Why does capital flow from equal to unequal countries?

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Venue: Virtual Paris (Wish I was there!)
This Paper

- Examines the correlation between current account balances & the degree of inequality.

- Documents that advanced economies with higher net income Gini coefficients run larger current account deficits.

- Countries with higher income inequality: $S^p$, $S^g$, $I$ low. But $S^p + S^g - I \leq 0$

- In a nutshell: Endogenously incomplete financial markets. Friction: contract enforcement. Higher income risk → deeper financial markets/looser borrowing constraints. HH incentive to repay debt to retain financial market access.

- Lower aggregate savings (driven by $S^p$) implies capital flows from equal to unequal countries. Savers in equal countries lend to borrowers in unequal countries → returns higher.
Does Figure 1 tell us that capital is flowing, on net, bilaterally from equal to unequal countries?

- All countries? Is the Finnish CA surplus the marginal dollar that is closing the US CA imbalance?
- China was accumulating a lot of US$ reserves during this time. Sovereign not private flows.

Figure 1: Relationship between income inequality and the current account balance in advanced economies.
Foreign Holdings of U.S. Securities by Country
Empirics Vs. Theory: Openness Vs. Opening Up

- Cross-sectional data analysis. Theoretical model: Transition from one SS to another as countries open up.

- Red flag: emerging economies —no statistical significance: relationship is absent.

- So what makes this an advanced economy story? Especially when these countries have been open for a long time.

- Financial development? Without bilateral data we don’t know which countries are exporting capital to developed countries with high income inequality.

- Need to use more rich data on bilateral capital flows. Figures hide important granularity. IMF’s CPIS, CDIS. BIS data on banking flows. US TIC data. EPFR fund flow data.
Empirics Vs. Theory: Openness Vs. Opening Up

- "Uphill" capital flow patterns focus on why capital flows from poor to rich countries. Safe assets? Financial development?

- Within vs. across country inequality: Capital flows from unequal emerging markets (Brazil) to unequal developed countries (US).


- Reverse causality? Do capital flows lead to increased inequality? Context of liberalization: income shares of the rich rise, poor fall. (Li & Su, 2020).
Theoretical Mechanism: Krueger & Perri (2006) meets the Open Economy

- (i) Cross-country heterogeneity in income inequality + (ii) differences in financial development → observed pattern of CA deficits/surpluses.

  (i) ⇒ heterogeneity external lending/borrowing pattern. Sure! If poorer households drive the fall in Sp, holding Sg & I constant we expect to see CADs.

  (ii) follows from closed economy model results on borrowing constraints & interest rates (value of HH autarky lower). Add integration dynamics.
    * Low inequality ⇒ Tight borrowing constraints, low $r^A$.

- I am not convinced by the borrowing constraints/full risk-sharing setup. Realistic? Rests on poor HHs in countries w/ high inequality can sustain higher levels of debt/always repay their debts/never optimal to renege. Credit constraints?

- In the data, do levels of financial development vary significantly across developed countries?
Conclusion

- The paper puts forth a provocative hypothesis.

- I suggest tighter link between motivating empirics (cross-sectional analysis) & theoretical model (transition from one SS to another).

- The distinction between opening & openness matters.

- Bilateral/more granular data essential. Even for a few countries.

- Calibration/quantitative exercise to cross-validate theory with data. Move beyond a qualitative treatment.

- Hope suggestions are helpful!