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What matters for financial development? Capital controls, institutions, and interactions

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Abstract

We investigate whether financial openness leads to financial development after controlling for the level of legal development using a panel encompassing 108 countries over the period 1980 to 2000. We also examine the issue of the optimal sequence of liberalization in both goods and financial markets. Our findings suggest that a higher level of financial openness spurs equity market development only if a threshold level of legal development has been attained. On the issue of sequencing, we find that trade openness is a prerequisite for capital account liberalization while banking system development is a precondition for equity market development.

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1. Introduction

Recent years have witnessed a surge of interest in issues surrounding globalization, including financial globalization. A series of financial crises in the 1990s rekindled the debates on the effects of removing capital controls, which led many observers to reconsider

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gains and pains of financial liberalization (Kaminsky and Schmukler, 2001a,b, 2002; Schmukler, 2003).[1]

Many studies have argued capital account liberalization can affect economic development through financial development; liberalized financial markets may contribute to developing financial markets that provide funds to borrowers who may have productive investment opportunities.[2] Theory suggests that capital account liberalization can lead to development of financial systems through several channels. 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, removing capital controls allows domestic and foreign investors to engage in more portfolio diversification. These two points can be summarized as that financial liberalization may reduce the cost of capital and increasing its availability for the borrowers. Stultz (1999) shows that financial globalization reduces the cost of equity capital because of the reduction in the expected returns to compensate risk as well as in agency costs (also, Henry, 2000; Bekaert et al., 2000, 2001). Third, not least, the liberalization process usually increases the efficiency level of the financial system by weeding out inefficient financial institutions and creating greater pressure for a reform of the financial infrastructure (Claessens et al., 2001; Stultz, 1999; Stiglitz, 2000). Such an improvement in financial infrastructure may alleviate information asymmetry, decreasing adverse selection and moral hazard, and further raising the availability of credit.

The link between financial liberalization and financial development is not unequivocal, however. It is often argued that to benefit from more open cross-border financial transactions, financial systems need to be equipped with reasonable legal and institutional infrastructure.

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.[3] Levine et al. (2000) investigate whether the level of legal and regulatory determinants of financial development influences the development financial intermediary sector. La Porta, Lopez-de-Silanes, Shleifer, and Vishny (hereafter La Porta et al., 1997, 1998) argue that the national legal origin (whether English, French, German, or Scandinavian) strongly affects the legal and regulatory environment in financial transactions and explains cross-country differences in financial development. 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). In contrast, Common law

[1] In this study, we do 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 markets. Ito (2004) investigates the correlation between financial liberalization and the output performance of crisis-hit economies.

[2] See, for instance, Leahy et al. (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, while Spiegel (2001) examines an APEC sample. Arteta et al. (2001) and Klein (2005) document the presence of nonlinearities in growth effects of capital account liberalizations. 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 et al. (2002).

[3] For the analysis of legal development on financial development, see Beck and Levine (2004), Claessens et al. (2002a), Caprio et al. (2004), and Johnson et al. (2002). For a general discussion on the importance of legal and institutional foundations for financial development, see Beim and Calomiris (2001) and Stultz (1999).