
ECONOMICS

Does Financial Liberalization Spur Growth?

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The authors examine the association between financial liberalization and economic growth. The authors determine that average annual real economic growth increases by 1 percent subsequent to equity market liberalization across a sample of developing and developed countries. This result is robust across alternative liberalization indicators, model specifications, time period selection, and sample size. When comparing post-liberalized countries to those that did not undertake financial liberalization, the results are even more pronounced, with average annual real GDP growth a full 2.2 percent higher for the liberalized countries.

Economic theory suggests that financial systems with fewer constraints achieve higher investment (with lower financing cost) and economic growth rates. This study empirically tests the relationship between economic growth and equity market liberalization. Equity market liberalization occurs when foreign investors have the ability to invest in domestic equity securities and foreign securities are available to domestic investors.

Regressing economic growth on indicators of equity market liberalization, the authors determine that average annual real economic growth increases by about 1 percent following equity market liberalization across four different country samples and through time. To confirm a robust association that equity market liberalization matters for economic growth, the authors use a number of econometric model specifications involving regressions of real per capita GDP growth on

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multiple equity market liberalization indicators and other control variables. Indicators of equity market liberalization include: (1) the year of formal regulatory change (i.e., official equity market liberalization); (2) the first sign of equity market liberalization defined as the year associated with the earliest of the following events: official liberalization, announcement of the first American Depositary Receipt, or the launch of the first country fund; and (3) the intensity of equity market liberalization based on the ratio of the market capitalization of the constituent firms composing the International Finance Corporation (IFC) Investable Index to those that compose the IFC Global Index for each country.

To account for the possibility that higher growth might be caused by factors other than equity market liberalization during the study period, the authors include different mixes of control variables across model specifications. In particular, capital account liberalization, past banking-sector reform, macroeconomic stability, the world business cycle, and reform of the legal infrastructure were all candidate control variables across the models under review. The authors find that the impact of equity market liberalization on growth is not weakened when other potential variables associated with growth are included in the regressions.

The authors then examine the possibility that higher growth might be caused by other contemporaneous domestic reforms rather than equity market liberalization. After accounting for reforms with respect to the legal environment, the quality of institutions, the investment condition, and the degree of financial development, the authors find that although some portion of economic growth is associated with these other domestic reforms, equity market liberalization still has a statistically significant impact on growth.

The authors also break down the sample to examine those countries that have undertaken more comprehensive domestic reform. The authors test the extent of such reform, in combination with equity market liberalization, to better understand if the equity market liberalization effect for these countries is greater than it is for those countries that liberalize equity markets but do so with only minor domestic reforms in these other areas. The authors find that for countries with a higher-than-average level of financial development,

the growth-enhancing benefits from equity market liberalization both add to economic growth and provide a greater incremental effect relative to those countries that started with below-average financial development and then liberalized. In addition, countries that benefited the most from liberalization shared common attributes of relatively better quality institutions and of relatively better investment environments, thereby bringing a larger effect on growth from liberalization.

Lastly, the growth gap widens between those countries that undertake financial liberalization and those that do not, with real GDP growing by an additional 2.2 percent on an average annual basis for those countries that do liberalize.

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