



Income distribution and the current account

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ABSTRACT

In this paper, we investigate whether changes in income distribution can explain current account developments in a sample of 20 countries for the period 1972–2007. We analyze the relationship between the personal and the functional income distribution in our sample, before disentangling their effects on the current account. A consistent finding is that rising (top-end) personal inequality leads to a decrease of the current account, controlling for standard current account determinants. By contrast, a fall in the share of wages in national income leads to an increase in the current account. We further analyze how different measures of income distribution affect the financial balances of the household, corporate and government sectors and discuss potential theoretical explanations of our findings. We conclude that changes in personal and functional income distribution have contributed considerably to the widening of current account balances, and hence to the instability of the international economic system, prior to the global financial crisis starting in 2007.

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1. Introduction

The global current account imbalances are widely considered to be an important contributing factor to the global financial crisis starting in 2007. However, it has so far proven difficult to explain the emergence and persistence of the global imbalances in a fully satisfactory manner (Phillips et al., 2013; Chinn et al., 2014). In recent years, there has also been a revival of interest among economists for the potential link between income distribution and macroeconomic imbalances. Rajan (2010) argues that bottom and middle income households in the United States (U.S.) were able, prior to the financial crisis, to sustain their consumption relative to top income households despite declining relative (permanent) incomes, facilitated through government credit expansion policies. According to Rajan (2010), rising inequality thus played an important role in explaining the decrease in U.S. national saving and the unsustainable rise in personal debt and, as a consequence, the rising U.S. current account deficit. Similar arguments can be made for the case of the United Kingdom (U.K.) (Kumhof et al., 2012). On the other hand, Pettis (2013) forcefully argues that the persistent current account surpluses of China and Germany, the two countries with

the largest current account surpluses worldwide before the crisis, were not primarily the result of household thriftiness, but rather of low wages relative to profits leading to weak aggregate consumption relative to domestic production (see also van Treeck and Storn, 2012).

Whereas the above discussion suggests that both the personal and the functional distribution of income may affect the stability of the international economic system as a whole, the academic literature has been remarkably silent on the potential relationship between changes in income distribution and the pre-crisis current account imbalances. Rather, most previous work has focused more narrowly on the implications of income distribution for either private consumption or private investment. Moreover, the potentially rather different implications of the functional and the personal distribution of income for aggregate demand and the current account are rarely discussed in a systematic fashion. This gap in the literature is all the more noteworthy as the relationship between factor shares, *i.e.*, the shares of wages and capital in the national income, and personal income inequality, *i.e.*, the distribution of income across households or individuals, has been at the forefront of recent advances in inequality research (Piketty et al., 2018). The present paper contributes to the analysis of the macroeconomic effects of changes in factor shares and personal income inequality.

The demand effects of income distribution are theoretically ambiguous. According to standard models of rational household behavior, neither the personal nor the functional distribution should have an effect

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on aggregate saving and investment, and hence the current account balance. In models with heterogeneous households, higher personal income inequality can lead to either higher or lower spending on goods and services. For example, in simple Keynesian models and in life-cycle models where rich households have a higher preference for wealth (Carroll, 1998; Dynan et al., 2004), a higher inequality of lifetime incomes should lead to higher saving. By contrast, in models with positional externalities in goods and services, a rise in inequality can lead to “trickle-down consumption”, or “expenditure cascades”, i.e., depress the (financial) savings of those households that see their relative incomes decline (Frank et al., 2014; Bertrand and Morse, 2016).

A fall in the share of wages in the national income, i.e., a change in the functional distribution of income, can either increase or reduce aggregate demand. According to the traditional “underconsumption view”, capitalists (firms) have a lower propensity to spend than workers (households) so that a fall in the wage share reduces aggregate demand (Hobson, 1909; Lavoie and Stockhammer, 2013; Pettis, 2013; Grigoli et al., 2014). On the other hand, higher profitability may also boost investment (Kumhof et al., 2012; Lavoie and Stockhammer, 2013; Gruber and Kamin, 2016).

The contribution of the present article is to analyze the current account effects of income distribution for a sample of 20, mainly industrialized, countries for the period 1972–2007. We analyze the relationship between personal and functional income distribution in our sample, before trying to disentangle their effects on the current account. Our main findings are as follows: Firstly, a rise in top-end inequality (relative to trading partners) leads to a lower current account, controlling for a set of standard determinants of current account balances. Secondly, a fall in the share of wages in national income leads to an increase in the current account. Thirdly, there is also tentative evidence that (top-end) income inequality has affected current account positions mainly through its negative effect on household net lending, whereas the wage share has affected both household net lending (positively) and corporate net lending (negatively). Finally, we show that the relative contributions of (changes in) personal income inequality and the wage share to the (widening of) the current account positions of a number of large economies prior to the global financial crisis were considerable. Interestingly, the quantitatively most important current account deficit countries (U.S., U. K.) combined strongly rising top-end income inequality with relatively small changes in the wage share. By contrast, the most important surplus countries (China, Germany, Japan) experienced strong decreases in the wage share, but relatively little changes in top household income shares. While we remain agnostic as to the underlying theoretical explanations of our findings, they are consistent with trickle-down consumption triggered by rising top-end income inequality in the main current account deficit countries and underconsumption linked to falling wage shares in the main surplus countries. We expressly limit our focus of attention to the pre-crisis period. Clearly, the global financial crisis both has revealed the unsustainability of national current account positions and thus has fundamentally changed the saving and spending patterns of households, corporations and governments.

The remainder of this paper is structured as follows. In Section 2, we review competing hypotheses discussed in the literature about the macroeconomic effects of income distribution and its implications for the current account. Section 3 discusses important stylized facts about income distribution, sectoral financial balances and the current account in some selected large economies. Section 4 presents the empirical analysis. Section 5 concludes.

2. Competing hypotheses about the macroeconomic implications of income distribution

2.1. Missing variables in current account estimations?

In face of the widening of current account imbalances especially since the late 1990s and prior to the global financial crisis starting in

2007, a number of competing hypotheses have been put forward (see Chinn et al., 2011, for a survey). These include the twin deficit hypothesis that current accounts are driven by government deficits (Abbas et al., 2010; Bluedorn and Leigh, 2011; Kumhof and Laxton, 2013); the savings-glut hypothesis that high savings in emerging markets are responsible for their current account surpluses (Chinn and Ito, 2007); the demographic hypothesis that population structure and life-cycle savings dynamics have contributed to the current account imbalances (Cooper, 2008); the asset bubble explanation that wealth effects are the main force behind saving–investment imbalances (Fratzscher and Straub, 2009); the financial–development argument that countries with deeper financial markets attract foreign saving flows resulting in current account deficits (Gruber and Kamin, 2007; Caballero et al., 2008); and the structural policy hypothesis that product and labor market regulations are important drivers of current accounts (Kerdrain et al., 2010). However, there is as of yet no consensus as to what explains the emergence and persistence of the global imbalances during the period leading up to the global financial crisis starting in 2007. Chinn et al. (2011, p. 18) suggest the possibility of missing variables in existing estimation models.

Few authors have approached the issue of global imbalances with an explicit focus on income distribution. In the remainder of this Section we review the existing literature on how changes in the personal and the functional income distribution may affect saving and investment.

2.2. Personal income distribution

Standard life-cycle and permanent income models with rational expectations predict that the distribution of (the permanent component of) income and aggregate saving will be unrelated in the presence of standard preferences. By contrast, the traditional Keynesian view is that rising income inequality across households will be a drag on aggregate demand and thus lead to a higher current account, to the extent that high income households have a lower marginal propensity to spend than low income households. Leigh and Posi (2009, p. 58) argue that “[i]f the rich save more than the poor, then a mean-preserving transfer from poor to rich would raise aggregate saving rates.” Yet, while the view that “the rich save more than the poor” (out of lifetime income) is both intuitively appealing and empirically relevant (Dynan et al., 2004), the effects of a change in income inequality on saving are *a priori* undetermined.

In life-cycle models with bequests, a higher income share of rich households should result in higher saving and lower consumption, because bequests are a luxury (Carroll, 1998). Income inequality may also positively affect saving through the precautionary saving motive (Carroll and Kimball, 1996), wealth in the utility function (Zou, 1995), or different degrees of patience across income groups (Mankiw, 2000). By contrast, in the presence of positional externalities in consumption (Frank, 2007), households with declining relative incomes may reduce their saving by such an extent as to overcompensate the increased saving of the richer households. In particular, the expenditure cascades model by Frank et al. (2014) which seeks to explain the rise in U.S. household expenditure-to-income ratio as a result of rising income inequality since the early 1980s is based on the notion that “people generally look to others above them on the income scale rather than to those below” (Frank et al., 2014, p. 7). Similarly to Rajan (2010), an implication of the expenditure cascade hypothesis is that growing income inequality may contribute to a lower current account via its negative effects on household net lending. In a recent version of Kumhof et al. (2012), a somewhat different explanation of the negative saving effects of top-end income inequality is offered: When higher top income arises on traded financial assets, it can have large wealth effects relative to income effects. This, in turn, may induce top income households to borrow more, including from the rest of the world.

In empirical works, different measures of saving or net lending have been used. Dynan et al. (2004) derive various measures of household

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