<u>Proposal to the Center for Equitable Growth – May 2011</u>

<u>Consumption Inequality, Income Inequality and Global Imbalances</u>

Pierre-Olivier Gourinchas & Maurice Obstfeld
UC Berkeley, NBER and CEPR

Some recent accounts of the origins of the 2007-09 financial crisis have focused on the role of increasing income inequality, especially in the United States (for example, Raghuram Rajan and Robert Reich). In these accounts, adverse economic and political effects of increasing inequality on lower income groups were buffered by policies that increased the access of the relatively poor to credit – for home loans, consumer credit, etc. They also led to a decline in household saving and, arguably, a larger current account deficit for the United States. The ultimate inability to refinance or repay housing loans caused the crisis.

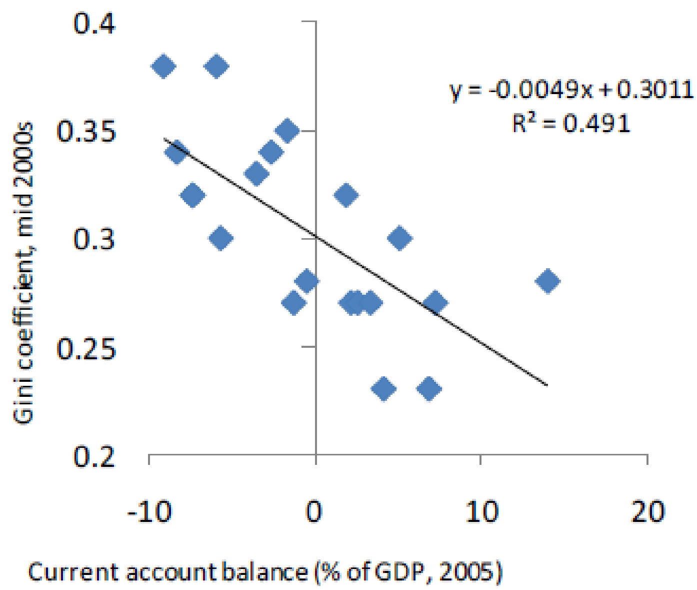
But other countries saw housing crashes and financial instability, raising the question whether similar inequality trends can be seen there. In fact, data for the mid-2000s show a remarkable association between income inequality and external deficits for advanced countries, with higher inequality associated with a higher deficit (see below). At first sight this may seem counterintuitive: in the presence of borrowing constraints on the relatively poor, a shift in the income distribution toward the rich might be thought to raise saving, and thereby lower the current account deficit. We conjecture that instead, there is a strong and systematic tendency for increasing income inequality to be associated with greater financial liberalization, which allows the poor to consume more (perhaps with negative longer-run effects on financial stability) even as income shifts toward the rich.

The first goal of our research would be to document in more detail such a trend, both across countries and over time. An important component of this work would be to understand the relationship between consumption and income inequality.

Measures of income inequality for a large and growing sample of countries can be obtained from the World Top Incomes database. Measures of consumption inequality for seven advanced countries can be obtained from source data for papers published in the January 2010 *Review of Economic Dynamics*. We would also draw on recent databases on domestic financial reforms and financial development compiled by the World Bank (Beck et al. 2010) and the IMF (Abiad et al. 2008).

A second (and much more ambitious) goal, assuming we find the statistical correlations we expect, would be to explain its causes. Does greater inequality lead to political pressures for some forms of financial liberalization – as Rajan has put it, a “Let them eat credit” response? Does financial liberalization itself generate inequality? Or are the two phenomena jointly determined – perhaps the result of a “small government” viewpoint that eschews many forms of government intervention in markets? These questions raise deep issues of identification, and it may prove necessary to proceed here on a narrative and country basis.

Chart 15: Inequality and current account balances in advanced economies



From: Andrew G. Haldane, "Global Imbalances in Retrospect and Prospect." Bank of England, November 2010.

References

Abiad, Abdul, Enrica Detraghiache and Thierry Tressel, "A New Database of Financial Reforms," IMF Working Paper WP/08/266, December 2008

Beck, Thorsten, Asli Demirguc-Kunt and Ross Levine, "A New Database on Financial Development and Structure", *World Bank Economic Review*, 14, 2000

Rajan, Raghuram. *Fault Lines.* Princeton: Princeton University Press, 2010.

Reich, Robert, *Aftershock: The Next Economy and America's Future*, New York: Knopf, 2010