

Robin Hood in a Financially Open Economy: Does Globalization Escalate Social Conflict ?

Hideaki Murase
(Nagoya City University)

Abstract

Recently, a lot of political groups have expressed strong protests against “financial globalization” through street battles and demonstrations. These anti-globalization activists argue that international capital flow is one of the major sources of increased economic turmoil and social unrest in developing countries; thus capital movements should be restricted. However, their argument sharply contrasts with the standard economics prediction that liberalization leads to more efficient world capital allocation and must be beneficial. Should international financial liberalization benefit developing countries? This paper studies the effects of international financial liberalization on domestic distributive conflict under aristocratic political regimes. In the model, redistributive policy is strategically determined by rich capitalists to prevent distributive conflict with poor workers. We examine how the incentive for the rich to redistribute is affected by liberalization. It is shown that the incentive crucially depends on the direction of capital flows: with capital outflows the rich redistribute less, and vice versa. However, the direction of capital flows itself is determined by the level of distributive conflict or political risk, and the level of conflict is in turn determined by redistributive policy. Then, there may be a feedback loop between the level of redistribution and the direction of capital flows, which leads to the possibility of multiple equilibria: one equilibrium is characterized by a high political risk, capital outflows, and a low level of redistribution, while another is characterized by the opposite features. The access to international financial markets may benefit aristocratic countries but need not, since the rich may find it more profitable to engage in capital flight than to resolve conflict. Further, the equilibrium multiplicity may explain: why aristocratic open economies are unstable in the sense that small shocks to expectations (sunspots) and to fundamentals can generate large capital flow reversals; why some aristocratic governments are egalitarian (like Asian developmental dictatorships), but others are not. It is also shown that the democratization of political regimes can eliminate a bad equilibrium with conflict and capital flight, i.e., it can restore the standard economics prediction.

Keywords: Financial liberalization; Distributive conflict; Political risk; Redistributive policy; Aristocracy; Self-fulfilling expectations; Multiple equilibria; Capital flow reversal; Democratization

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