Dr. Ferdinand Fichtner, Head of the Forecasting and Economic Policy Department at DIW Berlin

FIVE QUESTIONS FOR FERDINAND FICHTNER

»Rising income inequality inhibits consumer demand«

1. Mr. Fichtner, DIW Berlin examined the relationship between rising income inequality and economic growth. Would Germany have higher growth if income inequality had not risen in recent years? Yes, Germany's economic growth would actually have been somewhat higher if income inequality had not sharply increased between 1991 and 2015. The German economy showed an unrealized growth potential of around two percentage points due to the rise in income inequality in the period under inspection (1991 to 2015). This corresponds to a good one-twentieth of a percentage point of a lost growth per year.

2. How do you explain the negative impact of income inequality on economic growth? There are three main transmission channels between income inequality and economic growth. The first channel is the classical economic channel. Rising income inequality generally leads to income flowing to the part of the population with a relatively high savings rate. Part of the income disappears into these people's savings accounts and does not show up as consumer demand. Our estimates showed that rising income inequality inhibits growth in this way. There is also a relationship between income inequality and productivity. In the short run, we generally assume that income inequality should boost productivity to some extent because people see an incentive in the ability to increase their personal income faster by doubling their effort on the job. We call this the "incentive channel". The human capital channel has a counteractive effect. High income inequality generally leads to low wage earners being unable to afford to go to school longer or invest in apprenticeships. In the long run, this leads to a decline in the productivity. According to our estimates, this overcompensated for the incentive channel with the effect of higher income inequality leading to stronger growth in productivity in the short run.

3. Which channel has the greatest impact? In the short run, the savings rate channel has a relatively strong effect. This means that coupled with a rise in the savings rate, a rise in income inequality inhibits demand relatively quickly – for consumer goods in particular – and in turn hinders economic growth. But in the longer run, the human capital channel is the dominant mechanism: people invest less in education, which triggers a decline in productivity. Again, our estimates showed that a delay of at least ten years is to be expected. For example, the rise in income inequality that we observed after 2000 in Germany is only now affecting economic growth.

4. How does income inequality affect Germany's imports and exports? According to our simulation, the rise in economic inequality has resulted in weaker export and import figures for the German economy. However, imports are more strongly affected, which means that the trade balance (the difference between exports and imports) has also increased.

5. What are the consequences of that? A rising trade positive balance can compensate somewhat for income inequality's highly inhibitory effect on domestic demand. This means that GDP does not decline to the same extent as domestic demand. Given this relationship, our most important finding is: when discussing the consequences of income inequality the focus should not be GDP. Private consumer demand is a much more important factor. It declines much more powerfully than GDP. Ultimately, private consumer demand is what counts when assessing quality of life in Germany.

Interview by Erich Wittenberg

To hear the recorded interview in German, visit www.diw.de/interview

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