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Does Exchange Rate Volatility Matter for the Effect of Financial Liberalization on the Composition of Capital?

ABSTRACT

This paper aims to investigate the impact of financial liberalization on the composition of capital through the channel of exchange rate volatility. It uses the panel data of 105 developed and developing countries for 1976-2017 and employs the seemingly unrelated regression method for unbalanced panel data developed by Biorn (2004). The paper concludes that both de jure and de facto measures of financial liberalization have a significant direct positive impact on the composition of capital. In contrast, the indirect effect through exchange rate volatility hampers the quality of capital. However, the net effect confirms that the overall impact of financial liberalization on the composition of capital through exchange rate volatility improves the quality of capital stock because of the catalyst role of financial liberalization, as it absorbs the adverse effects of exchange rate volatility. These findings will help policymakers formulate policies to stabilize the exchange rate market after financial liberalization to promote investment, improve capital quality, and economic prosperity.

AUTHORS

Anwar Mughees Alam
Ph.D. Scholar, School of Economics, IIIE, International Islamic University Islamabad, Islamabad
Author's Contributions: 1, 2, 3, 4, 5, 6, 7
anwar.phdeco150@iiu.edu.pk
https://orcid.org/0000-0002-5114-5491

Arshad Ali Bhatti *
Assistant Professor, School of Economics, IIIE, International Islamic University Islamabad, Islamabad
Author's Contributions: 1, 2, 4, 6
arshad_bhatti@iiu.edu.pk
https://orcid.org/0000-0002-5752-6623

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*** Correspondence author**

Author's contribution in the article: 1- Conceived and designed the analysis, 2- Reviewed and compiled the literature, 3- Collected the data, 4- Contributed data or analysis tools, 5- Performed the analysis, 6- Wrote the paper, 7- Financial support for the conduct of the study, 8-Other