Session Discussion:
Financial Markets and Macroeconomic Imbalances

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Financial Markets and Macroeconomic Imbalances

- The aim of this session is to understand how the financial markets affect the macroeconomic imbalances
  - Cross-border portfolio investment vs. Top 1% income
    - "Financial Globalization vs. Income Inequality: The surprising Role of Foreign Portfolio Flows in Taming the Top 1%" by Si Cheng (CUHK)
  - Financial structure (bank- vs. market-based) vs. Inequality
    - "Financial Structure and Income Inequality" by Giovanni Ferri (Lumsa)
  - Incomplete markets with industrial revolutions vs. Global imbalances
    - "Industrial Revolutions and Global Imbalances" by Alexander Monge-Naranjo (FRB-STL)

Portfolio investment vs. top 1% income

- “financial globalization in terms of delegated portfolio flows may help reduce inequality”
  - “a one-standard-deviation increase in foreign portfolio flow shocks is associated with about 16%-standard-deviation reduction in top 1% income” in “the standard measures of inequality” by WWID
  - “a one-standard-deviation increase in foreign flow shocks is associated with a 6%-standard-deviation reduction in cash flow inequality”
- It is neat to use “fire sales and fire purchases” as portofolio flow to avoid reverse causality

Story: Portfolio investment vs. top 1% income

- "cost of capital channel (asset reallocation channel?)"
  - portfolio investment $\rightarrow$ reduction in cost of capital for a local firm $\rightarrow$ boosting up price of capital $\rightarrow$ local rich families sell their shares $\rightarrow$ and lose future sales income associated with these shares.
- "the governance channels"
  - financial globalization $\rightarrow$ better corporate governance $\rightarrow$ reduction in the probability for large shareholders
- "a one-standard-deviation increase in foreign flow shocks transforms into around 5%-standard-deviation reduction in inequality through" cost of capital channel

Financial structure vs. Inequality

- "more finance (both bank- and market-based) reduces income inequality but only up to a point"
- "Beyond that point, income disparity rises if finance is expanded via market-based financing, while it doesn't rise significantly when finance grows via bank lending"
  - "this inequality-enhancing mechanism works through expanding the top part of the income distribution"
- New featires
  - considering financial structure (bank- vs market-based)
  - considering a long-run span: 1989-2012
  - including almost one hundred developed and emerging countries: 97 economies

Story: Financial structure vs. Inequality

- Inverted U-Shape
  - Kuznets (1955): industrialization $\rightarrow$ inequality via urbanization $\rightarrow$ migration from rural area to city (which requires financial development) $\rightarrow$ narrowing inequality
  - early stages of financial development $\rightarrow$ benefits for a small part of society $\rightarrow$ increase in inequality $\rightarrow$ financial development $\rightarrow$ better credit availability $\rightarrow$ more decisions for better allocation free from inherited wealth $\rightarrow$ reduction in income inequality
- U-Shape?
  - enlarging rent extraction via financial deregulation or harmful or inefficient financial innovation $\rightarrow$ increase in inequality

Industrial revolutions vs. Global imbalances

- New stylized fact: "alternating waves in historical global imbalance generated by sequential industrial revolutions"
  - "Newly industrialized countries often accumulate foreign assets as they grow rapidly"
  - "This pattern occurs several times since at least mid-19th century"
- Theory (Model): a simple model with (1) sequential industrial revolutions, (2) hard currency constraint on consumption and (3) incomplete financial markets
  - taking off $\rightarrow$ hard currency constraint to limit consumption $\rightarrow$ more saving and investments given expectaion of receiving a higher income (than already industrialized countries and the pre-industrialized days of itself)
  - With the last ingredient, Lucas (1990) puzzle is also solved

Comments

- All three are GREAT papers to expand our knowledge on the relationship between financial markets and macroeconomic imbalances.

- I have two comments for this session as a whole:

  1. Reverse causality

  2. Policy implications

Reverse causality?

- All three papers focus rather on how financial markets or structures lead to macroeconomic imbalances
  - Careful identification is conducted to understand this causality
- I am also interested in how macroeconomic imbalances lead to different financial market and structure
  - Concentration of income at top 1% $\rightarrow$ International portfolio flows
  - Income inequality $\rightarrow$ Financial developments (e.g. bank vs market based)
  - Global imbalances $\rightarrow$ Industrial revolutions or the degree of completeness in international financial market
- Dynamic interactions between financial markets and macroeconomic imbalances seem worth further investigation

Policy implications

- What are policy implications when financial markets do matter for macroeconomic imbalances?
- Clearly, economies are not at their first best in three papers

Policy implications: Portfolio investment vs. top 1% income

- "a more price-efficient global financial market may surprisingly help solve social issues related to inequality"
  - This implies a case against Piketty's policy recommendations related to global capital tax
  - Is this effect long-run or short-run?
- Increase in cross-border portfolio investment may reduce local inequality, but will it increase global inequality through better investment opportunities for riches?
  - If so, the policy must consider the balance between local and global inequalities

Policy implications: Financial structure vs. inequality

- If inequality is enhanced by rent-seeking or asymmetric and uninsurable opportunities (benefits from financial innovations), it should be remedied

- How large is the inequality stemming from these distortions?

- If inequality induces financial developments and *vice versa*, designing optimal policy against inequality becomes not at all a trivial task

Policy implications: Industrial revolutions vs. global imbalances

- How large are welfare costs from global imbalances or the shift of global imbalances in this mechanism?
  - If they are large, which is the best policy tool?
    - tax
    - eliminating hard-currency constraint
    - promoting financial innovation to make global financial markets more complete
- If the global financial markets become more complete with financial innovations, will there be no global imbalances in the future?