

Financial Liberalization and Economic Growth: Do Prudential Supervision and Regulation matter?

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Introduction: Since the late 1970s many countries have started to liberalize financial system so as to enhance economic growth. However, events following the implementation of financial reforms in some countries did not provide much support to the theoretical promises of the liberalization thesis. In fact, some countries witnessed dramatic crises which were followed by painful economic downturns (Diaz, 1985).

Previous research: Some researchers have tried to investigate why financial liberalization policy has different effect on growth in various countries. For example, Hellmann et al. (2000) investigate the role of capital requirements and deposit rate regulations. Among others, McKinnon (1991) emphasizes the sequencing of economic reform while Levine et al. (2000) and Bekaert et al (2005) focus on the role of governance and legal factors.

Aim: In this paper, we investigate empirically the role of the quality of supervision on the response of growth to financial liberalization in a sample of 30 countries over the period 1973-2005 using dynamic panel approach. Our index for the quality of supervision is constructed based on Bank for International Settlement (BIS) standards so called the Basel Accord.

Measure of financial liberalization: The aggregate index for financial is constructed from several elements as:

1. The elimination of credit controls, such as directed credit to preferential sectors, ceilings on credit, and excessively high reserve requirements,
2. The deregulation of interest rates, including whether the government directly controls interest rates, or whether floors, ceilings, or interest rate bands exist,
3. Privatization of state owned banks in the financial sector.
4. The end of regulations on offshore borrowing by domestic financial and non-financial institutions,
5. The use of multiple exchange rates, and controls on capital outflows.
6. the evolution of regulations on the acquisition of shares in the domestic stock market by foreigners,
7. Repatriation of capital and repatriation of dividends and interest.

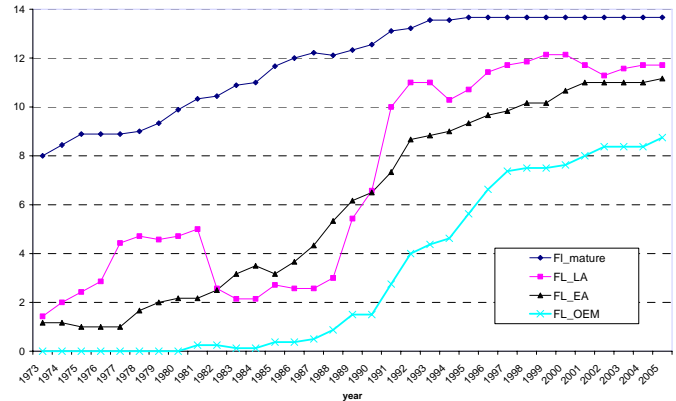


Table 1 Financial liberalization and economic growth: the role of supervision and regulation: GMM-DIF estimation
Dependent variable: log of real GDP per capita $\ln Y_{i,t}$

	supervision		Legal factors	
	Basel principles (1)	Law and Order (2)	Insider tradin (3)	
$\ln Y_{i,t-1}$	0.8470* (0.0505)	0.7997 (0.0542)	0.6890 (0.0616)	0.8075 (0.0561)
$\ln Y_{i,t-2}$	-0.0899** (0.0474)	-0.0721** (0.0448)	-	-0.0929* (0.0445)
Hc_t	0.0404* (0.0082)	0.0378** (0.0092)	0.0602* (0.0144)	0.0405* (0.0097)
Govcons _t	-0.0037* (0.0012)	-0.0050* (-0.0014)	-0.0037* (0.0018)	-0.0041* (-0.0013)
Invst _t	0.0011 (0.0007)	0.0017* (0.0007)	0.0021* (0.0008)	0.0017* (0.0007)
Inflcpi _t	-0.00001 (9.5e-06)	-0.0001 (-8.8e-6)	-0.0001 (-7.8e-6)	-0.00001 (-9.03e-6)
Trde _t	0.0004 (0.0005)	0.0001 (0.0005)	0.0005 (0.0006)	0.0002 (0.0005)
FLib _t	0.0033* (0.0009)	0.0015 (0.0010)	0.0016 (0.0028)	0.0033* (0.0010)
FLib _t . Basel	-	0.0028* (0.0011)	-	-
FLib _t . LawOrder	-	-	0.0001 (0.0010)	-
FLib _t . TEnforcement	-	-	-	0.0034* (0.0016)
Constant	1.7450* (0.3236)	2.0127* (0.4187)	2.1594* (0.4386)	2.0795* (0.4348)
m_1	-3.37	-3.33	-2.91	-3.29
m_2	-1.93	-1.91	-1.58	-1.72

Results: Our results show that financial liberalization has a positive contribution on economic growth. However, the response of growth to liberalization is different in various countries. The findings show that the impact of liberalization on growth is significantly greater for countries with high compliance to Basel supervisory principles and better regulations regarding investment. This result is consistent with the Repullo (2004) model where he shows that Basel supervisory principles are effective instruments in eliminating excessive risks taking by banks.