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Capital markets integration, growth and income distribution

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Abstract

The paper considers a two-country model of overlapping generation heterogenous economies with intergenerational transfers carried out in the form of bequest and investment in human capital. We examine in competitive equilibrium the transitory and long-run effects of capital markets integration. First, we explore how the regime of public education affects the dynamics of the integrated economy. Second, we study the effects of capital markets integration, in equilibrium, on the intragenerational income distribution in both the host and investing country. © 2002 Elsevier Science B.V. All rights reserved.

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1. Introduction

Although financial markets progressed gradually towards a competitive global industry during the 1980s, the integration of these markets gathered speed during the 1990s. The European Community's single market in financial services and the banking reforms in major advanced countries contributed

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largely to this process. Consequently, gross flows of portfolio and foreign direct investment more than tripled between the mid-1980s and the mid-1990s and the cross-border transactions in bonds and equities currently surpass the value of most advanced countries' GDP (see, e.g., International Monetary Fund (IMF), 1998). Given these facts, and in the light of the recent Asian financial crisis, the study of the effects of free capital movements assumes increasing significance. The main objective of this paper is to examine the dynamic effects of the capital markets integration (CMI) upon:

(a) Aggregate production and its allocation between countries.
(b) The distribution of incomes in the capital-importing and capital-exporting countries.

The framework we shall use to analyze these issues is a two-country overlapping generations (OLG) economies with intergenerational links.[1] There are two main features in our economies: (a) Intergenerational transfers, motivated by altruism between parents and their offspring, exist and are accomplished via transfers of physical capital and investment in educating the younger generation; (b) Heterogeneity of consumers in each generation. The significance of these intergenerational transfers to capital accumulation and growth has been extensively studied in the literature in the last two decades. Let us mention few examples, out of many: Kotlikoff and Summers (1981), Becker and Tomes (1986), Gale and Scholz (1994), Bernheim (1991), Lord and Rangazas (1991) and Horioka et al. (2000). Intergenerational transfers, in their various forms, are among the significant factors affecting inequality in the distribution of income, hence our model includes this feature. The main reason for considering *heterogenous population* is our aim to study the impact of CMI on inequality in distribution of intragenerational income in the "domestic country", from which (by assumption) initially capital flows, and the "foreign country" which enjoys incoming capital. These issues have not been explored in the literature, particularly not in a dynamic framework.[2] As capital integration affects wages and interest rates in different countries in different ways, the relative sizes of investment in education and bequest transfers change differently across countries and across individuals. Equilibrium levels of physical capital, effective labor and output will therefore differ between integrated economies. Heterogeneity results

[1] OLG models have been used to highlight different features of capital markets integration. For example, see Buiter (1981) for the response of international capital movements to country differences in pure rate of time preferences and Yoon (1998) for the bequest accumulation (or reduction) effects caused by capital mobility.

[2] The evolution of human capital and its impact on income distribution has been studied extensively in different contexts (see also Loury, 1981; Galor and Zeira, 1993; Eckstein and Zilcha, 1994; Park, 1996; Fernandez and Rogerson, 1998).