Capital Account Liberalization, Institutions and Financial Development: Cross Country Evidence

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The empirical relationship between capital controls and the financial development of credit and equity markets is examined. We extend the literature on this subject along a number of dimensions. Specifically, we (1) investigate a substantially broader set of proxy measures of financial development; (2) create and utilize a new index based on the IMF measures of exchange restrictions that incorporates a measure of the intensity of capital controls; and (3) extend the previous literature by systematically examining the implications of institutional (legal) factors. The results suggest that the rate of financial development, as measured by private credit creation and stock market activity, is linked to the existence of capital controls. However, the strength of this relationship varies with the empirical measure used, and the level of development. These results also suggest that only in an environment characterized by a combination of a higher level of legal and institutional development will the link between financial openness and financial development be readily detectable. A disaggregated analysis indicates that in emerging markets the most important components of these legal factors are the levels of shareholder protection and of accounting standards.

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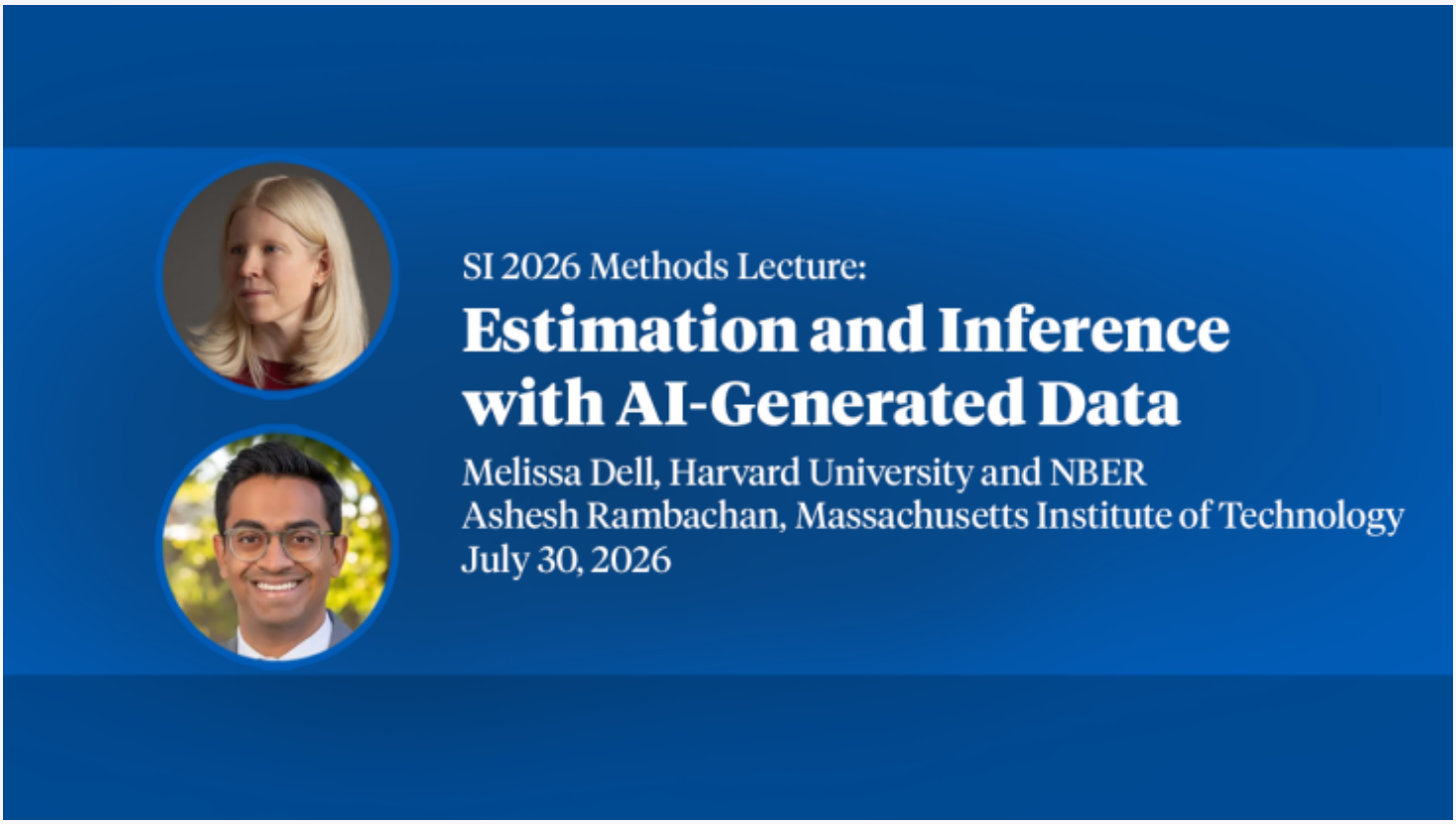


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