

# International financial integration and economic growth

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## Abstract

This paper uses new data and new econometric techniques to investigate the impact of international financial integration on economic growth and also to assess whether this relationship depends on the level of economic development, financial development, legal system development, government corruption, and macroeconomic policies. Using a wide array of measures of international financial integration for 57 countries and an assortment of statistical methodologies, we are unable to reject the null hypothesis that international financial integration does not accelerate economic growth even when controlling for particular economic, financial, institutional, and policy characteristics.

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## 1. Introduction

Theory provides conflicting predictions about the growth effects of international financial integration (IFI), i.e., the degree to which an economy does not restrict cross-border transactions. According to some theories, IFI facilitates risk-sharing and thereby enhances production specialization, capital allocation, and economic growth (Obstfeld, 1994; Acemoglu and Zilibotti, 1997). Further, in the standard neoclassical

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growth model, IFI eases the flow of capital to capital-scarce countries with positive output effects. Also, IFI may enhance the functioning of domestic financial systems, through the intensification of competition and the importation of financial services, with positive growth effects (Klein and Olivei, 2000; Levine, 2001). On the other hand, IFI in the presence of pre-existing distortions can actually retard growth.<sup>1</sup> Boyd and Smith (1992), for instance, show that IFI in countries with weak institutions and policies—e.g., weak financial and legal systems—may actually induce a capital outflow from capital-scarce countries to capital-abundant countries with better institutions. Thus, some theories predict that international financial integration will promote growth only in countries with sound institutions and good policies.

Although theoretical disputes and the concomitant policy debate over the growth effects of IFI have produced a burgeoning empirical literature, resolving this issue is complicated by the difficulty in measuring IFI. Countries impose a complex array of price and quantity controls on a broad assortment of financial transactions. Thus, researchers face enormous hurdles in measuring cross-country differences in the nature, intensity, and effectiveness of barriers to international capital flows (Eichengreen, 2001).

In practice, empirical analyses use either (i) proxies for government restrictions on capital flows or (ii) measures of actual international capital flows. The International Monetary Fund's (IMF) IMF-restriction measure is the most commonly used proxy of government restrictions on international financial transactions. It classifies countries on an annual basis by the presence or absence of restrictions, i.e. it is a zero-one dummy variable. Quinn (1997) attempts to improve upon the IMF-restriction measure by reading through the IMF's narrative descriptions of capital account restrictions and assigning scores of the intensity of capital restrictions. Unfortunately, the Quinn (1997) measure is only available for selected years for most countries (1958, 1973, 1982, and 1988). The advantage of the IMF-Restriction and Quinn (1997) measures is that they proxy directly for government impediments. The disadvantage of both measures, as noted above, stems from the difficulty in accurately gauging the magnitude and effectiveness of government restrictions.

Empirical studies also use measures of actual international capital flows to proxy for international financial openness. The assumption is that more capital flows as a share of Gross Domestic Product (GDP) are a signal of greater IFI. The advantage of these measures is that they are widely available and they are not subjective measures of capital restrictions. A disadvantage is that many factors influence capital flows. Indeed, growth may influence capital flows and policy changes may influence both growth and capital flows, producing a spurious, positive relationship between growth and capital flows, and growth may affect capital flows. This highlights the need to account for possible endogeneity in assessing the growth IFI-relationship.

Empirical evidence yields conflicting conclusions about the growth effects of IFI.

<sup>1</sup> To paraphrase Eichengreen's (2001, p.1) insightful literature review, there are innumerable constellations of distortions for which liberalization of international capital controls will hurt resource allocation and growth. For example, in the presence of trade distortions, capital account liberalization may induce capital inflows to sectors in which the country has a comparative disadvantage.

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