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The impact of monetary policy on inequality in the UK. An empirical analysis[☆]



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ABSTRACT

The UK has experienced a dramatic increase in earnings and income inequality over the past four decades. We use detailed micro level information to construct quarterly historical measures of inequality from 1969 to 2012. We investigate whether monetary policy shocks played a role in explaining this increase in inequality. We find that contractionary monetary policy shocks lead to an increase in earnings, income and consumption inequality and contribute to their fluctuation. The response of income and consumption at different quantiles suggests that contractionary policy has a larger negative effect on low income households and those that consume the least when compared to those at the top of the distribution. Our evidence also suggests that the policy of quantitative easing may have contributed to the increase in inequality over the Great Recession.

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1. Introduction

The latest financial and sovereign crises left Western economies with rising levels of inequality. A number of studies (e.g. Belfield et al., 2014; Blundell and Etheridge, 2010; Brewer and Wren-Lewis, 2012) present evidence of rising income inequality for the UK up to 2007–2008. According to Belfield et al. (2014) the Gini coefficient for UK households' disposable income has increased over the last 45 years from 0.25 in 1967 to 0.36 in 2007–2008. Similar trends appear for net labour earnings where the Gini increased from 0.32 in 1968 to 0.35 in 2008 (Brewer and Wren-Lewis, 2012).

A growing area of research is trying to explain the rising trend and to identify the contributing factors. Skill based education and technological advances, changes in the family structure, employment status and occupation, structural reforms in the labour market, globalisation and increased international trade have all contributed to wage and income inequality (see for example Bound and Johnson, 1992; Card, 2001; Feenstra and Hanson, 2008). However, the above factors are only part of the story: trying to decompose changes in income inequality, Brewer and Wren-Lewis (2012) find that a large amount of the UK income inequality for the period 1968–2007 remains unexplained and this amount has increased to over 50% over the total variation towards the end of the period.

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While fiscal policy has received substantial attention as a contributing factor to inequality, the role of monetary policy is still to be decided. Earlier studies present a contradictory view on the matter: Galbraith (1998), for example, argues that strict inflation targeting policies caused a series of recessions, higher unemployment rates and therefore a rise in inequality. Coibion et al. (2012) note that the expansionary monetary policy of Federal Reserve boosted share prices benefiting mainly shareholders, participants of financial markets and trade, who are usually the wealthier households. In addition, low income households hold most of their wealth in liquid assets which are the most vulnerable to inflation inducing monetary policies. In a recent contribution, Auclert (2016) points out that the impact of monetary policy through this channel depends on the maturity duration of assets and liabilities. In particular, expansionary monetary policy tends to provide a larger benefit to households who have negative unhedged interest rate exposure—i.e. households whose maturing liabilities exceed their maturing assets. Opposite effects have been also documented: Expansionary monetary policies and low interest rates favour borrowers who may be low income households while savers and lenders are adversely affected (Doepke and Schneider, 2006).

Hence monetary policy can have an ambiguous effect on inequality. The relationship complicates further by taking into account the sources of income of households. If policy affects wages and labour income, then households for which wage is the most important source of income will be affected by more. If monetary policy substantially alters asset prices, high income households which hold financial wealth will be highly affected.

Coibion et al. (2012) investigate whether the US monetary policy has contributed to changes in consumption and income inequality. The authors use household level data from the Consumer Expenditures Survey (CEX) since 1980 at quarterly frequency to construct their different measures of inequality and to see how these measures respond to monetary policy shocks as identified by Romer and Romer (2004). Their findings suggest that contractionary monetary policy shocks significantly increase income, consumption and wage inequality among US households.

In the present study we investigate whether monetary policy shocks have affected earnings, income and consumption inequality in the UK.¹ While our work is closely related to Coibion et al. (2012), there are a number of important distinguishing features. First, our paper uses a substantially longer quarterly time series for the inequality measures—from 1969 to 2012. This period includes a number of recessions and expansions where the Bank of England used a variety of policies, with this variation providing a stronger identification of policy shocks. Second, in addition to investigating the impact of standard monetary policy, we also examine the impact of unconventional monetary policy on inequality.²

Using a Structural Vector Autoregression (SVAR) we find that contractionary monetary policy shocks lead to an increase in earnings, income and consumption inequality. These results remain invariant to alternative specifications of the VAR. We find that the monetary policy shock makes important contributions to historical fluctuations in the inequality measures. In order to investigate the possible factors behind the increase in inequality we estimate the SVAR using data for households at different percentiles of the distribution. Results from this exercise suggest that the contractionary monetary policy shock decreases wages and income for households at the low end of the distribution while households at the upper end are less affected. This is consistent with richer households deriving a larger proportion of their income from investments. Finally, our results also suggest that the policy of quantitative easing led to an increase in the inequality measures.

These results have important policy implications at a time when the Bank of England is contemplating the possibility of switching from unconventional to conventional monetary policy. Our results suggest that policy makers need to take redistributive effects of policy changes into account.

The rest of the paper is structured as follows: Section 2 describes the variables used, their transformations and the construction of the inequality measures. Section 3 describes the estimation of the structural VAR model and the identification scheme. Section 4 presents the main results for earnings, income and consumption, while Section 5 concludes.

2. Data

We construct inequality measures for four variables: disposable income, total consumption, consumption of non durables and gross wage. The first three variables are at household level while the last one is at individual level. We draw micro data from the Family Expenditure Survey (FES) from 1969 to 2012. The FES is an annual survey which provides detailed information on demographics, income, expenditure and consumption for on average of a representative sample of 7000 UK households per year. The households who participate on FES are asked to keep a diary with their spending of a 2 week period. In 2001 FES merged with the National Food Survey and became the Expenditure and Food Survey (EFS) and with the Living Costs and Food Survey (LCFS) in 2008.³ Even though the FES has been running from 1957 there are discontinuities and small samples prior to 1968 and for this reason we start our sample from 1969. Some studies (see for example Foster, 1996; van de Ven, 2011) point out representation problems with the survey: FES tends to over represent mortgage holders, people

¹ In a previous version of this paper we use annual data on the Gini coefficient in a mixed frequency VAR to investigate this issue. See Mumtaz and Theophilopoulou (2015).

² Over the past year, additional studies have applied similar methods to investigate this issue for different sets of countries. This includes Guerello (2016) for the Euro Area and Furceri et al. (2016) for developed and emerging countries who find that monetary contraction raises inequality and Inui et al. (2017) for Japan who report an unstable relationship between inequality measures and policy changes.

³ In 1993–1994 the FES changes from a calendar year to financial year (April to March) and the EFS goes back to the calendar year in 2006.

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