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Economics focus

The beautiful and the damned

The links between rising inequality, the Wall Street boom and the subprime fiasco

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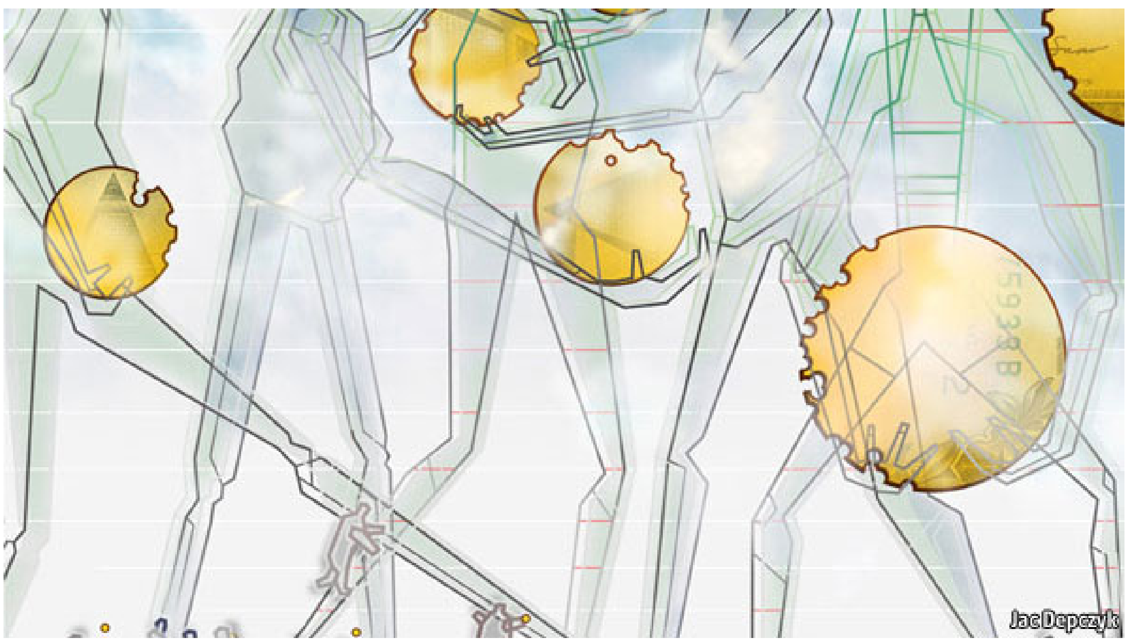

THERE was not a single year between 1952 and 1986 in which the richest 1% of American households earned more than a tenth of national income. Yet after rising steadily since the mid-1980s, reckon Thomas Piketty and Emmanuel Saez, two economists, in 2007 the income share of the richest percentile reached a staggering 18.3%. The last time America was such an unequal place was in 1929, when the equivalent figure was 18.4%. The similarities in the evolution of income inequality in the years leading up to the Depression and the global economic crisis make for one of the most striking parallels between the two episodes. Some talk of a repeat of the Roaring Twenties, when Jay Gatsby threw lavish parties at his Long Island mansion—although this time round, the dubious profits have been made from real-life finance, not fictitious bootlegging.

Economists have been thinking hard about the causes, extent and consequences of the recent rise in inequality. At the annual meeting of the American Economic Association (AEA) in

Denver this month, there was a spirited debate about one of the most controversial hypotheses so far. That has been advanced by Raghuram Rajan, of the University of Chicago Booth School of Business, in a recent book, “Fault Lines”. He argues that increased inequality—more precisely, the political response to it—helped to cause the financial crisis.

Mr Rajan reckons that technological progress increased the relative demand for skilled workers. This led to a widening gap in wages between them and the rest of the workforce, because the supply of the skilled did not keep pace with demand. This reasoning is widely accepted. But Mr Rajan goes further than most when he argues that this growing gap lay behind the credit boom whose souring precipitated the financial crisis.

Governments, he argues, could not simply stand by as the poor and unskilled fell farther behind. Ideally, more should have been spent on education and training. But in the short run, credit was an easy way to prop up the living standards of those at the bottom of the economic pile. This was especially true in America, with its relatively puny welfare state.

Mr Rajan thinks, therefore, that it is no coincidence that America in the early 2000s saw a boom in lending to the poor, including those folks that banks used to sniff at. He points to the pressure the government put on the two state-backed housing giants, Fannie Mae and Freddie Mac, to lend more to poorer people. Affordable-housing targets, slacker underwriting guidelines and the creation of new “low down-payment” mortgages were all used as instruments of public policy.

The push for affordable credit worked. Subprime mortgages, whose share of all mortgages serviced rose from less than 4% at the turn of the century to a peak of around 15% before the crisis, were the most visible examples of this. They helped push American home-ownership rates to record highs. But the credit boom also inflated an enormous housing bubble, whose collapse precipitated a financial crisis brought on by defaults on those very subprime mortgages. According to Mr Rajan, therefore, well-intentioned political responses to the rise in inequality that many found disturbing ended up having devastating side effects.

This is a provocative idea. But do the facts support it? Two prominent economists—Daron Acemoglu of the Massachusetts Institute of Technology and Edward Glaeser of Harvard University—argued at the AEA meetings that Mr Rajan's hypothesis, for all its plausibility, is flawed. Neither critic doubts that inequality rose and that poorer people gained access to more credit. But they disagree with Mr Rajan on the link between the two.

Mr Acemoglu argues that the expansion in credit came far too late for Mr Rajan's hypothesis. The subprime boom began around 2000. Yet those at the bottom of the income distribution were getting hammered by technological change in the 1980s. Since then, the least-skilled workers in America have not become still worse-off, largely because they work in service industries which are hard to automate. Inequality has continued to rise because the rich have done even better; it is those in the middle who have fared relatively poorly. Why would the state try to help the poorest at a time when they were doing better than before?

Mr Glaeser has a different criticism. He thinks that the role of easy credit in the housing bubble was not as large as Mr Rajan believes. He refers to research by Atif Mian, of the University at California, Berkeley, and Amir Sufi, of the Booth School, which shows that increased mortgage availability pushed up American home prices by only around 4.3%. This was a small fraction of the rise in prices during the boom. Irrational exuberance and a willingness to bet on prices rising for ever were probably much bigger contributors to the bubble than credit expansion.

Let's all agree to blame the speculators and lobbyists

Mr Acemoglu does believe that there is a link—albeit not a causal one—between increased inequality and the crisis. He thinks both were the consequence of politicians' willingness to deregulate the financial sector, which partly reflected the industry's lobbying prowess. A consequence, documented by two more economists, Ariell Reshef and Thomas Philippon, was that salaries in finance soared, causing a substantial part of the explosion in top incomes noted by Messrs Piketty and Saez. Runaway lending and lax standards, which fuelled the boom and contributed to the crisis, were others. So he thinks Mr Rajan is right to focus on politics but that they did not play out in quite the way he believes.

Ultimately it may be hard to prove a causal connection between inequality, subprime lending and the Wall Street boom. Even so, most economists at the AEA gathering agreed that the three forces combined in the American economy in an unsustainable and unhealthy way. To misquote “The Great Gatsby”, the rock of the world was founded securely on a fairy's wing.