Abstract (summary):

The trend toward financial liberalization has increased over the last 30 years. Due to changes in prices, transaction costs, returns on assets, and quantitative limits on the foreign ownership of domestic financial and non-financial assets, financial liberalization policies have impacted the decisions of foreign and domestic investors regarding the allocation of investments which directly affects the movement of international capital flows. In addition, during the 1990s when liberalization in financial sectors and capital flows moved aggressively forward, many countries, particularly in emerging markets, experienced macroeconomic disequilibrium such as the deterioration of economic fundamentals and a disarrangement of exchange rates and asset price bubbles. This was the result at least in part, of substantial surges in cross-border capital flows, especially in short-term flows. As a result, these countries became more vulnerable to sudden stops and capital reversals which mostly ended in financial crisis.

This dissertation tests an array of relationships between financial liberalization policies and the behavior of international capital flows. It examines how foreign direct investments, portfolio flows, private loan flows, and net capital flows respond to financial liberalization policies in terms of direction, volume, composition, and the probability of a surge in capital flows. In addition, it explores whether increased regulation and supervision in the banking sector can reduce surges in international capital flows, particularly in short-term flows. This dissertation uses a new measure of financial liberalization from Abiad (2008) which reflects the removal of legal restrictions on domestic financial transactions and capital movements in order to investigate such effects. Financial liberalization policies are segregated into six categories: elimination of credit restrictions and reserve requirements, elimination of interest rate controls, elimination of entry barriers in the banking sectors, privatization of state-owned banks, capital account liberalization, and security market liberalization. We investigate the panel data for 43 countries, including 8 industrialized countries, 30 emerging market countries, and 5 less-developed countries, from 1973 to 2005.

We find that domestic financial liberalization and capital account liberalization are crucial factors in determining the direction and volume of capital inflows. However the effects of financial liberalization on capital flows are varied, depending on the economic region, the types of financial liberalization policies, and the forms of capital flows. In emerging markets, the increasing trend toward financial liberalization tends to tilt the composition of international capital flows away from FDI flows. We find that the relaxation of domestic financial restrictions is related to a higher probability of a surge of capital inflows. In emerging markets, the probability of a surge in private loan flows decreases substantially when financial liberalization is accompanied by strong prudential regulation and banking supervision.