Financial Liberalizations, Booms, and Crashes

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November 12, 2026

Summary

- Research question: does financial liberalization increase economic growth at the cost of financial fragility?

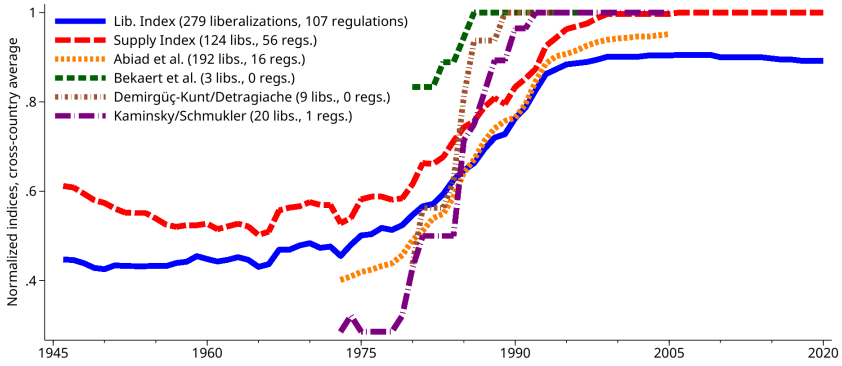
- How do authors answer it?
  - Empirical strategy: new banking-regulation database (18 advanced economies, 1946–2020) to estimate how credit, GDP and crisis risk respond to liberalization.
  - Welfare analysis: they feed these estimates into a CRRA agent's expected utility and compare liberalizing vs. not liberalizing.

- What do the authors find?
  - Empirical findings: liberalizations that relax credit-supply constraints generate a boom-bust cycle
    - ↑ Credit: $\approx +3.5\%$ after 5 years, mostly real estate / non-tradables, no increase in rates or spreads $\Rightarrow$ supply shift
    - ↑ GDP, temporarily: $\approx +0.74\%$ after 3 years, back to trend by year 8
    - ↑ Crash risk: crisis probability $\approx +10$ pp by year 8 (unconditional: 1.9%)
    - Other reforms: none of these patterns
  - Welfare findings: liberalization improves welfare (only if risk aversion $\gamma < 7.2$)

Contribution

- New data: longest and most granular banking-regulation index for advanced economies.
- Type of liberalization matters: credit-supply reforms generate boom-bust dynamics.

Figure 1: Comparison with other liberalization indices for 18 advanced economies (Grimm et al., 2026)



Index Construction / Supply Dimension Assignment

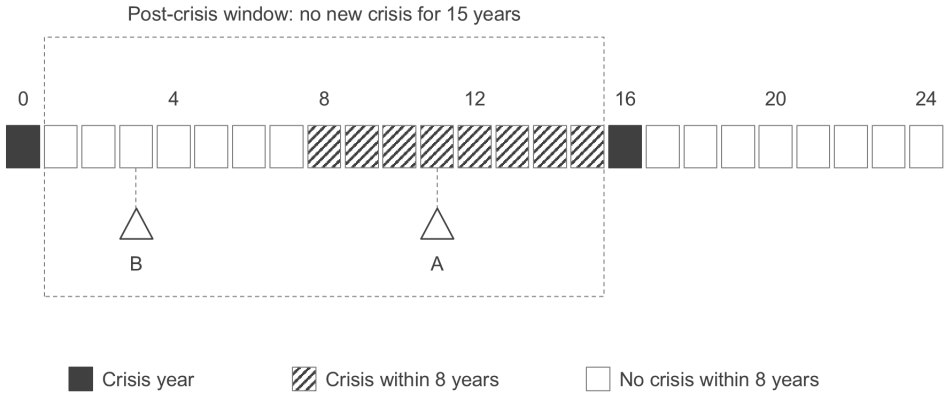
- The authors characterize credit-supply policies as those that directly cap or price lending, or constrain banks' capacity to lend
- Concern: very different policies get equal weight.
- Concern: the index does not measure intensity.
- Suggestion: test the classification, not just its parts. Check separately for the effect of reserve requirements (a continuous measure).

Table 1: Overview of the banking regulation questions

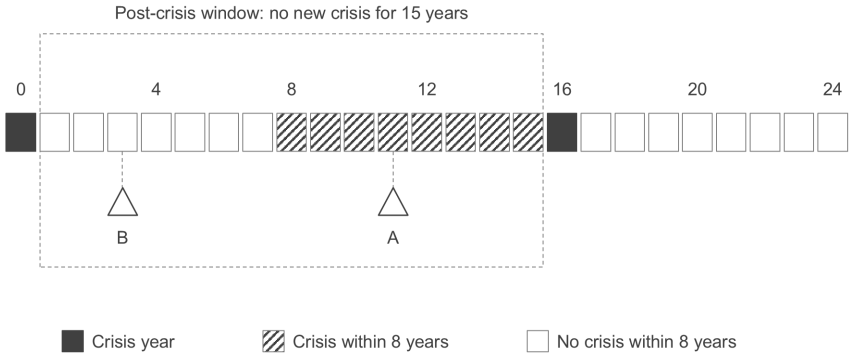
Credit-supply-related policies
(1) Can commercial banks operate in the mortgage market?
(2) Do regulations restrict foreign banks from entering?
(3) Do regulations restrict entry by domestic banks?
(4) Do regulations limit geography or branching?
(5) Do authorities regulate mortgage interest rates?
(6) Do ceilings limit overall credit expansion?
(7) Do authorities control lending rates?
(8) Do reserve requirements apply?
(9) Must banks hold government securities?
Other liberalization policies
(10) Do capital adequacy requirements cover residential mortgages?
(11) Does a public mortgage securitization program exist?
(12) Do regulations set maximum LTV ratios for residential mortgages?
(13) Can commercial banks conduct investment-banking activities?
(14) Is the exchange rate system unified?
(15) Do regulations restrict inflows of portfolio investment?
(16) Do regulations restrict capital inflows into domestic bank accounts or as bank loans?
(17) Do regulations restrict outflows of portfolio investment?
(18) Can banks lend to nonresidents/foreigners?
(19) Do regulations specify capital adequacy rules?
(20) Do authorities control deposit rates?
(21) Can banks issue certificates of deposit?

Source: Table 1 of Grimm et al. (2026).

Post-crisis bias

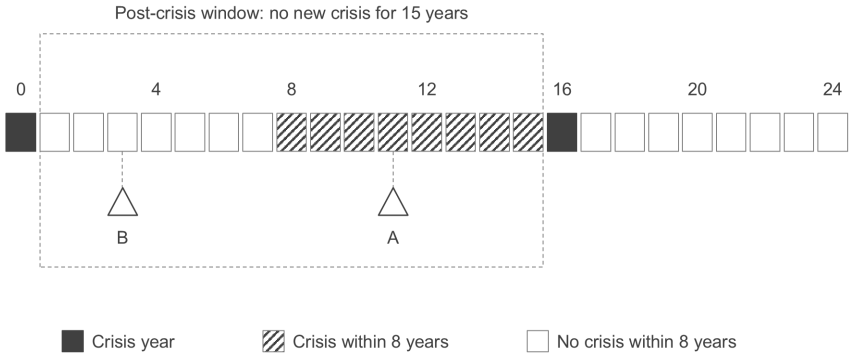


Post-crisis bias



- The empirical literature suggests that financial liberalization declines in the aftermath of financial crises. However, this re-regulation gradually disappears over time (Saka et al., 2020).
- This implies that re-regulation takes place at point B and liberalization at point A.

Post-crisis bias



- One suggestion to address post-crisis bias is to include flexible controls since the last crisis (alternatively, drop the crisis years and the 5 years after).

Cross-border spillovers

- Concern: The local projections include only each country's own reforms. Cross-border spillovers from neighbouring countries or trade partners could potentially influence the results.

- Suggestion:
  - Show robustness to excluding neighbouring countries or trade partners with large bilateral exposure to the treated country.

References I

Grimm, M., Schularick, M., & Verner, E. (2026). *Financial liberalizations, booms, and crashes* (Finance and Economics Discussion Series No. 2026-034). Board of Governors of the Federal Reserve System. Washington, D.C. https://doi.org/10.17016/FEDS.2026.034