

ABSTRACT

Many factors can initiate a banking crisis. This study analyses the possible impact of financial liberalization on the probability of banking crisis in India and Pakistan. The study also attempts to find out how the relationship between financial liberalization and banking crisis changes when institutional environment is considered. No study has yet been conducted that specifically analyzes the role of financial liberalization in escalating the probability of banking crisis in India and Pakistan; although both of these countries embarked on the path of financial liberalization almost simultaneously. Moreover, India and Pakistan are taken in the panel of various studies but no research has been done with special consideration given to India and Pakistan. This study is a valuable contributor to the existing literature of banking crisis with respect to India and Pakistan. The study utilizes probit model to empirically test the relationship between financial liberalization and banking crisis in India and Pakistan. The span of the study ranges from 1971 to 2010 in order to compare the pre and post liberalization era of both the countries. India and Pakistan provide a very exciting ground for the comparison because they share economic history of remarkable resemblance. The impact of other variables on the probability of banking crisis of both the countries is also analyzed. The study concludes that financial liberalization increases the probability of banking crisis in India and Pakistan. The study also finds out that between the two variables of institutional environment, general institutional quality has a negative impact on the probability of banking crisis in case of India, although results remain insignificant. While the other variable of political repression does not show any significant impact on the probability of banking crisis, except for Pakistan where it shares a positive link. The study is a notable reminder about the aggressive financial liberalization policies that developing countries often follow to pursue high levels of economic growth. The study illustrates that India and Pakistan must evaluate their liberalization policies thoroughly before implementing them and emphasis must be laid on developing strong institutional environment.