Liberalisation of Capital Markets and Financial (In-)Stability

The financial crises of the 1990s have spurred the research interest in the question of whether and how liberalised financial markets might lead to or mitigate erratic national and international capital markets. Economists are divided on this question more than ever. Some, such as Krugman, Rodrik, Stiglitz or Soros, tend to argue – in light of the experiences of the 1990s – in favour of a not-too-quick and not-too-complete liberalisation of financial markets, i.e. in favour of – at least some – capital controls. Others, however, like Obstfeld, Stulz or Mishkin, continue to emphasise the traditional views, namely that liberalised capital markets improve allocation, mainly by channelling resources to the best users, by promoting transparency and accountability, and by disciplining policy makers.

A recent work of Kaminsky and Schmukler might contribute to reconciling the diverging views. They have provided a systematic historical assessment of how financial liberalisation (episodes of de-liberalisation included) factually developed in 28 countries (14 industrialised and 14 emerging economies). "Financial liberalisation" is differentiated in three ways: into liberalisation achievements of the capital account, of the domestic financial sector and of the stock market. The overview on dates of liberalisation is reproduced in the two tables. Moreover, the authors develop a measure for the degree of liberalisation achieved and for the severity of financial market cycles, and booms and busts in stock markets (not shown in the tables).

One result of the authors' analysis is (see the attached tables) that the process of liberalising the

Table 1

Financial Markets, Liberalisation Dates, 2003: Mature Economies

	Capital account	Domestic financial sector	Stock market	Full liberalisation
G-7				
Canada	Pre 73p/Mar75 –	Pre 73 –	Pre 73 –	Jan 73 –
France	Jun 85p/Jan 90 –	Jan 85 –	Pre 73 –	Jun 85 –
Germany	Pre 73p/Mar 81 –	Pre 73 –	Pre 73 –	Jan 73 –
Italy	May 87p/Jan 92 –	Jan 74 – Dec 74 Jan 81 –	Pre 73 –	May 87 –
Japan	Jan 79p/Jul 80 –	Jan 79p/Dec 91 –	Jan 85 –	Jan 85 –
United Kingdom	Oct 73p/Oct 79 –	Jan 81 –	Pre 73 –	Jan 81 –
United States	Jul 73 –	Pre 73p/Jan 82 –	Pre 73 –	Jul 73 –
Small European Countries				
Denmark	Oct 88 –	Jan 73p – Jan 75 Mar 79p/Jan 81 –	Pre 73 –	Oct 88 –
Finland	Jan 87p/Jun 89 –	Jan 86p/Jan 90 –	Pre 73/Jan 90 –	Jan 90 –
Ireland	Jan 79p/Jan 92 –	May 85p/Feb 86 –	Pre 73p/Jan 92 –	Jan 92 –
Norway	Jan 80p – Dec 81 Jan 85p/Jan 88 –	Jan 79 – Dec 79 Sep 85p/Jan 88 –	Jan 84p/Jan 89 –	Jan 88 –
Portugal	Sep 89p/Aug 92 – -	Jan 84p/Mar 90 –	Pre 73 – Dec 75 Jan 86 –	Mar 90 –
Spain	Jan 75p/Jan 80/ Jun 88p/Dec 92 –	Jan 74p/Jan 81 –	Pre 73 –	Jan 80 –
Sweden	Jan 84p/Jan 89 –	Jan 78p/Jan 85 –	Pre 73p/Jan 80 –	Jan 85 –

Note: This table reports the dates of partial and full liberalisation of financial markets. The first three columns provide information by sector: capital account, domestic financial sector, and the stock market. The last column provides information on an integral measure of financial liberalisation. A country is considered to be fully liberalised when at least two sectors are fully liberalised and the third one is partially liberalised.
"–" followed by a blank means that it covers the period until June 1999. Pre 73 means that the sector is already fully liberalised at that time, with no significant measures taken at that date.

Source: Kaminsky, G.L., Schmukler, S.L., Short-run Pain, Long-run Gain: The Effects of Financial Liberalization, NBER Working paper 9787, June 2003, table 1.

Table 2

Financial Markets, Liberalisation Dates, 2003: Emerging Economies

	Capital account	Domestic financial sector	Stock market	Full liberalisation
Asia				
Hong Kong	Jan 73 –	Aug 94p/May 00 –	Pre 73 –	Aug 94 –
Indonesia	Jan 78p/Jan 88 – Feb 91	Jan 78p/Jan 83 –	Dec 88p/Aug 89 –	Dec 88 – Feb 91
Korea	Jan 93p/Jan 96 –	Jan 88p/Jan 95 –	Jan 91p/May 98 –	Jan 96 –
Malaysia	Jun 79p – Dec 93 Sep 94 – Aug 98	Oct 78p – Sep 85 Feb 91 –	Jul 73/Jan 75p/ 84 – Dec 97	Feb 91 – Dec 93 Sep 94 – Dec 97
Philippines	Jan 76p – Dec 82 Jan 94p –	Jul 81p/Dec 82 –	Mar 86p/Jan 94 –	Jan 94 –
Taiwan	Jan 87p/Jan 97 –	Sep 84p/Jul 89 –	Jan 87p/Apr 98 –	Jan 97 –
Thailand	Jan 79p – Dec 81 Jan 92/Aug 95p – Apr 97 Jan 73 –	Jun 89p/Jun 92 –	Jan 88p/Jan 90 –	Jan 92 – Apr 97 Jan 98 –
Latin America				
Argentina	Apr 76p/Dec 78 – Mar 82	Jan 77 – Jun 82 Oct 87 –	Jan 77p – Jun 82 Jan 89 –	Dec 78 – Mar 82 Dec 89 –
Brazil	Jan 90p – Dec 93 Mar 95p	Jan 76 – Dec 78 Jan 86p/Jan 89 –	Pre 73p/Jun 91 –	Jun 91 – Dec 93 Mar 95 –
Chile	Jun 79p – Dec 82 Apr 90/Jun91p/Sep 98 –	Jan74p/May75-Nov82 Jan 84p/Jan 85 –	Jan 87p/Jan 92 –	Apr 90 – May 91 Jan 92 –
Colombia	Jan 91p/Sep 98 –	Aug74p/Sep80-Dec85 Jul 86 –	Jan 91p –	Sep 98 –
Mexico	Pre 73 – Jul 82 Nov 91 –	Jan 74p – Aug 82 Oct 88p/Apr 89 –	Jan 89p/Jan 91 –	Nov 91 –
Peru	Pre 73p – Dec 86 Jan 91 –	Pre 73p – Dec 81 Jan 91 –	Jan 92 –	Jan 92 –
Venezuela	Pre 73 – Jan 83 Mar 89 – Dec 93 Apr 96 –	Aug 81 – Jan 84 Jan 89 – Aug 94 Apr 96 –	Jan 77 – Dec 87 Jan 90 – Jun 93 Jun 95 –	Aug 81 – Jan 83 Jan 90 – Jun 93 Apr 96 –

Note and source: See table 1.

financial markets has often been reversed in emerging economies, while it has developed more or less uni-directional in rich countries. In all types of countries the beginning of liberalisation reforms occurred already in the 1970s. There is also a difference in the sequencing of reforms. Industrial countries started mainly with their stock markets, while developing countries opened up the reform path in their domestic financial sectors.

The main question of the authors is, of course, what the nature of the connection is between the degree of financial liberalisation achieved and the severity of financial instability. Their answer is straightforward: In the long-run they could not find evidence that financial instability increased after capital market liberalisation. In the short-run, however, there *is* such an effect. This effect is more pronounced in emerging than in mature economies.

Finally, the authors ask what the reason for the difference between long- and short-run behaviour might be. They found that the quality of institutions matters. Often, primarily in emerging economies, institutional improvements have been implemented not before – as economists recommend – but only after liberalisation.

R.O.

Reference:

Kaminsky, G.L., S.L. Schmukler, "Short-Run Pain, Long-Run Gain: The Effects of Financial Liberalization", *NBER Working Paper* 9787, June 2003.