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Capital account liberalization, financial development and industry growth: A synthetic view

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A B S T R A C T

This paper synthesizes studies analyzing the effects of capital account liberalization on industry growth while controlling for financial crises, domestic financial development and the strength of institutions. We find evidence that financial openness has positive effects on the growth of financially dependent industries, although these growth-enhancing effects evaporate during financial crises. Further analysis indicates that the positive effects of capital account liberalization are limited to countries with relatively well-developed financial systems, good accounting standards, strong creditor rights and rule of law. It suggests that countries must reach a certain threshold in terms of institutional and economic development before they can expect to benefit from capital account liberalization.

1. Introduction

The growth effects of capital account liberalization are an issue that will not go away. Since the turn of the century additional countries have moved to relax and remove restrictions on capital flows (Fig. 1). The subsequent decade then saw the fastest global growth in more than 30 years, an outcome in which many low- and middle-income countries shared. This coincidence of timing encouraged

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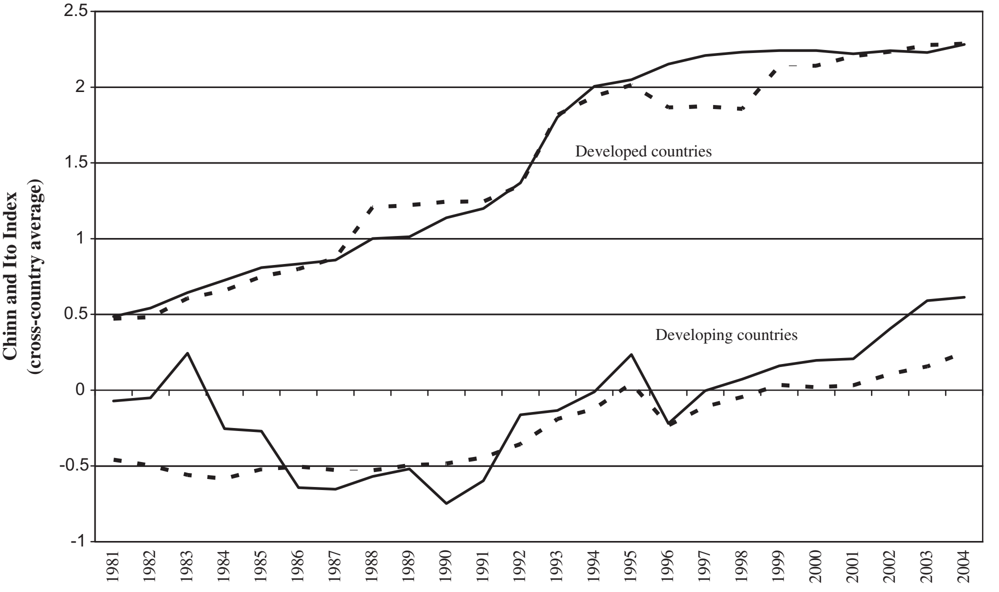

Fig. 1. The evolution of capital account liberalization. The solid lines are cross-country averages for the countries used in the empirical analysis of this paper. The dotted lines are cross-country averages for all the countries included in the Chinn and Ito (2006) dataset.

causal arguments that capital mobility was contributing to growth. Indeed some explanations made the connection explicit, such as the so-called Bretton Woods II model which portrays capital mobility as an essential element of high global growth in recent years.[1]

The crisis of 2007–2008 then turned these arguments on their head. It is now argued that an open capital account, combined with high savings in countries like China, fueled the capital flows that inflated housing markets and asset valuations in the United States. Openness to capital flows, it is further argued, allowed current account deficits to widen unsustainably in Central and Eastern Europe and encouraged the development of dangerous currency and maturity mismatches everywhere from Hungary to South Korea.[2] A movement to reimpose restrictions on capital flows may now be getting underway in response. Recent experience thus highlights the fact that the debate over the growth effects of capital account liberalization remains fundamentally unresolved.

Since Rodrik (1998), who found no correlation between capital account liberalization and growth, large amounts of computer time have been consumed in attempts to identify or discredit the existence of an effect.[3] It is of course possible to find no evidence of an effect when one exists; this can result from noisy data, omitted variables or other forms of model misspecification.[4] But it is equally possible to find evidence of an effect when none exists owing to reverse causality running from growth and higher incomes to capital account liberalization.

[1] The locus classicus of Bretton Woods II is Dooley et al. (2003).

[2] The idea that the costs and benefits of capital mobility leave a different impression in crisis and non-crisis periods is hardly novel. Thus, Eichengreen and Leblang (2003) distinguish crisis and non-crisis periods using the standard model of the macroeconomic effects of capital account liberalization.

[3] Recent surveys of this literature are Eichengreen (2001), Kose et al. (2006), Henry (2007), and Rodrik and Subramanian (2008).

[4] As one economist once put it, the secret of successful research is to define one's null so that failure to estimate a significant coefficient can be claimed as success.