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Capital account liberalization and income inequality ☆

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ABSTRACT

This article makes both a theoretical and an empirical contribution to the literature on financial liberalization and income inequality. In the first part, we develop a tractable model that features agents with varying investment abilities and a banking sector. There are two possible interventions to liberalize the banking sector: first, a reduction in reserve requirements, and, second, an increase in the amount of foreign funds that can be used to finance domestic loans. Financial liberalization leads to enhanced banking sector efficiency and adjustments in interest rates affecting income of investors and savers, and, therefore, income inequality. Theoretically, the impact of financial liberalization on income inequality is ambiguous. Yet, the model suggests that financial liberalization will improve income distribution in countries where financial depth is high. Our empirical estimates confirm this conditional effect. More precisely, the estimates suggest that capital account liberalization only tends to lower income inequality if the level of financial depth, as measured by private credit over GDP, exceeds 25 percent.

1. Introduction

Developments related to the global financial and economic crisis have raised concerns about growing income inequality within countries, and the differential effects of financial liberalization across income

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levels, leading to calls for more empirical and theoretical research on the relationship between financial liberalization and income inequality (Atkinson and Morelli, 2011).

Previous research has investigated various determinants of income inequality, such as labor markets (Gordon and Dew-Becker, 2008), technological change (Acemoglu, 2002) or institutions (Acemoglu et al., 2013). Research on the impact of financial liberalization on income distribution is scarce though. Some of the few exceptions are studies by Agnello et al. (2012), Ang, 2010, Cornia and Kiiski (2001), Delis et al. (2014) and Jaumotte et al. (2013). These studies provide mixed evidence on the impact of financial liberalization on income inequality. In a panel of 62 countries for the period 1973 to 2005, Agnello et al. (2012) find that financial reforms, measured by the aggregate financial index due to Abiad et al. (2010), is associated with less income inequality. However, their study also suggests that the effect on income distribution varies across liberalization policies. Especially directed credit and removal of excessively high reserve requirements seem important for reducing income inequality. Yet, other financial liberalization policies, such as privatization, reducing entry barriers and increases in international capital flows, do not affect income distribution. Ang (2010), focusing on India, finds that financial liberalization exacerbates income inequality. Interestingly, his study suggests that financial development reduces income inequality. Cornia and Kiiski (2001) suggest that both external and internal financial liberalization policies correlate positively with income inequality in many developing countries. In line with Agnello et al. (2012), Delis et al. (2014) find that financial liberalization, measured by the aggregate liberalization index, tightens the distribution of income for the period 1997-2005. Furthermore, they provide evidence that enhancing privatization laws, removing credit controls and lowering entry barriers reduce income inequality. However, the negative effect of financial liberalization on income inequality weakens and becomes insignificant in the case of low-income countries. Moreover, income inequality increases with security market liberalization. Jaumotte et al. (2013) find that trade globalization leads to less income inequality, whereas financial globalization induces more income dispersion.

This paper seeks to contribute to the literature by focusing on financial depth as the main channel via which capital account liberalization (a particular form of financial liberalization) affects income inequality. To the best of our knowledge, there are no other papers that pay attention to financial depth as a moderator of the impact of capital account liberalization on income distribution.

We develop a theoretical model comprising agents with varying investment abilities and a banking sector. Agents with the best investment skills become investors, and earn the highest amount of money. Agents with fewer investment skills become savers, and earn less money. The financial regulator affects banks by setting reserve requirements and by restricting the amount of foreign funds that can be used to finance domestic loans. Financial liberalization lowers the wedge between interest rates on deposits and loans and, hence, improves banking efficiency. The increase in bank efficiency and related changes in interest rates affect the incomes of investors and savers and, therefore, income inequality.

The impact of financial liberalization on income inequality is ambiguous. Yet, our model suggests that financial liberalization will improve income distribution in countries where financial depth is high. The main reason for our finding is that in countries with high financial depth, the interest rate elasticity of loan demand is high. A financial liberalization policy that improves bank efficiency and reduces borrowing costs will lead to a sharp increase in aggregate loan demand, requiring an increase in the deposit rate to restore equilibrium in the financial market. The increase in the deposit rate improves the income of savers and, hence, income distribution. However, in countries where financial depth is low, the interest elasticity of demand for loans is low, so that an increase in bank efficiency, and the related decrease in borrowing costs, will only have a minor impact on loan demand. In this case financial market equilibrium requires a decrease in the deposit rate, which reduces the income of savers and consequently increases income inequality.

We provide evidence for our theoretical predictions by conducting Generalized Method of Moments (GMM) estimations using a revised and updated cross-country dataset on income inequality by Galbraith and Kum (2005). The empirical analysis focuses on liberalizing the capital account, which is the most relevant area of intervention. Especially in economically weak countries, governments use capital controls because foreign borrowing could undermine governments' ability to control domestic funds and exchange rates (Agénor and Montiel, 2008). Over time, governments have (gradually) reduced capital controls. Although, considerable differences across countries persist (Abiad et al., 2010).