MONETARY POLICY AND THE DISTRIBUTION OF INCOME: UK evidence that both higher interest rates and QE raise inequality

Higher interest rates worsen income inequality, according to research by **Haroon Mumtaz** and **Angeliki Theophilopoulou**, to be presented at the annual congress of the European Economic Association in Mannheim in August 2015. Their study also looks at the effect of quantitative easing (QE) on income inequality and concludes that in contrast to conventional policy, QE has probably increased inequality.

The researchers use the Gini coefficient, a measure of income inequality, to look at previously unexplored effects of monetary policy. Analysing UK data for the period from 1969 to 2012, they find that when monetary policy contracts (interest rates rise to keep inflation down), it worsens inequality. For example, an interest rate increase of 0.1% increases inequality by around 0.5%. The research also finds that monetary policy explains around 10-20% of the variation in income inequality, especially during the 1970s and 1980s.

Monetary policy can affect inequality through a number of channels so its final impact is ambiguous. For example, expansionary monetary policy can boost profits more than wages and increase the income of (typically wealthier) firm owners more than the income of employees who may not have access to corporate profits. On the other hand, low interest rates will harm savers more than borrowers, leading inequality to fall.

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A number of recent studies present evidence of rising income inequality for the UK over the last five decades. Factors that typically contribute to an increase in inequality are argued to be technological progress, international trade, population characteristics and fiscal policies. But recent papers have found that a large amount of inequality remains unexplained even when these factors are accounted for.

This paper examines the possible role of monetary policy in driving inequality in the UK, a factor that has been unexplored in the existing literature. Monetary policy can affect inequality through a number of channels so its final impact can be ambiguous.

For example, expansionary monetary policy can boost profits more than wages and increase the income of (typically wealthier) firm owners more than the income of employees who may not have access to corporate profits. In addition, it can increase firms' profitability, the value of dividends and shares so that financial participants benefit more than non-participants. In both cases, inequality will increase through the income and financial segmentation channels.

On the other hand, low interest rates will harm savers more than borrowers, and inequality can fall through the savings redistribution channel.

This study investigates whether monetary policy has contributed to an increase in inequality in disposable income, gross wage, total consumption and non-durable consumption in the UK. The authors construct measures of inequality for the aforementioned variables by using micro data from the Family Expenditure Survey (FES).

More specifically, they construct time series for the Gini coefficient and standard deviation of log levels from 1969 to 2012 at the quarterly frequency. To estimate the impact of monetary policy on these inequality measures, they use a simple empirical model that makes it possible to simulate the impact of a surprise change in policy interest rates on these inequality measures.

The results suggest that a contractionary monetary policy shock that increases interest rates by 10 basis points results in an increase of the Gini coefficient for income and earnings on the impact of about 0.5% and the increase is persistent and statistically significant suggesting that inequality rises after a policy contraction. Inequality in consumption increases by more than 0.5% on the impact, especially for non-durables consumption, but the response is short-lived.

The researchers also find that the contribution of the monetary policy shocks to the variation of the measures is in the range of 10-20% and that monetary policy shocks have contributed to the historical variation of these variables especially during the 1970s and early 1980s.

They also investigate if unconventional monetary policy (QE) has had an impact on inequality in the post-2008 period. By using their model to forecast inequality over the post-2008 period, under the counterfactual assumption of higher than usual long-term interest rates, they conclude that, in contrast to conventional policy, QE probably increased inequality over the recent past.

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Monetary Policy and Inequality in the UK

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