FINANCIAL GLOBALISATION VERSUS INCOME INEQUALITY: The surprising role of foreign portfolio flows in taming the top 1%

Financial globalisation related to foreign direct investment is widely seen as raising income inequality, but new research documents a surprising finding: large swings of capital flows delegated through the global mutual fund industry could in fact reduce the income of the top 1%. The study by **Si Cheng**, **Massimo Massa** and **Hong Zhang** will be presented at the annual congress of the European Economic Association in Manchester in August 2019.

The new finding emerged from the authors' attempt to fill perceived gaps in existing research on how financial globalisation influences income inequality: the question of whether the impact of foreign indirect investment might differ from that of foreign direct investment; and potential spurious correlation of financial globalisation measured at country-level with other country characteristics affecting income distribution.

By linking large waves of delegated portfolio flows – in particular those triggered by fire sales and fire purchases – to measures of inequality from the World Wealth and Income Database, the study finds the two to be negatively related.

Differentiating flow shocks by countries of origin shows that the mitigating effect comes mainly from capital flows of foreign funds. Since fire sales and fire purchases of a foreign fund tend to be exogenous to the economic conditions of the investing country, such a finding suggests that financial globalisation in terms of delegated portfolio flows might reduce inequality.

To investigate this finding, the authors construct a dataset of worldwide ownership of both public and private firms for the 2001 to 2013 period, merging ownership information with detailed accounting data so as to be able to measure inequality as the fraction of sales revenues accrued to rich families in each country or industry.

This measure of income inequality understands macro inequality as having micro foundations rooted at the firm level – wealth concentrated in a small group of rich persons is driven directly and indirectly by the sales revenues of companies they own, that is, cash flow inequality.

With this novel dataset and measure of income inequality, the researchers' empirical analysis first confirms that delegated portfolio shocks in general and foreign delegated portfolio shocks in particular are negatively related to cash flow rights inequality.

In order to pin down the economic mechanism, the study shows that large swings of portfolio flows and especially foreign portfolio flows significantly reduce the allocation efficiency, suggesting that the industries sold by ultimate owners subsequently outperform their holding ones. In addition, lower allocation efficiency (induced by large inflow shocks) leads to lower cash flow rights inequality.

The authors find that a one-standard-deviation increase in foreign flow shocks transforms into an 11% standard-deviation reduction in inequality through this 'asset misallocation' channel. They further show that only strategic trades involving transfer of controlling ownership in a particular industry affect inequality but not marginal trades. In addition, ultimate owners tend to sell their core assets to foreign institutions, suggesting that diversification plays an important role in rich families' strategic trades.

The study then goes on to investigate alternative mechanisms such as corporate governance, taxation, labour market conditions, technology shocks, education, financial development and liquidity, but finds that these do not generate or explain the observed phenomenon.

These results have important normative implications, the authors say. They suggest that unlike in the case of technology shocks or foreign direct investment, the delegated portfolio investment in global financial market could mitigate income inequality. Foreign portfolio flows induce local ultimate owners to rebalance their assets and benefit from diversification, which could have some unintended consequences because rich families tend to sell industries that can subsequently outperform their holding ones.

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