Annotated Bibliography: Financial Systems, Industrial Organization, and Economic Development

Survey of Literature


This paper studies the determinants of vertical integration in a new dataset of over 750,000 firms from 93 countries. The authors present a number of theoretical predictions on the interactions between financial development, contracting costs, and the extent of vertical integration. They find that contracting costs and financial development by themselves appear to have no effect on vertical integration. However, they also find greater vertical integration in countries that have both greater contracting costs and greater financial development.


The purpose of this paper is to provide a new rationale for pyramidal ownership in family business groups. A pyramid allows a family to access all retained earnings of a firm it already controls to set up a new firm, and to share the new firm's nondiverted payoff with shareholders of the original firm. The authors present a model that is consistent with recent evidence of a small separation between ownership and control in some pyramids and can differentiate between pyramids and dual-class shares, even when either method can achieve the same deviation from one share–one vote.


The authors present a model of economic development where the importance of financial differences caused by limited enforcement can be measured. Economies where enforcement is poor direct less capital to the production sector and employ less efficient technologies. Simulations reveal that the resulting effect on output is large. In addition, the model correctly predicts that the average scale of production should rise with the quality of enforcement. Finally, the authors find that the importance of limited enforcement rises with the importance of capital in production.


Many rural households in developing countries rely on livestock markets to sell output and trade assets in order to smooth consumption. This paper provides evidence that adverse selection plays an important role in the determination of prices and trading volumes in India's largest livestock market.
In order to identify adverse selection effects, the author exploits natural variation in the observability of cow quality. He then presents a model of trade in dry and milking cows with adverse selection. Comparing the model with the data, the author concludes that welfare losses due to adverse selection appear to be an important cost of using household production assets as substitutes for formal financial instruments in developing economies.


This paper develops a macroeconomic model with an imperfectly competitive bank-loans market and collateral constraints that tie investors’ credit capacity to the value of their real estate holdings. Lending margins are optimally set by banks and have a significant effect on aggregate variables. Over the long run, stronger banking competition increases output by triggering a reallocation of available collateral towards investors. In the short-run, output, credit and housing prices are more responsive on impact to shocks in an environment of highly competitive banks. The authors find that stronger banking competition implies higher persistency of credit and output after a monetary shock.


This paper empirically investigates the role of dynamic production inputs and their associated adjustment costs in determining the dispersion of total factor productivity (TFP) and static measures of capital misallocation within a country. Using information from 33 developing countries, the authors find that countries exhibiting greater time-series volatility of productivity are also characterized by greater cross-sectional dispersion in productivity. In addition, a similar relationship between productivity volatility and the dispersion of the marginal revenue product of capital is found. Calibrating a standard model of investment with adjustment costs, the authors show that increasing the volatility of productivity to the level observed in these developing economies can quantitatively replicate the observed relationship between static misallocation and volatility observed in the data. These findings suggest that the dynamic process governing productivity shocks is a first-order determinant of differences in misallocation and, hence, income across countries.


This paper presents two dynamic spatial competition models for the provision of financial services in Thailand. The models are studied through key examples and a series of simulation exercises. For example, when the government bank maximizes the total access to financial system, it is shown that (i) the government bank goes to more isolated and poorer markets, anticipating that the commercial bank will serve the most profitable markets first; and (ii) the behavior of the government bank is substantially affected by the presence of the commercial bank. Results suggest that the expansion of the financial providers in Thailand depicts relevant spatial dimensions, with the government bank behaving differently from commercial banks, with a concern on overall financial access as opposed to profit maximization.

In this paper the authors propose a general methodology to measure the extent of “tunneling” activities. The methodology rests on isolating and then testing the distinctive implications of the tunneling hypothesis for the propagation of earnings shocks across firms within a group. They find that a significant amount of tunneling is taking place in the Indian economy, much of it occurring via non-operating components of profit.


This paper analyses the industrial organization of the Dutch rural market for small scale deposits in the early twentieth century. It first measures the nature and level of competition for deposits between boerenleenbanken, rural cooperative microfinance banks that dominated this market. It then determines the nature of the relationship between interbank competition and bank-level financial stability in the Dutch case. This case study is useful because its peculiarities permit the isolation of the two key factors that influence competition in banking: transaction and information switching costs. The analysis combines a cross-section of balance sheet financial performance data pertaining to 1,141 banks with socio religious data from the closest census year, farming survey data, and land registry topographical data.


In this paper, the author estimates the degree of market power at the bank-level for 84 banking systems worldwide. In addition, he analyzes the sources of bank competition, placing emphasis on the impact of financial reform and the quality of institutions. Results show that financial liberalization policies reduce the market power of banks in developed countries with advanced institutions. However, banking competition does not improve at the same pace in countries with weaker institutions and a lower level of institutional development. These conclusions hold across a wide array of identification tests and estimation methods. The main policy implication is that a certain level of institutional development is a precondition for the success of reforms aimed at enhancing the competition and efficiency of banking markets.


Globalization increasingly involves economies that usually suffer from severe imperfections in their financial systems. This paper analyzes how credit frictions affect the distributive impact of trade liberalizations. The authors find that free trade significantly widens income differences among firm owners in less-developed economies (LDCs). For example, while wealthy entrepreneurs are better off, relatively poor business people lose. The authors explain that with integrated markets, profit margins shrink—which makes access to credit particularly difficult for the least-affluent agents. Richer entrepreneurs, by contrast, win because they can take advantage of new export opportunities. These
findings would be consistent with the observation that some liberalizing LDCs have observed a surge in top-income shares.


This paper presents a transaction cost model to explain why family businesses exist and why some of them experience success in different industrial and geographical contexts. The authors identify a class of non-tradeable assets that are *firm specific, but generic in application*. While many types of firms may possess such assets, this paper proposes that family firm governance provides relative advantages in developing, sustaining, and appropriating the value of these assets through combinations with other types of assets. These combinations would be the ones that explain the versatility, limitations, and success of family businesses.


This paper studies the dynamic nature of some durable-goods markets. Specifically, since some of these goods experience rapid prices declines and quality improvements, the authors are interested in studying these markets in a dynamic context. In order to do so, they develop a dynamic model of consumer preferences with heterogeneous consumer tastes, who repeat purchases over time. Using panel data for the digital camcorder industry, they estimate this model. The results suggest that standard cost-of-living indices overstate welfare gain in later periods due to a changing composition of buyers.


This article studies the effects of differences in *local* financial development within an integrated financial market. The authors find that financial development increases the probability that an individual starts his own business, favors entry of new firms, increases competition, and promotes growth. As predicted by theory, these effects are weaker for larger firms, which can more easily raise funds outside of the local area. Overall, the results suggest *local* financial development is an important determinant of the economic success of an area even in an environment where there are no frictions to capital movements.


This paper is motivated by the desire to study family business groups and mainstream internationalization models governed by the concept of firm-specific advantages. The author explains these two ways: the "easy" path of relying on connections (i.e., what here is termed "the bamboo network") and the more "difficult" path of building competitiveness (i.e., going beyond the bamboo network) is exposed and explained. This study thus contributes to the understanding of the firm internationalization process.

This paper outlines an approach to estimating the fixed costs associated with bank expansion using a method of simulated maximum likelihood. The authors suggest that the expansion costs are heterogeneous across banks, causing some to expand only to neighboring provinces while allowing others to jump across Spain. Then, the authors are concerned with the study of the origin of this heterogeneity, because it represents an important component to understanding the barriers to free entry in the financial system and hence the degree of market power that financial institutions may have.


This paper reviews existing studies of the role of emerging market business groups, a ubiquitous but poorly understood organizational form. The author shows existing evidence suggesting that the performance effects of group affiliation are large and generally positive. There is substantial evidence that part of this is due to welfare-enhancing functions originating in the idea that groups substitute for missing outside institutions, but that part is also due to welfare-reducing minority shareholder exploitation. The paper identifies areas where research is needed before current competition policy experiments in countries like China, India, and Korea can be evaluated.


This paper examines the hypothesis that business groups facilitate mutual insurance among affiliated firms. The paper finds substantial evidence of risk sharing by Japanese, Korean, and Thai groups but little evidence of it elsewhere. In addition, the authors find no correlation between measures of capital market development and the nature of the legal system. Surprisingly, the popular view that risk sharing in business groups is important is not validated by this analysis.


This document studies the construction of business networks across firms in an emerging economy, Pakistan, and estimates the value that membership in large networks brings in terms of access to bank credit and improving financial viability. The authors estimate the value of joining a giant network by exploiting entry and exit of firms over time. They conclude that membership increases total external financing, reduces the propensity to enter financial distress, and better insures firms against industry and location shocks.


This paper examines the impact of ownership structure and other relevant factors on the variability of bank performance in the Middle East and North Africa (MENA) region. Among its results, the paper finds majority foreign-owned private banks, especially MENA foreign-owned banks, performed significantly better than other types of banks. It also finds stock or publicly traded banks,
as well as the extent of overall foreign bank presence in a respective banking industry, to be associated with relatively better performance.


This paper asks whether vertical integration relaxes financial constraints in developing economies. The author shows that vertical integration trades off the benefits of joint liability against the costs of rendering the supply chain more opaque to external investors. Surprisingly, the model predicts that the motives for vertical integration are not necessarily higher in developing countries. In particular, vertical integration is more likely to arise at intermediate levels of investor protection and better contract enforcement with suppliers reduces vertical integration only if financial markets are sufficiently developed. Finally, the paper shows evidence supporting both predictions.


In this paper, the author shows how a targeted program of utility subsidies leads to the persistence of low-quality infrastructure in a developing country. Using customer billing data from Colombia, he estimates a model for household electricity demand. The results suggest that the existing subsidy program, which provides greater transfers in areas with unreliable supply, deters investments to modernize infrastructure. As a policy proposal, the author analyzes less costly programs that may provide stronger investment incentives.


This paper develops a model of multimarket spatial competition where small, single-market banks compete with large, multi-market banks (LMBs) for retail loans and deposits. Consistent with empirical evidence, LMBs are assumed to set retail interest rates uniformly across markets, have different operating costs, and have access to wholesale funding. If LMBs have significant funding advantages that offset potential loan operating cost disadvantages, then market-extension mergers by LMBs promote loan competition, especially in concentrated markets. However, such mergers reduce retail deposit competition, especially in less concentrated markets. The authors conclude showing that prior empirical research and their own analysis of retail deposit rates support the model's predictions.


This article studies the role of finance constraints in determining the lack of transition of firms from very small family firms to larger firms that employ non-family labor. The authors use data based on unit level data drawn from India to estimate the effects of financial development on firm transition at the district level. They find that finance constraints play an important role in firm transition from family firms to larger firms. They also find that access to electricity, the firm’s location in urban areas, and whether the firm has experienced an expansion in its operations previously matter greatly in firm growth. Interestingly, state assistance, such as loans, training and marketing does not seem to matter so much.

The author analyzes South Africa’s Free Basic Water Policy (a policy in which households receive a free water allowance equal to the World Health Organization’s recommended minimum of 6 kiloliters per month) to evaluate the welfare effects of free water, and derive optimal price schedules from the social planner’s problem. Using a novel panel dataset of 60,000 households for monthly data from 2002 to 2010, this paper shows that without government subsidy, the mean monthly consumption would decrease to levels below the recommended allowance. More positively, the author shows that it is possible to make a Pareto improvement by reallocating the current subsidy to form an optimal tariff without a free allowance, which would increase welfare while leaving the water provider’s revenue unchanged. Overall, this optimal tariff would also reduce the number of households consuming below the WHO-recommended level.


The authors of this paper are interested in the study of the effect of Wal-Mart's entry into Mexico on Mexican manufacturers of consumer goods. Using information from interviews, the authors develop a dynamic industry model in which firms decide whether to sell their products through Walmex (short for Wal-Mart de Mexico), or use traditional retailers. The results suggest that the arrival of Walmex separates potential suppliers into two groups. Those with relatively high-appeal products choose Walmex as their retailer, whereas those with lower appeal products do not. These predictions match very well with the results from the firm interviews. In addition, the model's predictions are also supported by establishment-level panel data that characterize Mexican producers' sales and investment.


Using aggregate balance sheet data from banks across the EU-25 over the period from 1997 to 2005, this paper provides empirical evidence that national banking market concentration has a negative impact on European banks’ financial soundness as measured by the Z-score technique while controlling for macroeconomic, bank-specific, regulatory, and institutional factors. In addition, the authors’ analysis reveals that Eastern European banking markets exhibiting a lower level of competitive pressure, fewer diversification opportunities and a higher fraction of government-owned banks are more prone to financial fragility whereas capital regulations have supported financial stability across the entire European Union.


In this paper, the author makes an empirical analysis on the present situation of reform and development of rural financial market. This paper finds that, although the monopoly status of rural credit cooperatives still exists, there is a decrease in this monopoly power. The author describes the rural financial market structure and finds an increase in market performance of rural credit cooperatives. Finally, this study proposes to lower the access threshold, enforce the market
competition, and establish a diversified, multi-level rural financial market in order to improve the rural financial market performance.

**Industrial Organization and Microfinance Institutions (MFIs)**


This paper analyzes the effects of entry of a new MFI in a previously monopolistic microcredit market. The author first presents a model of asymmetric information and assumes that institutions can offer only one type of contract. The model allows competition which can lead to equilibriums in which MFIs differentiate their contracts in order to screen borrowers. These equilibriums can make the poor borrowers worse off. Interestingly, the screening process described creates a previously unexplored source of credit rationing. Finally, the author proves that the presence of an altruistic MFI in the market reduces rationing and, via this channel, positively affects the competitor's profit.


This paper studies the competition and heterogeneity in the microfinance industry. The authors observe that competition has brought down average lending rates but has also generated concern that the poorest borrowers are being excluded from the market while new entrants compete with existing firms for only the most reliable borrowers. Using a Bertrand differentiated product framework, the authors model the price setting and demand functions of MFIs. Using a 7 year panel dataset covering over 70 countries, they estimate parameters of the Nash price equilibrium and simulate the shape and structure of the underlying demand equation. Findings indicate that the growth in MFIs notably increased consumer welfare during recent years.


This article reviews some of the open questions highlighted by the recent Indian microfinance crisis. The authors show some of the key lessons learned about the microfinance industry, both in India and more broadly, and their implications for borrowers. They also study the interplay of regulation, market structure, and borrower welfare by surveying recent contributions that reflect the renewed academic interest in microfinance.


This paper investigates empirically the effect of competition between microfinance NGOs seeking subsidized capital from individual social investors. Using data from Kiva, an online peer-to-peer (P2P) microfinance platform, the authors find that competition has a sizable negative impact on projects' funding speed and that the effect is stronger between close substitutes. This is important because competition for subsidized capital implies organizational pressures similar to those faced when NGOs compete for donations.

This article discusses market share of the microcredit industry in Bangladesh. The authors show evidence that there have been large variations in the size of MFIs operating in the market, and that, at the same time, there have been small localized MFIs operating only within the confines of a small area. Using Tobit regression methods, the authors conclude that the size of the MFIs, years of operation in the village, average loan size, deposit interest rates, and loan amount disbursed for unique loan purposes (i.e., housing loan) are key determinants in determining MFIs’ share of a village microcredit market.


As suggested in the title, the authors of this paper are interested in studying the driving forces behind the lending rate in the microfinance market. They use a global panel data set of MFIs. They find that the average MFI does not enjoy monopoly market power in its market, but cannot reject that perfect competition or monopolistic competition are better descriptions of the MFI’s average market type. These conclusions hold up in both static and dynamic regressions, as well as in different sub-samples.


This paper describes important trade-offs that microfinance practitioners, donors, and regulators navigate. Drawing evidence from large, global surveys of microfinance institutions, the authors find a basic tension between meeting social goals and maximizing financial performance. For example, non-profit MFIs make far smaller loans on average and serve more women as a fraction of customers than do commercialized microfinance banks, but their costs per dollar lent are also much higher. Potential trade-offs therefore arise when selecting contracting mechanisms, level of commercialization, rigor of regulation, and the extent of competition.


This paper investigates empirically the economic efficiency of MFIs in Ghana using a Cobb-Douglas Stochastic frontier model. The estimated results showed an overall average economic efficiency of 56.29%; indicating a high degree of inefficiency in the economic behavior of the units in the industry. The study further exposes that age and savings indicators of outreach and productivity, and cost per borrower are significant determinants of economic efficiency. It is therefore recommended that practitioners improve upon technical training programs, operate diversified savings products to improve on portfolio quality and ensure sustainability, and heighten the extent of social commitment to both staff and clients.