IMPROVING ECONOMIC POLICY

# Jonathan D. Ostry: Inequality, growth, and globalisation

# Comments by Zsolt Darvas

ECFIN Annual Research Conference 2017

Fostering inclusive growth:

Inequality and fairness in integrated markets

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# Overview

- **Comprehensive presentation** focusing on two issues:
  1. The correlation between income inequality, redistribution and growth
  2. The impact of financial globalisation on growth and income inequality
- **Key conclusions:**
  1. High inequality and low growth are correlated
  2. Redistribution is a pro-growth policy through the greater equality it creates
  3. Financial globalisation does not always create growth, but always creates more inequality
- **Policy suggestions:**
  1. Deploy various policies, including capital controls, to manage capital flows
  2. Financial liberalisation only after greater financial depth and inclusion
  3. Redistribution and financial inclusion can mute the negative impact of financial globalisation on inequality

# Main comments

- Excellent and rich analysis: I agree with many conclusions
- Four questions:

1. Inequality and growth: how robust is the correlation?

2. Has globalisation played a role in the fall of global income inequality?

3. What to do with financial globalisation?

4. Target audience of the paper: EU countries or emerging/developing countries?

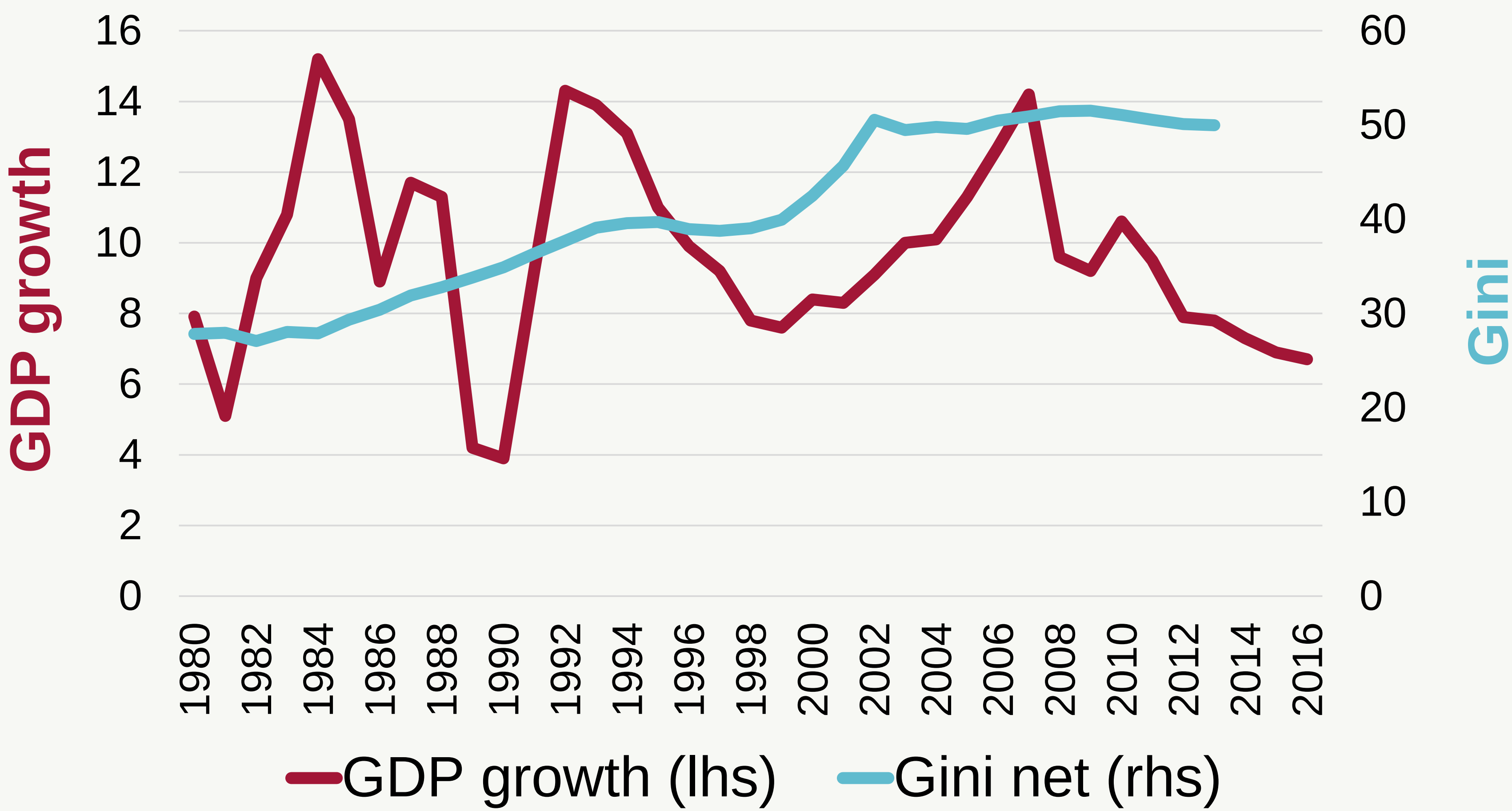
# 1. Inequality and growth: how robust is the correlation?

- The empirical evidence about the impact of inequality on growth is **inconclusive**. So is theory.
- Greater inequality could **reduce** economic growth:
  - by reducing the capacity of low-income households to invest in education
  - under-investment in human capital by poorer segments of society might reduce social mobility and adequate allocation of talent
  - greater inequality might lead to political instability and social unrest
- Greater inequality could **increase** growth:
  - if it provides incentives to work harder and take risks in order to capitalise on high rates of return
  - high return for education might encourage more people to study
  - higher inequality could foster aggregate savings and capital accumulation, because the rich consume relatively less

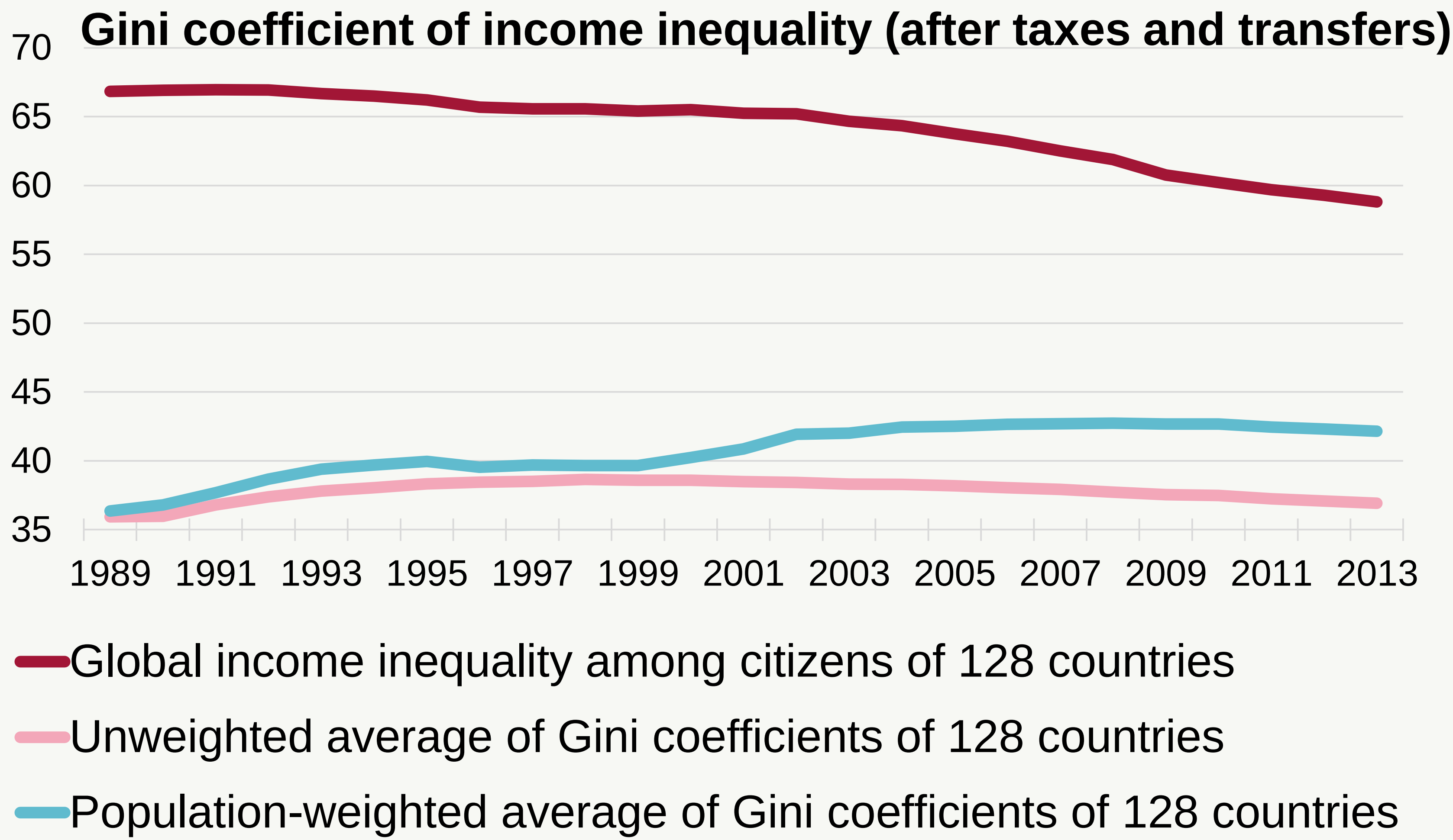
# 1. Inequality and growth: how robust is the correlation? *cont'd*

- **Correlation could be state-dependent**, e.g.:
- **Aghion, Akcigit, Bergeaud, Blundell and Hemous (2015):**
  - Significant **positive** correlation between top income inequality and growth in those US states which are close to the most productive US state ('frontier growth')
  - But **negative** correlation between top income inequality and 'non-frontier growth'
- **Anderson and Maibom (2016):**
  - Trade-off between efficiency and equity only at the frontier of the possible set of combinations of economic performance and income equality, but many countries are below the frontier → these countries can improve both simultaneously
  - Empirical stochastic frontier analysis (for OECD countries) supports these theoretical predictions: **positive** correlation between inequality and growth at the frontier; **negative** correlation below the frontier

# China: growth remained robust and even accelerated with increased income inequality



# 2. Global income inequality fell in the past decades: has globalisation played a role?




*Source: Darvas, Zsolt (2016), 'Some are more equal than others: new estimates of global and regional inequality', Bruegel Working Paper 2016/08*

# 3. What to do with financial globalisation?

- OK, financial globalisation might not always increase growth and excessive capital inflows might cause instability
- One conclusion is clear: do not hurry to liberalise in countries with tight capital controls
- But what about countries with free capital movements? E.g. should the EU change its Treaty and remove free capital mobility form the four economic freedoms?
- What about the distortions that capital controls create?
- Would capital controls ensure financial stability? E.g. China, tight controls, yet massive expansion of shadow banking

# 4. Target audience of the paper?

| | Income inequality (net Gini: after redistribution) | Redistribution (market minus net Gini) | Chinn-Ito financial openness (1: full, 0: zero) | IMF growth forecast, average for 2018-2022 |
|---|---|---|---|---|
| European Union | 30.0 | 19.4 | 0.97 | 1.8% |
| Emerging market and developing economies | 44.1 | 3.8 | 0.32 | 5.0% |

*Note: Gini, redistribution and Chinn-Ito: weighted average for the 28 EU members and 124/128 emerging and developing countries; growth: IMF WEO.*

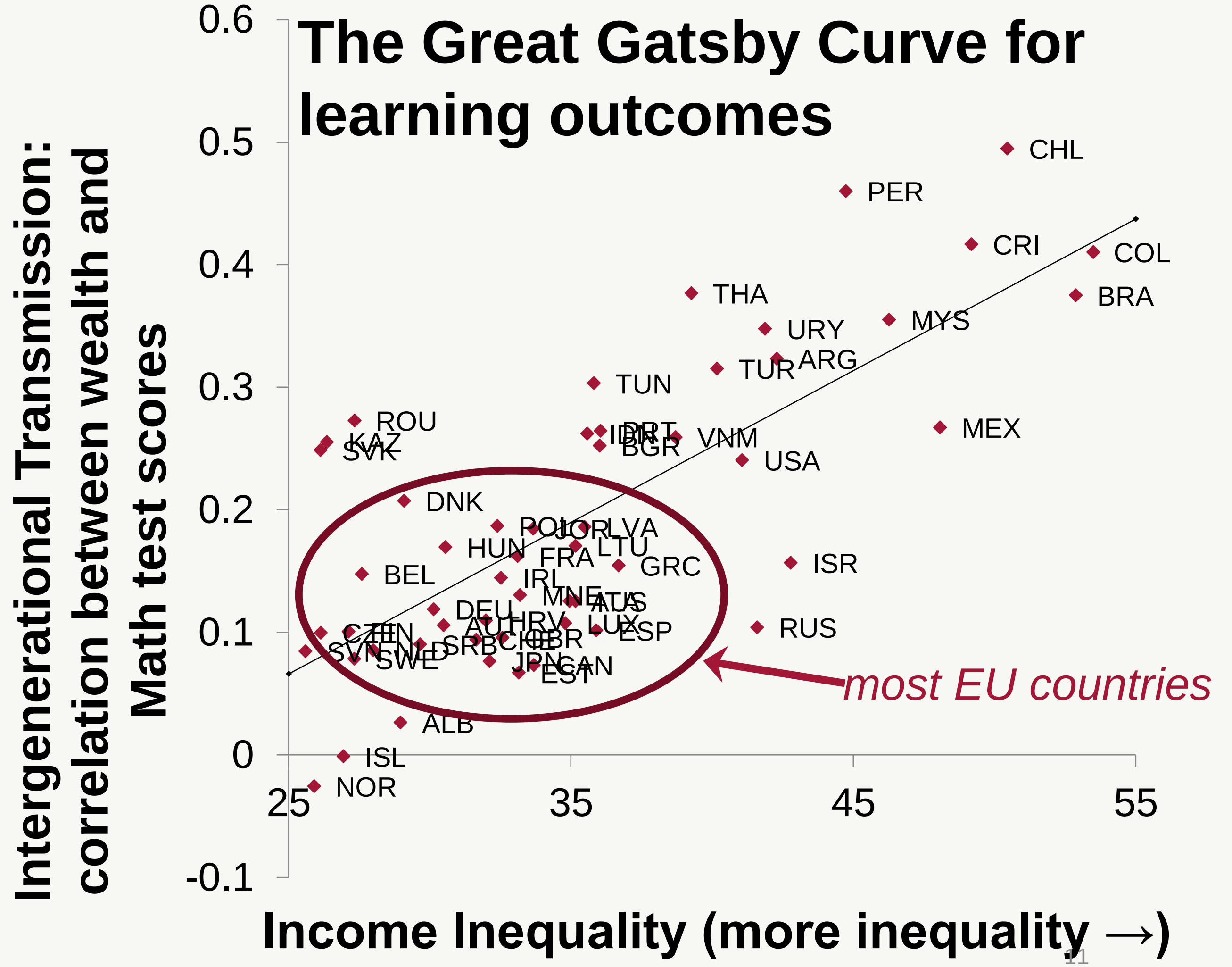
- EU countries: low inequality, high redistribution, almost full openness, low growth
- Emerging/developing countries: high inequality, low redistribution, low openness, high growth

bruegel

# Comments on the two “Myths about inequality” of Marcel Fratzscher

# “Myth 1: Most Western countries have a functioning social market economy that offer opportunities for everyone”

- Who shares this myth?
- Yet EU doing much better than many other countries
- (Of course, could be improved)

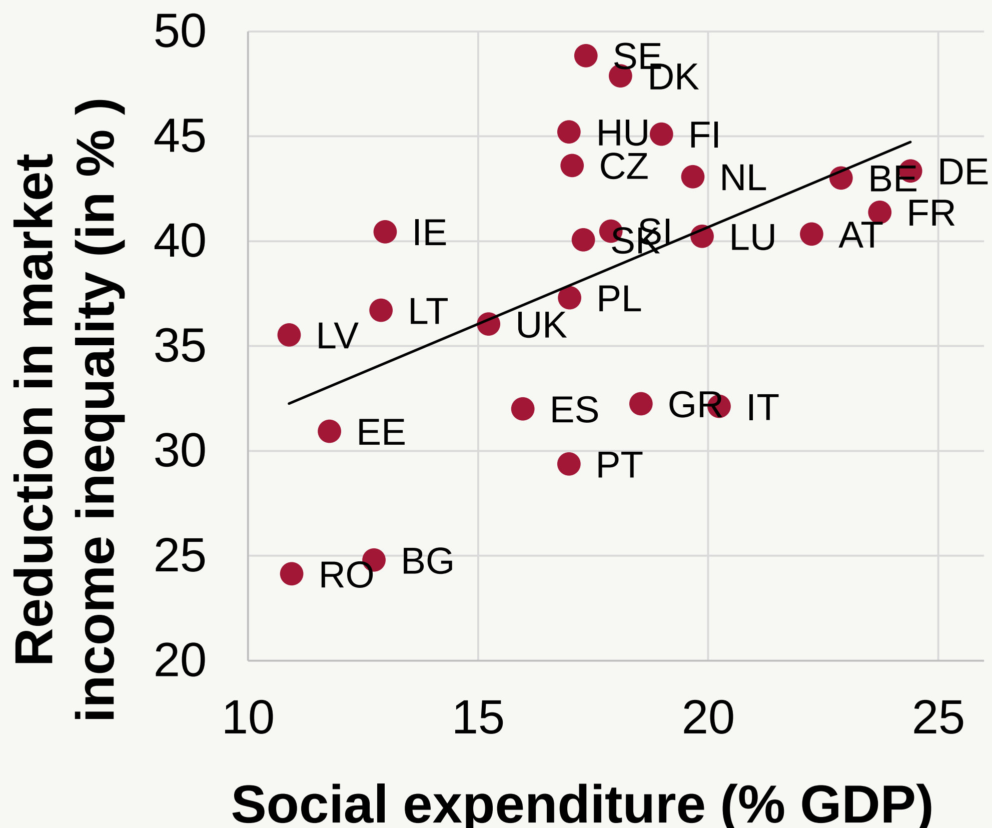



Source: Sandefur (2015)

# "Myth 2: More redistribution through taxes and transfers is necessary and sufficient to reduce inequality."

- Who shares this myth?
- Yet a simple correlation shows that countries with more redistribution tend to achieve a greater reduction in market inequality
- The issue is rather efficiency: countries with the same level of social spending achieve different reductions

**Social expenditure vs income inequality reduction**




Source: Darvas and Wolff (2014)

*Thank you for your attention*