Annotated Bibliography: Formal and Informal Financial Institutions


This paper considers a model of growth and income distribution in the presence of imperfect capital markets. Moral hazard on the part of borrowers is the source of both capital market imperfections and the emergence of persistent income inequalities. This model generates a Kuznets curve: in early phases of growth inequalities increase but in later stages they decrease. When the rate of capital accumulation is high enough the economy converges to a unique steady state with a unique invariant income distribution.


This paper derives consumption and investment equations from a common core theory with both risk and productive activities. This specification is empirically tested using both OLS and IV estimation. The authors seek to quantify the consumption and investment smoothing impact of financial institutions on households including those running farms and small businesses. They show that a government development bank and commercial banks are particularly helpful in smoothing consumption and investment. Findings also suggest that the informal sector seems most helpful in investment, not consumption. Production credit groups, a type of village-level fund, and agricultural cooperatives do not have statistically significant impact.


This paper uses the Panel Study of Income Dynamics to test whether risk-sharing is complete between or within families in the U.S. The authors generate tests to accommodate wide variety in the configuration and availability of family data. The results of these exercises reject inter- as well as intra-family full risk-sharing even assuming that leisure is endogenous or that leisure and consumption are non-separable.


This paper develops a model of informal risk-sharing in social networks, where relationships between individuals can be used as social collateral to enforce insurance payments. The authors show two results. First, the degree of informal insurance is governed by the expansiveness of the
network. For example, two-dimensional networks, where people have connections in multiple directions, are sufficiently expansive to allow very good risk-sharing. Second, in second-best arrangements, agents organize in endogenous “risk-sharing islands” in the network, where shocks are shared fully within, but imperfectly across islands. As a result, network based risk-sharing is local: socially closer agents insure each other more.


The purpose of this paper is to study the spillover effects that cash transfers cause in a community. Cash transfers to eligible households indirectly increase the consumption of ineligible households living in the same villages. This effect operates through insurance and credit markets: ineligible households benefit from the transfers by receiving more gifts and loans and by reducing their savings. Thus, the transfers benefit the local economy at large; looking only at the effect on the treated underestimates their impact. This article analyzes the effects of this class of programs on the entire local economy, rather than on the treated only, and uses a village-level randomization, rather than selecting treatment and control subjects from the same community.


This paper analyzes how relative wage movements among birth cohorts and education groups affected the distribution of household consumption and economic welfare. The empirical work draws on the various available cross-sectional data sets to construct synthetic panel data on U.S. consumption, labor supply, and wages during the 1980s. The authors find that low-frequency movements in the cohort-education structure of pretax hourly wages among men drove large changes in the distribution of household consumption. According to them, these results constitute a spectacular failure of between-group consumption insurance. Finally, the authors perform a welfare analysis, which indicates that the cost of between-group consumption variability is larger than the cost of aggregate consumption variability by two orders of magnitude.


This article models economic development as a process of institutional transformation by focusing on the interplay between agents' occupational decisions and the distribution of wealth. Because of capital market imperfections, poor agents choose working for a wage over self-employment, and wealthy agents become entrepreneurs who monitor workers. If inequality is sufficiently high, there will be trade in employment contracts; otherwise, there is either subsistence or self-employment. Thus, in static equilibrium, the occupational structure depends on distribution. The authors try to demonstrate the robustness of this result by extending the model dynamically and studying examples in which initial wealth distributions have long-run effects.


This paper explores financial stability in a theoretical model. According to the authors, this is important because the relation of financial stability to economic performance and even the meaning of the term itself are poorly understood. They define “fragility”, which occurs when entrepreneurs
who want to undertake investment projects have low net worth; the heavy reliance on external finance that this implies causes the agency costs of investment to be high. High agency costs in turn lead to low and inefficient investment. Finally, the authors give standard policies for fighting financial fragility, which can be interpreted as transfers that maintain or increase the net worth of potential borrowers.


Recent models of financial crises typically stress financial constraints or distorted financial incentives. Adaptations of the Mundell-Fleming model represent Argentina as a Belgium with larger external shocks. According to the authors, these models share weaknesses since emerging market models of financial constraints are just adaptations of developed economy ones with tighter financial constraints. In this article, in contrast, the authors have advocated a model which distinguishes between the financial constraints affecting borrowing and lending among agents within an emerging economy, and those affecting borrowing from foreign lenders. This ‘dual liquidity’ model offers a parsimonious description of the behavior of firms, governments, and asset prices during financial crises. Finally, this paper provides prescriptions for optimal policy responses to these crises.


A growing literature studies social networks and their implications for economic outcomes. This paper highlights, examines, and addresses econometric problems that arise when a researcher studies these network effects using sampled network data. In applied work, researchers generally construct networks from data collected from a partial sample of nodes. This manuscript shows that even if nodes are selected randomly, partial sampling leads to non-classical measurement error and therefore bias in estimates of the regression coefficients or GMM parameters. In order to illustrate their point, the authors provide analytical and numerical examples which show the severity of the biases in common applications. Finally, this manuscript derives asymptotic theory that allows for each network in the data set to be generated by a different network formation model.


This article studies the following question: are consumers effectively insured against idiosyncratic shocks to income or wealth, either by formal institutions such as charities, private insurance, and government programs or by informal mechanisms such as gifts and “loans” from relatives, friends, and neighbors? The author claims that, under full insurance, consumption growth should be cross-sectionally independent of idiosyncratic variables that are exogenous to consumers. This proposition is tested by cross-sectional regressions of consumption growth on a variety of exogenous variables. He finds that full insurance is rejected for long illness and involuntary job loss but not for spells of unemployment, loss of work due to strike, and an involuntary move.


This paper attempts to assess both the aggregate growth effects and the distributional consequences of financial liberalization as observed in Thailand from 1976 to 1996. The authors develop a general equilibrium occupational choice model with two sectors, one without intermediation and the other
with borrowing and lending. They estimate key parameters of the production technology and the distribution of entrepreneurial talent using distinct Thai datasets. They claim that without an expansion in the size of the intermediated sector, Thailand would have had lower growth rate, high residual subsistence sector, non-increasing wages but lower inequality. The authors conclude that the financial liberalization brings welfare gains and losses, and also induces greater demand by entrepreneurs for workers.


This paper presents a model in which both the extent of financial intermediation and the rate of economic growth are endogenously determined. In this framework, financial intermediation promotes growth because it allows a higher rate of return to be earned on capital, and growth in turn provides the means to implement costly financial structures. Thus, financial intermediation and economic growth are inextricably linked. This model also generates a development cycle reminiscent of the Kuznet hypothesis. In particular, in the transition from a primitive slow-growing economy to a developed fast-growing one, a nation passes through a stage in which the distribution of wealth across the rich and poor widens.


This paper addresses the following question: Do claims on private assets provide sufficient liquidity for an efficient functioning of the productive sector? Or does the state have a role in creating liquidity and regulating it either through adjustments in the stock of government securities or by other means? In this model, firms can meet future liquidity needs in three ways: by issuing new claims, by obtaining a credit line from a financial intermediary, and by holding claims on other firms. The paper studies several cases such as aggregate and idiosyncratic uncertainty, and a combination of both. The authors find that the government can improve welfare by issuing bonds that commit future consumer income. They claim that the government should manage debt so that liquidity is loosened when the aggregate liquidity shock is high and is tightened when the liquidity shock is low.


This paper presents evidence suggesting that information and incentive problems in the capital market affect investment. To reach this conclusion, the authors examine two sets of Japanese firms. The first set has close financial ties to large Japanese banks that serve as their primary source of external finance and are likely to be well informed about the firm. The second set of firms has weaker links to a main bank and presumably faces greater problems raising capital. The authors find that investment is more sensitive to liquidity for the second set of firms than for the first set. This analysis also highlights the role of financial intermediaries in the investment process.


This paper exploits variation in policies and institutional characteristics to evaluate the impacts of village-level microfinance institutions in rural Thailand. The authors use policies related to the successful/unnecessary provision of services as exogenous variation in effective financial
intermediation. They find that institutions can promote asset growth, consumption smoothing and occupational mobility, and can decrease moneylender reliance. The authors find it surprising that much publicized policies such as joint liability, default consequences, or repayment frequency had no measured impacts.


This paper builds a theory of trust based on informal contract enforcement in social networks. In this model, network connections between individuals can be used as social collateral to secure informal borrowing. The authors define network-based trust as the largest amount one agent can borrow from another agent and derive a reduced-form expression for this quantity. They arrive to three main conclusions. First, dense networks generate bonding social capital that allows transacting valuable assets. Second, strong ties between employers and trusted recommenders reduce asymmetric information about the quality of job candidates. Third, using data from Peru, they show empirically that network-based trust predicts informal borrowing, and structurally estimate and test the model.


This paper develops a model of a dynamic economy in which lenders cannot force borrowers to repay their debts unless the debts are secured. In such an economy, durable assets play a dual role: not only are they factors of production, but they also serve as collateral for loans. The dynamic interaction between credit limits and asset prices turns out to be a powerful transmission mechanism by which the effects of shocks persist, amplify, and spill over to other sectors. Finally, the authors show that small, temporary shocks to technology or income distribution can generate large, persistent fluctuations in output and asset prices.


This paper tests the implications of full consumption insurance. The object is to determine how much mileage can be obtained from a model with complete markets, with such features as private information or liquidity constraints omitted. Individual consumption responds to aggregate risk but not to idiosyncratic risk. The author finds that variables other than the change in aggregate consumption are predicted to be insignificant in explaining the change in household consumption. Using data from the Consumer Expenditure Survey, the conclusions are mixed. The results for one specification are mostly consistent with full consumption insurance; the results for the other specification are not.


Using data from rural and semi-urban Thailand, this article examines how financial constraints affect entrepreneurial activity. The analysis uses nonparametric and reduced form techniques. The results indicate that financial constraints play an important role in shaping the patterns of entrepreneurship in Thailand. In particular, wealthier households are more likely to start businesses. Wealthier households are also more likely to invest more in their businesses and face fewer constraints. Finally,
the authors also provide evidence that financial constraints place greater restrictions on entrepreneurial activity in the poor Northeast compared to the more developed Central region.


This article proposes a conceptual framework for measurement necessary for an analysis of household finance and economic development. The authors build on and, where appropriate, modify corporate financial accounts to create balance sheets, income statements, and statements of cash flows for households in developing countries, using an integrated household survey. They also illustrate how to apply the accounts to an analysis of household finance that includes productivity of household enterprises, capital structure, liquidity, financing, and portfolio management. The conceptualization of this analysis has important implications for measurement, questionnaire design, the modeling of household decisions, and the analysis of panel data.


This paper presents a full insurance model which is tested using data from three poor, high risk villages in the semi-arid tropics of southern India. The model incorporates a number of salient features of the actual village economies. Although the framework is rejected statistically, it does provide a good benchmark. The author observes that household consumptions co-moves with village average consumption. More clearly, household consumptions are not much influenced by contemporaneous own income, sickness, unemployment, or other idiosyncratic shocks, controlling for village consumption. There is evidence that the landless are less well insured than their village neighbors in one of the three villages.


This article studies models that display growth with financial deepening and increasing inequality along the way to perpetual steady state growth. The authors provide a benchmark model, which is essentially a complete markets model but with transaction costs of financial intermediation. In addition, they provide proof for stochastic dynamic programming for the case of unbounded return functions and perpetual growth with a non-convex transaction technology. The model is calibrated and quantitative predictions are reported for Thailand over the period 1976 to 1996. The authors conclude that a discrepancy between the model and the data, suspect barriers to financial deepening as a cause, and evaluate the associated welfare loss.


This article offers a new method for the evaluation of financial institutions, one that combines socioeconomic survey data with appropriate accounting standards. A government-operated development bank in Thailand is found to be offering a risk-contingency or insurance system while being regulated as a more standard, loan-generating bank. Farmer clients experiencing adverse shocks receive indemnities that improve their well-being. With proper provisioning and accounts, that welfare gain could be weighed against premia or government subsidies.