THE WELFARE GAINS OF FINANCIAL LIBERALIZATION: CAPITAL ACCUMULATION AND HETEROGENEITY

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Abstract
Without any individual heterogeneity and under complete markets, the welfare impact of financial openness is quantitatively limited (c.f. Gourinchas and Jeanne, 2006). Not only are inequalities in wealth and in labor productivity a feature of most societies, but financial markets also suffer from many well-known frictions. This article shows that when households face uninsurable idiosyncratic risks on income and borrowing constraints, the welfare implications of financial liberalization are considerable. For instance, the average increase in welfare of a typical emerging market economy that switches from a closed capital market to perfect capital mobility would be equivalent to a permanent increase in average consumption of roughly 5.4%. This is about 3.9 times larger than the welfare gains of the same policy under the complete markets environment without any individual heterogeneity. Individual heterogeneity accounts for 2/3 of this additional increase in the average welfare gain, while market incompleteness accounts for the remaining 1/3. In our calibration, the median household in capital-scarce countries is in favor of international financial integration, but if the pivotal voter is wealthy enough, such reform might not be implemented, since richer households have a vested interest on capital market closeness. (JEL: E21, E60, F40)