. Moral suasion is unlikely to convince Chinese politicians to not devalue the Yuan as their assets in dollars and euro will depreciate



substantially. A third protectionist solution is not convincing at all as it is likely to trigger a retaliation spiral paving the way for global wars. Indirect and global political interactions are an issue at stake here: nationalistic political parties and the associated protectionist policies are more likely to become popular if the timing of Chinese reforms is too slow and so the adjustment process too painful in the medium-run. A fourth solution is to resort to an old idea of John Maynard Keynes on 'global automatic stabilizers'. In the post-WWII context, Keynes proposed an international institution, the so-called 'International Clearing Union' (ICU), to reabsorb both commercial surpluses and deficit, seen as equally worrisome (see also the article in Italian of A. Bramucci 2012). In particular, persistent commercial surpluses were seen as a potential source of long-term shortages of global demand. The main idea was to coordinate thorough the ICU both re-evaluations and demand expansions for the countries in surplus, and de-evaluation and control of capital movements for countries in deficit. Such an institution would go in the right direction to help reabsorbing global imbalances, but lack enforcement power to ensure that the necessary adjustments are effectively put in place.

Combining a global rule for wage adjustment with WTO sanctions can represent a more clever and reliable way to revive global demand. The first part of the proposal would consist in linking real wage growth not only to productivity growth, as proposed by A. Watt (2011), but also to commercial surplus. Conditioned to the country's level of development (so the prescribed adjustments should take into account of initial level of GDP per capita and obviously adjusted for PPPs), countries experiencing medium-term growths both in productivity and in the commercial surplus have to increase real wages. Otherwise, other countries could raise tariffs on the products exported by the country that does not follow the rule. The effective capacity to implement of the rule can be

reinforced by giving to Unions, either global or local, and NGOs the power to control for specific situations where the rule is not respected, i.e. special export-oriented zone in China where labour standards are particularly low. In the case of commercial deficits, the country could be asked to follow (real) wage moderation and to put under control public deficit. In such a context, these restrictive policies would have limited harmful effects on growth for the increase in external demand that follows the wage increase in the export-oriented countries. The proposal would have also positive effect in reducing the overall level of functional inequality worldwide, restoring a more balanced distribution between wages and profits.

Overall, the coordination of global demand and supply would be restored using a simple automatic stabilizer that will neutralize the protectionist treat and, at the same time, will relax the constraints that prevent inequality-reducing policies to be approved in western countries.

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