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The Distributional Effects of Financial and Trade Integration: The Role of Misallocation

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Findings in the literature generally suggest that the effect of financial integration on income inequality depends on countries' level of both economic and financial development: while financial depth (one of the most commonly used measures of financial development) tends to undermine the inequality-reducing effect of financial liberalization (the key indicator of financial integration) in developing countries, it is found to mitigate the inequality-increasing effect of financial liberalization in developed countries. Some recent studies, however, challenge these findings of the moderating role of financial development in the financial liberalization–income inequality nexus, documenting instead that financial depth magnifies the inequality-raising effect of financial liberalization. These conflicting results of research suggest that financial depth, which is typically measured as the ratio of private domestic credit to GDP, may not be as important for economic and welfare outcomes as the ability of the financial system to allocate resources efficiently. Recent studies finding a nonlinear or inverted U-shape relationship between finance and growth also hint at this direction. Research on the distributional effects of international trade has also produced conflicting results: while some studies find that trade reduces income inequality, others find that trade has zero or positive effect on inequality. Still other studies conclude that the effect of trade on income inequality depends on country characteristics such as the factor content of trade, national income level, or the type of political regime.

While the distributional effects of both financial and trade integration is most probably conditional on economic and institutional factors, a common corollary of these factors seems to be the level of allocative efficiency, or misallocation, stemming from different statutory and discretionary provisions and market imperfections associated with those factors. Hence, we ask the question: can the effect of financial and trade integration on income inequality depend on within-country allocative efficiency? Whereas financial and trade integration may change average incomes in an economy, the existing patterns of resource allocation, or misallocation, can determine which groups in the country gain—and which groups lose—from this economic integration, hence affecting the distribution of incomes and wealth in the economy. In other words, we hypothesize that the cross-country heterogeneity in existing misallocation—reflecting distortions and market imperfections that prevent efficient allocation of resources—also

determines whether countries experience a rise or fall in income inequality of its residents after integrating into global financial and trade relations.

Using data from the Standardized World Income Inequality Database (SWIID), the World Inequality Database (WID.world), the Competitiveness Research Network (CompNet) database, the KOF Globalisation Index and the World Bank for a sample of European countries, we find that the effects of financial and trade globalization on income distribution are conditional on the level of misallocation prevailing within countries. We show empirically that misallocation determines the magnitude and direction of the effects of financial and trade globalization on income inequality. In case of an efficient allocation of resources within a country, financial integration seems to have no significant effect on and trade reduces income inequality. As misallocation increases, however, financial integration starts to reduce income inequality, while the inequality-reducing effect of trade disappears and is even reversed at a certain point. We find, for example, that when the level of allocative efficiency changes from the highest to the lowest in our sample, an increase in the trade-to-GDP ratio by as much as 1.2-1.3 percentage points is enough to completely negate the inequality-reducing effect of trade, where trade starts affecting income inequality positively.

These findings suggest that whenever we discuss the distributional effects of globalization, we should acknowledge the fact that these effects are most probably conditional on existing country-specific and time-specific distortions and market imperfections that manifest themselves in differences in resource misallocation. This implies that policymakers should take both the differences in country-specific distortions and imperfections and the differences in the effects of financial and trade integration into consideration when designing policy measures addressing the distributional consequences of globalization.