Journal of International Money and Finance 62 (2016) 25–51

Contents lists available at ScienceDirect

Journal of International Money and Finance

journal homepage: www.elsevier.com/locate/jimf

Financial liberalization, insurance market, and the likelihood of financial crises

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A R T I C L E I N F O

Article history:
Available online 17 December 2015

JEL Classification:
G22
G23
E44
O16

Keywords:
Financial crisis
Financial liberalization
Insurance market
Country risk
Panel data

A B S T R A C T

This paper provides empirical evidence to investigate the direct impact of financial liberalization on the likelihood of currency/systemic banking crises, and examines the roles of insurance market, country risk, and economic conditional variables on the relationship between financial liberalization and financial crises in 39 countries. Our empirical results support that financial liberalization does have a significantly negative impact on the likelihood of currency/systemic banking crises, and that the indirect effects of insurance development and lower country risk decrease the probability of crises, but the indirect effect of economic conditional proxies is enhanced with the likelihood of a financial crisis. The policy implication is that the government or authority should strengthen the positive role of the insurance sector in order to combat financial crises.

1. Introduction

Many recent debates have centered around the effectiveness of a program of financial liberalization as a means of spurring economic growth. Various experiences have shown that countries do benefit in several ways from financial liberalization (i.e., Klein and Olivei, 2008; Quinn and Toyoda, 2008; Shehzad and De Hann, 2009; Rousseau and Wachtel, 2011; Baier et al., 2012). Conceptually, the most straightforward advantage is having a greater supply of external financing available at lower costs (Beck et al., 2013). However, several notable financial or banking crises have prompted many studies to explore

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http://dx.doi.org/10.1016/j.jimonfin.2015.12.002
0261-5606/

their causes (e.g., Caprio and Klingebiel, 1996; Angkinand et al., 2010), essentially blaming financial liberalization for having a strong link with these crises[1] (e.g., Demirgüç-Kunt and Detragiache, 2001), even as some studies do not concur (e.g., Shehzad and De Hann, 2009). Thus far, the financial liberalization–crisis nexus in the literature offers no concrete conclusion.

As to those inconsistent results, studies such as Shehzad and De Hann (2009), Angkinand et al. (2010), and Amri et al. (2011) address the importance of supervision, regulation, or the overall level of financial liberalization upon the financial reform–crisis relation. Mixed findings about this relation may be ascribed to different economic, institutional, or financial conditions. If financial liberalization is indeed inevitable, then other ways to manage its drawback(s) should be found, like offering sound regulations, a complete supervisory mechanism, or a channel for mitigating financial and banking risks. For example, Haiss and Sümegi (2008) suggest that insurance has the function of enhancing the capacity of individuals and enterprises to bear risks, and reduces uncertainty and volatility in the economic system.

In addition to the insurance industry, macroeconomic factors (e.g., inflation, GDP, and monetary policy) are also important determinants of financial crises (Angkinand et al., 2010; Joyce, 2011). Previous studies advocate political stability's positive impact on economic performance (e.g., Bellettini et al., 2009; Pasiouras and Gaganis, 2013) – that is, an institutional framework is central to economic growth. For example, Law et al. (2013) argue that an increase in economic development may not result in greater growth due to corruption or political interference. Moreover, political stability and institutional quality are found to play an important role on the likelihood of a crisis (Cavallo and Cavallo, 2010; Shehzad and De Hann, 2009). As investigations into the relationship between institutional quality and financial crises have fallen behind in the literature, we therefore examine the effect of institutional risk on the likelihood of financial crises. To sum up, our goal is to present the roles of insurance market, country risk, and economic conditional variables on the relationship between financial liberalization and financial crises. This is the first globally focused paper with cross-county data that deals with financial crisis issues, and investigates two main hypotheses – the "institutional enhancement hypothesis" and the "institutional deterioration hypothesis"[2] – when analyzing the impacts from financial liberalization.

To shed light on these issues, this paper explores whether or not there are impacts from different dimensions of financial liberalizations by considering economic, institutional risk, and financial conditions. This paper delves into three broad conditions: political and economic risks for *institutional condition*, life and non-life insurance sectors for *financial condition*, and private capital flow and real interest rate for *economic condition*. One crucial area of focus is on how and to what extent do different kinds of conditions under financial liberalization relate to financial crises.

The contributions of this paper are threefold. First, we investigate the financial liberalization–financial crisis nexus using multifaceted indicators with cross-country data. The multidimensional liberalization measure provides a more comprehensive evaluation than a single liberalization indicator and offers a detailed discussion on the channels. Second, in order to eliminate the potential endogeneity bias from the model and take time lags of financial policy into consideration, we regress lagged one period of all independent variables on the current period of the financial crisis dependent variable. Third, we discuss the impacts of insurance sector, institutional risks, and economic characteristics as additional conditions on the likelihood of financial crises. Overall, our findings suggest that financial liberalization has a negative impact on the occurrence of currency and systemic banking crises – that is, financial liberalization enhances the stability of currency and banking systems. In addition, a well-developed insurance industry and low country risk decrease the likelihood of crises, but higher private capital flow and high real interest rate are positively associated with the likelihood of crises.

[1] Financial liberalization also incurs certain risks.

[2] For example, "institutional enhancement hypothesis" means that a higher degree of financial liberalization has a negative impact on the likelihood of financial crises, and institutional environments adversely affect that negative impact. Institutional environments support the "institutional enhancement hypothesis." However, if institutional environments favorably influence that negative impact, then the "institutional deterioration hypothesis" is supported.