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Journal of International Money and Finance

journal homepage: www.elsevier.com/locate/jimf



Do financial reforms help stabilize inequality?



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ARTICLE INFO

Article history:

Available online 4 June 2016

JEL Classification:

C01

C12

D63

G15

Keywords:

Inequality

Gini coefficient

Financial reform

Unit root

Panel

Fractional integration

ABSTRACT

We explore the relationship between financial reforms and income inequality using a panel of 29 countries in 1975–2005. We extend panel unit root tests to allow for the presence of some financial-reform covariates and further suggest an associated but novel, semi-parametric approach. Results demonstrate that although both gross and net Gini indices follow a unit root process, this picture can change when financial reform indices are accounted for. In particular, while gross Gini coefficients are generally not stabilized by financial reforms, net measures are (more likely to be). Thus financial reforms enacted in the presence of a strong safety net would seem preferable.

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1. Introduction

In recent decades and across many countries, inequality – as measured by the Gini coefficient – has risen (e.g., [Guest and Swift, 2008](#); [Solt, 2009](#)). Over the same period there has been a global push to reform and deregulate the financial sector.

That financial reforms (FRs) and income distribution interaction is straightforward to motivate (e.g., [Kumhof and Ranciere, 2015](#); [Agnello et al., 2012](#); [Claessens and Perotti, 2007](#)). For instance if inequality reflects unequal access to funds by those with poor credit histories or limited collateral, then better functioning, more accessible financial markets might reduce income dispersion. However, if credit flows

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mirror the (typically uneven) distribution of abilities, then financial deepening might exacerbate inequality. Overall, however, the literature has generally taken a positive perspective on the issue (see the seminal studies of Beck et al. (2007) and Demirgüç-Kunt and Levine (2009)).

Our contribution is to re-examine this link – but from a novel and distinct perspective. Using a series of covariance stationarity and long-run memory tests, we analyze the univariate properties of the income inequality index taking into consideration the information contained in the FR measures.

A conventional approach to analyzing the reforms–inequality link might be to test for a common trend. But cointegration does not make sense here. First, cointegration between two or more series requires that, although the variables are non-stationary, a linear combination is stationary. Although the stochastic process that represents inequality may be non-stationary (e.g., in the mean and/or covariance), can we say the same of financial reform dummy variables? If FRs have taken place and are considered unlikely to be implemented again, then these dummy variables are not of that nature.¹ They will take an integer value, say 1, for the specific period(s) during which they were active/implemented. But can one then argue that the proportion of 1's in the sample is an estimator of some underlying probability of the same reforms occurring again at any given future time period? If one cannot make that argument, then linearly combining these dummies with the non-stationary inequality-process will not yield a stationary combination.

Second, and related more intuitively to the first, although FRs will have distributional consequences, it seems unlikely that they were used systematically as an instrument to shape inequality. Yet, if there was an equilibrium relationship between them, this is what we should expect: e.g., inequality rises, policy makers/finance participants respond by promoting FRs, then reversing or stalling them if inequality stops rising. This sequence, however, seems both implausible and counterfactual.² More likely, this global trend toward less regulated finance reflected a mixture of historical happenstance and evolving institutional preferences.³

Our approach instead relies on a literature claiming that when researchers test for a unit root they typically ignore information contained in other key variables (Hansen, 1995). In fact, even aside from the arguments above, our approach is independent of whether cointegration is present or not between the two variables. Methodologically, our approach also has parallels with the literature on panel unit root tests for conditional, β convergence in economic growth (e.g., Barro, 1991, Meligkotsidou et al., 2012).⁴

Accordingly, we ask if, when measures of FRs are incorporated into a unit root Gini regression, might they then lead us to reject the presence of a unit root in inequality? If so, then the information contained in the FR variables affect the power of the unit root test leading to the conclusion that income inequality returns back to its own steady state after a shock occurs (note, not to a common steady-state formed by the covariate and the inequality index, but to its *own* steady state). Indeed, this would be consistent with the 'insurance' objective of financial services; if short-run shocks to inequality persist in the long run, then FRs would not have met that objective.⁵

The paper proceeds as follows. Section 2 discusses the data. The series on international financial reforms are taken from Abiad et al. (2010). The Gini coefficients measuring (gross and net) income

¹ As we discuss below, our non-parametric approach is independent from the hypothesis that the FR variables are endogenous or exogenous.

² In the Abiad et al. (2010) database that we use, for example, FRs were rarely reversed; the amount of significant policy reversals in the sample is put at only 5%.

³ For example, the reduction of financial frictions and obstacles: the breakdown of Bretton Woods, the suspension of dollar-gold convertibility, the establishment of the Eurodollar market, the electoral success of "pro-market" governments, the spontaneous development of financial services etc.

⁴ This idea related to international economic convergence: i.e., poorer countries' per capita incomes will tend to grow at faster rates than richer economies. This implies that all economies should eventually converge in terms of per capita income. This is β convergence as opposed to σ convergence, which refers to a reduction in the dispersion of levels of income across economies.

⁵ Note that this is *not* the same as saying that financial reforms have worsened or improved inequality. FRs – such as widening credit availability – clearly have great potential for giving, for example, low-income agents more productive uses for their savings and human capital. Our interest here is in assessing the traditional insurance role for financial markets. For an analysis of the stationarity and persistence properties of the Gini series using a variety of methodologies, see McAdam and Christopoulos (2016).

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