DOI: 10.1007/s10272-013-0481-8

Rising Inequality, Recession and Slow Recovery: A Sad American Tale*

Rewind the clock to the U.S. economy of 2006 and 2007. Unemployment was near historic lows, inflation was tame and home prices were rising quickly. The broad consensus was that the U.S. could enjoy the benign macroeconomic conditions of the "Great Moderation" for years to come.[1] But we now know that this conventional wisdom was badly mistaken. Instead of more Great Moderation, we got the Great Recession. Home prices plummeted, lending to households dried up and unemployment soared. The recovery, such as it is, has been disappointing, with no improvement whatsoever in the civilian employment-population ratio since the official recession ended.

Our new research offers a perspective on this sad history that is largely missing from most discussions of what went wrong. Others have focused on the "wealth effect" of rising home prices, an increase in uncertainty and difficulty accessing credit. We argue, however, that one cannot adequately explain recent events without understanding the link between the rising inequality of American incomes and the unsustainable trends of household spending and debt that sowed the seeds of the Great Recession.

On the surface, the argument that higher inequality was responsible for a rapid *rise* in household spending seems to get things backward. Going back at least to Keynes, economists have proposed that those with high income spend a smaller share of it than others, which suggests that rising inequality should raise saving and create a drag on consumer demand. But in the unusual decades before the Great Recession, we find that things were different.

We show that the rise of inequality that began around 1980 resulted in large part from a slowdown of income growth for the bottom 95 percent of the income distribution, that is, for just about everyone. These households could have responded by cutting either consumption growth or saving growth. The data tell us that during this period much of the response was in saving, consistent with the widely discussed fall in the American saving rate. This response rescued the economy from demand drag during the years prior to the Great Recession, but it also put the ratio of household debt to income on an unsustainable path. Financial innovation in household lending – credit cards, new kinds of mortgages, home equity credit lines, et cetera – facilitated this trend for a long time. And falling interest rates delayed the day of reckoning, as households could refinance into lower cost loans that required less and less collateral.

Survey data show that the debt trend was much more severe in the bottom 95 percent. According to the Federal Reserve's Survey of Consumer Finance, the debt-income ratio rose 68 percentage points for the bottom 95 percent between 1989 and 2007, but just ten percentage points for the top five percent. Eventually, the debt leverage of the bottom 95 percent collided with limits on further borrowing when interest rates rose and the rise of home prices stalled. With liquid savings depleted and much of new borrowing cut off, household spending collapsed and the Great Recession began.

We have constructed original data that reveal important behavioral differences between the affluent and everyone else during this period. A recession, by definition, is a decline in out-

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* This paper is based on B.Z. Cynamon, S.M. Fazzari: Inequality, the Great Recession, and Slow Recovery, 2013, available at http://ssrn.com/abstract=2205524.

1 The "Great Moderation" is the name given to the period of reduced macroeconomic volatility in the U.S. dating back to the middle 1980s.

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put which causes a decline in income. Conventional consumer theory implies that when incomes decline, households will try to maintain a smooth consumption path by drawing down savings or borrowing. This theory predicts that in a recession we should see consumption relative to income rise, because consumption stays relatively stable while income declines.

Our data confirm this consumption-smoothing theory for the top five percent: their consumption-income ratio rises significantly in recessions. The increase is especially striking during the Great Recession. By 2012, however, the top five percent consumption-income ratio had returned to its normal range, as it did following earlier slowdowns.

Things are much different for the bottom 95 percent. The consumption-income ratio for this group was likely already high at the beginning of our data in 1989, as suggested by the decline in the aggregate saving rate starting at least five years earlier. From 1989 to the eve of the Great Recession, the consumption-income ratio for the bottom 95 percent rose further along a fairly smooth trend. This high spending of the bottom 95 percent was an important engine of demand growth for the U.S. economy over those decades. But when the recession hit, their consumption-income ratio plummeted, exactly the *opposite* of the behavior predicted by the consumption-smoothing theory. Nothing like this had happened to this group in earlier recessions; what was different this time? Our answer is that the ability of the bottom 95 percent to borrow more to finance an unsustainable pace of consumption came to an abrupt end.

According to this research, rising inequality did not create much demand drag when it started in the 1980s. Instead, it led households onto an unsustainable path of debt accumulation that would eventually cause an economic collapse. But what are the consequences of inequality for consumption in the aftermath of the Great Recession? With the excessive borrowing by the bottom 95 percent cut off, we argue that the U.S. economy cannot generate the consumption it needs for robust recovery. The problem is that even though the demand growth that preceded the recession was financed in an unsustainable way, the economy *needed* that demand to maintain full employment. There is no evidence that demand was excessive prior to 2007 – inflation was tame and interest rates were low. But the financial crisis shackled household demand. The consumption profile from the Great Recession into 2013 is far below comparable data for other postwar U.S. recessions.

In principle, other sources of demand could fill this consumption gap. Businesses could invest more, but why should they with a stagnant economy? Affluent households could consume more, but that would further magnify the social tension from inequality. Governments at all levels could raise spending, but state and local governments remain financially constrained and the political debate at the federal level seems to be only about how much austerity to impose.

We believe that the best way to repair U.S. demand generation would be if the trend toward greater income inequality is reversed, or at least stabilized. Redistributive tax policy could help to meet this goal, although it is politically contentious. A better alternative – and one more consistent with political ideology in the U.S. – is for wage growth to keep pace with productivity growth. This condition was satisfied in the decades of broadly shared prosperity following World War II. It is far from obvious how to implement policies to achieve this goal, but there may be no other way to generate the demand necessary in a sustainable way.

Policy issues notwithstanding, a first step toward resolving the problem is to have a clear understanding that inequality is more than an issue of social justice. Our research shows that inequality also compromises the basic demand engine that the economy needs to grow at full employment.