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Financial liberalization and the onset of financial crisis in Western European states between 1983 and 2011: An econometric investigation

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ABSTRACT

This paper argues that financial liberalization played a significant role in destabilizing Western European economies since the financial crisis of 2008. This process owes much to changes in the financial governance of Western Europe in the late 20th century. This contrasts with the conventional story that the Eurocrisis is primarily due to peripheral countries' excessive government spending or the German government's neo-mercantilist policies. The paper shows a robust and statistically significant positive correlation between gross locational capital flows over GDP and the onset of financial crisis, using linear probability models and logit regressions, providing evidence for the hypotheses.

1. Introduction

This paper seeks to answer two questions. How has financial liberalization affected the onset of financial crisis in Europe? Specifically, is it to blame for the 2008 financial crisis? Many conventional economists agree that there is a link between financial liberalization and financial crisis in developing countries, but that sufficient macroprudential policies and institutional integrity protect "developed" states, such as those in the European Union from crisis in the event of financial liberalization. Further,

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conventional analysis of the Eurozone crisis has focused predominantly on the role divergent current account and fiscal balances have played within Europe following the Eurozone's creation (Feldstein, 2012; Krugman, 2012). While these factors may be significant for explaining Europe's sovereign debt crisis, these explanations neglect the role financial integration played in facilitating the trade in the Eurozone that exacerbated current account divergence.

I argue that European financial liberalization reforms from the 1970s through the 1990s increased European vulnerability to financial crisis, and that the onset of the EMU accelerated this process. In order to qualify for membership, states with little experience with financial liberalization rapidly opened their financial markets to outside capital markets, and unprecedented capital flows ensued. This increased their vulnerability to hot capital inflows, and to the risk of capital flight in a moment of crisis. My hypotheses are informed from two angles. First, empirical surveys of the incidence of crisis and changes in international capital flows in Europe reveal trends of both an increasing frequency of financial crisis since the early 1980s, and a rapid and substantial increased volume of international lending and borrowing, both in absolute terms, and relative to GDP. Second, an institutional history of the European financial architecture shows a landscape in which a few states – namely Germany and the Netherlands – led the European financial liberalization process following the Second World War, followed by successive waves of states' financial liberalization in the 1980s and 1990s. The last states to liberalize – Greece, Italy, Portugal, and Spain – are currently in a state of sovereign debt crisis. These states had less experience with liberalized finance and the absence of capital controls relative to other European states, and most of these countries rapidly liberalized in order to qualify for membership in Europe's Economic and Monetary Union (EMU). Further, financial actors in Europe's more financially sophisticated centers embraced many instruments and practices US bankers employed in the lead-up to the subprime mortgage crisis in 2007, and this increased systemic risk in the region considerably.

These two sets of facts motivate this econometric analysis of the connection between financial liberalization and European financial crisis that supports these hypotheses. I design a model to evaluate the correlation between financial liberalization, using both gross locational capital flows and institutional variables such as bank entry liberalization and supervision, and the onset of financial crisis in Austria, Belgium, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the UK, between 1983 and 2011. I include controls frequently used in the literature to account for trade flows, fiscal balances government debt over GDP, change in domestic investment, GDP per capita, and short-term interest rates. Throughout various permutations, the model robustly supports the idea that financial liberalization has played a significant role in increasing the likelihood of financial crisis in these countries, even in the presence of structural breaks.

This paper is organized as follows. The paper's next section discusses the institutional changes in Europe that encouraged the rapid liberalization from the 1980s through the early 2000s, presents empirical data demonstrating the increasing frequency of financial crisis in Europe since the 1980s, as well as the substantial increase in financial flows throughout the region at the same time, and outlines a literature review of econometric analyses of the links between financial liberalization and financial crisis. The fourth section presents the econometric model described above, and discusses its findings. The last section synthesizes the above analysis, and points toward future research.

2. Literature review

2.1. Institutional history

Significant institutional change in Western European financial sectors created the context for the large change in cross-border borrowing and lending that occurred in the 1990s, and again in the early 2000s. This process partly reflected global trends in economic policy regarding the costs of financial regulation and economic growth, but had much to do with the creation of the EMU, which mandated key financial liberalization reforms for would-be members. This period of change represented an acceleration of financial trends apparent since the Second World War: the Netherlands and Germany, instituted liberalization measures in the 1960s and 1970s respectively; France and the Scandinavian states, removed capital controls and interest rate ceilings, while simultaneously privatizing banks in