“Income inequality and Current Account Balances”

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Discussion by

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Disclaimer: The views expressed in this discussion do not necessarily coincide with those of Banco de Portugal or the Eurosystem

The paper: Q&A

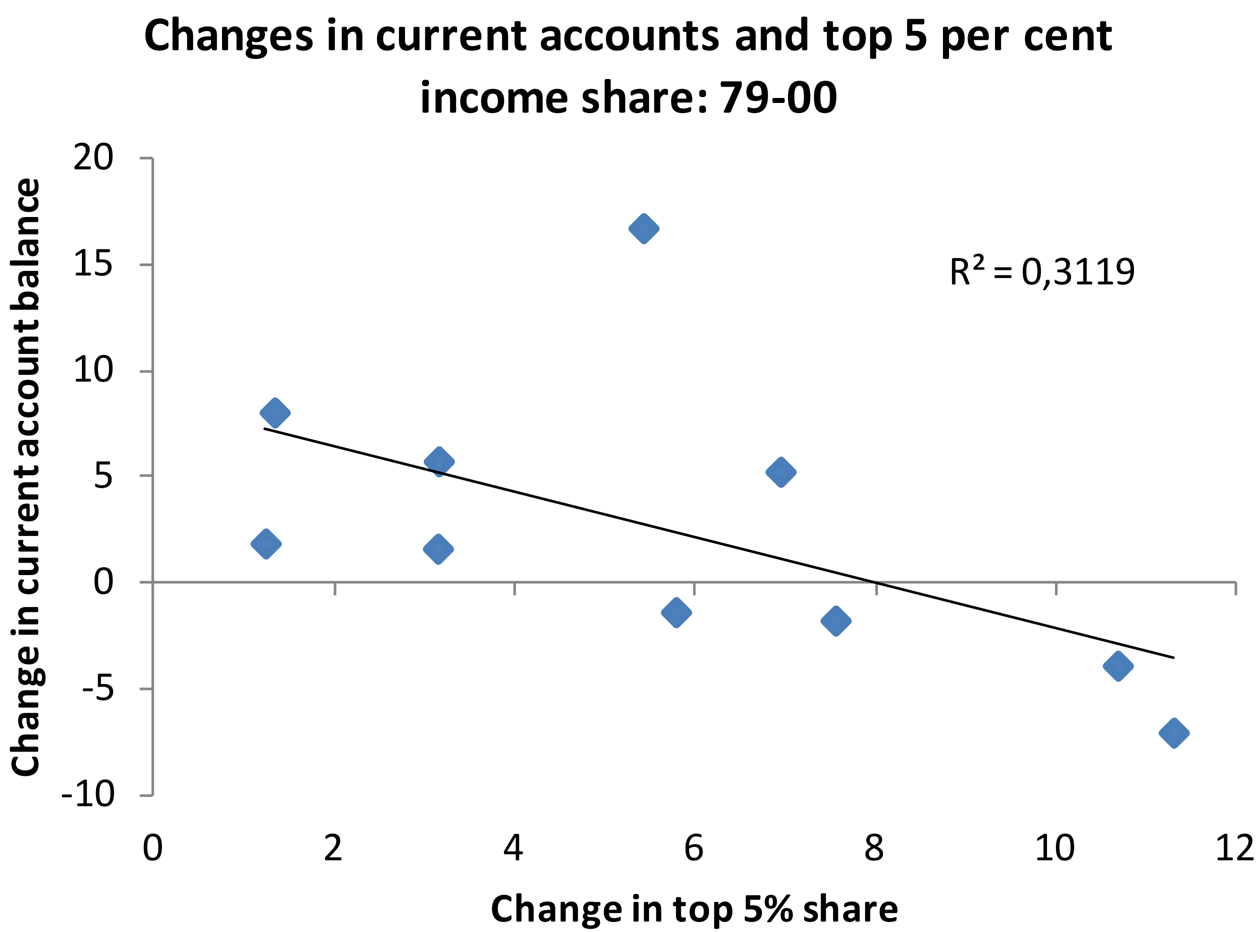
The questions

1. Does an increase in income inequality lead to current account deficits?
2. What are the channels driving this relation?

The answers (in progress)

1. Top income inequality significantly predicts lower current account balances in a cross-section of OECD countries
2. The fundamental source of the inequality shock matters
3. The depth of the financial system matters

The empirical evidence in one chart



Note: The countries displayed in the chart are: SWE, US, UK, FR, PT, NOR, AUS, NZ, CAN and FIN.

Skeptical comments on the empirical evidence

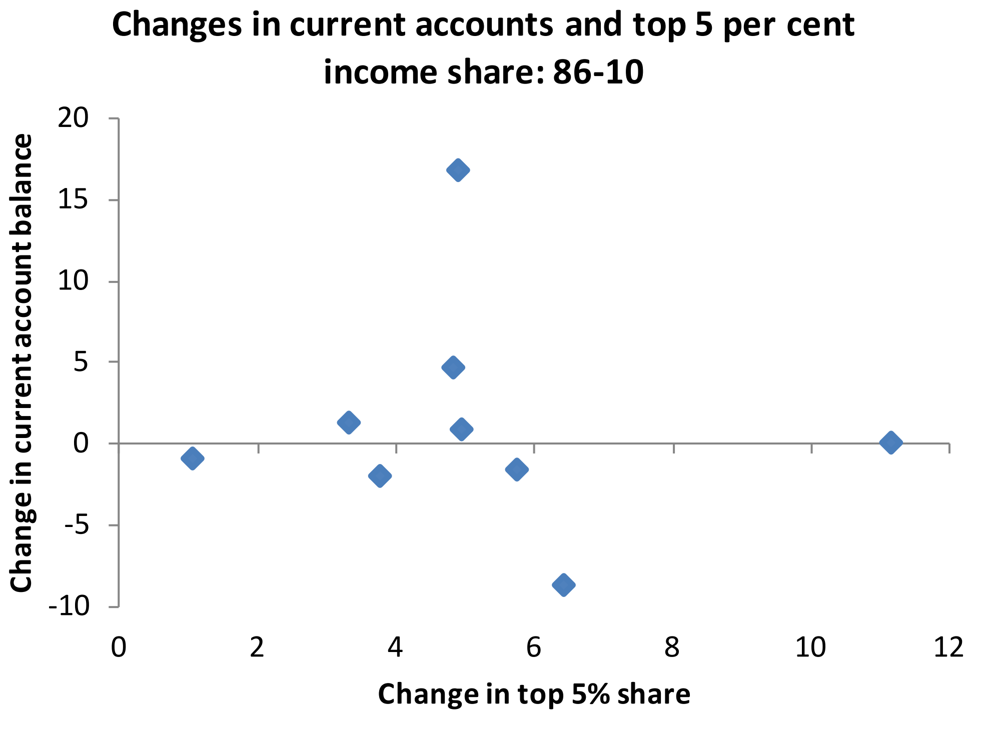
- Top income inequality measures are significant when added to the full IMF's External Balance Assessment
- But, if we assess the evidence for each individual country (instead of the pooled GLS) the conclusions are disappointing

	Coefficient	t-value
SWE	**0,62**	**3,2**
US	**-0,31**	**-10,8**
FIN	0,02	0,1
UK	**-0,25**	**-5,0**
FR	**0,41**	**3,1**
PT	0,07	0,5
NOR	**1,01**	**3,0**
NZ	0,07	0,3
CAN	**0,32**	**3,3**
AUS	**-0,30**	**-2,4**

Sample: 1960-2014
Dependent variable: Current account as a percentage of GDP
Explanatory variable: Top 5% income share

Skeptical comments on the empirical evidence

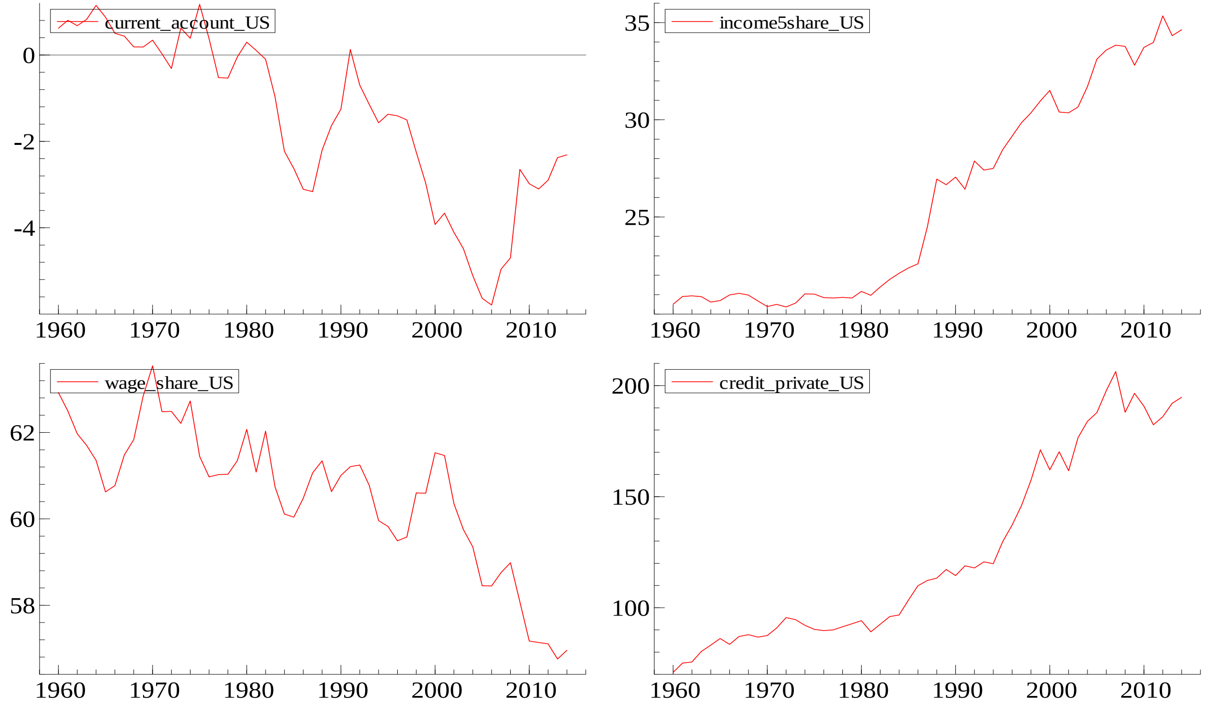
- The conclusions are also not robust across different samples



Note: The countries displayed in the chart are: SWE, US, UK, FR, PT, NOR, AUS, NZ and CAN.

Skeptical comments on the empirical evidence

- Conjecture: The significance of the inequality measure in explaining current accounts may be due to the fact that, in some countries, both variables are I(1).



Skeptical comments on the empirical evidence

- The coefficients would remain valid under cointegration among the variables: however, in the case of the US, a simple cointegration test between the current account and the top 5% income share rejects cointegration at standard levels of significance

- Somewhere in the future the current account balance in the US and in the UK will become balanced again. Do we think that the top income share will also have reverted to past values? Are we asking too much of time-series data?

The theoretical channels in two slides

1. The model:

    - Two countries
    - Each country has two types of households: the top 5% and the bottom 95% in the income distribution
    - They both earn labour income but only the top earn dividends
    - Utility based on consumption and wealth for top earners
    - Dividends are held only by the top earners
    - Both countries start with a balanced net foreign position

The theoretical channels in two slides

2. The shock: a permanent increase in income inequality

    a) This shock implies a persistent increase (decline) in consumption of top earners (bottom 95%) and a permanent increase in desired wealth holdings by top earners
    b) In case inequality increases due to a **shock to dividends**: actual wealth of top earners increases more than desired wealth; top earners consume part of this additional wealth, so they borrow (domestically and abroad): **there is a current account deficit**
    c) In case inequality increases due to a **shock to labour income at the top**: actual wealth increases less than desired wealth; in order to increase their wealth, top earners save and lend (domestically and abroad): **there is a current account surplus**
    d) The larger the domestic financial markets, the stronger the impact on the current account

Preliminary comments on the theoretical model

- The model is currently presented in its bare bones: this is a strength, not a weakness
- Solving the model is far from trivial, in particular because we are dealing with permanent shocks and different steady states
- The mechanisms that are highlighted give us already plenty of food for thought

Preliminary comments on the theoretical model

Four counterfactual issues that emerge when thinking on the US experience through the lenses of the model:

1. According to the model, the original "inequality" shock in the US should be related with an increase in dividends accruing to top earners. Instead, the evidence suggests that inequality in the US in the past decades increased mostly due to labor market outcomes.

2. According to the model, a current account deficit is associated with an increase in borrowing from top earners. But the increased leverage in the US was mostly associated with low-medium income households.

Preliminary comments on the theoretical model

Four counterfactual issues that emerge when thinking on the US experience through the lenses of the model:

3. The model seems to suggests that the income inequality shock is accompanied by an even higher increases in consumption inequality. But the data for the US suggest some smoothing of income inequality shocks.

4. In the model, a current account deficit is associated with a rise in the world interest rate increases. But a gradual decline in real interest rates was observed since the 80s.

Conclusions

- The questions addressed in this paper are very challenging
- Many institutions/incentives/policies are fundamental determinants of current account balances
- The paper has already identified novel channels to think on the link between income inequality and current accounts... and it is still work in progress!
- However, the empirical and theoretical relevance of these channels remain open issues.