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WEEKLY ECONOMIC COMMENTARY

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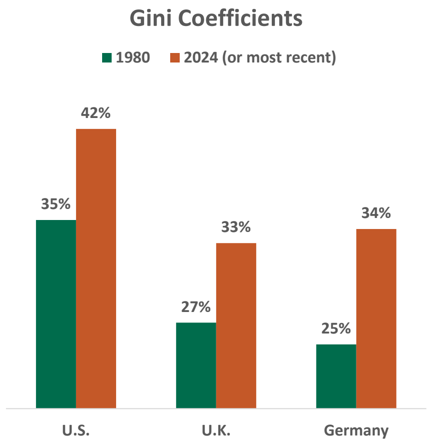
I'm writing this week from London, the start of a four-country tour of Europe to see clients. I typically don't have a lot of free time while on these journeys, but I did sneak away on the weekend for an economics field trip.

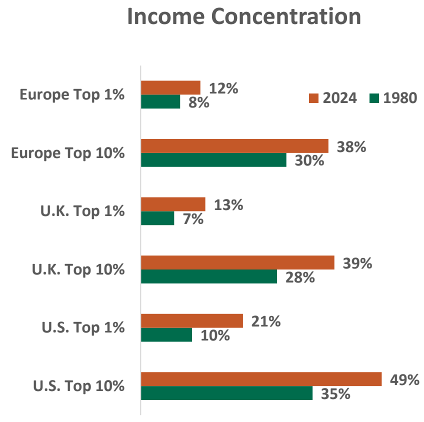
The destination was the British Museum, which contains the former reading room of the British Library. It is a circular structure ringed with stacks of books, a fitting setting for scholarship. Among those who took advantage of the facility was Karl Marx, an economist whose seminal work *Das Kapital* is required reading for many students in the field.

Marx proposed that concentrations of wealth and worker discontent would pave the way to capitalism's end. We have both of those conditions around the world in the present day, and populism is rising.

As countries think about how they might address inequality, they must answer some key questions. How significant is economic inequality? What is the root cause of divergent fortunes? Would redress help or hinder economic growth? Some reflections on these topics follow.

There are a series of measures that attempt to gauge the level of unevenness in outcomes within societies. Some are based on incomes, and others are based on wealth.





Sources: World Bank, World Inequality Database

One of the most common ways of measuring income inequality is with a "Gini coefficient," which is based on the shape of a country's income distribution. A higher Gini score corresponds to greater concentration. Cross-sectional perspectives, which look at the relative fortunes of those at the top and bottom of the ladder, are also instructive. Viewed through either lens, inequality has risen significantly in recent decades.

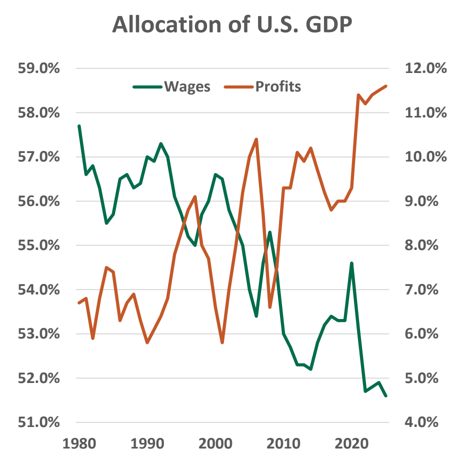
The concentration of wealth has also gone to greater extremes. According to the World Inequality Database, the top 10% of the population holds 70% of wealth in the United States, and 60% in Europe. The top 1% of the population in the U.S. holds 35% of total wealth, and around 25% in Europe. All of these levels are significantly larger than they were a generation ago.

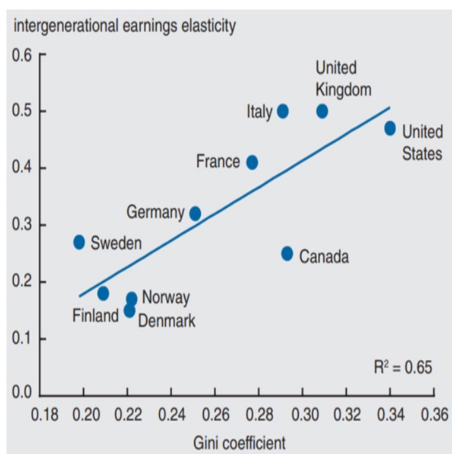
There are certainly challenges in measuring income and wealth that affect these outcomes. Different authors have approached the exercise in different ways, using different assumptions. Debate over the calculations has been intense, and partisan. But there is little question that financial unevenness has risen.

The prosperity of recent years has not been evenly felt.

There are three leading explanations for these developments. The first is the impact of globalization, which has tended to reward skilled workers at the expense of those carrying more basic backgrounds. There are displaced industrial workers in many countries who have struggled to regain their footing on the economic ladder.

The second is technology. Factory robotics have curtailed the need for assembly-line workers, and e-commerce has disrupted traditional channels and providers. In the years ahead, AI will have a heavy bearing on employment in service industries. Those that engineer transitions are richly rewarded, while those affected by them have often struggled. In the United States today, the profit share of gross domestic product (GDP) is at a multi-decade high, while the wage share of GDP is at a multi-decade low.





Sources: BEA, Federal Reserve Bank of Chicago

The third is changing policy. Alterations to competitive restrictions, labor laws and tax codes are all thought to have played a role in accelerating inequality in many countries.

To be sure, globalization, technology and policy changes have aided overall economic growth. And while threatening to some classes of workers, the increased access to goods at more modest prices has helped living standards. But recent studies suggest that rising inequality may limit the strength and duration of economic expansions.

Studies from the IMF and the OECD have found that economic growth is generally lower in countries with higher levels of economic inequality. Lower income households have high propensities to consume; when their fortunes decline, so does growth in consumption. They also tend to invest less in human capital, which impairs productivity.

High levels of economic inequality are associated with much lower levels of economic mobility, meaning that those who start off in the lower earnings quintiles struggle to move into higher tiers.

That outcome runs counter to the ethic held by many nations that individuals should be able to climb the economic ladder through hard work.

Societies with high levels of inequality are also prone to volatile politics, and even unrest. Today, we are seeing the signs of economic anxiety in parties to the left and to the right of center, across a range of countries. Should these constituencies gain more control over policy in the years ahead, populist policies may tend to hinder economic growth. As an example, tax changes aimed at dividing the pie more equitably could diminish the incentives that brought the pie to its current size.

It's hard to correct inequality without harming economic growth.

It is worth noting that a certain amount of inequality is endemic to any economic system. Those willing to work harder and take risks should, over time, do better. Many economists therefore are more interested in reinforcing equality of opportunity, as opposed to correcting inequality of outcomes.

Education can be a means to this end. Cultures that continually invest in education preserve competitiveness and provide opportunity. AI, however, has the potential to change the relationship between schooling and economic fortune. Designing a retraining program for displaced workers in the current day will be very difficult.

The concept of equality is central to the visions of many nations. But around the world, income inequality is rising and equality of opportunity is falling. Reversing this negative cycle will be essential to keeping Marx in his place.

Health, Wealth and Prosperity

A breeze knocks loose a small piece of ice at the top of a mountain. As it rolls downhill, more and more snow clings to it. Before long, an unstoppable snowball is making its descent.

A snowball effect of asset values can similarly empower *wealth effects*: the tendency for consumers to spend more as the value of their investments rises. Wealth effects are surprising at first glance: household investments may be illiquid and tend not to produce substantial cash flow. However, a rising net worth builds a consumer's confidence in their ability to afford purchases.

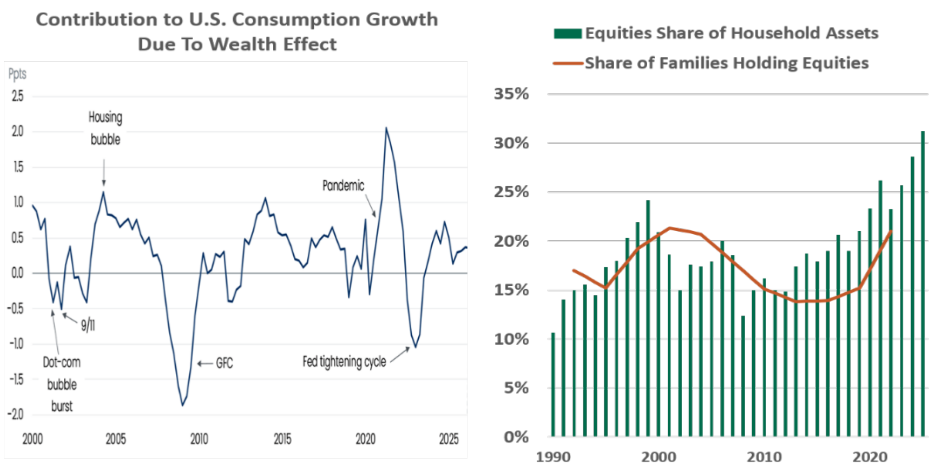
Households' two primary investments are typically homes and stocks. Both have had a very strong run in the decade to date: the U.S. FHFA house price index has cumulatively gained 59% since January 2020, while the S&P 500 index has more than doubled. The wealth effect is not directly observable, but asset gains have a statistically significant relationship with personal consumption. Oxford Economics estimates that for each $1 gain in value, the current marginal propensity to consume is $0.04 for equity portfolios and $0.02 for homes.

Wealth effects help to explain some of the surprises in this cycle. Persistent inflation has not deterred consumption, as investments have given consumers a cushion. Labor force participation by older workers has trended down, as appreciating retirement savings equipped them to leave the workforce. The saving rate is holding near historic lows; an asset reserve allows workers to save less of their wage income. And wealth effects are naturally unequal: households with more investments will enjoy greater gains, adding to a feeling of an uneven, K-shaped expansion.

Wealth effects have been evident in past expansions. In the Dot Com boom of the 1990s, consumption growth exceeded 5% in 1998 and 1999; in much of the property bubble of the 2000s, it held over 3%. Wealth contributed about one percentage point to growth in those cycles. Real consumption in the past year grew 2.3%, implying a more modest wealth effect now.

But the wealth effect feels larger in this cycle because individual participation in financial markets has never been easier. The Federal Reserve has found an ascending share of households own stocks (setting records for younger cohorts), and equities' share of household wealth continues to climb. An aging population and easy access to financial platforms have kept market performance top of mind. And while the rate of homeownership is holding steady around 65%, that still represents increasing net worth for a majority of households.

Past cycles taught the lesson that wealth effects are a force multiplier in both directions. Incremental spending from wealth is the first to be halted when belts are tightened. This can compound the breadth of a contraction, spreading a market shock to the broader economy.



Sources: Oxford Economics, Federal Reserve Board, Haver Analytics

Wealth effects allowed consumers to spend through an uncertain cycle.

The spending that flows from wealth gains is more discretionary, especially major purchases like automobiles and home improvement. These feel affordable during run-ups, and easy to defer when values are plunging. Wealth effects may also empower more consumers to trade up to luxury brands and premium experiences; trading down will always be an option.

We worry about the lingering damage that can be done after a fall in wealth. Behavioral economics teaches us about loss aversion: Humans feel greater pain from a loss than pleasure from a gain. After a substantial contraction, skittish investors may stay on the sidelines, prolonging a downturn and preventing a return to productive investment.

The descending snowball cannot grow forever; it will eventually settle on firm ground. Today's market gains will inevitably settle, too. We hold out hope for a smooth landing, not a meltdown.

Winter is Coming, Again

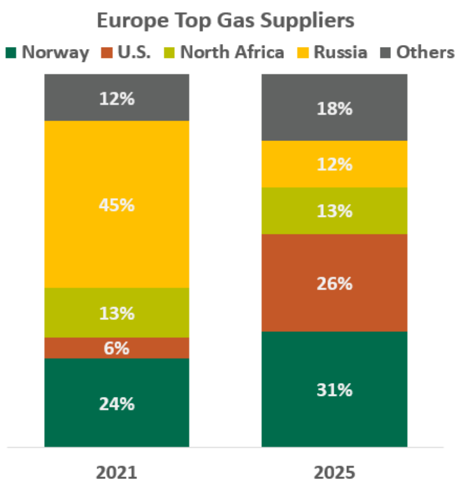
In *Game of Thrones*, the phrase "winter is coming" signaled a looming threat that required preparation long before it arrived. Europe's gas market faces a similar challenge today.

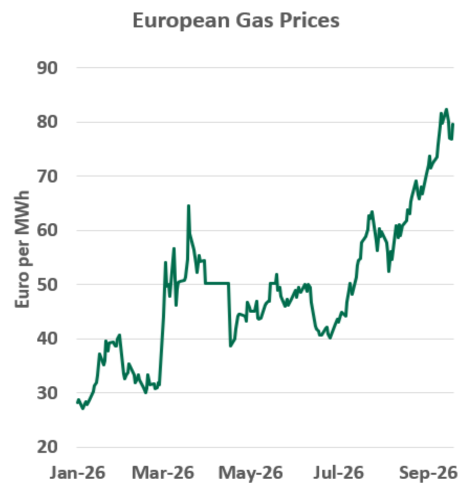
The continent is not facing a repeat of the 2022 energy crisis. European policymakers' push to diversify supply sources and expand import capacity have added to resilience amid the current disruption of energy supply chains.

Yet Europe's safety cushion is thinner than normal at this time of the year. Gas storage facilities are only around 68% full, well below the seasonal norm, with key countries like Germany and the Netherlands lagging. Germany's inventories are sitting at their lowest level at this point in the year since record-keeping began in 2011.

The result is a market that is adequately supplied, but far from comfortable. European benchmark gas prices have already surged this year and are trading above levels envisioned in the European Central Bank's adverse scenario. A cold winter, disruptions to Middle Eastern supplies, or stronger gas demand from Asia could ignite bidding wars for cargoes and push prices higher.

Thin gas inventories and tight markets raise the risk of price shocks.





Sources: European Commission, Bloomberg

The outlook is further complicated by Europe's unfinished break from Russian supplies. While the bloc is preparing to phase out remaining Russian energy imports in 2027, some dependencies persist. Belgium, for example, relied entirely on Moscow for liquified natural gas in July. Replacing those remaining flows will require securing alternative sources in an already tight market.

Higher gas prices matter far beyond household heating bills. Gas is deeply embedded throughout the European economy through the generation of electricity. Research suggests gas shocks have a greater tendency than oil shocks to feed into underlying inflation and keep price pressures elevated for longer. That presents another challenge for policymakers already grappling with weak growth, strained public finances and rising political discontent.

Winter is coming. If Europe doesn't prepare adequately, it will take more than dragons to keep the continent warm.

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