

Financial Liberalization and Banking Crises

by

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July, 2006

Abstract:

Banking crises have often occurred within some years after substantial liberalization on financial markets and institutions. As a result the liberalization has been blamed for the crises in many countries. In this paper, we analyze whether the anecdotal evidence with respect to liberalization and crises is well founded and, if so, we ask what are the channels of crisis creation after a country has liberalized? We use financial liberalization measures for 33 countries that distinguish between domestic reform and relaxation of capital controls in foreign exchange markets. Domestic reforms are divided into four different kinds of measures that could impact differently on the banking system. A proxy for reform of the supervisory structure in each country is included as well.

We estimate both the direct impact of different kinds of liberalization on the likelihood of crises, and the interaction between liberalization and macroeconomic variables like credit expansion and current account deficits. The interaction between different kinds of liberalization and aspects of the “safety net” for the banking system is studied as well.

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Financial assistance is gratefully acknowledged from the Freeman Foundation Program in Asian Political Economy at the Claremont Colleges and the National Science Foundation.