

Within-Country Inequality, Global Imbalances and Financial Instability

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Milo Vandemoortele

Comments to m.vandemoortele@odi.org.uk

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Growth and Equity Programme
Overseas Development Institute
111 Westminster Bridge Road
London SE1 7JD
UK

Tel: +44 (0)20 7922 0300 Fax: +44 (0)20 7922 0399
www.odi.org.uk/programmes/growth-equity

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Executive summary

If income inequality is at the root of the [financial crisis](#), then what policies are necessary to build back better and support a robust and sustained recovery? Growing inequality within and between countries is a major source of the crisis, according to the [UN commission on reforms of the International Monetary and Financial System](#), led by noble-laureate Joseph Stiglitz.

There are two key consequences of rising income inequality. First, is a reduction in aggregate demand. As the UN commission report states ‘money was transferred from those who would have spent to meet basic needs to those who had far more than they could easily spend. This created a tendency toward reduced levels of aggregate effective demand’. The second consequence is social and political instability. A study of several Latin American countries found that a higher polarisation, combined with weak institutions, quickly translated into situations of [social tension and conflict](#).

To avoid these consequences, policymakers must address the structural issues behind rising inequality. However, in a highly unequal setting, powerful interests are also [more likely to dominate politics](#), entrenching special interests and therefore delaying policy reforms.

To circumvent the consequences of rising inequality, policymakers in western countries allowed, even encouraged, [policies that fuelled financial instability](#). These included lax regulation and loose monetary policy – manifest in the easy-credit for poor consumers and complex financial instruments and practices to maximise profit (e.g. derivatives, swaps, and high-frequency trading software programmes that allow for front running).

Within-country inequality contributes to financial instability, but so do gaping global imbalances, for three main reasons. First, capital flows in an unregulated market can be destabilising. Unrestrained capital flows, combined with monetary policy targeting domestic price levels, create lucrative arbitrage opportunities for international financial agents. Hedge funds, private equity funds and sovereign wealth funds have brought the flow of capital to a level beyond any historical precedence – so large that, in an unregulated international financial market, shifts in flows of capital can destabilise national economies (e.g. the [collapse of Iceland's economy](#) in 2008). Second, the US-dollar as an international borrowing standard generates inherent instability in the global financial system. In the wake of the East Asian crisis, countries have accumulated net dollar assets (i.e. reserves) as a form of self-insurance. For countries to be able to do this, the US must run a current account deficit which can become unsustainably large, thus reducing confidence in the US dollar as an international borrowing standard. Third, widening imbalances constrain developing countries fiscal space to implement countercyclical policies. Repeated rises and falls of confidence become difficult to avoid in countries with high debt-to-GDP ratios. This can severely constrain social spending and human development when they are most needed. Such investments have long-term countercyclical effects.

Within- and between-country inequality are mutually reinforcing. Unless real incomes improve for the majority of households, reducing inequality and polarisation, a robust and sustained recovery is unlikely. The alternative – returning to the pre-crisis consumption patterns and excessive borrowing – is a very real possibility if policymakers fail to address both domestic and global imbalances.

Policy recommendations to ensure a robust recovery from the crisis must therefore address the fundamental problem of rising inequality. At the national level they could include the following:

- Investments in infrastructure and human capital to reduce inequality and promote a sustainable recovery.
- Countercyclical policies to reduce vulnerability

- Institutional reforms, stronger regulation and early warning system in the financial sector

At the international level, policy recommendations could include:

- Diversifying the international borrowing standard beyond the US dollar
- Strengthening and democratise international financial governance - the G-20 meetings in the wake of the financial crisis, instead of the usual G-8 meetings, are a step in that direction
- Reducing incentives for developing countries to 'self-insure' by accumulating reserves
- [Enhancing fiscal space for developing countries](#)

1. Introduction

The UN Stiglitz Commission of Experts on Reforms of the International Monetary and Financial System¹ posits that economic globalisation has produced increasing income inequality both within and between countries. Widening inequality has important consequences for the evolution and resolution of the current financial and economic crisis.

This paper draws on academic literature and documentation regarding the current debate surrounding the global financial crisis.² It analyses how a combination of wealth inequality within countries and imbalances between countries has contributed to financial instability and the recent crisis. It is structured in five sections. After the introduction, the second section looks at how within-country inequality and polarisation contribute to financial instability. The third section examines the wealth inequality at the global level as a source of financial instability. The fourth section analyses the mutually reinforcing relationship between inequalities (both within and between countries) and how they perpetuate financial instability. The last section concludes and provides possible national and international policy responses to address these inequalities and consequently support a robust recovery from the crisis.

1 See <http://www.un.org/ga/president/63/interactive/financialcrisis/PreliminaryReport210509.pdf>.

2 Documentation regarding the current debate includes newspaper articles, blogs of prominent economists, relevant lectures (e.g. P. Krugman and R. Wade) and minutes from high-level policy meetings.

2. Within-country inequality drives financial instability

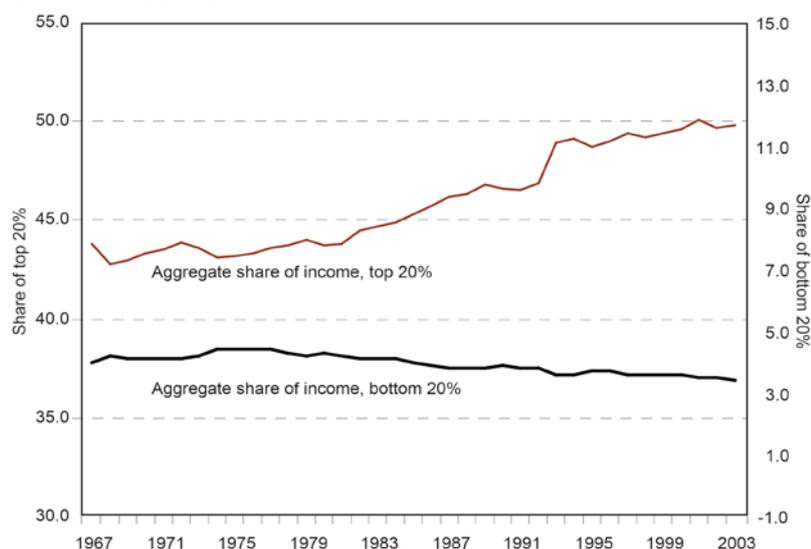
Inequality contributes to financial instability at the country level, through several interrelated channels. A rise in income and wealth inequality reduces the purchasing power of the middle- and low-income groups. The Stiglitz Commission states that as inequality rose ‘money was transferred from those who would have spent to meet basic needs to those who had far more than they could easily spend. This created a tendency toward reduced levels of aggregate effective demand’ (19). How and whether this reduction is dealt with will have both macroeconomic and political implications that contribute to financial instability.

This section first illustrates how inequalities have been increasing within countries. It outlines key consequences of increasing inequality in a society – namely, increases in social and political instability and a reduction in aggregate demand. It notes that pro-cyclical policies are more likely to be implemented in highly unequal societies. It outlines how policies to circumvent these consequences have been pro-cyclical and have in fact fuelled financial instability within these countries. The pro-cyclicality of such policies is more likely to generate financial instability in unequal societies.

2.1 Rising inequality within countries

Real wage rates for middle-income groups across much of the globe have stagnated or shrunk relative to top income earners in their respective countries³. Figure 1 shows that the share of total income going to the top quintile of households in the US rose from 44 per cent in 1967 to 50 per cent in 2003. Conversely, the share of income accruing to the bottom quintile of households fell from 4.0 to 3.4 per cent over the same period.

Figure 1: Aggregate shares of income in the US, 1967-2003



Source: US Census Bureau (2004), in Boushey and Weller (2006).

Economic globalisation has brought an increase in profit ratios, coupled with a downward pressure on labour incomes. In other words, profit ratios have reached a four-decade high (Turner, 2008) while the average worker has seen his/her real wage stagnate or decline (see Box 1). Figure 2 shows a declining trend in labour shares, accompanied by a significant increase in corporate profit growth – a trend that has been particularly evident since 2001 (Boushey and Weller, 2006). The

³ For evidence on Europe see Turner, 2008 for evidence in Latin America see Birdsall et al., 2008.

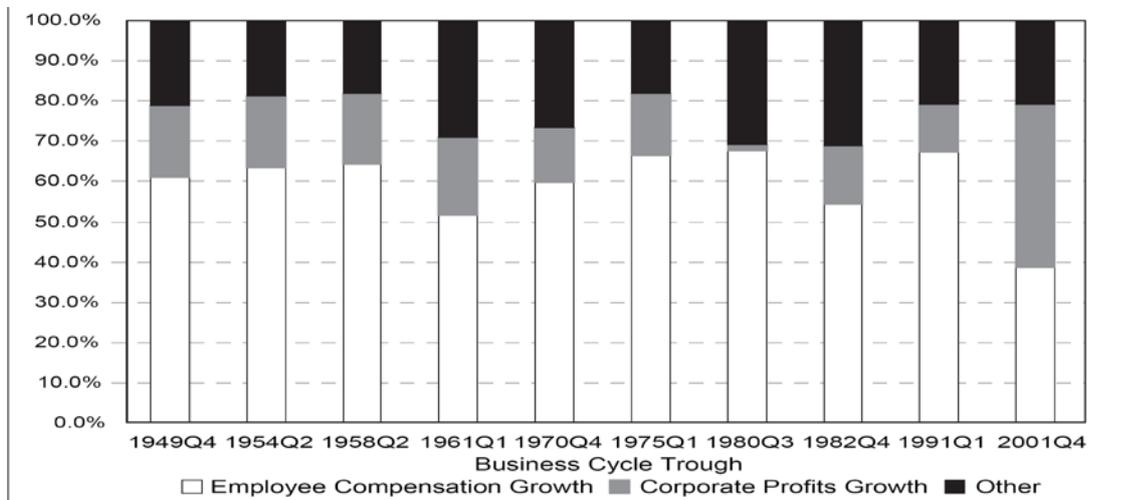
International Labour Organisation (ILO 2008) shows a steep increase in executive pay. In the US, for example, between 2003 and 2007, executive managers' pay grew in real terms by a total of 45 per cent, while that for the average American worker increased by less than 3 per cent. Similar patterns are reported in several other countries, including Australia, Germany⁴, Hong Kong, the Netherlands and South Africa.

Box 1. Former chief economist of the IMF on wages, profit ratios and rising inequality

"The simple truth is that corporations represent capital, and capital – in the form of factories, equipment, machines, money, and even houses – has been the single biggest winner in the modern era of globalisation. Corporate profits are bursting at the seams of investors' expectations in virtually every corner of the world....Many policymakers seem to be under the impression that surging profits are a purely cyclical phenomenon....Wait a bit, they predict, and wages will fully catch up later in the cycle. Not likely. Capital's piece of the pie has been getting bigger for more than 20 years, and the trend looks set to continue."

Source: Kenneth Rogoff (2005) Former chief economist of the IMF, (quoted in Van der Hoeven (2008))

Figure 2: Components of US national income growth over eight quarters, 1949-2001

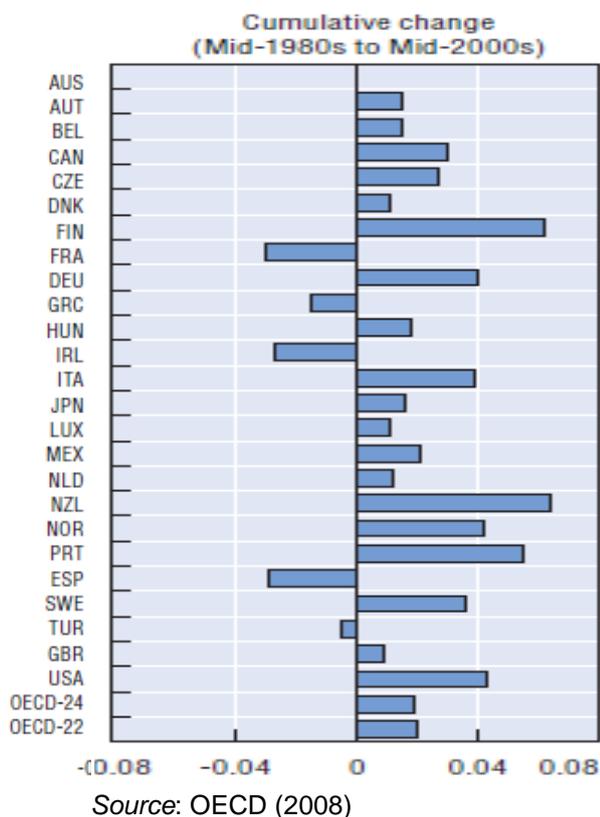


Source: Bureau of Economic Analysis (2004), in Boushey and Weller (2006).

With stagnant real wages among middle-income earners and rising wages among the wealthiest, it follows that inequality and polarisation in the country widens. This has indeed been the case - Figure 3 shows that inequality has risen across most of the OECD countries, between the 1980s and the mid 2000s.

4 In Germany, middle-income earners have experienced the longest period of contraction in their real wage rates in modern times, and they continue to decline (Turner, 2008).

Figure 3: Trends in income inequality in OECD countries (mid-1980s to the mid-2000s)



2.2 Consequences of increasing inequality

A large body of evidence supports the view that **inequality is harmful to growth** (see Cornia 2004; Easterly, 2000; Persson and Tabellini, 1994; Ravallion, 2000; Temple, 1999; Van der Hoeven, 2008; Box 2).

Box 2. Inequality is harmful for growth

Income inequality, especially at excessive levels, has several implications that undermine growth:

- it weakens the social contract that underpins social cohesion and political stability in a country - for example high income inequality is associated with higher crime rates, lower life expectancy and conflict
- perpetuates problems of accountability in government institutions, reducing the likelihood that economic and social policies will be developed and implemented to deliver inclusive growth and human development. For example, richer groups may secure economically-inefficient advantages (e.g. regressive taxes or an allocation of public funds for their interest rather than that of the country)
- it deepens macroeconomic instability as low-income households are less able to adjust to economic shocks (ILO, 2008)

Initial levels of income inequality matter for and economic growth. Cornia (2004) argues too high levels of inequality can have serious negative consequences. Indeed, more equal countries tend to grow and develop faster than highly unequal countries.

Rising income inequality is politically unsustainable. High inequality is linked to political instability, which in turn results in macroeconomic volatility (Alesina and Perotti, 1996). Essentially, they argue that high inequality in a society creates incentives for people to engage in activities outside the market (e.g. illegal drug trafficking, crime, etc.), which contribute to political and social instability. Such instability generates disruptions in the current economy and uncertainty about the

future, thereby discouraging the accumulation of wealth, savings and investment. Rising inequality therefore perpetuates macroeconomic instability by increasing political and social instability.

High inequality inhibits economic growth because it entrenches special interests and so delays policy reforms (Birdsall, 2008; Behrman et al., 2009). In a study examining the links between structural inequality and financial liberalisation in developed and developing countries, Behrman et al. (2009) find that higher schooling inequality reduces the impetus for policy change (15). They conclude that “in a highly unequal setting, powerful interests are more likely to dominate politics, pushing for policies that protect privileges rather than foster competition and growth” (15). This research highlights the relationship between rising inequality, political disinterest to implement countercyclical policies, and financial instability.

A rise in income and wealth inequality should, result in **reduced levels of aggregate effective demand** (See Stiglitz et al. 2009:16). As money is transferred from those with a higher marginal propensity to consume (middle-income groups) to those with a lower marginal propensity to consume (upper-income groups), effective demand is reduced. This has contractionary pressures on economies that are highly reliant on domestic consumption (e.g. the US, the UK).

Contrarily, Kaldor’s (1956) hypothesis posits that an increase in inequality will shift resources from those with a low propensity to save to wealthier groups with a higher propensity to save. In theory, there is a positive correlation between savings and investment, and gross domestic product (GDP) growth rates are directly related to investment – the conclusion here is that more unequal societies will grow faster. However, the relationship between income and savings is anything but straightforward. Increases in income in an unequal society have stimulated not only conspicuous consumption (which tends to have high import content and be capital-intensive, thus accompanied by major leakages outside the national economy) but also risky investments. Two concrete examples of the latter are the investments made to Madoff and Stamford. High inequality also reduces the demand for fiscal redistribution and investment for human development (Birdsall, 2000; Alesina and Perotti, 1996). Indeed, the presence of a middle-class is essential for stability and sustainable growth. Birdsall et al. (2000) stress that “a healthy market economy requires the active involvement of middle groups - as stakeholders, entrepreneurs, skilled workers, and consumers” (19). Easterly (2001), in a cross-country study, shows that “per capita income and growth depends positively on [the] middle class share” (327).

Asset prices in industrialised countries, enabled by complex instruments and weak regulation, were continually inflated by financial intermediaries. Investments in financial assets were not underpinned by any real expansion in production capacity (for example), rather by an irrational confidence in the market, reminiscent of Montesquieu’s critique of the money economy: ‘People of Baetica’, he wrote, ‘do you want to be rich? Imagine that I am very much so, and that you are very rich also; every morning tell yourself that your fortune has doubled during the night; and if you have creditors, go pay them with what you have imagined, and tell them to imagine it in their turn’ (cited in Milanovic, 2009).

Box 3: Inequality contributes to financial instability – research in the 1990s

Income inequality is positively correlated with volatility (see Aghion et al., 1999a), as well as with political instability, which in turn results in macroeconomic instability (see Alesina and Perotti, 1996). Aghion et al. (1999b) show that inequality is not only detrimental to growth but also pro-cyclical. Individual investments are an increasing function of initial endowments, they demonstrate; an individual’s level of investment today is directly related to their level of wealth. In other words, wealthier individuals are likely to invest more than their poorer counterparts. And, given decreasing marginal returns to individual capital investments, concentrating investment in fewer wealthier people would be detrimental to growth. Inequality in access to investment would also be pro-cyclical, as inequality in access to investment and the consequent separation of investors and savers generates persistent credit cycles and therefore macroeconomic volatility.

In the context of the current global financial crisis, the link between inequality and financial instability has been re-examined. Inequality within countries emerges as an important theme in the literature and debates. Generally, the consensus is, first, that rising inequality is at the core of the financial instability; second that policies to circumvent the consequences of inequality (outlined above) have been mostly pro-cyclical and have thus fuelled financial instability; and third that lax regulation, 'failure' of financial instruments and loose monetary policy are part and parcel of these policies, rather than lying at the root of the crisis (i.e. rising inequality).

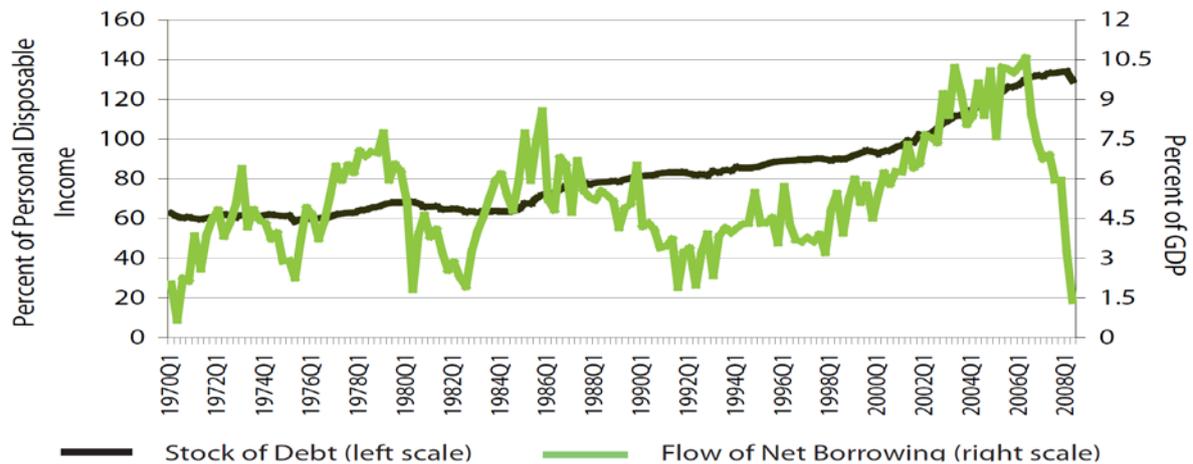
2.3 Policies to circumvent consequences of inequality have fuelled the instability

Addressing inequality requires that policymakers deal with policies that address the structural issues of inequality. Such policies are opposed by special interests, which have become more entrenched as a consequence of increased inequality. Yet rising inequality is politically unsustainable. For example, the US median wage has remained stagnant for 25 years, despite an almost doubling of GDP per capita. In Latin America, analysis suggests that poor people and middle-income earners have not benefited from the growth and market reforms of the last fifteen years (see Birdsall, 2008:xi). Rather than addressing the structural issues underlying increasing inequality, policymakers have tried to offset the decline in aggregate effective demand and to maintain social stability by supporting **loose monetary policy (i.e. low interest rates) and lax regulation**.

This has led to the provision of cheap credit, which permitted sustained consumption and investment among consumers at the expense of higher levels of household and business indebtedness. In the past decade, several countries (including the US, UK, Canada, Australia and New Zealand) have observed a marked decline in the household saving rate and a significant increase in consumption as a share of total aggregate demand, coupled with increases in household indebtedness (White, 2007).

In the US, for example, both political parties supported such policies to achieve macroeconomic and socio-political stability (see Dos Santos, 2008a). Figure 4 shows that household consumption and residential investment rose from 69.6 per cent of GDP in 1991 to 76.4 per cent in 2005. Conversely, the income share of the bottom 90 per cent of the population fell from 36 per cent of GDP to 32 per cent over the same time period, making an expansion in borrowing necessary. Indeed, borrowing in the US increased from 2 to 10 per cent of GDP over this period (green line). The stock of debt as a percentage of personal disposable income rose from approximately from 80 to 120 per cent between 1991 and 2005 (black line).

Alan Greenspan (former Chairman of the Federal Reserve) writes that 'government encouragement of subprime mortgage programs enabled many members of minority groups to become first-time home buyers', and that this 'boded well for the cohesion of the nation' (quoted in Dos Santos, 2008b). However, the consequences of the financial crisis show that overselling debt has extended into the lives of ordinary people, including the working poor.

Figure 4: US household debt and borrowing, 1970 Q1 – 2008 Q2


Source: Dos Santos (2008a).

2.4 Pro-cyclicality accelerated in more unequal society

To unpack how this boom and bust occurred, we must understand that during boom periods investors' net wealth increases. In the US, for example, house prices climbed by 104.5 per cent between the summer of 1997 and the start of the slump in the summer of 2007 (US Office of Federal Housing Enterprise⁵). Net wealth (total assets minus debt) in the UK rose from 633 per cent of disposable income in 1997 to 824 per cent in 2006 (Turner, 2008). As net wealth rose, so did borrowing capacity in the economy. Greater availability of credit (perpetuated by policymakers and complex financial instruments) led to higher asset prices, which in turn served as collateral for more borrowing. Investors therefore accumulated debt during the boom, increasing demand for investable funds. (In this case, the consumer debt accumulated was unprecedented – see Figure 4). As the interest rate is given by the marginal product of capital, interest rates rose, as they tend to during economic boom periods. The credit-fuelled boom enabled the middle class to continue consuming, and temporarily offset potential tensions arising from increasing inequality. It collapsed, however, when ordinary borrowers began defaulting on their debts.

Inequality during such booms perpetuates financial instability. If wealth is concentrated among a small portion of the population, those at the top of the income distribution find themselves with a large pool of excess capital and search for profitable opportunities to invest. When these large investments enter the financial sector, they – in the absence of effective management and regulatory controls – have the potential to generate excessive risk taking by market agents. Where this takes place, the result is endogenous financial fragility (see Milanovic, 2009; Minsky, 1982 and Box 4).

Box 4: Endogenous financial instability

Minsky (1982) explains that endogenous financial instability is more likely in a situation of rising inequality, where it becomes necessary for borrowers to increase indebtedness in order to face previously undertaken financial commitments (largely because expected income is insufficient to service the debt). In such a situation, borrowers and lenders are both speculating that it will be possible to refinance the debt in the future. In the context of a growing economy, borrowers and lenders are 'rational' in that their expectations keep being fulfilled. Financial agents, looking for larger profits will therefore undertake riskier decisions for as long as prosperity continues – engendering endogenous financial instability in the market.

Source: Mendonça and Deos (2009)

5 <http://www.fhfa.gov/>

Inequality can also engender financial instability, as it creates a **separation between the investors and the savers** – the investors being increasingly poorer and more vulnerable households. This happens because liberalisation of financial instruments fostered the transfer of risk to households in new ways that are not always obvious to households with limited experience or expertise in assessing their exposure to risk (White, 2007). In the US, for example, there has been a marked increase in the use of variable rate mortgages enabling low-income earners to become bankable, as they would not have been eligible to receive a mortgage carrying a higher fixed rate. The use of interest-only mortgages (markedly more costly to the borrower in the long run) also rose sharply.

Pro-cyclical policies, such as those of loose monetary policy and lax regulation, are **more likely to occur in more unequal societies**. We have already suggested that politicians will seek to avoid implementing policies to address structural economic and institutional failures where they are controversial, and will support policies that both expand the purchasing power of the middle class and sustain growth, whether or not they are sustainable in the longer term.

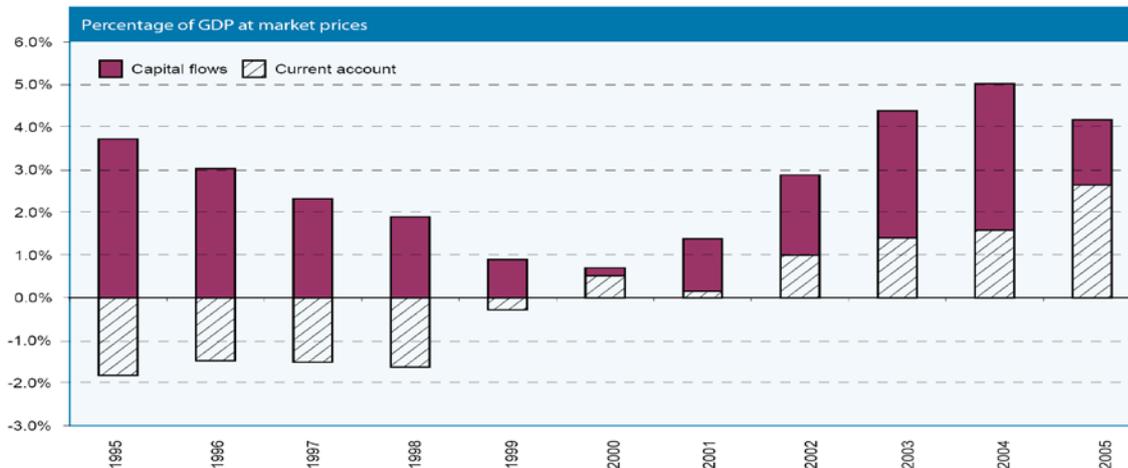
Income polarisation between socioeconomic groups makes the development of fiscal instabilities more likely (Woo, 2005). When politicians disagree on how to use government funds, each will have an incentive to overexploit the common pool of resources, with negative effects on fiscal balance and the 'national project for development'. This behaviour is 'more likely to occur and be more severe in societies with higher degrees of polarisation' (Woo, 2005). Further, the political instability associated with polarisation shortens the time horizons of policymakers, encouraging short-sighted policies that lead to fiscal deficits at the expense of macroeconomic stability. This in turn discourages private investments by foreign and local entrepreneurs, jeopardising economic growth.

3. Global imbalances and financial instability

3.1 Global imbalances

It is widely recognised that the global economy has generated unsustainable imbalances in recent years. Most significant is the current account deficit of the US, complemented by aggregate surpluses in several other countries – especially China and Japan. Figure 5 shows the increasing amount of reserves held by emerging economies, as a form of ‘self-insurance’. Figure 6 shows the widening external debt among industrialised nations.

Figure 5: Reserves among emerging economies, 1995-2005

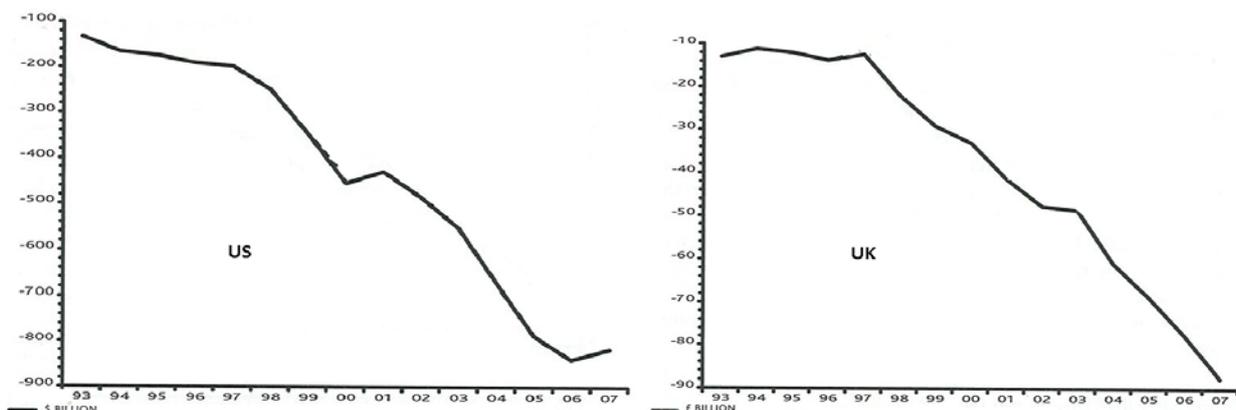


Source: Database of the UN Department of Economic and Social Affairs, in Ocampo (2007).

3.2 Global imbalances contributing towards financial stability

What are the key implications of global imbalances for global and national financial stability? This section makes three key points. First, a global financial system based on a global reserve system, denominated in single currency (the US dollar), is inherently destabilising. Second, capital flows in an unequal and unregulated global financial market are pro-cyclical, and when their volume reaches significant sizes the capital flows can become destabilising. Third, widening imbalances further constrain developing countries’ fiscal space to implement countercyclical policies.

Figure 6: US and UK trade balance, 1993-2007



Source: Turner (2008).

3.3 Reserve accumulation denominated in industrialised country currencies and financial instability

In the wake of the East Asian crisis, as a response to pro-cyclical capital flows and balance of payment crises in a largely unregulated international market, developing countries have accumulated large amounts of foreign exchange reserves as a form of 'self-insurance' (illustrated in Figure 5).

The fact that the international borrowing standard, and therefore the currency under which international reserves are denominated/traded, is a single national currency (the US dollar) generates inherent instability in the global financial system (see Triffin, 1961). First, for other countries to accumulate net dollar assets (i.e. reserves) the US must run a current account deficit. Second, the US can run an independent monetary policy. When the US sets interest rates it can have a destabilising effect on developing countries with dollar-denominated debt (for example changes in interest rates triggered the debt crisis in Latin America in the 1980s).

A pro-cyclical and therefore destabilising consequence of these two factors is that economic upswings in the US, usually coupled with an appreciation of the dollar, will benefit developing countries holding dollar assets, as they will see an increase in the real value of these assets in terms of their domestic currency. A depreciation of the dollar, however, can have contractionary consequences for developing country economies holding large amounts of US dollar assets.

Also destabilising is a reduction in confidence in the US dollar as an international borrowing standard. As the US current account and capital account deficits (widening capital account deficit with expansionary monetary policy) widen, confidence in the dollar is declining. China, for example, has threatened to begin trading in Euro and is set to purchase up to 32 billion Special Drawing Rights (SDR)⁶ (around US\$50 billion) in International Monetary Fund (IMF) notes (Jing, 2009). Central banks and other international finance agents may refuse to continue accumulating dollar assets.⁷ If this happens, the widening US current account deficit will become unsustainable, the dollar will depreciate significantly, reducing the real wealth of dollar asset holders, and the global economy would contract as a consequence.

There are important **distributional consequences** of an international reserve system based on the dollar, or on the currencies of other industrialised countries'. Seigniorage powers, that is, the power to print money and therefore control its supply, in the global economy are concentrated among industrialised countries. In addition, accumulation of reserves in US currency results in a large amount of developing country income being concentrated in industrialised countries (Cozzi and Nissanke, 2009).

3.4 Capital flows in an unbalanced and unregulated global financial market

'The "villains" among the reforms have not been trade liberalisation or privatisation, but financial sector reforms and the opening of the capital account', writes Birdsall (2002). The opening of capital accounts has undermined growth and reinforced inequalities which in turn has perpetuated global imbalances. Countries that have experienced banking and financial crises between 1975 and 1994 have also experienced an average reduction in GDP growth of 1.3 per cent over the

⁶ SDR (Special Drawing Right) an interest-bearing IMF asset based on a basket of international currencies (US-dollar, Yen, Euro and Pound Sterling). IMF members can convert SDRs into other currencies.

⁷ The gold standard was removed in the 1970s. Alternatives to the US dollar as an international borrowing standard (another national currency – pound sterling, euro; a basket of currencies; or an international currency) would remove only some of the destabilising factors in the current economy.

subsequent five years, compared with countries that did not experience such crises (Stiglitz, 1998 as quoted in Cornia, 2006:13). The liberalisation of capital accounts in Latin America generated a strong rise in wage inequality (See Szekely, 2003 as quoted in Cornia, 2006).

Since the 1997 Asian financial crisis, a number of prominent studies have demonstrated that international private capital flows have tended to increase financial fragility and the likelihood of financial crisis (see Cozzi and Nissanke, 2009). The combination of free capital movements and government monetary policy targeting low inflation attracts large speculative capital inflows to countries with large interest rate differentials (e.g. Iceland), and outflows from countries with low interest rate differentials. These financial agents in search of high-yield investments are more interested in nominal interest rates rather than real interest rates, as they do not purchase domestic products.

Unrestrained capital flows, combined with monetary policy targeting domestic price levels, create lucrative arbitrage opportunities for international financial agents. Hedge funds, private equity funds and sovereign wealth funds have brought the flow of capital to a level beyond any historical precedence – so large that, in an unregulated international financial market, shifts in flows of capital can destabilise national economies (e.g. the collapse of Iceland's economy in 2008). Additionally, financial actors have a strong collective interest in generating bubbles and lobby pertinent financial actors (e.g. central, regional or multinational banks and international lending agencies) accordingly. For developing countries, these large capital flows are especially destabilising, given their relatively small economies, largely unprotected from speculative forces in international markets.

3.5 Widening imbalances constrain fiscal space to implement countercyclical policies

Macroeconomic imbalances perpetuated by financial imbalances (specifically in the majority of developing countries not accumulating reserves) constrain developing countries' fiscal space to implement countercyclical policies. Countercyclical policies can improve the creditworthiness of a country and attract more stable investment. However, lack of sovereign default makes it difficult for developing countries to break free from a cycle of financial instability. Indeed, Dervis and Birdsall (2006) show that a number of high-debt emerging market economies face debt-to-GDP ratios that are unsustainable, thus repeated rises and falls of confidence become difficult to avoid. Structural⁸ long-term debt problems keep their growth rates low and have an unequalising effect on the growth process. This both severely constrains social spending and human development (which have long-term countercyclical effects) and makes the countries vulnerable to capital flow fluctuations.

However, not all emerging economies face these challenges. There are important differences among them, with many Asian countries in much better shape than some countries in Latin America, North Africa and the Middle East. Generally, developing countries, especially those facing large external deficits, face debt challenges that severely constrain their ability to implement countercyclical policies.

⁸ There is a likely relationship between weak national institutions and sovereign default, making it more difficult to break free from vicious cycles of financial instability (Mendoza, 2009).

4. Inequality within and between countries: Mutually reinforcing

'Keeping one's domestic house in order' is not sufficient to ensure financial stability, nor will international stability ensure financial stability at the national level. Both are mutually reinforcing. The persistent rise of inequality within countries in the past decade has risen concomitantly with global imbalances. This section clarifies the link between within- and between-country inequality, highlighting the relative importance of within- versus between-country inequality.

4.1 Higher inequality within countries perpetuates global imbalances

To circumvent the economic and political implications of rising inequality, loose monetary and regulatory policies have led to asset inflation, which in turn have generated perceptions of increased wealth and more spending. Domestic absorption in industrialised countries – particularly the US and UK – has gradually exceeded domestic production, expanding the external deficit.

The high levels of consumption and borrowing seen in industrialised countries have been subsidised by borrowing from abroad. Asia and oil-exporting economies buying up dollar-denominated assets have essentially enabled consumption in industrialised countries. If inequality within these countries is not addressed, and borrowing persists, global imbalances will only widen. Moreover, underpinning a sustained widening of global imbalances, perpetuated by internal imbalances, is a confidence in the dollar. As the US current account deficit grows, confidence in the dollar could fall – posing an important risk to international stability.

4.2 Higher global imbalances contribute to within-country inequality

Countries with external deficits are more prone to internal imbalances. Two types of country have high negative external imbalances: industrialised countries (i.e. US and UK) and many developing countries. For developing countries, so long as there is no long-term external demand for assets denominated in developing countries' currencies, investments in these assets will be mostly speculative and pro-cyclical. Additionally, high inequality in these developing countries is perpetuated by high external imbalances, as the fiscal space to implement countercyclical policies is restrained by the need to attract foreign capital inflows. Macroeconomic shocks, such as the financial crisis, tend to hit the poorest and most vulnerable countries hardest, given the relative small size of their economies and their constrained fiscal space to mitigate shocks.

External imbalances allow for internal imbalances (e.g. sizable increases in household debt in industrialised countries). Essentially, reserve accumulation is subsidising consumers in industrialised countries, who would otherwise not be able to increase consumption, given their stagnating wages.

Rising imbalances between countries are also a reflection of higher profit margins for many UK and US companies when repatriated from abroad. These profits flow to shareholders (tending to be wealthier) and further exacerbate inequalities. This is not limited to the wealthy elite in industrialised countries: China has seen growth in the number of billionaires, for example.

US dollar appreciation, associated with upswings, benefits the rest of the world – in particular those who hold dollar assets and see the real value of their assets rise. This appreciation also has implications for in-country income distributions, as the wealthier income groups tend to hold assets whereas middle-income and poorer people tend to hold fewer assets; these latter tend to be denominated in national currencies.

5. Conclusion and Recommendations

5.1 Conclusion

Inequality within and between countries is a key contributor to financial instability at the national and international level.

Within-country inequality creates a political environment whereby pro-cyclical policies are more likely to be implemented (i.e. poor regulation and loose monetary policy) with the objective of avoiding political instability and reductions in economic growth. Within-country inequality also generates pro-cyclical investment behaviour. Concentrating wealth among a small portion of the population reduces risk aversion among investors and generates excessive risk taking, particularly where regulation is weak. Together, these phenomena result in endogenous financial fragility. Concentration of wealth among a small group also reduces marginal returns on investments. Financial instability is heightened if rising inequality is coupled with increasing debt among a large portion of the population and an increased burden of risk on wage earners (from public or private sector providers of basic services).

Widening imbalances between countries contributes to financial instability, for three key reasons. First, a global financial system based on an international borrowing standard that is a national currency is inherently destabilising. Second, capital flows in an unequal and unregulated global financial market will be inherently pro-cyclical. When their volume reaches significant levels capital flows can become destabilising – in particular among poor and vulnerable countries with relatively small economies and weak institutional capacity to design and implement countercyclical policies. Third, widening imbalances further constrain developing countries' fiscal space to implement countercyclical policies.

These external and internal imbalances are mutually reinforcing, one driving the other. Within-country inequality is more important than global imbalances. Global imbalances have widened concomitantly with rising inequality in industrialised countries. This is no coincidence. Industrialised country policymakers, aiming to avoid the economic and social instability associated with rising inequality, have relied on external financing to subsidise consumption and easy credit for middle-income earners experiencing stagnant real wages. Intervention to reduce financial instability is needed at both national and international level.

5.2 Recommendations

Several national and international policy responses are available to address inequality. These will be indispensable in ensuring a robust and sustained recovery from the present crisis. Some will interpret them as outside the standard policy framework. But as Kanbur (2009) demonstrates, terms such as the 'Washington Consensus' have been interpreted and distorted for ideological reasons or to serve the interest of special interest groups. He points out that the original set of policy reforms, as suggested by Williamson, included a reordering of public expenditure priorities towards basic health and education. Williamson also cautioned against capital account liberalisation and against the abolition of safety and environmental regulations. Yet, the standard interpretation of the 'Washington Consensus' seldom paid attention to such policy advice.

5.2.1 National level

Addressing within-country inequality (especially in industrialised countries) should be a priority. Unless the underlying factors driving inequality are addressed, pro-cyclical policies to circumvent the political and economic consequences of inequality are unlikely to subside.

Significant improvements in the distribution of income are necessary. Rising inequality has generated mass borrowing by low- and middle-income households (as it did in the 1920s). Unless real incomes improve for the majority of households, a robust and sustained recovery is unlikely. Indeed, if real improvements in the income distribution do not occur, the probability of returning to the pre-crisis consumption glut and borrowing bonanza is not unlikely.

Consumption among middle-income groups can rise without governments having to foster asset inflation as a substitute for income growth. This type of consumption would be different from the pre-crisis consumption glut - it would be dominated more by wage goods that are more labour-intensive and less import-intensive.

Policies should aim to distribute wages to groups with higher marginal propensity to consume (Turner, 2008). Given the importance of the country-specific context in defining policy reforms (e.g. political economy, economic structure, institutional capacity), the policy recommendations proposed must be of a general nature. The appropriate set and sequence will need to be tailored accordingly.

Policy recommendations to ensure a robust recovery from the crisis must therefore address the fundamental problem of rising inequality. At the national level three key recommendations include:

1. Investments in infrastructure and human capital to address structural drivers of inequality and promote a sustainable recovery. Approaches to increase real wages of low- and middle-income earners include:
 - **Progressive tax cuts or tax-reforms**, where middle- and low-income earners see proportionally lower taxes than corporations and high-income earners (see Dos Santos, 2008a). Turner (2008) also argues that corporate profit levels should be redistributed within the firm (or multinational) in a sustainable manner so that average workers benefit from rising profit ratios. Weeks (2009), however, contends that taxes can be a clumsy instrument for demand management. The bureaucracy around approving new rates and instituting new taxes takes time, as does the implementation of new tax regimes. Although useful in the long term, progressive tax reform may not produce the short-term increase in public revenue for developing countries to cope with the impacts of the financial crisis. Rather, **increased public expenditure** is likely to have higher multiplier effects, as savings from lower taxes might not necessarily be fully spent. However, there is also the danger that increased public expenditure can crowd out private investment – especially if an economy is operating below its full potential. Cornia (2004), nonetheless, suggests that this is not a danger where public investments reduce market failures or develop important physical, productive or human capital – as they will all improve the investment climate, returns on private investment and ‘crowd in’ rather than ‘crowd out’ private investment. Trade-offs between progressive tax reform and increasing public expenditure depend on country contexts, tax infrastructure and the political economy.
 - In countries where workers have increasingly relied on capital markets to finance services such as housing, pensions, education and health care (e.g. US and UK), **public provision of these basic services needs to be strengthened**. Privatisation of these services, without a publicly provided safety net, has passed on to individuals the financial risks associated with ill health, uncertainty in the labour market and investment. In past decades, wage earners made significant payments to financial firms in order to manage these risks and access basic services (Dos Santos, 2008a). In

the short term, as millions of people are losing their homes, their retirement savings and their jobs, quality public alternatives, where they do not exist, are essential. In the medium to long term, risks associated with these services should be minimised.

- **Enabling access to basic education and health services** across regions and socioeconomic groups will generate positive externalities and engender sustainable economic and social development. Jansen and Lee (2007), for example, show that policies that provide wider access to education not only stimulate growth and reduce inequality simultaneously, but also play an important role in determining a country's ability to cope with technological and economic changes.
- Hailu and Weeks (2009) propose a **policy package to bolster demand**, without deepening inequalities. The current global recession is delivering a powerful 'demand constraint' across the globe. This includes expansionary fiscal policy (following the rule that overall deficit does not exceed public investment); a monetary policy that tolerates reasonable inflation to achieve higher growth; and a managed exchange rate regime to promote exports without causing unmanageable inflation spirals.

2. Countercyclical policies to reduce vulnerability

- **Implementing countercyclical policies**, to reduce vulnerability to external financial shocks, are necessary. These may include GDP-linked bonds or capital controls (see Box 5), among other policies. Brazil provides a good example of how countercyclical policies have cushioned an economy against external shock (see Box 6).

Box 5: Insulating developing countries from the financial crisis contagion – Managing capital flows

Capital controls can be, under certain conditions, an effective mechanism to insulate developing countries from the contagion effects of a financial crisis and can help reduce financial fragility. Capital controls in Malaysia were successful because there was little attempt to evade them. This owed to the characteristics and structure of the Malaysian banking system. For instance, the Central Bank of Malaysia had strong supervisory and regulatory powers. Domestic commercial banks had the largest share of the financial market in the 1990s but government controlled, either directly or indirectly, four of the largest banks. Replicating Malaysian-style capital controls elsewhere would be difficult in the absence of a strong oversight and enforcement system. Such conditions were important because they were essential to guaranteeing political and social stability.

Source: Cozzi and Nissanke (2009).

Box 6: Lessons from Brazil – countercyclical policies

Prior to the crisis, Brazil implemented countercyclical policies and augmented its reserve position. It maintained economic growth and reduced inequality (as measured by the Gini index) through investment in education and conditional-cash transfer programmes. Post-crisis it had the fiscal space to loosen monetary and credit policy. At the beginning of the year, interest rates were 12.75%. They were cut to 11.25% in March 2009. Government has been able to increase credit supply from state-owned banks and has provided deposit guarantees. In terms of fiscal policy, it has provided tax cuts, social programmes and public investment – specifically a programme to build 1 million homes for low-income workers. Under this programme, families earning less than a given income will be able to acquire their own home in exchange for a marginal payment per month. This has the aim of increasing growth by up to 2% and creating 1.5 million new jobs, as well as easing Brazil's housing problems (exacerbated by high interest rates that made mortgages unaffordable for many).

Source: Bernardo (2009).

3. **Institutional reforms, stronger regulation and an early warning system in the financial sector.** Financial actors, regulatory agencies, credit rating agencies and policymakers have interests in promoting asset inflation and expanding debt. An independent institution with the responsibility to monitor events, identify problems and facilitate crisis management is necessary at the country level. These should also propose a

‘macroprudential regulatory framework’ (White, 2007) that puts more emphasis on the health of the financial system as a whole rather than the state of individual institutions.

Addressing fundamental sources of financial instability will have positive corollary effects and enable countries to build back better. Indeed, Rodrik (2003) contends that macroeconomic stability is a fundamental principle necessary to produce a growth path that allows a country to take full advantage of trade openness. Macroeconomic stability provides confidence in the future economic performance of a country, encouraging investment.

5.2.2 Policies at the international level

Second to addressing structural issues underpinning within-country inequalities are several policies to mitigate expanding international imbalances and the financial instability they engender.

As part of a consultation process on international financial institutions, the UK’s Prime Minister, Gordon Brown, met with senior global economists to discuss the challenges that lie ahead in ensuring high and sustainable global growth in the future. Key concluding points from this session overlap with key recommendations emerging from the analysis in this paper.

Three key policy recommendations at the international level include the following:

1. **Diversify the international borrowing standard beyond the US dollar.** In the wake of the East Asian financial crisis, many Asian countries accumulated net dollar asset. Paradoxically, this was in part because of the perceived stability of the dollar as a store of value – which was particularly true in the early days of the East Asian crisis. Today, however, global economic stability hinges precariously on the confidence of the dollar. Hence the need for a diversification of the international borrowing standard beyond the US dollar. China, among others, is beginning to diversify their asset holdings to alternative currencies or baskets of currencies (see Jing, 2009).
2. **Strengthen and democratise international financial governance.** In doing so, **incentives for developing countries to ‘self-insure’ by accumulating reserves would be reduced.** Reserve accumulation in some developing countries has highlighted the lack of credible protection available in the international financial system. Yet, reserve accumulation is perceived as largely unsustainable. Policy options and institutional arrangements to reduce incentives to self-insure should be explored. The G-20 meetings in the wake of the financial crisis – instead of the usual G-8 meetings – are a step in that direction.
3. Countries are experiencing slower growth (in part from reduced private and external demand), reduced fiscal revenue, and increased need to mitigate against the poverty and growth impacts of the financial crisis. Donors can support developing countries to **enhance fiscal space in order to implement counter-cyclical policies.** This can be done at the national level, providing additional general budget support; at the sectoral level, protecting education and health budgets; or at the programme level, financing expanded social protection programmes or ‘labour-intensive public works’ (to stimulate demand from low- and middle-income groups). However, donor funding that has already been allocated can not easily be adapted – thus **additional ‘policy space’** to use overseas development assistance to implement counter-cyclical policies is essential.

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