

# Inequality. QE. Trade War and More.

Populists may be wrong in their prescriptions, but they are not wrong in their prognoses.

## Inequality

*If it feels like inequality, it probably is.*

1% of the world's population hold 47% of its wealth. To qualify, they must have at least 700,000 USD in assets. The share of wealth of the top 1% has been growing since the early 2000s. The share of wealth of the bottom 90% has been shrinking monotonically since the 1960s.

Emmanuel Saez and Gabriel Zucman of the University of Berkeley estimate that in the US, the share of wealth of the top 0.1% has been rising steadily since the mid-1980s and has reached some 20% whereas the bottom 90% has seen a corresponding decline to some 25% of total wealth.

The progression of widening inequality has been steady, but it has only recently been noticed due to the rise of social media and transparency. Social media allow rich and poor to live in close cyber proximity exacerbating the perception of inequality.

Senator Elizabeth Warren would like to tax the rich to feed the poor. The self-interest of incumbent elites is aligned against her and anyone who would threaten the status quo. Years of entrenchment have established a mass of orthodoxy to preserve the lie that the current organization of economic activity works for all.

*Capitalism doesn't work for all. All work for a few capitalists.  
And this isn't even real capitalism.*

What do populists want, and will it solve the problem?

Raise taxes on the rich. This sounds easy but apart from the US where taxes are on global income and wealth, other countries may struggle. People will shift assets offshore to other countries depriving the local economy of funding and depressing growth, which usually hurts the poor even more than the rich. For taxes to work, they would have to be worldwide and comprehensive.

Expropriation of assets. This will trigger a mass exodus of capital and people denuding the economy of human and financial capital. Foreign investors would flee. Expropriation of assets is a disastrous policy and again hits the poor harder than the rich who probably already have assets offshore. And since incumbent elite are unlikely to want to expropriate their own assets, it suggests some kind of regime change, which would again likely be messy, noisy and dangerous.

Universal basic income. Capitalists would regard this as a market distorting policy, raising the cost of labour and creating more unemployment which in turn slows the economy and again impacts all, and yet again hurting the poor disproportionately more. However, if automation and technology will already create the unemployment, then perhaps a universal basic income to cover the lost employment income would be justified. The arguments against: inflation from increased demand, no change in standard of living since inflation would rise to compensate, disincentivising work, falling labour participation, seem to be mitigated by the future to which we appear to be headed. We seem not to be able to hit inflation targets and automata are taking our jobs anyway. A universal basic income would need to be funded of course and could lead to ballooning national debt. However, we seem to have found an innovative way of dealing with the national debt, which is to have our central bank fund it, directly if need be, and indirectly if regulatory propriety needs to be observed.

Rigged economy

The pre crisis (2008) years were defined by high salaries and bonuses for high finance. House prices were rising, but so were leverage levels and debt burdens. When the bubble burst, we were almost thankful that governments rode to the rescue and attempted to bailout the financial system. The policy they engaged was quantitative easing. Under QE, central banks cut rates and bought government bonds in an effort to provide liquidity to the market and depress lending costs across the whole yield curve. My making funds cheap, it was hoped, investment and consumption would rise to drive the economy. What happened was a little bit different. QE depressed interest rates which led to a surge in assets prices. When assets are valued using discounted cash flow models, their value rises as the discount factor, which are interest rates, fall. So QE basically distributed wealth to the people pro rata to their assets. This was excellent for those with lots of assets and less good for anyone who had no assets except their ability to work or cash on deposit.

People were told that a burgeoning economy would lift all boats, that if rich people got richer, they would spend more, invest more, employ more, and the wealth would trickle down to poorer people. Since the crisis, unemployment has fallen but the labour participation rate has been stubbornly low. Wage growth has increased from the lows in 2012, but still struggles to break into the target range of 3.5% – 4.0%, a disappointing outcome considering that the Fed's balance sheet went from below 1 trillion USD to 1.2 trillion USD during the initial stages of the crisis, then grew steadily over the next 5 years to 4.5 trillion USD where it has hovered since 2015.

*QE was a de facto relative transfer of wealth from the poor to the rich. And didn't work.*

*The QE Trap.*

When QE was tapered in 2015, the result was a gentle but steady flattening of the yield curve. When balance sheet reduction was undertaken, flattening pressures managed to invert the USD yield

curve as excess reserves were depleted and primary dealers struggled to fund the short term money market. Basically, QE works by making money cheap so people invest and consume. But, attempting to operate the economy beyond its natural growth rate is unsustainable since the unwinding of QE induces recessionary pressures on the economy via the credit market.

The latest thinking is to engage fiscal policy to boost economic activity. This is in part an admission that QE has been ineffective. Fiscal policy can be highly redistributive. This is an opportunity and a risk. It can either try to alleviate some of the inequality or it can be used to exacerbate it.

When all you have is a hammer, every problem is a nail. QE didn't work. It was meant to raise inflation and growth but what it did instead was channel liquidity into assets while demand and output remained weak. The recovery from the recession of 2007 – 2009 was a weak recovery and any growth since then would have happened with or without QE. Instead of seeking alternatives to improve long term productivity and sustainability, additional rounds of QE were undertaken to boost growth. The bulk of the impact went into financial markets, with only a minority of the impact affecting the real economy. As the European economy has turned back towards recession, China's growth slows as it stabilizes its credit markets, and the US slows as well, central banks have turned again to QE. This is an exercise in futility. Not only did it not work, it had adverse side effects such as increasing inequality, blunting emergency financial crisis fighting tools, distorting market prices and disrupting efficient capital allocation. Moreover, it creates a long-term dependence that cannot be exited safely, as the US Fed has now discovered. As every central bank engages in QE, it leads down a path of ever increasing debt levels, often not even to finance anything, ever declining inflation, moribund growth, lengthening a runway of ever decreasing albeit positive returns, but with ever increasing risk of disruption and an accumulated scale of imbalance to be corrected.

### Trade war and more.

The inability of the global economy to return to pre-crisis levels of growth has led to a more selfish and uncooperative world. This has manifested in multiple ways. Discontent is an opportunity for populists. Apparently irrational behaviour can be explained by a general state of tension. Surprising political choices are driven not by positive choice but by the rejection of the status quo. Within this general air of discontent, protectionism is a natural symptom.

*When the pie is not growing, or shrinking, nobody is willing to share.*

A low level, cold, trade war has been in progress for about a decade. US President Trump has only brought it out into the open and converted it into a hot war with tariffs and embargoes. In an already highly globally integrated economic system, such policies have significant collateral damage and unintended consequences. Where once outsourcing to China was a deliberate economic and commercial policy intended to reduce costs and mute inflation, US economic policy has become protectionist. Technology transfer once regarded as a necessary evil in bringing China up to speed to supply America with cheap goods, is now seen as intellectual property theft.

*More than a trade war.*

A battle can become a war if it brings to the surface more fundamental differences. This is the case between China and the US. There is a history of enmity between the two nations dating back to the early 1900s, further if you consider the Chinese Exclusion Act of 1882.

More recently, when communism died some 3 decades ago, capitalism lost its nemesis which it so required for balance and for essence. Without communism, capitalism loses its raison d'être. The rise of

China with its own economic and political organization, a state directed form of capitalism presented American capitalism with the nemesis it sought. The success of China represented a threat to the legitimacy of American capitalism. The result is a clash, not of economies but of ideology. This type of conflict is highly durable. The Soviet communism American capitalism conflict was different in that both sides were diametrically opposed. The Sino American conflict is more complex.

China has adopted free markets where the central government deems a free market is the best organization. It maintains central control where it deems a free market would fail. China's primary objective appears to be stability at all costs, as opposed to growth at all costs. It appears to be pursuing a diversified external policy, reaching out and building bridges in all directions. It considers American insularity a pity. China wants to grow, not just to improve the welfare of the people, but because growth implies stability. China will probably have to find its own balance between stability and efficiency, for the product of the two is often stationary.

America and China are not diametrically opposed, and this complicates the engagement strategy, for both, but particularly for the US. It wants to say its capitalism is superior, yet it fails its own standards at home where inequality is high, there is poverty and growth is probably slower than it should be given the pace of innovation. America points to China's environmental credentials, China is the largest emitter of carbon today, but has historically been the largest polluter in terms of current climate conditions, but China has probably peaked and is taking the most action to improve its climate impact. America points to China's human rights record, harsh treatment of criminals, racial discrimination and oppression of ethnic minorities, surveillance and privacy issues, and lack of freedom of expression and dissent. However, America's own record is far from exemplary including areas like harsh criminal sentencing, racial disparity (black people are 13% of the population but 40% of the prison

population), rising hate crime, national security procedural issues (read torture and detention without trial), surveillance and data protection issues, and efforts to limit freedom of expression and assembly.

*If anything, the American complaint against the Chinese seems like envious competition.*

This type of competition does not end easily. It tends to fester and escalate. It tends to be fought by proxy, in the shadows, in unexpected places and along unexpected lines. We can only hope that it does not escalate into an all-out shooting war. This is unlikely given the geographical realities of both countries but logic and rationality rarely direct warring nations. It is more likely that each side will first try to disengage their interests. The world had become more globalized up until recently and supply chains and financial and commercial infrastructure are very much internationally integrated. Combatants will seek to disengage their assets and interests before engaging in more open conflict. It is already underway. Each side will want distinct systems, networks, physical and non-physical infrastructure, so that they are not mutually dependent. The first battles will be in particular industries, or territories, HK, Taiwan, TPP, 5G, IoT standards, cyberwarfare. How it may escalate is hard to predict, but it is unlikely to find resolution soon. The countries are too alike to resolve their differences easily.