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Trade liberalization, capital account liberalization and the real effects of financial development ☆

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Abstract

This paper provides evidence that international economic integration changes the real effect of domestic financial institutions. Using a cross-country panel we show that domestic financial development has a smaller effect on growth in countries that are open to trade and capital flows than among countries that are closed in both dimensions. We then use sectoral data to show that this decline in the importance of financial development can be explained by its irrelevance for tradable sectors in countries that are fully integrated to the world economy. We also explore the consequences of these findings for the sequencing of reform.

JEL classification: F36; F43; O16; O24

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1. Introduction

The last 30 years have witnessed a burst in trade and capital account liberalization. For instance, according to Wacziarg and Welch (2003) the percentage of countries open to trade

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increased from 16 to 73% between 1960 and 2000, and Edwards (2004) reports that the degree of capital mobility has increased in all regions of the world between 1970 and 2000. Also, as we will show later, in our sample of 108 countries for the 1970–2003 period, the number of countries that allows free trade grew from 24 to 88 in the case of goods, and from 10 to 47 for capital.

A number of studies have attempted to document the real effects of international integration (Sachs and Warner, 1995; Quinn, 1997; among many others). The benefits on the aggregate of lifting barriers to trade and capital flows, and particularly the latter, are still debated. Indeed, the disparate performance – both in terms of the effects on growth and the continuation of the reform process – of many middle-income countries that liberalized since the late 1980s precipitated research on the question of weather international integration has different effects across countries with dissimilar domestic institutional quality (Rodrik, 1999). A related angle is the impact that integration can have on the development of local institutions (see Rodrik, 2000; Levine and Schmukler, 2005; Klein and Olivei, 1999). As more and more research points to the importance of institutions for growth (see Acemoglu et al., 2005 for a review of the literature), determining the way the massive process of integration might interact with these becomes essential.

This paper explores the question of how international integration affects the role of one particular institution that has been shown to be quite important for growth: the development of the financial system (see, for instance, King and Levine, 1993; Demirgüç-Kunt and Maksimovic, 1998; Rajan and Zingales, 1998; Jayaratne and Strahan, 1996).

Whether international integration and domestic financial development are substitutes or complements is in the end and empirical question that is quite important in designing the reform process. A few papers have looked at this question from the perspective of whether the level of financial development affects the relation between capital account liberalization and average growth across countries (see Kraay, 1998; Arteta et al., 2001). Others have focused on documenting the relation between policies and outcomes in the integration front with those related to the domestic financial system. For instance, Aizenman and Noy (2004) and Ito and Chinn (2006) look at whether trade openness leads to financial openness and vice versa, and at the relation between financial openness and domestic financial development.

Our approach is different. Instead of relating openness to domestic finance directly, we look at whether international integration affects the *importance* of the domestic financial system for economic growth. In that sense we complement the existing literature by saying something about why these two reforms might be related. Theoretically, the relation between trade and capital account liberalization is not a simple one. On one hand, integration raises new investment opportunities and calls for capital reallocation, both of which would make domestic financial development more relevant. On the other hand, integration could allow some – the tradable sectors, in particular – to gain greater access the international capital markets, making the local financial system less relevant.

We first use cross-country data to show that the real effects of financial development on growth are much stronger when a country is closed to both trade and capital flows. In fact, the real effects of domestic financial development are largely insignificant in countries that are open in both dimensions. We next use sectoral data to explore the causes of this differential effect of financial development across regimes. We find that financial development has a relatively smaller effect on tradable sectors, especially so when a country is open to both trade and capital flows. So, our sectoral results indicate that the small real effect of financial development in countries that are open to trade and capital flows is probably the result of the irrelevance of