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International Financial Liberalization and Economic Growth

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Abstract

This paper pulls together existing theory and evidence to assess whether international financial liberalization, by improving the functioning of domestic financial markets and banks, accelerates economic growth. The analysis suggests that the answer is "yes." First, liberalizing restrictions on international portfolio flows tends to enhance stock market liquidity. n turn, enhanced stock market liquidity accelerates economic growth primarily by boosting productivity growth. Second, allowing greater foreign bank presence tends to enhance the efficiency of the domestic banking system. In turn, better-developed banks spur economic growth primarily by accelerating productivity growth. Thus, international financial integration can promote economic development by encouraging improvements in the domestic financial system.