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Journal of Development Economics 74 (2004) 269–307

JOURNAL OF Development ECONOMICS

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Evaluation of financial liberalization: a general equilibrium model with constrained occupation choice ☆

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Received 1 September 2002; accepted 1 March 2003

Abstract

The objective of this paper is to assess both the aggregate growth effects and the distributional consequences of financial liberalization as observed in Thailand from 1976 to 1996. A general equilibrium occupational choice model with two sectors, one without intermediation and the other with borrowing and lending is taken to Thai data. Key parameters of the production technology and the distribution of entrepreneurial talent are estimated by maximizing the likelihood of transition into business given initial wealth as observed in two distinct datasets. Other parameters of the model are calibrated to try to match the two decades of growth as well as observed changes in inequality, labor share, savings and the number of entrepreneurs. Without an expansion in the size of the intermediated sector, Thailand would have evolved very differently, namely, with a drastically lower growth rate, high residual subsistence sector, non-increasing wages but lower inequality. The financial liberalization brings welfare gains and losses to different subsets of the population. Primary winners are talented would-be entrepreneurs who lack credit and cannot otherwise go into business (or invest little capital). Mean gains for these winners range from 17% to 34% of observed, overall average household income. But liberalization also induces greater demand by entrepreneurs for workers resulting in increases in the wage and lower profits of relatively rich entrepreneurs, of the same order of magnitude as the observed overall average

☆ Prepared for the conference on macroeconomic policies and poverty reduction, Washington, DC, March 14–15, 2002, organized by the international monetary fund.

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doi:10.1016/j.jdeveco.2003.03.005

income of firm owners. Foreign capital has no significant impact on growth or the distribution of observed income.

JEL classification: E2; G1; O1; O4
Keywords: Economic development; Income distribution; Credit constraints; Financial liberalization; Maximum likelihood estimation

1. Introduction

The objective of the paper is to assess the aggregate, growth effects and the distributional consequences of financial liberalization and globalization. There has been some debate in the literature about the benefits and potential costs of financial sector reforms. The micro credit movement has pushed for tiered lending, or linkages from formal financial intermediaries to small joint liability or community groups. But a major concern with general structural reforms is the idea that benefits will not trickle down, that the poor will be neglected, and that inequality will increase. Similarly, globalization and capital inflows are often claimed to be associated with growth although the effect of growth on poverty is still a much debated topic.[1]

Needless to say, we do not study here all possible forms of liberalization. Rather, we focus on reforms that increase outreach on the extensive domestic margin, for example, less restricted licensing requirements for financial institutions (both foreign and domestic), the reduction of excess capitalization requirements, and enhanced ability to open new branches. We capture these reforms, albeit crudely in the model, thinking of them as domestic reforms that allow deposit mobilization and access to credit at market clearing interest rates for a segment of the population that otherwise would have neither formal sector savings nor credit.

We take this methodology to Thailand from 1976 to 1996.[2] Thailand is a good country to study for a number of reasons. First, Thailand is often portrayed as an example of an emerging market, with high income growth and increasing inequality. The GDP growth from 1981 to 1995 was 8% per year, and the Gini measure of inequality increased from 0.42 in 1976 to 0.50 in 1996. Second, Jeong (1999) documents in his study of the sources of growth in Thailand, 1976–1996, that access to intermediation narrowly defined accounts for 20% of the growth in per capita income while occupation shifts alone account for 21%. While the fraction of non-farm entrepreneurs does not grow much, the income differential of non-farm entrepreneurs to wage earners is large and thus small shifts in the population create relatively large income changes. In fact, the occupational shift may have been financed by credit. Also related, Jeong finds that 32% of changes in inequality

[1] See for example Gallup et al. (1998) and Dollar and Kraay (2002) for evidence that growth helps reduce poverty and the concerns of Ravallion (2001, 2002) about their approach.

[2] We focus on this 20-year transition period, not on the financial crisis of 1997. Our own view is that we need to understand the growth that preceded the crisis before we can analyze the crisis itself.