

Accepted Manuscript

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PII: S1042-4431(16)30186-X

DOI: <http://dx.doi.org/10.1016/j.intfin.2016.11.010>

Reference: INTFIN 909

To appear in: *Journal of International Financial Markets, Institutions & Money*

Received Date: 15 April 2016

Revised Date: 27 September 2016

Accepted Date: 20 November 2016

Please cite this article as: B.M. Blau, Economic freedom and crashes in financial markets, *Journal of International Financial Markets, Institutions & Money* (2016), doi: <http://dx.doi.org/10.1016/j.intfin.2016.11.010>

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ECONOMIC FREEDOM AND CRASHES IN FINANCIAL MARKETS

Benjamin M. Blau^a

Abstract

Using a unique empirical approach that accounts for the possibility that financial market crashes are endogenously determined by market structures, this study examines how economic freedom contributes to crashes in financial markets. On one hand, economic freedom might provide an unregulated framework that contributes to the likelihood of crashes. On the other hand, economic freedom may mitigate regulatory uncertainty thus providing a level of transparency that reduces the likelihood of crashes. Results in this study provide strong support for the latter idea as countries with higher levels of economic freedom experience lower probabilities of market crashes and more positive skewness in asset returns. A closer examination of the data suggest that the components of economic freedom that contribute most to the reduction in crash risk is the level of free trade and, to some extent, the strength of property-right protection.

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