Financial Liberalization and Growth

Does financial liberalization spur growth? The answer, according to a recent NBER Working Paper by **Geert Bekaert**, **Campbell Harvey**, and **Christian Lundblad** is "yes." Equity market liberalization, the researchers show, leads to a one percent increase in a country's annual growth rate over a five-year period.

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Traditional approaches to understanding economic growth have overlooked the importance of financial liberalization — that is, primarily, opening the equity market to foreign investors — but its effect cannot be accounted for by macroeconomic factors or broader measures of financial development.

In **Does Financial Liberalization Spur Growth?** (NBER Working Paper No. 8245), the authors explore the relationship between equity market reform and growth. They suggest a number of ways in which financial liberalization can contribute to increased growth. For example, improved risksharing may lower the cost of capital, leading to greater investment and higher risk/higher return projects. Open capital markets also may mean more efficient capital markets and in general increase financial development.

The researchers then show that in a large sample of countries over a period since 1980, financial liberalization leads to a one percent increase on average in a country's annual growth rate over a five-year period. This result is subjected to a number of tests, including changing the liberalization dates, different groupings of countries and different regional indicators, and is still shown to be robust.

Following a financial liberalization, the ratio of investment-to-GDP rises while the consumption-to-GDP ratio falls and the trade balance worsens; this suggests that foreign capital inflows are invested rather than consumed. Moving away from their average result, the researchers show that across countries, a large secondary school enrollment, a small government, and an Anglo-Saxon legal system enhance the effect of liberalization.

Much of the current research on economic growth has been framed in the context of a debate about "convergence" between low-income and high-income countries. Earlier studies found a positive relationship between the initial level of income per capita and subsequent growth — and therefore that there was no convergence effect — and that a wealthy country would enjoy faster growth rates in the future.

More recently Robert Barro, holding constant initial levels of human capital and other determinants of the steady state level of per capita GDP, has shown that poorer countries do grow faster than wealthy countries, a conditional convergence effect. Jeffrey Sachs's work emphasizes that policy choices — such as respect for property rights and openness to international trade — are particularly important determinants of long-term growth prospects; this suggests that poor countries can become part of the "convergence club" by implementing appropriate policies. Government policies for example might ensure a climate in which technological advances can thrive. Bekaert, Harvey, and Lundblad show that financial liberalization is an important policy choice that may lead countries into the convergence club.

— Andrew Balls