

Inequality III

9/24/2008

Today's Agenda

1. Inequality → Income
 - A. Evidence
 - B. Demand composition
 - C. Capital Markets
 - D. Human Capital
2. Financial Crisis & Developing Countries
 - A. Inequality → Growth: Empirical Evidence
 - Use initial inequality as independent variable
 - Alesina & Rodrik (1994) results. (Table 7.3)
 - Historical analyses: Latin America vs. US & Canada
 - Reveals strong negative relationship but what drives this relationship?
 - B. Inequality and demand composition
 - Income determines level and pattern of consumption e.g. share of food falls as income rises
 - Composition of product demand influences distribution of income. Then, is there a role for historical inequalities
 - Example
 - C. Inequality, capital markets, and development
 - Problem of collateral: credit markets might be shut down for individuals who have relatively small amounts of collateral
 - Collateral increases credibility as borrower because bank knows benefit of repayment exceeds benefit of default
 - Example

- D. Inequality and development: Human capital
- More unequal distribution of income leads to lower human capital accumulation (thus lower income growth)
 - Marginal products of physical and human capital (in an individual context)
 - Effect of inequality on accumulation of human capital

2. Financial Crisis and Development

http://blogs.cgdev.org/globaldevelopment/2008/09/us_financial_crisis_will_mean.php

Global Development: Views from the Center

[« Weekly Development Policy News | Main | Poor in Developing Countries are Victims of Our Mistakes \(Development Impacts of Financial Crisis\) »](#)

September 22, 2008

U.S. Financial Crisis Will Mean Slower Growth, Rising Inequality in Developing World (Development Impacts of Financial Crisis)

For many developing countries, the U.S. credit crisis will mean slower growth and rising inequality. The effects will be protracted, and not all will show up at the same time. And the nature and degree of impact will vary widely. Some countries, notably those with extensive foreign exchange reserves and strong fiscal positions, will be much better able to cope than others. But overall the crisis is very bad news for developing countries and especially for the poor.

During the first stage, impacts will be felt through two channels. First, lower growth in the industrial countries will mean less demand for developing countries' exports, both manufactured goods and most commodities (gold will be a notable exception). A few

developing countries are growing based on domestic demand but many are growing based on exports, and for them sagging rich-world demand will be a problem.

The second channel will be a reduction in capital inflows to developing countries. Because the U.S. crisis has created a global credit crunch, investors are becoming more risk averse and thus less willing to invest in developing countries. As uncertainty and risk have increased in international capital markets, investors will continue to shift the composition of their portfolios, away from riskier assets, such as emerging markets securities, and into traditional stores of value, such as U.S. treasury bonds and gold.

Countries with strong reserve accumulations and solid fiscal positions will be better able to cope. In the past many developing countries faced financial crises of their own when they were unable to roll over maturing debt and also unable to pay it off. This time many countries have substantial reserves -- and I'm not just talking about China. Some countries in Latin America have ample reserves, too.

Most at risk are countries that have deteriorating current account balances and fiscal problems. Possible examples include several Eastern European countries, Turkey, Argentina, maybe even Brazil. Mexico is susceptible because of its close ties to the U.S., and Russia also is potentially in trouble. Of course, the numbers are still evolving and it's too early to be picking winners or losers with any confidence.

But even for countries with adequate reserves and strong macroeconomic performance, the global credit crunch will impose a cost. The combination of less export demand and perceived higher-risk for investors means that developing country governments and businesses needing access to capital will face higher interest rates, both externally and locally. Higher interest rates and less willingness to lend make it harder for middle class and poor people to borrow. Moreover, developing countries will need to cut fiscal expenditures to deal with reduced sources of revenue and finance. History shows that when fiscal expenditures are cut, social programs and infrastructure projects that help the poor are especially vulnerable to being curtailed.

Thus, the result will be increased poverty and inequality.

All of that is just the first stage. How the second stage develops is going to depend on the depth of the crisis and the cost of resolving it. In addition to the public costs associated with the de facto nationalization of Fannie Mae and Freddie Mac, the latest U.S. government proposal involves creating a new entity, something like the Resolution Trust Corp. that was created to deal with failed Savings and Loans (S&Ls) in the 1980s. But at this point we don't know the size of the assets that this new entity will be absorbing, and we have no way to know the amount of public money that will be put at risk. What we do know is that the U.S. fiscal deficit will soar; but nobody knows by how much. This uncertainty can itself be a problem if it undermines confidence in the dollar, and if the U.S. government then responds by raising interest rates, to defend the dollar.

Developing countries know well the problems that can come from high U.S. interest rates. A number of previous crises were triggered when significant increases in U.S. interest rates reversed capital inflows to developing countries, exposing macroeconomic fragilities in these countries. At this time, we don't know for sure if this will happen, but if it does, for developing countries already weakened during stage one, that is, suffering from reduced export demand and capital flows, high U.S. interest rates could be like getting hit with a double whammy.

Facing high interest rates, governments in the developing world would have to adjust their fiscal position again! That is, raise taxes or cut expenditures, beyond what was needed during the first stage. And poor people get hit a second time, as the most likely expenditure cuts are those directly directed to the poor.

For all these reasons, the dip in growth rates that accompanies a crisis such as the current U.S. financial crisis is extremely worrying. In the long run, growth may rebound, but during the dip many people may lose their jobs and the real value of their wealth. There are huge distributional effects. The rich can minimize the impact of the crisis because they are able to diversify their portfolios and even move funds abroad as needed. Who pays for all this? The middle class -- some of whom slip into poverty -- and the already poor. In Latin America in the 80s and 90s the sharp reduction in the size of the middle class due to various financial crises has had important political effects, leading directly to the rise of leftist regimes that are opposed to the U.S.

Fortunately, many developing countries not only have reserves, they also have more and better policy tools for responding to external shocks, including flexible exchange rates in a number of cases. How well they are able to cope with the fallout from the crisis unfolding in Washington and New York is hard to predict. In the past, developing countries were not well prepared to cope with such shocks. This time countries are better prepared but the shock is also much larger. So the impact on the developing world will depend a great deal on the magnitude of the crisis resolution in the United States.

More Development Impacts of Financial Crisis Blog Posts

- [Poor in Developing Countries are Victims of Our Mistakes](#) by Nancy Birdsall
- [Thoughts on the Financial Crisis and the Other Kind of Contagion](#) by Ruth Levine
- [If Foreign Aid Contracts, AIDS Treatment Jobs are a Safe Bet](#) by Mead Over
- [Middle Income and Emerging Markets May Be Most at Risk](#) by Rachel Nugent
- [Crisis? Not If We Take a Long View](#) by Michael Clemens
- [Microfinance Likely to Weather the Storm](#) by David Roodman
- [Crisis a Set Back for Accountability and Good Governance in Developing World](#) by Vijaya Ramachandran
- [In the Long Run We Are All Dead, But in the Meantime, Financial Crises Take a Heavy Toll](#) by Nora C. Lustig
- [Poor People Will Get Hurt And Confidence in the Market Will Fall](#) by Peter Timmer

