

ABSTRACT

Globalization has become the centre of attention for the last three decades. One of its form is Capital account liberalization which we can simply observe from the declining number of restrictions among countries for cross-border financial transaction, and the increasing level of capital flow between countries. On the other side, income inequality seems to corresponds with the increase of capital account liberalization. Prasad & Rajan (2008) stated that a country needs a good institutional quality to be able to utilize the benefits of capital account liberalization rather than the risks it has. Almost a decade after, Bumann & Lensink (2016) finds that a country needs at least 25% of financial depth as a threshold variable to successfully exploit capital account liberalization benefits. This research aims to study whether income inequality corresponds to the increase of capital account liberalization in 28 Europe countries. Furthermore, this research seeks to understand the role of institutional quality and financial depth as threshold variables. By employing System GMM Estimator, this study finds that capital account liberalization has a positive correlation to income inequality, even after the interaction of capital account liberalization and financial depth. Conversely, the interaction of capital account liberalization and institutional quality yields negative correlation to income inequality level. These findings emphasize the urgency for policy authority to consider institutional quality before or during the implementation of capital account liberalization.

Keywords: *capital account liberalization, financial depth, GMM Estimator, income inequality, institutional quality, threshold.*

