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The impact of economic openness on standard of living and income inequality in eight countries

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A R T I C L E   I N F O

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A B S T R A C T

Since the late 1980s and early 1990s, many Emerging Market Economies (EMEs) have opened their doors for international capital flows, but sudden capital outflows caused economic recessions in these countries, leaving more people unemployed and raising poverty concerns. On the other hand, foreign capital financed more domestic investment, causing economic expansion and growth; with more job opportunities poverty could be reduced. This paper follows this theory and examines how standards of living and income inequality change across business cycle phases in eight EMEs.

1. Introduction

Improving living standards and fighting against poverty have long been the concerns of all government leaders and international (economic) institutions such as the World Bank. On one hand, the fight against world poverty seemed to be effective if industrialized countries open both current accounts and capital accounts to Emerging Market Economies (EMEs thereafter); on the other hand, the resulting open-market policies seemed to give economic fluctuations in EMEs new characteristics. This paper aims to find how business cycle characteristics changed and how standards of living and poverty were influenced by a major financial liberalization in a few EMEs.

Since the late 1980s and early 1990s, many EMEs have opened their doors to international capital flows, but sudden capital outflows caused economic recessions in these countries, leaving more people unemployed and raising poverty concerns. On the other hand, foreign capital financed more domestic investment, causing economic expansion and growth; with more job opportunities poverty could be reduced. This paper follows the *traditional hypothesis* that economic growth oriented policies such as openness policies argued by

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McKinnon (1973) and Shaw (1973) will enhance economic growth, improve living standards and reduce poverty.

There has been a large amount of literature on the links between economic openness particularly financial development and economic growth including for example, two main arguments by Schumpeter (1911) and Robinson (1952). Schumpeter asserts that innovations provided by the financial sector are key drivers of economic growth. Robinson (1952), on the other hand, argues that "where enterprise leads finance follows", implying that economic growth determines financial development. However, there has not been much research on the links between economic openness and poverty reduction, not to mention that there has not been much research that approaches this topic from a business cycle perspective. Some of them approached it from the microeconomic perspective. For example, Rosenzweig (2003) examines the impact of openness in India in the form of imported agricultural innovation on the wages of the poor and their incentives and ability to obtain formal schooling in the rural area. Others approached the issue from a macroeconomic perspective including Beck et al. (2004), Arestis and Caner (2004, 2009), Tornell and Westermann (2004), Kaminsky and Schmukler (2008), Adam (2011), Haddad et al. (2012), and Lim and McNelis (2014) among others. Beck et al. (2004) assess the relationship between financial development and changes in the distribution of income using data on 52 developing and developed economies with data averaged over the period 1960 to 1999. They also assess the direct relationship between financial development and poverty alleviation using data on 58 developing countries with data over the period 1980 to 2000. They find that "financial development reduces poverty by exerting a disproportionately positive effect on the poor." Arestis and Caner (2004, 2009) conduct an empirical analysis of the relationship between the capital account dimension of financial liberalization and poverty for developing countries for the period 1985–2005. They indicate that "countries with higher institutional quality have lower poverty rates, but that there is no statistically significant relationship between the degree of capital account liberalization during the period and the poverty rate." Tornell and Westermann (2004) show that in developing countries trade liberalization has typically been followed by financial liberalization, which has indeed led to financial fragility and a greater incidence of crises. However, financial liberalization also has led to higher GDP growth. They showed that occasional crises need not forestall growth and may even be a necessary component of a developing country's growth experience. Kaminsky and Schmukler (2008) construct a new comprehensive chronology of financial liberalization and show that a key reason for the inconclusive evidence[1] is that the effects of liberalization are time-varying. Financial liberalization is followed by large booms and busts only in the short run. In the long run institutions improve and financial markets tend to stabilize. Adam (2011) empirically investigates the impact of Ghana's financial openness induced growth on poverty and finds that a positive relationship exists between growth and standard of living but is disproportionate toward the poor. Haddad et al. (2012) present strong evidence pointing to an important role of export diversification in conditioning the effect of trade openness on growth volatility. Indeed, the effect of openness on (growth) volatility is shown to be negative for a significant proportion of countries with relatively diversified export baskets. Lim and McNelis (2014) examine the relationships of the Gini coefficient with trade-openness, aid and foreign direct investment flows. Both their empirical and simulation results suggest that trade and financial openness can be effective policies for reducing inequality in low income countries, provided that the gains from capital are re-distributed. This paper will take part in and examine how standards of living and poverty change before and after financial liberalization in eight EMEs using such simple statistics as correlation coefficient; furthermore, this paper will examine these characteristics across their individual business cycle phases using such nonlinear statistics as the Markov chain. These countries are Argentina, Brazil, Chile, and Mexico from Latin America and India, Indonesia, South Korea (officially called the Republic of Korea) and Thailand from Asia. They are selected from the list of countries studied by Bekaert et al. (2003) and Kaminsky and Schmukler (2008). Tables 1.1, 1.2, and 1.3 show some of the background information including the dates of financial liberalization in the eight EMEs investigated in this paper.

The main results in this paper are, first, post-financial liberalization recessions are rare and often occurred amid currency and financial crises, which aggravate the negative impact of recession on the standard of living and poverty. Second, economic recessions in the United States may have a contagious impact on EME

[1] Many argue that it (financial liberalization) triggers financial bubbles and crises. Others claim that financial liberalization allows markets to function properly and capital to move to its most profitable destination. The empirical evidence on these effects is not robust (Kaminsky and Schmukler, 2008).