Inequality and Macroeconomics

Benjamin Moll Princeton

University of Luxembourg/European Investment Bank "Inequality and ...?" Lecture Series

The Main Point of My Talk

• Macroeconomics and inequality is a two-way street

inequality \iff macroeconomy

- 1. macroeconomic shocks and policies affect inequality
- 2. inequality affects macroeconomic aggregates
- This idea may sound obvious to you but
 - it only made its way into mainstream macro relatively recently
 - lots of people (economists, journalists, ...) frequently forget
- Another theme: large gap between
 - current research in academic macroeconomics
 - macroeconomics in media/blogs, undergraduate teaching

- 1. Inequality in macroeconomics: a history of thought
- 2. How inequality affects how we should think about monetary policy

 based on joint work with Yves Achdou, SeHyoun Ahn, Andreas Fagereng, Xavier Gabaix, Jiequn Han, Martin Holm, Greg Kaplan, Pierre-Louis Lions, Jean-Michel Lasry, Gisle Natvik, Galo Nuño, Gianluca Violante, Tom Winberry, Christian Wolf I find it useful to categorize macroeconomic theories into three generations, corresponding roughly to following time periods

- 1st generation: 1930 to 1990
- 2nd generation: 1990 to financial crisis
- 3rd generation: after the financial crisis

Main drivers of this evolution

- 1. better data
- 2. better computers
- 3. current events (rising inequality, financial crisis)

First Generation Macro Theories: 1930 to 1990



First Generation Macro Theories: 1930 to 1990

- Old Keynesian models: systems of equations in aggregate variables
- Real Business Cycle (RBC) and New Keynesian models: representative agent
- Both are still heavily used, especially by Central Banks (where they are pretty much the only models currently in use)
- Both have no role for inequality by assumption

What's Wrong with First Generation Theories?

- a lot... but for the purpose of this talk focus on two things:
- 1. cannot speak to a number of important trends/facts in the data
- 2. cannot think coherently about national well-being/welfare which depends on distribution

Long-Run Growth is Unequally Distributed



Source: Piketty, Saez, Zucman (2016), "Distributional National Accounts"

Bottom of Distribution hit Hardest in Recessions



Fig. 9. Percentiles of the household earnings distribution (CPS). Shaded areas are NBER recessions.

Source: Heathcote, Perri, Violante (2010), "Unequal We Stand..."

"The most important discovery was the evidence on the pervasiveness of heterogeneity and diversity in economic life."

(James Heckman, 2001 Nobel Lecture)

"While we often must focus on aggregates for macroeconomic policy, it is impossible to think coherently about national well-being while ignoring inequality and poverty, neither of which is visible in aggregate data."

(Angus Deaton, 2016 Nobel Lecture)



Second generation theories incorporate heterogeneity from micro data, particularly in income and wealth



Second generation theories represent economy with a distribution...



Second generation theories represent economy with a distribution... that moves over time, responding to macroeconomic shocks, policies

Second Generation Macro Theories: 1990 to 2008



To contrast them with representative agent models, these theories are often referred to as "heterogeneous agent models"

• important early contributions in the 1990s by Aiyagari, Bewley, Huggett, Krusell-Smith, Den Haan,...



Fig. 9. Percentiles of the household earnings distribution (CPS). Shaded areas are NBER recessions

... and examine welfare implications of such distributional changes

Second Generation Theories: Inequality \Rightarrow Macro

- 2nd generation theories featured rich heterogeneity
- ... but typically found small effects of heterogeneity on macroeconomic aggregates, particularly consumption and saving
- Summary by Lucas (2003):
 - "For determining the behavior of aggregates, [Krusell and Smith] discovered, realistically modeled household heterogeneity just does not matter very much. For individual behavior and welfare, of course, heterogeneity is everything."
- Reason: rich and poor differ in their wealth but not their consumption and saving behavior – rich = scaled version of poor
- Note: in some notable exceptions from same time period inequality does affect macroeconomy – important contributions by Banerjee-Newman, Benabou, Galor-Zeira, Persson-Tabellini, ...
 - most of these about developing countries, long-run growth
 - some of these somewhat abstract \Rightarrow hard to take to data

What's Wrong with Second Generation Theories?

They don't square well with consumption, saving behavior in micro data

• e.g. evidence on marginal propensities to consume (MPCs) out of transitory income changes



• data source: Jappelli & Pistaferri (2014), note: self-reported MPCs

They don't square well with consumption, saving behavior in micro data

• e.g. evidence on saving rates across the wealth distribution



- Note: depending on particular variant, 2nd generation models may also feature downward-sloping saving rates (De Nardi & Fella 2017)
- Data source: Fagereng, Holm, Moll & Natvik (2017)

- Angus Deaton (2016) again:
 - "While we often must focus on aggregates for macroeconomic policy, it is impossible to think coherently about national well-being while ignoring inequality and poverty, neither of which is visible in aggregate data."
 - "Indeed, and except in exceptional cases, macroeconomic aggregates themselves depend on distribution."
- Second generation models are exactly such "exceptional cases"

Third Generation Theories: after the Crisis

Recent Janet Yellen's speech "Macroeconomic Research After the Crisis": http://www.federalreserve.gov/newsevents/speech/yellen20161014a.htm

- "My second question asks whether individual differences within broad groups of actors in the economy can influence aggregate economic outcomes – in particular, what effect does such heterogeneity have on aggregate demand?"
- "Prior to the financial crisis, representative-agent models were the dominant paradigm for analyzing many macroeconomic questions."
- "However, a disaggregated approach seems needed to understand some key aspects of the Great Recession. To give one example, consider the effects of negative housing equity on consumption..."
- "While the economics profession has long been aware that these issues matter, their effects had been incorporated into macro models only to a very limited extent prior to the financial crisis [= 2nd generation]."
- "I am glad to now see a greater emphasis on the possible macroeconomic consequences of heterogeneity [= 3rd generation]."

Third Generation Theories: after the Crisis

In order to match micro data, 3rd generation theories emphasize

- household balance sheets,
- e.g. nominal vs real assets, liquid vs. illiquid
- MPCs that are high on average but heterogeneous. Example:



(a) High and heterogeneous MPCs...

(b) ... that depend on balance sheets

Source: Kaplan, Moll, Violante (2017) "Monetary Policy According to HANK"

Mechanisms Through Which Inequality \Rightarrow Macro

- 1. Demand side
 - rich spend smaller fraction of their income than poor \Rightarrow increase in inequality causes lower consumer spending
 - more subtle versions of this story, e.g. what matters is not whether you're rich but whether you're liquid-wealth rich
 - stories that emphasize housing and mortgages,...
- 2. Supply side
 - credit constraints in education \Rightarrow poor children get inferior education \Rightarrow bad for long-run growth
 - credit constraints in entrepreneurship ⇒ wealth distribution matters for entry, allocation of capital
 - deregulation, tax cuts may boost growth, raise inequality

3. (Political economy, e.g. too much inequality leads to revolution)

• Theory makes no clear prediction whether inequality is good or bad for macro, only common feature is that distribution matters

History of Thought on Inequality & Macro: Summary

- 1st generation: 1930 to 1990
 - Old Keynesian IS-LM, RBC model, (New Keynesian model)
 - no role for inequality by assumption
- 2nd generation: 1990 to financial crisis
 - early heterogeneous agent models
 - "macro \Rightarrow inequality" but "macro \notin inequality"
- 3rd generation: after the financial crisis
 - current het agent models which take micro data seriously
 - rich interaction: "inequality \iff macro"

What's Been Driving this Evolution?

1. Better data

- explosion of availability of high-quality micro data
- e.g. administrative data from places such as Internal Revenue Service, Social Security Administration,...
- need large samples to document fine-grained heterogeneity, particularly since distributions are typically very skewed

2. Better computers

- models with heterogeneity (generations 2 and 3) much harder to compute than those without (generation 1)
- 3rd generation models harder than 2nd generation ones

3. Current events

- · rising inequality in many developed countries
- cannot understand some key aspects of Great Recession without thinking about heterogeneity

Example of Better Data

- Models with heterogeneity traditionally assume changes in individual income are normally distributed
- Social Security Administration data: bad description of data
- · Recent models take new evidence on board

One-year change



Source: Guvenen, Karahan, Ozkan, Song (2016) "What Do Data on Millions of U.S. Workers Reveal about Life-Cycle Earnings Dynamics?"

Five-year change

Media and Undergrad Teaching are Stuck pre 1990

- Both almost exclusively concerned with first generation theories in which there is no role for inequality by assumption
- Media often critizices macroeconomists for ignoring heterogeneneity. Here is a 5 May 2017 example from Reuters:
 - "The preference for high theory and abstruse mathematical modeling meant that mainstream economics had come to rest on a number of gloriously improbable assumptions."
 - "In their models, millions of households were reduced to a single 'representative agent,' a God-like being, omniscient and immortal."
 - "This unreal creature inhabited a world where peace or equilibrium – ruled. Crises were impossible in such an Eden..."

http://de.reuters.com/article/us-review-crisis-breakingviews-idDEKBN1811XP

• This is simply a wildly inaccurate description of academic macroeconomics, at least after end of 1990s

- Place where "macroeconomists ignore heterogeneity" criticism does apply: undergraduate teaching
 - undergrads typically learn Old Keynesian IS-LM
 - or maybe RBC-type representative agent models
 - but very rarely heterogeneous agent models
- For similar points, see
 - Kocherlakota (2009) "Some Thoughts on the State of Macro" http://online.wsj.com/public/resources/documents/KOCHERLAKOTA20090930.pdf
 - Ricardo Reis (2016) "Is Something Really Wrong with Macroeconomics?" http://personal.lse.ac.uk/reisr/papers/17-wrong.pdf

Aside: Inequality-Growth Cross-Country Regressions

Large number of papers:

- country-level data on GDP growth, inequality measure (e.g. Gini)
- regress growth in subsequent 10 years on inequality in base year
- see e.g. recent IMF and OECD studies that got a lot of press

Example: Inequality and Economic Growth in OECD Countries



Source: Kolev and Niehues (2016) who criticize the literature

Most economists are quite skeptical of such studies

See e.g. Banerjee and Duflo (2003) "Inequality and Growth: What Can the Data Say?"

• "On the question of whether inequality is bad for growth, [cross-country] data has little to say. It is clear that the most compelling evidence on this point has to come from micro data."

Reasons:

- 1. many omitted variables in such cross-country regressions
- 2. relation could be very non-linear (see e.g. Banerjee-Duflo, 2003)
- "inequality ↔ macro", not just "inequality ⇒ macro" (see e.g. Fuest, 2017)
- 4. typically lack of evidence on particular mechanisms
 - This skepticism is probably justified

Inequality Changes How We Should Think about Macroeconomic Policies: Case of Monetary Policy

- Based on Kaplan, Moll and Violante (2017) "Monetary Policy According to HANK"
- "HANK" = Heterogeneous Agent New Keynesian model
- Goal: introduce heterogeneity into models used by Central Banks
 which we like to call
- "RANK" = Representative Agent New Keynesian model

How monetary policy works in RANK

Total consumption response to a drop in real rates

 $C \text{ response} = \underbrace{\text{direct response to } r}_{>95\%} + \underbrace{\text{indirect effects due to } Y}_{<5\%}$

- Direct response is everything, pure intertemporal substitution
- However, data suggest:
 - 1. Low sensitivity of C to r
 - 2. Sizable sensitivity of C to Y
 - 3. Micro sensitivity vastly heterogeneous, depends crucially on household balance sheets

How monetary policy works in HANK

- Once matched to micro data, HANK delivers realistic:
 - wealth distribution: small direct effect
 - MPC distribution: large indirect effect (depending on ΔY)

 $C \text{ response } = \underbrace{\text{direct response to } r}_{\text{RANK: >95\%}} + \underbrace{\text{indirect effects due to } Y}_{\text{RANK: <5\%}}$ $HANK: <1/3 \qquad HANK: >2/3$

- Overall effect depends crucially on fiscal response, unlike in RANK where Ricardian equivalence holds
- **Q:** Is Central Bank less in control of *C* than we thought?

Macro Also Matters for Inequality

- HANK allows studying distributional implications of monetary policy
 - lower interest rates ⇒ negative income effect on savers, positive on borrowers
 - Yellen again: "even though the tools of monetary policy are generally not well suited to achieve distributional objectives, it is important for policymakers to understand and monitor the effects of macroeconomic developments on different groups within society"
- Empirical evidence?

Distributional Effects of Monetary Policy?



Source: Coibion, Gorodnichenko, Kueng, Silva (2016) "Innocent Bystanders"

- In HANK model with wealthy-hand-to-mouth also fiscal policy is much more powerful than in RANK
 - See Kaplan and Violante (2016) "Wealthy 'hand-to-mouth' households: key to understanding the impacts of fiscal stimulus"
- RANK: clear pecking order between monetary and fiscal policies
 - away from zero lower bound, monetary policy can by itself restore first-best equilibrium allocation ("divine coincidence")
- HANK: no longer true
 - Is fiscal policy sometimes preferable to monetary policy when there are incomplete markets and distributional concerns?



• Macroeconomics and inequality is a two-way street

inequality \iff macroeconomy

- · Current research in macroeconomics takes this seriously,...
- ... incorporates enormous heterogeneity observed at micro level, in particular the large disparities in income and wealth
- Doing so often delivers strikingly different implications for monetary and fiscal policies...
- ... and allows us to study their distributional implications

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