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Financial development and financial liberalization in Asia: Thresholds, institutions and the sequence of liberalization

Hiro Ito *

Department of Economics, Cramer Hall 241, 1721 SW Broadway, Portland State University, Portland, OR 97201, United States

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Abstract

This paper investigates whether financial openness leads to financial development after controlling for the level of legal/institutional development, and whether trade opening is a precondition for financial opening. The focus is on Asia. In a panel encompassing 87 less developed countries over the period 1980 to 2000, a higher level of financial openness is found to spur equity market development only if a threshold level of legal development has been attained, a condition which tends to prevail particularly among emerging market Asian countries. On the issue of sequencing, trade openness is found to be a prerequisite for successful inducement of financial development via capital account liberalization.

JEL classification: F36; F43; G28

Keywords: Financial development; Capital controls; Financial liberalization; Legal institutions; Sequence of liberalization

1. Introduction

The Asian crisis of 1997–1998 confronted policy makers with the conundrum of financial globalization. While more open financial markets can contribute to economic development, it is the openness of financial markets that can make developing countries more vulnerable to financial disruptions (Kaminsky & Schmukler, 2001a, 2001b, 2002; Schmukler, 2003).[1]

* Tel.: +1 503 725 3930; fax: +1 503 725 3945.
E-mail address: ito@pdx.edu.

[1] This study does not discuss the merits of capital controls in the context of financial crises. For a review, see Aizenman (2002). Kletzer and Mody (2000) survey the debate in the context of "self-protection policies" for emerging mar-

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Despite the experience of the 1990s, East Asian policy makers do not appear to have abandoned the path of financial liberalization. Rather, as is best exemplified by the Chiang Mai Initiative, they have re-emphasized economic development through more integrated financial markets in the region. The progress in financial development has occurred against a backdrop of regional trade arrangements. As Pomfret (2005) documents, the Asian currency union also started being discussed in the region, signifying the importance of how to sequence liberalization policies.[2] In sum, the debate is not whether to liberalize, but how to liberalize. This study attempts to inform that debate.

A common view is that capital account liberalization leads to the development of financial markets that channel funds to borrowers with the most productive investment opportunities.[3] Theory suggests several mechanisms for this occurrence. First, financial liberalization may mitigate financial repression in protected financial markets, allowing the real interest rate to rise to its competitive market equilibrium (McKinnon, 1973; Shaw, 1973). Second, the removal of capital controls allows domestic and foreign investors to engage in more portfolio diversification, thereby reducing the cost of capital, and increasing the availability of funds.[4] Third, and not least, the liberalization process usually increases the efficiency of the financial system by weeding out inefficient institutions, creating greater pressure for reform of the financial infrastructure, and alleviating information asymmetry issues such as adverse selection and moral hazard (Claessens et al., 2001; Stulz, 1999; Stiglitz, 2000).

The link between financial liberalization and financial development is not unambiguous, however. One common argument is that to benefit from more open cross-border financial transactions, financial systems need to be equipped with reasonable legal and institutional infrastructure. Specifically, in economies where the legal system does not clearly define property rights or guarantee the enforcement of contracts, the incentives for loan activities can be limited. Legal protections for creditors and the level of credibility and transparency of accounting rules are also likely to affect economic agents' financial decisions.[5] Hence, the ambiguity can be reconciled by hypothesizing that financial liberalization can lead to financial development only if the economic system is equipped with a reasonable level of legal and institutional development.

In this paper, I also examine another oft-discussed issue related to the sequence of liberalization, that is, the order of liberalization in goods and financial markets. The prominent work by McKinnon (1991) argues that liberalization in the trade sector must precede liberalization in

kets. Ito (2004) investigates the correlation between financial liberalization and the output performance of crisis-hit economies.

[2] See Eichengreen (2004) on the arguments for Asian currency union.

[3] See, for instance, Leahy, Schich, Wehinger, Pelgrin, and Thorgeirsson (2001) for OECD-specific results. Klein and Olivei (2001) document the linkage between financial development and economic growth for developed countries, and its absence for less developed countries. Spiegel (2001) examines an APEC sample, while Arteta, Eichengreen, and Wyplosz, (2001) document the fragility of many of these group-specific results. IMF (2001, Chapter 4) surveys both the growth and finance, and finance and liberalization literatures. For the most recent review on finance and growth, refer to Quinn, Toyoda, and Inclan, (2002).

[4] See Stulz (1999), Henry (2000), and Bekaert, Harvey, and Lundblad (2000), Bekaert et al. (2001).

[5] La Porta et al. (1997, 1998) and Levine (1998, 2002) show that low levels of shareholder rights are associated with poorly developed equity markets (especially in French civil law countries), while Claessens, Djankov, Fan, and Lang, (2002) and Caprio, Laeven, and Levine (2004) find that greater creditor rights are positively associated with financial intermediary development. For the analysis of legal development on financial development, see Beck and Levine (2004) and Beim and Calomiris (2001).