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Theorizing income inequality in the face of financial globalization

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ABSTRACT

Based on an extended post-Keynesian model, we find that the association between the savings rate and income inequality is negative if savers' funds are borrowed by spending households for consumption but positive if savings are channeled to investing firms for production. A negative association, such as the one that exists in the U.S., hinges on an income illusion created by an asset bubble and cheap credit. Thus, financial globalization leads consumption and income inequality to diverge, and the divergence is more extreme if lower-income groups have higher debt ratios. A positive association, such as the one that exists in China, relates to liquidity constraints faced by consumers such that consumption inequality closely follows income inequality. Our results imply that income inequality must be reduced in both types of countries to increase savings in deficit economies with negative associations and to reduce savings in surplus economies with positive associations.

1. Introduction

The 2008 financial meltdown continues to have a major effect on the world economy and certain economic factors are believed to be associated with what was the largest financial crisis since the 1929-1933 Great Depression. These factors include rising income inequality in both emerging and advanced countries, which has weakened effective demand and consumption spending (Sheng, 2014). Furthermore, a savings glut has occurred in Asian countries, primarily in China, and a savings deficiency has occurred in Western nations, primarily in the U.S (Broome, 2009; Gu & Sheng, 2010). Relaxed monetary policies and low interest rates are utilized in many economies, which have caused a large asset bubble and rampant financial speculation (Peterson & Venteicher, 2013; Seabrooke & Tsingou, 2010). Additionally, overdeveloped capital markets in the West and underdeveloped financial systems in Asia have driven Asian savings into Western markets and led to even lower interest rates, a fueling of consumer credit, and an exacerbation of bubble speculation (Lambie, 2009; Sheng, 2011a, 2011b). At a global level, financial, physical and knowledge infrastructure is poorly integrated, which is a concern in the face of the globalization of financial capital and Internet communication. Traditional industrial policies based on closed national economies and partnerships between national governments and local multinational corporations have failed, and a new policy focused on institutional infrastructures is needed (Choi, Berger, & Kim, 2010). At a micro level, moral hazards lie at the core of many of the causes of financial turbulence; at a macro level, inadequacies of political institutions bear the majority of the blame (Hou, 2011). Benefits from foreign financial resources may not outweigh the costs of destabilizing speculation. The real appreciation of currency may

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be a major determinant of the deterioration of the current account imbalances. Hence, rapid disinflation policies are necessary to avoid financial crises (Dropsy, 1995).

Previous studies have provided competing explanations for the causes and effects of the global crisis. The present study offers a concise explanation by integrating the main themes of other studies that have evolved separately. Whereas some studies claim the importance of the relationship among income inequalities, credit booms, and financial crises, other studies invalidate this inequality-credit-crisis nexus by highlighting the importance of low interest rates and typical business cycles. Nevertheless, recent studies continue to emphasize the adverse effects of inequality on current accounts, government debt, and aggregate savings. This study focuses on international differences in the association between inequality and savings for three reasons. First, many authors view income inequality as one of the most important global economic problems, and these authors connect inequality with savings. Second, high public and household debt or low aggregate savings contribute to account deteriorations, which is implied by the national accounts identity (Ang, 2011). Third, the root causes of large global imbalances coincide with those of the financial crisis. Thus, studies should focus on inter-country differences in the association between inequality and savings to determine how these factors are involved in economic globalization (Sheng, 2010, 2013).

The negative savings rate in the U.S. plays an important role in the development of global imbalances because of the effect of savings on the current U.S. account deficit. The term global imbalances refers to the fundamental imbalance in global payments; a widening U.S. current account deficit is associated with surpluses in a number of countries. According to simple accounting identities, a current account deficit necessarily equals capital inflows to the country. Therefore, a current account deficit equals the negative difference between domestic savings and investments. Hence, global imbalances have often been studied by analyzing savings and investments from both a global and U.S. perspective (Salotti, 2010).

Although inequality is generally increasing in many places, national savings rates have increasingly diverged across countries. This recent phenomenon implies the development of a new association between inequality and savings that merits further study, as the associations directly implicates global imbalances. The association between inequality and savings is negative in most OECD countries but positive in some Asian economies (Mah-Hui & Ee, 2011). Global imbalances can be epitomized by comparing the U.S. and China. Because they are perceived to be major sources of the global imbalances, as their large account imbalances have global impacts, the differences between the U.S. and China are a focal point in this study. This study offers an explanation for the differences in the association between inequality and savings between the U.S. and China.

Finance may play an important role in determining what type of association between inequality and savings prevails in an economy. This study develops a theory that suggests that income inequality is positively associated with the savings rate if savers' funds are allocated to investing firms for production in the financial sector, which occurs in China; however, the theory also suggests that income inequality is negatively associated with the savings rate if savers' funds are lent to spending households via financial intermediation for consumption, which occurs in the U.S. Our theory is based on an extended post-Keynesian model that introduces household leverage because modern credit facilities and lending offers constrained spending via liquidity rather than income. Furthermore, when foreign savings are available at low cost, domestic spending is no longer constrained by national income (Hamouda & Harcourt, 1988). Our extension has a critical impact on our understanding of the association between inequality and savings. The traditional Cambridge approach predicts a positive association because spending is subject to income, but our model accounts for a negative association that is caused by habitual consumer credit use for deficit spending, and there is no need to resort to complicated inter-temporal calculations.

The fundamental change to the Cambridge model is that our extension incorporates the fact that sophisticated finance and marketing services create income illusion as a long-term effect on spending behavior. Individuals in the U.S. can use their credit limits as a way of forecasting incomes; in particular, with access to a large amount of credit for a long period of time, individuals are likely to infer that their lifetime incomes are permanently higher. In this situation, individuals' willingness to use credit for spending is also higher. This income illusion is reinforced by financial globalization and enters into our definition of borrowing households' consumption propensity in the U.S. but not in China. In China, individuals could not previously borrow against future income growth and now only have a limited capacity to do so. Instead, individuals in China must save to make large purchases.

With regard to the income illusion, Kumhof and Ranciere (2010) point out that much of the increased aggregate income in the past three decades was distributed to the top income group, so the group of households with stagnant real wages created political pressure to improve their living standards. Policymakers responded to this pressure by providing easy access to mortgage finance for which these households would not have otherwise qualified. Eased housing financing allowed millions of workers to buy new homes and receive cheap credit for increased consumption through the equity in their homes, the prices of which rose rapidly with the resultant lending boom, which generated a long-held income illusion. Liberalizing loans to workers without addressing inequality itself would only increase household indebtedness and postpone the costs of the inequality problem. Rising inequality leads workers to borrow to maintain their consumption as their real incomes decline relative to those of the wealthy. This cycle leads workers to borrow more as they become increasingly indebted. The trigger for a financial crisis occurs when their leverage begins to be perceived as unsustainable. Because rising household leverage caused by income inequality in the U.S. has been built on housing bubbles, the sudden burst in 2007 led to a negative net worth in household balance sheets. This drastic change led to enormous loan losses that exceeded bank capital reserves, and many banks were forced into insolvency or mergers. The consequence