Journal of International Money and Finance 31 (2012) 2147–2161

Contents lists available at SciVerse ScienceDirect

Journal of International Money and Finance

journal homepage: www.elsevier.com/locate/jimf

Does inequality lead to a financial crisis?

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JEL Classification:
E25
E32
E51
G01
N1

Keywords:
Top incomes
Income inequality
Redistribution
Credit booms
Financial crises
Financial de-regulation

A B S T R A C T

The recent global crisis has sparked interest in the relationship between income inequality, credit booms, and financial crises. Rajan (2010) and Kumhof and Rancière (2011) propose that rising inequality led to a credit boom and eventually to a financial crisis in the US in the first decade of the 21st century as it did in the 1920s. Data from 14 advanced countries between 1920 and 2000 suggest these are not general relationships. Credit booms heighten the probability of a banking crisis, but we find no evidence that a rise in top income shares leads to credit booms. Instead, low interest rates and economic expansions are the only two robust determinants of credit booms in our data set. Anecdotal evidence from US experience in the 1920s and in the years up to 2007 and from other countries does not support the inequality, credit, crisis nexus. Rather, it points back to a familiar boom-bust pattern of declines in interest rates, strong growth, rising credit, asset price booms and crises.

1. Introduction

The recent financial crisis in the US has been attributed to a rise in inequality by several authors. In his 2010 book, *Fault Lines*, Raghuram Rajan argued that rising inequality in the past three decades led to political pressure for redistribution that eventually came in the form of subsidized housing finance. Political pressure was exerted so that low income households who otherwise would not have qualified

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doi:10.1016/j.jimonfin.2012.05.006

received improved access to mortgage finance. The resulting lending boom created a massive run-up in housing prices which reversed in 2007 and led to the banking crisis of 2008.

Along these lines, Kumhof and Rancière (2011) study the links between inequality, credit and crises complementing the Rajan hypothesis with a DSGE model. In this model, rising income inequality and stagnant incomes in the lower deciles lead workers to borrow to maintain consumption growth. As these households become increasingly indebted, they continue to borrow more to maintain their consumption. This increases leverage, and eventually a shock to the economy leads to a financial crisis. They posit that their story holds both for the 1920s stock market boom in the US and the run-up to the 2008 crisis. The focus on income inequality by Rajan and Kumhof and Rancière (RKR) is a novel approach to understanding macroeconomic outcomes prior to the recent financial crisis, and to the Great Depression.[1] The theme deserves further empirical scrutiny from other time periods and countries.

There is reason to wonder about the generality of this new view since income inequality rarely plays a significant role in the large literature on financial instability and credit booms. Mendoza and Terrones (2008) study the experience of a large number of advanced and emerging economies since the 1960s finding that current account deficits, strong economic growth and fixed exchange rates accompanied credit booms. Borio and White (2003) have also elaborated a view of pro-cyclical financial systems. Periods of expected low and stable inflation, strong economic growth and liberalized finance can give rise to complacency amongst borrowers, lenders and regulators. Endogenous market forces that might normally “rein in” these imbalances seem to be absent. Massive buildups in credit lead to financial instability in this case. Income inequality plays no active role in generating the boom–bust outcome in these contributions.

In this paper, we present new empirical evidence on whether rising inequality has any explanatory power in accounting for credit booms and financial crises. Rather than limiting the focus to inequality as the RKR frameworks do, we control for more traditional determinants of the credit cycle. Different from these authors, we also bring evidence from a much larger sample than the two unique periods in US economic history that are the focus of RKR. Our sample is a panel of 14 mainly advanced countries from 1920 to 2008 covering a wide variety of boom–bust episodes and financial crises.

We find very little evidence linking credit booms and financial crises to rising inequality. Instead, the two key determinants of credit booms are the upswing of the business cycle or economic expansion and low interest rates. This is very much consistent with a broader literature on credit cycles. While inequality often ticks upwards in the expansionary phase of the business cycle, this factor does not appear to be a significant determinant of credit growth once we condition on other macroeconomic aggregates. Neither is income concentration a good predictor of the financial crises that often follow above average growth in credit. The anecdotal evidence from several historical credit booms finds little support for the inequality/crisis hypothesis.

Section 2 reviews the literature on the link between inequality, credit booms and financial crises. Section 3 presents evidence on the credit boom/financial crisis linkage. Section 4 takes one step back to explore the determinants of credit booms. Here we examine inequality and other determinants of credit growth. Section 5 discusses our findings within the context of historical narratives. Section 6 concludes.

2. Income inequality, credit booms, and financial crises

Since the 1970s income concentration has increased dramatically in the US and several other nations. Atkinson et al. (2011) focus on the rapidly rising share of pre-tax income amongst the top 1% of tax units since the 1980s that is marked in several nations such as the US and the UK. Many other studies have confirmed the stagnating wages and incomes for the lower deciles in the US and the fact that the median wage for US male workers has not risen since 1973 (e.g., Goldin and Katz, 2008).[2] Rajan

[1] We refer to Rajan and Kumhof and Ranciè as (RKR) throughout the paper.

[2] Kopczuk et al. (2010) show that mobility at the top of the income distribution is stable and cannot explain the rise in annual earnings concentration since the 1970s.