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Essays on financial liberalization

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Introduction

The objective of this introductory chapter is to outline the motivation for this thesis and provide an overview of the chapters to follow.

Financial liberalization has attracted much attention as a policy to promote economic development. While there are many theoretical arguments in favor of it, the actual economic experience of countries that adopted financial liberalization has been mixed. The recent financial and economic crisis once more has questioned our conventional wisdom about financial liberalization and gave rise to new questions.

This thesis seeks to enhance our understanding of the role of financial liberalization for the economy. To this end, it concentrates on three important economic variables, namely economic growth, income inequality and financial instability, asking what is the relationship of financial liberalization with each of these variables.

The remainder of this introduction is structured as follows. Section 1.1 determines the relevance of financial liberalization. Section 1.2 presents the aim and scope of the thesis. Section 1.3 outlines the methodological approach. Section 1.4 provides a short preview of the thesis.

1.1 Relevance of Financial Liberalization

To a large extent, the initial debate about financial liberalization was inspired by the seminal work of McKinnon (1973) and Shaw (1973) who criticized the financial repression that prevailed in transition and developing countries in the 1970s and 1980s. Financial repression refers to a set of policies by which governments try to channel funds into their own pockets. It includes various measures such as reserve requirements, directed credit to preferred sectors and regulation of international capital flows. According to McKinnon (1973) and Shaw (1973), financial repression led many developing countries to suffer from below-equilibrium interest rates, resulting in a lack as well as misallocation of saving and investment. Another indicator of the deficiencies due to financial repression was the capital flight that occurred despite capital controls (Dooley et al., 1986).

Against this background, McKinnon (1973) and Shaw (1973) suggested that domestic financial liberalization was desirable in order to encourage savings, financial intermediation and release economic resources from inferior uses. To this end, an array of policy measures was proposed, including a market-based allocation of funds rather than by banks or public authorities, and more competition among financial institutions to avoid monopolies.

Apart from its adverse effect on economic growth, financial repression has been blamed for rising income inequality since directed credit usually is heavily subsidized and because larger borrowers benefit from privileges. Moreover, low interest rates potentially spur corruption and divert credit to influential groups (World Bank, 2005). However, whether financial liberalization, in contrast to financial repression, alleviates income inequality is an open issue that has been challenged in many respects (e.g., Charlton, 2008).

The extent of financial liberalization around the world went up substantially in the 1980s and 1990s. A major driver of this trend was the growth of international trade in goods and services. Another important force was the internationalization of capital flows, chasing profit opportunities and enhanced possibilities for international risk-sharing. Despite a common global trend, the changes in financial liberalization have varied in terms of content, timing, and speed across countries.

Financial liberalization is not only a success story. There is evidence that financial liberalization might contribute to crises (Demirgüç-Kunt and Detragiache, 1998; Kaminsky and Reinhart, 1999). Indeed, unrestricted circulation of capital could undermine economic stability through various channels. To begin with, high capital mobility means that countries may suffer from sudden capital reversals, if investors become increasingly worried about a country's ability to serve its liabilities. Excessive capital flight can result in financial and economic crises, eventually causing the collapse of the financial system (Rodrik, 1998; Ocampo et al., 2008). Another problem is that financial liberalization can aggravate moral hazard problems. In a globalized capital market, financial institutions have to cope with increased competitive pressures. Against this background, lenders are inclined to save on screening and monitoring efforts in order to secure their profits. This increases overall risk in the financial sector (Demirgüç-Kunt and Detragiache, 1998; Hellmann et al., 2000; Claessens, 2009). Finally, financial liberalization poses problems for countries' welfare systems. Social programs and security networks are funded by taxing both capital and labor. If capital is highly mobile, it tends to flow to countries where these taxes are low (Charlton, 2008).

To conclude, the effects of financial liberalization are two-sided. On the one hand, financial liberalization appears to have real potentials for economic growth, but on the other hand, it can bear on stability and income inequality. Concerning economic growth, numerous empirical studies have been conducted, with conflicting findings. Thus, the liberalization-growth nexus is not as clear cut as it may seem. Regarding the link between financial liberalization and income inequality, the lack of scientific research impedes any judgment. Also, the role of financial liberalization in the financial and economic crisis of 2008/09 is poorly understood. The goal of this thesis is to shed further light on these important issues.

1.2 Aim and Scope of the Thesis

As indicated in the previous section, financial liberalization involves various policy measures that unfold through different channels of the financial sector such as credit and competition. This thesis aims at identifying and understanding such channels by means of rigorous empirical and theoretical analyses. Moreover, it tries to include

aspects that have not been considered in the existing literature. Specifically, this thesis is distinguished by the following features:

1. It brings together the empirical literature on financial liberalization and economic growth. Numerous empirical studies have tried to assess the impact of financial liberalization on GDP per capita growth, with conflicting findings. Summarizing this literature is not a straightforward task, requiring a systematic approach.
2. Whereas a lot of research has been devoted to the relationship between financial liberalization and economic growth, very few models analyze the effects of financial liberalization on income inequality. This thesis tries to partly fill this gap by means of a simple model that studies the impact of financial liberalization on income inequality via the banking sector.
3. The 2008/09 global financial and economic crisis has led to new questions about financial stability. Financial liberalization, so the argument goes, has been a driver of unsustainable credit expansion. However, it remains unresolved whether this notion is true. This thesis intends to further illuminate this important issue by examining the association between financial liberalization and financial instability.
4. The fourth distinction is that new datasets will be used. Income inequality data that is both reliable and comparable across countries is difficult to obtain. This thesis relies on new estimates of the Gini coefficient as they seem better than previous data in many respects. Apart from income inequality data, new cross-country data for financial instability will be employed.

The previous points can be summarized in three main research questions:

1. What is the empirical evidence concerning the impact of financial liberalization on economic growth?
2. What is the impact of financial liberalization on income inequality?
3. How does financial liberalization relate to financial instability?

Answers to these questions, at least from the perspective of this thesis, will be provided in the last chapter. The path to finding answers to the proposed questions shall be briefly described next.

1.3 Methodology

The research questions will be investigated in separate chapters. Depending on the question, an empirical model and/or a theoretical model will be developed. Limitations and possibilities for future research will be mentioned at the end of each chapter. Policy implications of the research will be discussed in the last chapter of this thesis.

Methodology for studying research question 1

The theoretical link between financial liberalization and economic growth is not unequivocal. This has encouraged many researchers to run regressions in order to let the data speak. There exists an array of studies, covering different countries as well as time periods, and using various estimation techniques. Instead of conducting yet another empirical study, it appears more fruitful to provide a systematic review of the existing empirical literature on the basis of a rigorous statistical method referred to as meta-analysis (Stanley, 2001). For this purpose, statistical information from comparable empirical studies, investigating the impact of financial liberalization and economic growth, has been gathered. The relevant information includes the 441 t -statistics from regressions with per capita GDP growth and financial liberalization, along with other study characteristics such as sample size and the set of control variables. Using regression-based techniques, the meta-analysis examines the relationship of these study characteristics with the t -statistic.

Compared to a typical literature survey, an important advantage of meta-analysis is that it allows for a more powerful assessment of whether the effect of financial liberalization is similar across a set of comparable studies.

Methodology for studying research question 2

Standard models implicitly presume that the growth effects of financial liberalization will spread evenly across the income distribution. However, this presumption is very superficial and seems inconsistent with the experiences of many countries over the past decades. To the best of my knowledge, there rarely exist any formal models that analyze the impact of financial liberalization on different income groups.

This thesis makes a new attempt to study the link between financial liberalization and income inequality. It develops a simple model that features savers and investors. Savers and investors generate different levels of income, implying inequality. Financial liberalization affects savers' and investors' incomes via the banking sector. Banks are faced with two types of financial liberalization policies, namely falling reserve requirements and decreasing international capital controls. These policies cause changes in the interest rate on deposits and the cost of borrowing, modifying the distribution of income. The theoretical analysis will be complemented by an empirical evaluation of the model's findings.

The empirical approach involves an assessment of the impact of capital account and reserve requirement liberalization on income inequality across a wide variety of countries and years. To this end, dynamic panel data models will be employed. Whereas data on financial liberalization is readily available, income inequality data is not. As discussed in Atkinson and Brandolini (2001), income inequality data is subject to several problems. This thesis relies on estimated Gini coefficients of pre-tax household income from the University of Texas Inequality Project (UTIP) (Galbraith and Kum, 2005). The dataset covers 148 countries from 1963 to 2008.

Methodology for studying research question 3

To investigate the theoretical link between financial liberalization and financial instability, financial liberalization policies are being incorporated into a standard model of the loan market that is due to De Meza and Webb (1987).

An empirical assessment of the liberalization-instability nexus complements the theoretical analysis. Financial instability is measured as the amount of impaired loans in total loans. The cross-country data has been developed as part of a recent research

project on financial instability.¹ The dataset covers 85 countries from 2000 to 2009. This data is combined with financial liberalization data from Abiad et al. (2010). The empirical analysis pays special attention to the 2009 economic shock that was triggered by the 2008/09 financial crisis. It is conjectured that this shock tightened the link between financial liberalization and financial instability.

1.4 Preview of the Thesis

Financial liberalization has been embraced by governments worldwide. Its impact on the economy still poses many questions though. This thesis seeks to deal with three of them. Chapter 2 intends to evaluate the impact of financial liberalization on economic growth. Chapter 3 investigates the theoretical relationship of financial liberalization with income inequality, whereas chapter 4 provides an empirical assessment of the theory. Chapter 5 investigates the link between financial instability and financial liberalization. Finally, chapter 6 summarizes the main research findings and discusses policy implications as well as directions for future research.

¹ The data has been developed as part of DFID-ESRC Award ES/J009067/1.

