CHAPTER I

Introduction

1.1 Background

The financial sector is part of an economy that consists of various industries, including banks, insurance firms, and investment houses, providing financial services. According to Goldsmith (1969), this sector has a role in mobilizing funds to the “highest-valued users in the economy.” However, the role of the financial sector in encouraging economic growth, historically, has been a topic of debate. Schumpeter (1911) stated that the financial sector has a vital role in enhancing economic growth. This view was opposed by Robinson (1952), who argued that finance does not cause growth but follows growth. Meanwhile, Lucas (1988) claimed that the role of finance on growth was over-stressed.

One of the topics in the finance-growth debate is the effect of financial liberalization. This debate began in the 1970s, fueled by criticism of the policies of financial repression. This policy is a standard policy implemented since the 1950s, especially in emerging countries. The financial repression policy gives authority to the government to intervene and control the financial sector, for example, by regulating interest rates and credit allocation. Criticism of this policy begins with the hypothesis by McKinnon (1973) and Shaw (1973). Their thesis explains that the financial repression policy is the cause of the low level of savings and investment, which causes the low rate of economic growth. Therefore, they suggest the implementation of financial liberalization policies. They believe that freeing the financial sector from government intervention and operating based on market mechanisms will increase its efficiency.

In general, financial liberalization policies include deregulation of controls on interest rates and credit allocation, removal of barriers for foreigners to enter and transact in domestic financial markets, and privatization of financial institutions (Bumann et al., 2012). Various international organizations, such as the World Bank and the International Monetary Funds (IMF), strongly recommend using this policy.

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They encourage emerging countries, in particular, to include these policies in economic development programs. However, the effectiveness of this policy is still in dispute.

The Neostructuralists Taylor and Van Winjbergen (1983) opposed the McKinnon-Shaw hypothesis. They argued that the increase in interest rates resulting from financial liberalization would not affect the supply of investment funds. Empirical studies also show that there is no agreement on the relationship between financial liberalization and economic growth. Some studies show that liberalizing the financial sector has a growth-enhancing effect (Sulaiman et al., 2011; Mekki and Maktouf, 2018; Adam, 2020). This effect can arise because financial liberalization increases competition in the financial sector, opens capital markets, increases the probability of risk diversification, and introduces new financial instruments and services. These effects lead to the financial sector being more efficient in mobilizing available funds, thus increasing savings and investment rates and boosting economic growth (Bumann et al., 2012).

On the other hand, several studies have concluded that financial liberalization undermines economic growth (Bouzid, 2016; Saeedi and Moghadamfar, 2018; Chiu, 2019). This damage occurs because financial liberalization can cause asymmetric information problems, bank runs, and the fragility of financial markets due to high competition. These problems destabilize the financial sector and can lead to a financial crisis. The twin crises in the Southern Cone, Mexico, and Asia are examples of financial crises caused by financial liberalization (Andersen and Tarp,2003).

This ambiguous result can be explained, in part, by the use of different measures of financial liberalization in empirical studies. For example, some studies use measures that focus solely on the liberalization of equity markets or capital accounts (Saeedi and Moghadamfar, 2018; Lin and Liang, 2019; Saidi, 2019). While the scope of the financial sector is broader than that, this measure does not explain financial liberalization adequately. One measure that explains the various aspects of financial liberalization is the IMF database created by Abiad, Detragiache, and Tressel (2010). This database is based on seven dimensions of

reforms in the financial sector. There have been many studies that use this measure. However, because this database has never been updated, the data is available only up to 2005. Thus, studies that discuss the effect of financial liberalization using this index for the period after that are still limited.

Therefore, it is essential to analyze the relationship between financial liberalization and growth, notably because the debate has been buzzing again after the 2008 Global Financial Crisis. This crisis began in the United States in 2007, spreading to various countries, especially developed countries. However, various emerging countries have also been affected. The 2008 Global Financial Crisis caused the most significant decline in global GDP after the Great Depression, around -5.1 percent. According to Arestis (2016), one of the main factors causing this crisis is financial liberalization. In the aftermath of this crisis, various experts also advised the government to intervene and control the financial sector to maintain financial system stability.

Even so, the Financial Reform Index data from the IMF shows that most countries have maintained or even intensified financial sector freedom after this crisis. Focusing on 30 developed and emerging countries that are members of the OECD and the G-20, the Financial Liberalization Index data from the IMF shows that the average index for developed countries is 0.96 and 0.69 for emerging countries in 2018. This value has increased compared to 2009, which was 0.94 and 0.66 for developed and emerging countries, respectively.

On average, developed countries have fully liberalized their financial sector in 2018, such as Australia, Belgium, Denmark, Finland, France, Greece, Israel, Italy, New Zealand, Spain, Sweden, and the United States. Several countries have tightened barriers in their financial sector after the 2008 Global Financial Crisis, such as Japan, Ireland, the Netherlands, and the United Kingdom. Japan increased control over its credit allocation in 2010, bringing its index down to 0.76. At the same time, the other three countries nationalized several banks due to bankruptcy caused by the 2008 Global Financial Crisis. Ireland and the Netherlands had an index of 0.95, while the U.K. was 0.90 in 2018. In addition, some countries have maintained restrictions on their financial sector in the last decade, such as Germany

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and Norway with an index of 0.90, and Switzerland with an index of 0.95. On the other hand, Portugal and South Korea have increased their liberalization intensity since the 2008 crisis and, by 2018, had an index of 0.86.

In comparison, IMF data show that the financial sector in most emerging countries is still under government control. However, there has been an upward trend of liberalization in the last two decades. In 2018, China's financial liberalization index showed a value of 0.42, while the Brazil and Turkey indexes both scored 0.52. Then, in India, the financial liberalization index was 0.62, Indonesia was 0.71, and Argentina was 0.76. Countries with indexes close to developed countries are South Africa, Chile, and Mexico, with the index of 0.81, 0.90, and 0.90, respectively.

Seeing how emerging countries are starting to increase liberalization in the financial sector, there is hope that this policy can positively affect the economy. However, differences in character between developed and emerging countries can cause the effects of financial liberalization to vary. Therefore, coupled with the lack of agreement theoretically and empirically, the author wants to analyze further the effect of financial liberalization using the extended Abiad et al. (2010) database. Given the results of previous empirical studies, this study analyzes the effect of financial liberalization on economic growth and the probability of a financial crisis in both developed and emerging countries.

1.2 Research Problems

Empirical studies indicate that financial liberalization has an ambiguous effect. Several studies show that this policy can increase the probability of a financial crisis. Nevertheless, the data shows that the financial liberalization policy is still a reliable policy for economic development. Therefore, it is necessary to analyze the positive and negative effects of financial liberalization to predict the outcome of this policy.

Based on the explanation above, the questions that will be analyzed in this study are as follows:

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1. How is the relationship between financial liberalization, financial crisis, and economic growth in developed and emerging countries?
2. What is the net effect of financial liberalization in developed and emerging countries?

1.3 Research Objectives

Based on the background and research problems described above, this study aims to:

1. Describe the relationship between financial liberalization, financial crisis, and economic growth.
2. Describe the net effect of financial liberalization on economic growth.

1.4 Research Advantages

Several benefits are expected to be taken from this study, including:

1. This research can expand insights and knowledge about the effect of financial liberalization on economic growth and financial crisis.
2. The study results can be used as study material and additional references for further research.
3. This research is expected to be used as input and consideration for the government to formulate appropriate policies.

1.5 Systematic of Writings

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The writing system consists of several chapters, each of which gives an overview of the study conducted. This study consists of five chapters, namely:

CHAPTER I: Introduction

This chapter consists of five subsections: background, research problems, research objectives, research advantages, and systematic writings.

CHAPTER II: Literature Review

This chapter consists of three parts, namely, theoretical background, empirical review, and hypothesis. In the theoretical background section, the theories that underlie this study are explained. The empirical review section contains the

results of previous empirical studies. Then, based on theoretical reviews and empirical studies, the research hypotheses are compiled.

CHAPTER III: Research Methodology and Theoretical Framework

This chapter contains several subsections, including the theoretical framework of the research data, types and source of data, empirical strategy, the definition of variables, and methods used in analyzing the data obtained.

CHAPTER IV: Empirical Results and Analysis

This chapter is a discussion section that contains the results of the research process. In this section, a discussion of the results of the research problems described above is explained.

CHAPTER V: Conclusions

This chapter is the concluding part. It presents conclusions from the research results that have been obtained, along with suggestions that can be used for further research.