Inequality and Financial Fragility

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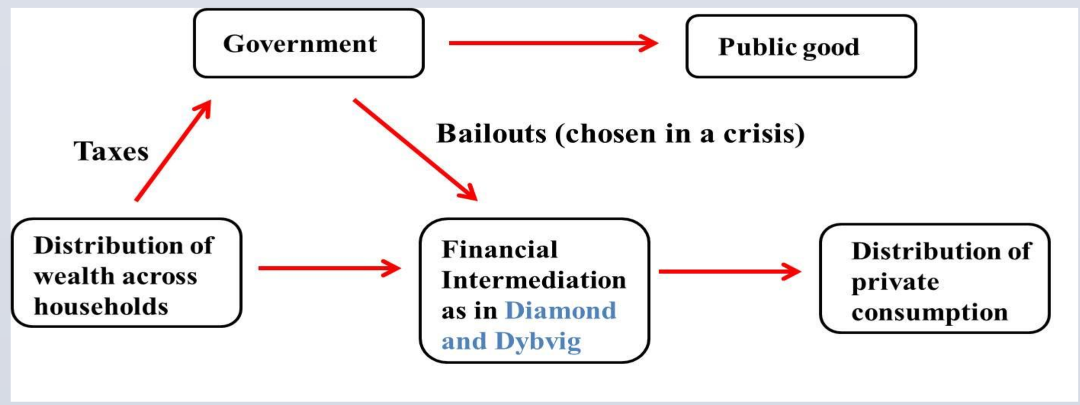
Summary

- How does the distribution of wealth influence financial fragility?
- Guarantees made by a utilitarian government will be credible for relatively poor individuals, but may not be for wealthier investors
  - Wealthier investors have a stronger incentive to panic in a crisis
- Panics and bailouts will tend to be concentrated among institutions catering to wealthy investors.
- Distribution of wealth affects the size of the fragile component of the financial system
  - Redistribution policies should take this effect into account

The model

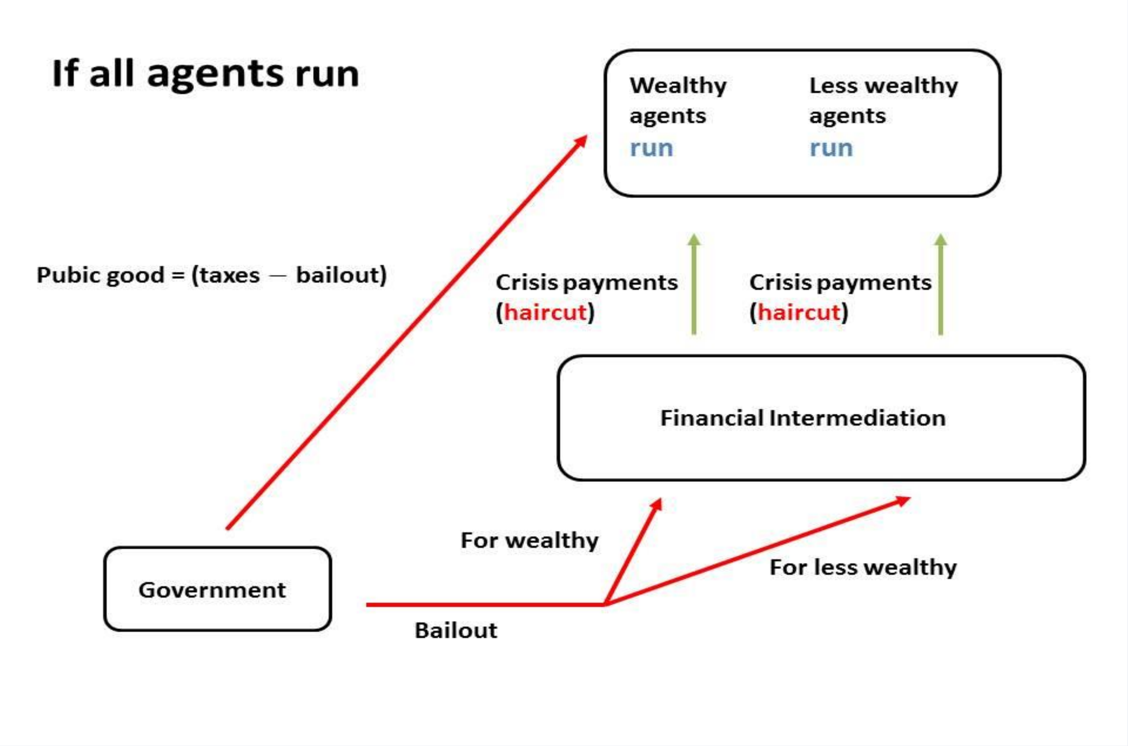
- Model of financial intermediation based on Diamond and Dybvig (1983)
  - Add wealth inequality across agents
  - Add govt.using tax revenue to provide a public good
- In a financial crisis, tax revenue is distributed between public good and bailouts to banks



- Wealth distribution is central in shaping the policy response during a banking crisis and the nature of financial fragility
- If govt. could commit to bail-out banks experiencing runs – crises will be averted. (Deposit insurance)
- But, govt. lacks commitment → any bailouts chosen ex-post once the crisis is underway.

Policy responses in a banking crisis

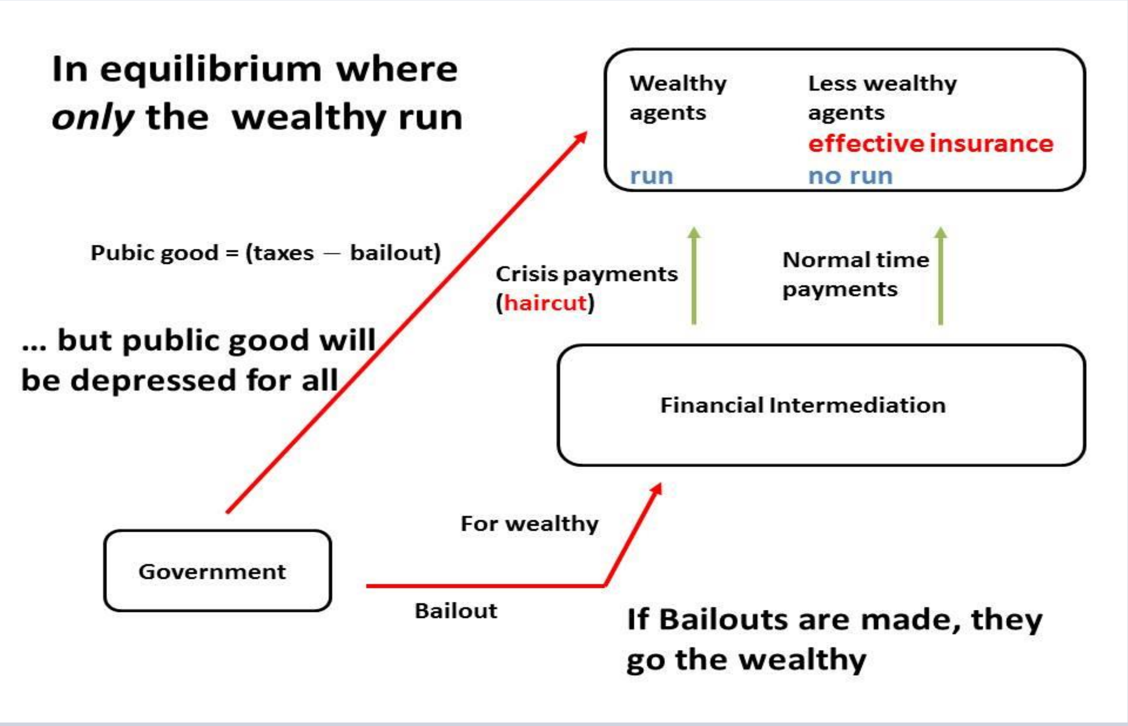
- The ex-post bailout response of the govt. assigns higher priority on low-wealth agents



- Low-wealth agents anticipate larger bailout → smaller losses, which makes them less prone to run.
- Runs may end up being **off-equilibrium** for the low-wealth agents.
- High-wealth agents anticipate smaller bailout → larger losses, which makes them more prone to run.

Equilibrium runs

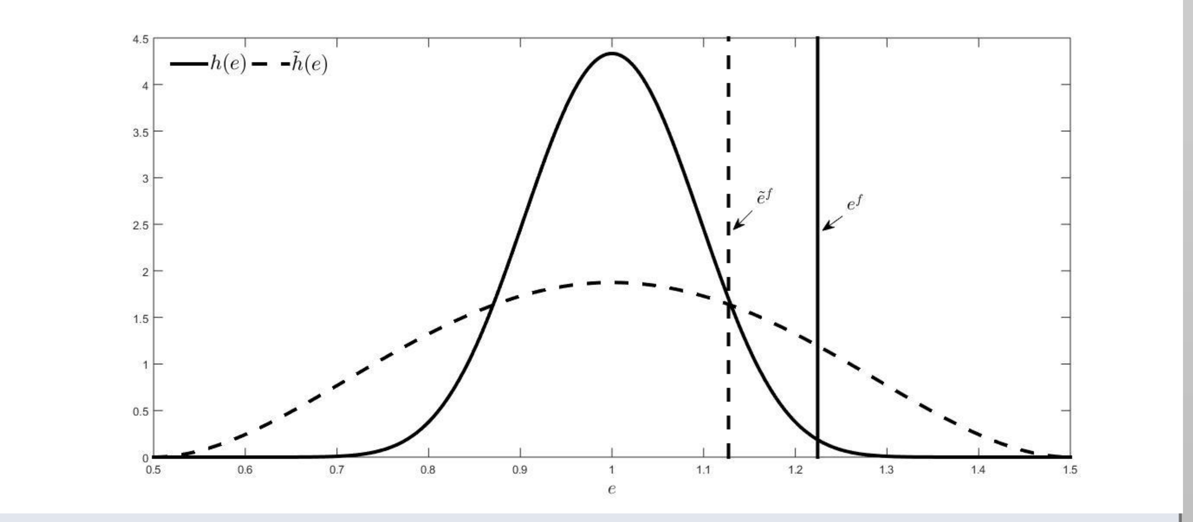
- If inequality is large, equilibrium runs restricted only to high-wealth agents.
- Bailouts (if any) target high-wealth agents and their institutions
  - even though, by construction, govt. is utilitarian



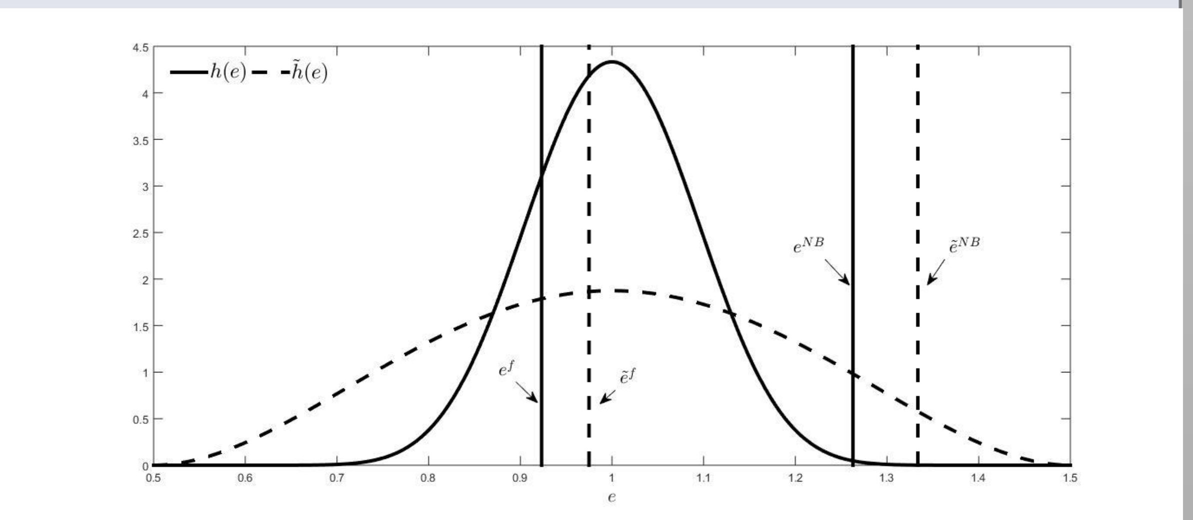
How the distribution of wealth affects fragility

- With bailouts, there is a cutoff e^f such that the economy is fragile for agents with wealth e if and only if $e > e^f$.
  - Without bailouts, all agents are equally fragile.
- Higher inequality can either increase or decrease fragility depending on whether more agents are pulled above or below e^f.

Case 1: More inequality leads to more fragility

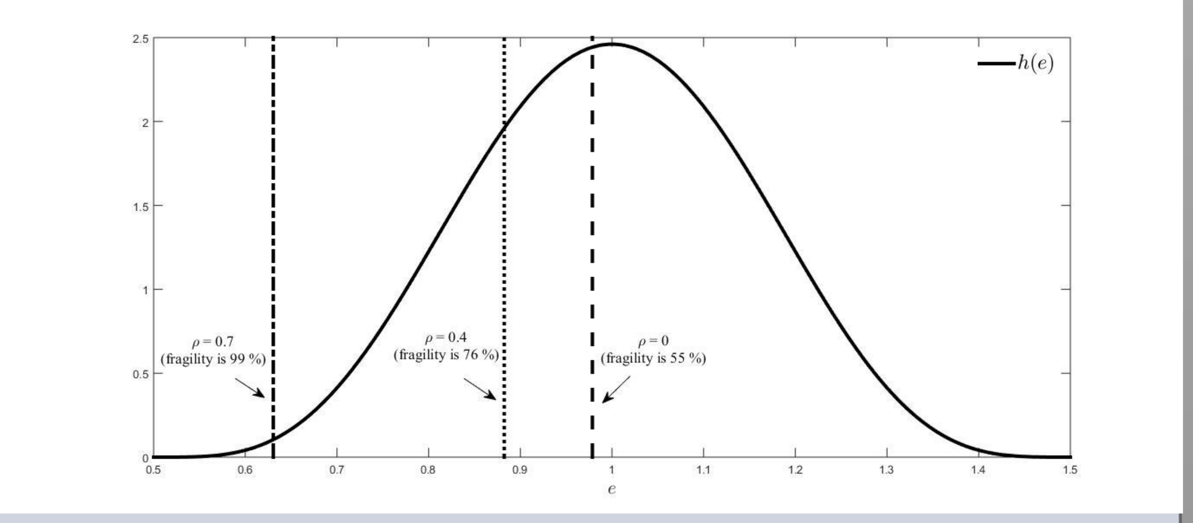


Case 2: More inequality leads to less fragility



Ex-ante redistribution and fragility

- A utilitarian policy maker will not necessarily choose to fully redistribute even when the standard costs of redistribution are completely absent.



- This occurs when progressive taxation pulls more agents above e^f and leads to fragility cost.

Financial crises and distributional concerns

- Renewed interest in the link between inequality and policy responses (Wall Street vs. Main Street).

The Paulson plan will buy toxic assets at inflated prices thereby creating a charitable institution that provides welfare to the rich at the taxpayers' expense. If this subsidy is large enough, it will succeed in stopping the crisis. But, again, at what price? (**Luigi Zingales, 2008**).

- Existing bank run models: inequality is either absent or largely irrelevant.
- I present a model of financial intermediation where distributional issues are central
  - Govt. is utilitarian, but lacks commitment
- The lack of commitment assumption fits recent events:
  - Govt. guarantees often are renegotiated (Iceland, Cypriot, others).
  - Resulting in ad-hoc and highly selective responses.
  - Based on political rather than legal considerations.

Main results

- If there are no bailouts, the distribution of wealth has no effect of fragility
- With bailouts, this distribution matters
  - financial panics will tend to be concentrated among wealthy investors and their institutions
  - bailouts will tend to benefit the wealthy
- Rising equality can make either raise or lower financial fragility
  - depends on the current distribution of wealth
- Redistribution policies should take these effects into account