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Financial liberalization, disaggregated capital flows and banking crisis: Evidence from developing countries ☆

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ABSTRACT

The aim of this paper is to examine whether financial liberalization has triggered banking crises in some developing countries. We focus in particular on the role of capital flows as their volatilities threat economic stability and growth. In the empirical model, based on panel logit estimation, we use the two common financial liberalization indicators (*defacto* and *dejure*) for a panel of 58 developing countries observed during the period 1984–2007. Unlike the previous studies, this paper reveals that both indicators of financial liberalization did not trigger banking crises. However, the results show that foreign debt liabilities to total liabilities and foreign direct investment liabilities to total liabilities increase the likelihood of banking crises.

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1. Introduction

Financial liberalization is defined as the implementation of a set of measures aimed at eliminating the different restrictions and repression on the financial sector of a country that could hinder the well-functioning of its economy. These measures consist essentially on freeing interest rates, reducing credit control, eliminating barriers to entry, and removing restrictions on overseas financial transactions. For McKinnon (1973) and Shaw (1973), the weak growth and the lack of performance of developing economies during the sixties are due to the ineffectiveness of their financial markets which were fully controlled by the government. For them, developing economies were under "financial repression regime" in which the government intervenes in the monetary sphere to set interest rates and to fix the different tools of monetary policy. McKinnon (1973) and Shaw (1973) viewed the liberalization of interest rates and capital account as an efficient solution to eliminate directed credits and to remove control of interest rates and high reserve requirements. They consider the external financial liberalization as an important economic policy tool that enhances economic growth. McKinnon (1973) and Shaw (1973), also consider financial liberalization as a mainstay of economic reforms in developing countries (Balassa, 1989a, b). They called policymakers of less developed economies to participate in the global financial integration to benefit the advantages of interconnected financial systems and to promote their banking and financial sectors.

In the late eighties, financial liberalization became a strategy suggested by the International Monetary Fund and the World Bank under a framework called "Structural Adjustment Programs" (SAPs henceforth) to rescue fragile economies, notably those of developing countries (Hamdi et al., 2013). This framework suggests the easing of portfolio restrictions on banks, changing the ownership of banks, enhancing competition among financial institutions, integrating of domestic entities to international markets, as well as changing the monetary policy environment (Ucer, 1998). As a result, numerous countries adopted the SAPs and have progressively liberalized their economies with the aims of improving financial development and economic growth (Bekaert et al, 2005; Tornell et al, 2004).

The debate on the impacts of financial liberalization on economic growth has received a great deal of attention by scholars and policymakers over the past three decades. However, the empirical studies have produced mixed and conflicting results. In fact, some authors (Levine, 2001; Mishkin, 2005; Prasad et al., 2003) showed that liberalization of capital flows can benefit both source and host countries by improving resource allocation, reducing financing costs, increasing competition and accelerating the development of domestic financial systems (IMF, 2012). On the other hand, several studies showed the adverse impact of financial liberalization and they demonstrated the potential role of liberalization on producing financial and economic crises (Caprio and Klingebiel, 1996; Demirguc-Kunt and Detragiache, 1998a, 1998b, 2000; Kaminsky and Reinhart, 1999; Mehrez and Kaufman, 2000).

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The main purpose of this study is to investigate the consequences of financial liberalization indicators (*dejure* and *defacto*) on the likelihood of triggering a banking crisis in a large sample of developing countries. We employ a logit panel model to identify the factors that determine the occurrence of a bank crisis. Our methodology follows the previous studies, (Choudhry and de Haan, 2009; Demirguc-Kunt and Detragiache, 1998a, b; Joyce, 2010), but it differs in at least three points. First, we used more recent data which covers the period from 1984 to 2007. Second, we included in our sample more developing countries; 58 in all.[1] Third, while recent studies have used only three indicators of foreign direct investments scaled by gross domestic product (GDP henceforth), we used in this paper six different ratios. Therefore, the paper focuses on the responses of foreign direct investment, portfolio flows, and other debt flows to financial liberalization and it examines the interaction between these indicators and the total foreign direct assets and liabilities. The main finding of this paper reveals that indicators of financial liberalization (*dejure* and *defacto*) did not trigger banking crises in our sample.

The remainder of the paper is organized as follows: Section 2 presents a brief literature review, Section 3 describes the methodology and data, section four presents the empirical results and section five concludes.

2. Literature review

Literature on financial liberalization is rich and abundant. Nevertheless, empirical evidence provided inconclusive results on the effects of liberalization on growth and financial stability. We can classify the literature in two categories.

Authors of the first category demonstrated that financial liberalization improves financial development and contributes to higher long-run growth (King and Levine, 1993; Bekaert et al., 2004, Arteta et al. 2001, Edwards 2001, Mishkin, 2008). They showed how financial liberalization can play an important role in the development of financial institutions in emerging market economies and how both external and internal liberalizations tend to improve the financial infrastructure and bank governance (Schmukler, 2004a, b). For example, Mishkin (2008) claimed that liberalization can reduce the cost of capital, thereby encouraging investment which promotes growth. He showed that globalization of the financial system helps promote the development of better property rights and institutions that make the domestic financial sector works better in getting capital to productive uses (Mishkin, 2006). In another study, Prasad et al. (2003) and Kose et al. (2004) showed that investment in developing countries is constrained by an insufficient level of domestic saving. They showed that opening up an economy to capital flows will promote domestic savings, lowers the cost of capital and reduces the consumption volatility. Angkinand et al. (2010) showed that the removal of capital control can lead to more foreign direct investment (FDI), which will bring in new technology and management skill. Henry (2007) argues that liberalizations in emerging countries do increase investment activities and strengthen growth, but that these benefits are temporary. Bekaert et al. (2005) argued that stock market liberalizations do increase growth. Using industry level data, the study of Levchenko et al. (2009) also shows the positive effects of liberalizations on growth. Bonfiglioli (2008) studied the effects of financial integration on the productivity (TFP) and investment using a sample of 70 countries observed between 1975 and 1999. The results for both *dejure* and *defacto* indicators suggest that financial integration has a positive direct effect on productivity, while it does not directly affect capital accumulation. In another recent study, Shehzad and De Haan (2009) investigated the impacts of financial liberalization on the likelihood of systematic and non-systematic banking crises for a large sample of developing and developed countries observed during the period 1973–2002. Using multivariate probit model, their results show that financial liberalization reduces the risk of systematic crises. Other studies conducted by Arteta et al. (2001), Edwards (2001), Bekaert et al. (2005), Alfaro et al. (2008), and Papaioannou (2009) focused on the role of institutions and show that liberalization in developing countries leads to larger capital inflows, and higher investment which in turn improve long-run economic growth.

Authors of the second group argued that liberalization is a principal threat of economic stability and the main cause of banking crisis. The studies by Díaz-Alejandro (1985), Kaminsky and Reinhart (1999) and Kose et al.(2003) show that liberalization generate high macroeconomic volatility. Kaminsky and Reinhart (1999) presented evidence of a positive association between banking crises and financial liberalization for a panel of 20 countries observed during the period 1970–1995. They found that 18 out of 26 banking crises studied were preceded by a liberalization of the financial sector. They concluded that the probability of a banking crisis increases by 40% if a country liberalizes its domestic banking system. In another study, Demirgüç-Kunt and Detragiache (1999) studied a sample of 53 countries observed during the period 1980–1995 and their results revealed that banking crises were more likely to occur in a deregulated financial system. Weller (2001) surveys 26 emerging economies using monthly data into before and after financial liberalization. His results suggest strong evidence of increasing frequency and severity of financial crises in the period that follows the date of liberalization. Noy (2004) conducted a study to investigate the link between financial liberalization and banking crises for a sample of 61 non-OECD countries during the period 1975–1997. He employed an empirical model based on panel probit estimation and concluded that if liberalization is accompanied by insufficient prudential supervision of the banking sector, it will result in excessive risk taking by financial intermediaries and a subsequent crisis in the medium-run. He stated that more immediate danger is the loss of monopoly power that liberalization typically entails. Arteta and Eichengreen (2002) surveyed a sample of 75 emerging markets and developing countries during the period of 1975–1997. Their results suggest that capital account liberalization increases the likelihood of banking crises for countries that liberalize interest rate controls. Reinhart and Rogoff (2008) examined the determinants of banking crises for a large sample of countries over the period 1800–2008. They found that, since the early 19th century, there was a strong correlation between capital mobility and banking crises. The same study also showed that during the periods where capital mobility was interrupted,[2] there was a remarkable decrease in banking crises.

In a different type of analysis, Kaminsky (2008) examined the determinants of sudden stop of international capital flows in 26 emerging countries. She showed that a high level of financial integration increases the risk of sudden stop of capital flows, even in the absence of macroeconomic imbalances found in the host country. More recently, Joyce (2010) conducted a study to assess the effect of financial integration on the costs and duration of systemic banking crises for 20 emerging countries over the years 1976–2002. He showed that the nature of capital flows (in and out) plays a very important role on the stability of the banking sector of a country. He also found that an increase in foreign direct investment in a country tends to decrease the number and

[1] We are interested to examine developing countries for several reasons. First, they are much exposed to external shocks as the level of their real income per capita is not sufficient to withstand a banking crisis. Second, banks' balance sheets of developing countries are mainly based on traditional activities and therefore, there is no diversification of risks. Consequently, they are vulnerable to any supply side shocks. Third, as Schmukler (2004) opined, deregulation, privatization, and advances in technology made foreign direct investment (FDI) and equity investments in emerging markets more attractive to firms and households in developed countries.

[2] For example, after the Second World War until the 1970s. According to Lane and Milesi-Ferretti (2005), the accumulation of larger stocks of gross foreign assets and liabilities has increased the magnitude of fluctuations in the value of cross-border holdings. Several other studies showed the close link between financial liberalization and banking crises.

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