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Impact of Financial Liberalization and Governance on the Financial Development in Developing Countries

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Abstract

The study examines the impact of financial liberalization and governance on the financial development in developing countries. The study takes the sample of 48 developing countries and time period from 2000 to 2014. The study uses the domestic credit to private sector (percentage of GDP) as proxy of financial development and for measurement of financial liberalization Chin-Ito index is used. The study finds that financial liberalization alone does not have a significant effect on financial development however when financial liberalization is endogenized with governance then this impact becomes positive and significant. Good governance enhances the positive and significant impact of financial liberalization. Therefore, financial development of the developing countries can be enhanced by the financial liberalization followed by good governance.

Key Words: financial liberalization, Financial Development, JEL Classification: O16, F30

INTRODUCTION

The major contribution in the economic development of the society is of financial sector development and for financial sector development financial liberalization play a major role. The set of instruments like institutions and markets and also including legal and administrative structure allow the transactions to be made through credit extension. All these make financial sector. The process of enhancement in quality, quantity and effectiveness of services of financial intermediaries is financial development. This procedure involves the communication of institutions and activities and is related to growth of the economy. In emerging and developing economies financial sector development is taken as an approach of growth of private sector to reduce poverty and to encourage economic growth.

Financial development is the need of every country in the present era as it is engine to growth and prosperity of the economy. Development of financial sector takes place via reforms in the financial policies and structural framework which is followed by the financial liberalization. But sometimes financial liberalization cannot give fruitful results if institutions are not properly administered. So, good governance also has a major role in the development of the financial sector and implementation of policies. Research in the area of financial sector liberalization and financial development along with the influence of government policies has been conducted internationally. Usually, individual country cases have been discussed by taking time series data; however, limited research has been embarked considering the developing economies as a group. It is evident from the literature that development of financial

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sector plays a key role in the growth and development of the economy and it can be achieved via financial liberalization.

Due to the entry of the foreign participants in the local markets increase competition and make that market to abide by the international market rules and regulations. This makes the financial sector more standardized. If an economy will be financially open for international participants of financial sector it will attract more inflow and outflow of capital which will strengthen the financial sector, due to this the local financial markets participants get more chances to access the international markets and being the international participants they can get benefits from the other markets. This will lead to the financial development of the economy by strengthening the financial institutions and by attracting more inflow of foreign direct investment. This financial development will in turn leads towards the economic development, making the economy more prosperous. There are many evidences signifying the importance of financial sector development for economic development. Financial development via aggregation of capital and technological evolution by escalation of saving rates, circulation and aggregation of savings, optimizing capital allocation and encouraging foreign capital inflows promote the economic growth. Countries which have well developed financial systems benefit from constant period of growth and many studies support and confirm this fact. Financial development is considered as the driver for growth. Financial development also calls for formulation of financial policies and regulatory structure. Lack of suitable and satisfactory policies of financial sector can impact dreadfully. Development of financial sector has strong impact on development of economy, both when it is well behaved and functions improperly.

Sometimes, financial openness alone cannot produce highly attractive positive result and in that case role of governance gets vital importance. Better governance policies and their implementation also help to develop and strengthen the financial sector. The policy makers have a number of choices; can impact interest rate, can choose about operation or cessation of financial institutions and also for financial intermediaries they can develop regulatory and administrative structure. It’s up to the discretion of policy-makers which financial system they allow to grow and flourish. It is also important to realize that government actions are often complementary to, rather than a substitution for, the market. This does not mean that the government will take over the market. Instead, the government can take necessary actions or steps to make markets more efficient. This is the essence of regulation and good governing policies help the financial sector of the economy to develop by making policies rather than making the market bound to the rules and regulations.

According to the World Bank (2013), states’ role in finance will differ by the confidence in country’s political system’s capability to encourage the public good. It is difficult and complicated to determine the proper role of states in the finance but is important as it is stated as “one size does not fit all when it comes to policy intervention.” More scope of government’s role in directing financial development can be seen in developing countries. However, if institutional framework is less effective then there will be less development, as a result of this risks of inappropriate interventions will enhance. Innovations in the financial system changes the role of government naturally, as some innovations create the need of new government interventions while some preclude the need of particular policies. Due to this complexity financial sector experts have different opinions regarding the pros and cons of state interference.

This research deals with the role of financial liberalization and governance in the financial development of the developing countries. This study analyses whether financial liberalization

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has any impact on financial development; and also analyses how this liberalization impacts the development of financial sector in the absence or presence of the governance.

LITERATURE REVIEW

Hellmann & Murdock (1995) analyzed the role of governance and financial institutions in financial development by the establishment of policies and procedures and by creation of reputational capital. According to the study complete liberalization for developing country is not the appropriate recommended policy. Rather the country should invest more of their resources in building reputational capital and governance mechanism. The study suggests the framework for attaining incentives from the policies of the government and development of the reputational capital. Reinhart & Tokatlidis (2000) examined the impact of financial liberalization and financial reforms on the financial development of the African countries. The findings of the study suggests that overall African countries cannot gain from liberalization as compared to other developing countries and middle income countries which may be due to lack of institutional reforms and financial market perfections. As the gain does not appear in the short term but in the long term it will give benefits to the Africa.

Wyplosz (2001) analyzed the impact of financial liberalization on financial sector especially focusing on exchange markets currency crises than bank crises and analyzes that either financial liberalization is hazardous or beneficial. The study takes the sample size of 27 developing and developed countries and employed autoregressive model of the exchange market pressure index with lags of the financial restriction variables. The study also analyzes that financial liberalization on one side beneficial for the development but if not managed properly can lead to crises. The study concludes that the developing countries can gain more from liberalization than developed countries. Similarly, Arestis, Demetriades, Fattouh & Mouratidis (2002) examined the effect of financial policies on the financial development of developing countries. The Johansen's cointegration technique and Error Correction Model was applied. In some countries it impacts positively while in others it impacts negatively. This variation appears due to the differences in institutional frameworks. Overall findings of the study suggest that the impact of financial policies including financial liberalization is ambiguous and depends on institutional and governing institutions.

There is a need of institutional and regulatory governance reforms before the implementation of financial liberalization (Crotty and Lee, 2005). The study took a sample of 17 emerging economies and sample period ranging from 1973 to 2004. Regulatory governance is taken as dependent and financial liberalization, degree of economic development and level of political risk are taken as independent variable in the study. The study takes "agency independence, accountability to government, legislature and public transparency and integrity" as elements of quality of governance.

Chin & Ito (2006) examine that which factor is necessary for financial development, either financial liberalization or legal and institutional development. This study analyzes the link between financial development, financial liberalization and legal and institutional development. This study takes the panel data of 108 countries which includes less developed economies and emerging economies and time period ranges from 1980 to 2000. The study finds development of general legal and institutional system is important than the finance related legal development. Study also finds that to reap the maximum benefit from openness, trade openness should be preceded by financial liberalization. The study also finds that for development of equity markets, banking system of the country should be well developed.

Kose, Prasad, Rogoff & Wei (2006) provide a way to measure the indirect benefits of financial globalization. The study says that the indirect effects of financial globalization on financial sector development, institutions, governance and macroeconomic stability are more important than any direct benefits which are achieved via capital aggregation or portfolio diversification. Quantity-based measures of integration are used. Dependent variable is growth which indicates the average real per capita GDP growth while independent variables include financial openness, initial income, human capital, investment rate and population growth. The study finds that financial globalization can play an important role in creating a number of benefits which increases long-run growth and welfare in developing countries. Complete opening of the capital account without sufficient essential supporting conditions, policies and governance can hinder the attainment of benefits and expose a country to abrupt stops of capital flows.

Ang & McKibbin (2007) investigate the impacts of financial liberalization on financial development which leads towards the economic development in Malaysia. The paper uses time series data and conduct co-integration and various causality tests for the estimation purpose. This paper uses four trivariate vector autoregressive (VAR) models. Each model includes per capita real GDP, financial depth and saving, investment, real interest rate or trade openness as conditioning variables. The paper use unit roots by using Augmented Dickey-Fuller (ADF) test. The result of the study is concluded as the financial liberalization cannot increase economic growth without a well-behaving and efficient financial system which responds to changing environment.

Greenidge & Moore (2007) the study finds the nexus between financial liberalization and financial development in three countries of Caribbean region that are Barbados, Jamaica and Trinidad and Tobago. The study takes financial development as dependent variable and financial liberalization, real per capita income, real deposit rate and the number of bank branches as independent variables. Due to the small sample size the study applies dynamic ordinary least square (DOLS) technique for the analysis. The study uses different measures for financial development and then applies principle component analysis to get single indicator of it. Owing to pace of implementation of liberalization policies, the study ends with interesting and different results regarding the impact of financial liberalization on financial development in the three countries. Overall findings of the study support the fact that financial liberalization impacts financial development positively.

Naceur, Ghazouani & Omran (2008) analyze the impact of stock market liberalization on the financial development and on the economic development of MENA countries. The study takes the sample of 11 MENA countries for the period of 1979-2005.The study take panel data and uses GMM technique for estimation. The paper takes economic development as dependent variable which is measured as per capita growth of real GDP while stock market liberalization along with macroeconomic reforms is taken as independent variable. "Trade openness, inflation, government consumption to GDP ratio and the black market premium" are considered as macroeconomic reforms. The study analyzes that impact of stock market liberalization on financial and economic development in short term is negative while in long term it is positive and liberalization should be started first for domestic economy then it should be opened for foreign markets.

Baltagi, Demetriades & Law (2009) analyze whether trade and financial openness either individually or collectively can leads toward financial development with global pace. The study uses Dynamic Panel GMM Estimation by fixed effects. The study takes financial development as dependent variable while lagged dependent variable, per capita income, trade openness, financial openness as independent variables. Financial development is proxied by private

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credit and stock market capitalization. The findings of the study express that relatively closed economies can get benefit most from opening up their trade and/or capital accounts for international markets. Khalaf & Sanhita (2009) examines the effect of financial activities i.e. financial repression and financial liberalization on financial development of Iraq. The study used the “Autoregressive Distributed Lag (ARDL) model”. The paper found that neither financial repression nor financial openness could impact positively on the financial development of Iraq. The paper analyzed that for positive impact on financial development better institutional reforms, better political environment and macroeconomic variables stability should be maintained in Iraq ,this will help in positive impact of financial liberalization on financial development.

According to Mishkin (2009), financial globalization can be helpful for financial development and economic growth and for eradication of poverty in emerging market countries. Liberalization reduces the power of government and entrenched private special interests and strengthen the institutional reforms to make the financial system strong and work better. But if financial globalization is not managed properly can cause financial crises which leads to economic hardship. The paper compares the different ages of globalization such as the first age of globalization (1870-1914) which ends up with “great reversal” and the second stage of globalization (1960-Present) and analyzed that in these ages globalizers have gained. Karikari (2010) investigated factors that determine financial development in SSA countries by focusing on the role of governance and financial liberalization. According to the results, financial liberalization itself does not improve financial development in SSA. Improved financial liberalization actually resulted in lower financial development but on the other hand, the impact of governance on financial development has improved over time which leads to financial development

Cooray (2011) studied the impact of government size and quality on size and efficiency of the financial sector, by taking a sample size of 71 economies. It was found that government sector size and quality both are important for financial sector efficiency however government quality is more important than the size of the government sector for financial sector development. The study analyzes that good governance is a precondition of financial development. Ahmed (2013) analyzed the role of financial liberalization in enhancing financial deepening and financial development leading to economic growth in Sub-Saharan African countries (SSA).The paper takes panel data of 21 Sub-Saharan African countries over the period of 1981–2009 and applies the GMM estimator. The study found that financial liberalization impact positively on financial deepening and resource mobilization in SSA region.

THEORETICAL BACKGROUND

The financial oppression which dominated in the developing and transforming economies in 1970s and 1980s showed an amalgamation of the state-driven development, patriotism, politics and bribery. The financial system was employed as tool of government where governments gave loan at lesser interest rates, used tools of monitory policy and government-assured foreign loans to confirm funding for public firms and for their own and left were given to the sectors they prefer. For apportionment of funds importance of State banks was necessitated. Bank administrators started concentrated to fulfill the complex necessities of funds allocated in spite of following prudential regulations. Lower Interest rates were given to depositors to maintain the low costs of loans. Sometimes this was considered as an important tool to enhance the quality of distribution of income. Thus oppressed finance was considered as system of inherent tax and subsidy; with the help of this, states transmit resources from creditor to those state favored debtors. Lower interest rates create high demand for loans

which made it mandatory for government to distribute the funds. Measures for controlling capital were necessitated not only to protect national savings but also to control capital sweeping due to lower interest rate and macroeconomic instability, and to get high returns from inflation tax. Capital controls were actually a form of tax imposed on payers who are not willing to pay tax and boost barberry.

The term financial liberalization covers a number of measures, such as the autonomy of the Central Bank from the government; means full liberty of capital to move into and out of the economy. Freedom of finance allows the full convertibility of the currency and leads to end of government-imposed differential interest rates; and the removal of restrictions of banks' ownership leading to de-nationalization, full freedom for foreign ownership and so on. These measures not necessarily need to be implied in their optimal such as The Narasimham Committee in India did not requires for a entire denationalization of banks; the committee recommended that the government, the Indian private sector and the foreigners each should share one-third equity in the currently-nationalized banks.

Every economy desires to develop financially and economically to participate in the race of the growth and development that's why financial development is the need of every country. Development of financial sector also includes/entails formulation of booming financial policies and regulatory structure. Lack of adequate financial sector policies could have catastrophic fallout. Financial development has serious impacts on economic development--both when it functions well or malfunctions. Bearing in mind the financial-economic development nexus alongwith the realization of financial repression's cost increased responsiveness for the need of financial liberalization. Economic think tanks and world financial bodies such as World Bank and IMF recommend for policies of financial liberalization. Financial liberalization means relaxation in financial industry's regulations. Financial liberalization appears when restrictions of financial markets and financial institutions are eradicated or when financial innovations such as subprime mortgage loans are imported to the financial markets. There is rapidly growing literature showing and supporting the fact that financial liberalization increases the financial development, impose disciplines on macroeconomic policies, breed competence gains for domestic firms by divulging them to competition from foreign entrant, and set free forces that result in better government and corporate governance(Kose et al., 2006).According to Isard (2005) in the last few decades a greater change in the global financial system appears due to movement of private capital from industrial countries to developing countries. Due to this flow of capital across border the growth of world GDP has been increased too much either we measure it in gross or net terms. This flow of capital has been outpaced faster than the GDP of developing countries. Such as increase in domestic financial activities, international financial activities also increased which leads towards the economic growth in long run but along with this economies are also vulnerable to financial crisis and risks associated with the increasing financial obligations. The reduction or removal of the restrictions on financial activities allows the investor to choose more effective destination for his investment. This efficient reallocation of funds will take place to most productive opportunities, which will leads to productive growth of financial and economic systems which in turn will benefits the whole society (Gehringer, 2014).

Financial liberalization allows concentration of the capital market, which is an obligatory provision for economic progress as cited by Shaw. Shaw said that financial oppression has many unconstructive results. In comparison to this financial liberalization has constructive impact on growth, thanking to most favorable distribution of funds with a saving price which shows its scarceness and the union of the domestic financial structure. Besides this also

reduces unemployment, propose a superior financial credit and the opening the way for overseas capital.

Financial liberalization, governance and financial development are linked with each other and influence each other either positively or negatively depending upon circumstances. Governance means the traditions and institutions by which authority in a country is exercised. The way to exercise the power through a country's political, economic and social institutions to manage a country's affairs at all levels is known as governance. It consists of processes, mechanisms and institutions, by which citizens coherent their interests, exert their legal rights and reconcile their differences. Basic governance indicators are: government effectiveness, rule of law, political instability and violence, voice and accountability and regulatory burden. Whereas, good governance along with other fundamental aspects is participatory, accountable and transparent. It is also efficient and unbiased and it encourages the rule of law. These are the institutions which make the financial sector developed, prosperous and strong. The well functioning or malfunctioning of these institutions have a strong impact on the financial sector and its development which in turn impact on the development of the economy. These institutions are actually the governing bodies and departments which make rules, laws, implement these rules and laws in any specific sectors.

Financial institutions itself are part of governance which regulate the financial sectors by its rules and regulation and play its role in the strengthening of the financial sector. If institutions will be strong and powerful to implement the policies and procedures then these institutions and governing bodies can control the financial sector, its development and become helpful, participative and controlling authorities in economies' economic situations. A strong financial system allows diversification of risk and effective capital distribution. According to this approach, financial liberalization impacts growth/development through indirect channels and these benefits can be detected in long periods. So, benefits of financial liberalization can be more compelling in economies with more robust institutions and good macroeconomic policies. Conventional wisdom based upon theory of market efficiency that free capital movement enhances the global distribution of savings and help resources to move in their most fruitful uses; hence escalating economic growth especially within countries having low capital and fewer saving, but actual studies did not found this. The defender of the financial liberalization says that to reap the benefits of financial liberalization, some preconditions should be developed which includes developed and well regulated financial system, good governance, sound macroeconomic policies etc but there is no clear empirical support for this argument.

Kose (2006) supports the opinion that financial integration acts as vehicle for many benefits including financial market development, institutional development, better governance and macroeconomic discipline. It is necessary to have a well developed, well supervised financial sector, good macroeconomic policies which prevent capital flows from making a country more susceptible to abrupt stops or reversal flows. Better macroeconomic outcomes of financial integration can be achieved when certain threshold condition should meet. These preconditions are trade integration, sound macroeconomic policies i.e monetary and fiscal, depth and sophistication of financial markets, quality of financial sector regulations, supervision, transparency and good governance etc.

Financial system is very important for development of the economy. Researchers believe that absence of developed financial system hamper the economic development. Policy makers should formulate the policies which promote and reinforce the subsistence of well functioning

financial system. On one side financial liberalization is important and beneficial for financial development; on the other side due to poor management and lack of good governance it can have reverse effects. According to Eichengreen (2003) due to widespread prevalence of the information asymmetries in the financial system then financial liberalization will not improve the welfare of the economy. In environment of financial fragility, financial liberalization may not be a universal remedy and to avoid severe drawbacks, vigilant approaches are required

Financial liberalization and globalization enhance the financial intermediary's stability which can get funds abroad and diversify their risks and get saved from local shocks. Globalization of financial markets offers more competition and alternatives of finance for local firms which allow them to flourish well. Due to this reason financial system become developed and contributes to development of the economy. For financial sector development, formulation of financial policies and administrative framework is necessary. Moreover development of financial sector involves the formulation of better financial policies and best administrative structure. Devastating results can appear due to lack of satisfactory financial policies. Even a well behaved or erroneous financial system has serious impacts on economic development of the economy.

The main limiting factor of the study is that it takes only 48 developing countries as the data of under consideration variables' of all developing countries is not available.

DATA AND METHODOLOGY

The main purpose of the study is to analyze the impact of financial liberalization on the financial development of any economy in the absence or presence of the governance. This study uses domestic credit to private sector percentage of GDP for financial development. Domestic credit to private sector is defined as financial resources given to private sector that are in the form of loans , trade credits , other accounts receivable and purchases of non-equity securities that create a claim for repayment. The Chinn-Ito index (2006) is used to measurement financial liberalization. This index is based on binary dummy variables which indicate the tabulation of restriction on financial activities across border which are Reported in the IMF's Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER). Governance is measured as average of six World Governance Indicators which include government effectiveness, regulatory quality, political stability and absence of violence, rule of law and voice and accountability. The control variables include legal origin, Inflation and real interest rate. The legal origin of the country means the origins of the country's law; means on which origin legal system of the country based. There are five categories of legal origin i.e. civil law, common law, Muslim law, customary law and mixed law. The study uses two systems; civil law and mixed law. Since, the sample of developing countries selected for the current research is using these two categories of legal origin. Inflation is measured by the annual growth rate of the GDP deflator. Real interest rate is the lending interest rate which is adjusted for inflation. The terms and conditions regarding lending rates vary from country to country; however, limiting their comparability. The study uses the data of real interest rate retrieved from data bank of World Bank.

This study uses the unbalanced panel data from secondary sources for the developing countries covering the time period from 2000-2013 and 48 countries.

The data for financial development is taken from Global Financial Development and World Bank while the data for the financial liberalization is collected from the Chinn-Ito Index (2013). The data for governance has been collected from the World Governance Indicators. Data for inflation and interest rate is collected from the World Development Indicators. The data for

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origin of legal system is collected from the data compiled by the University of Ottawa's World Legal System Research Group retrieved from (http://www.juriglobe.ca/eng/sys-juri/class-poli/droit-civil.php).

The Model

The study measures the impact of financial liberalization and governance on the financial development of the economy both individually and collectively. The study first analyzes the individual impact of financial liberalization on financial development without taking into account governance; then study finds this impact in the presence of governance. The study takes the following functional forms.

FD = f (FL, GOV, INF, INT, and LGO) ……….. (1)
FL = f (GOV) ……….. (2)

According to functional form (1) financial development is the function of financial liberalization, governance, inflation, interest rate and legal origin. According to this functional form governance is directly influencing the financial development. While second functional form states that financial liberalization itself is the function of governance which means that governance is not only directly influencing the financial liberalization but on the other hand indirectly influencing the financial development of the economy via financial liberalization.

The study first tests only the first functional form in which governance is taken as the independent variable to see the impact of governance directly on the financial development of the economy in the presence of financial liberalization. The equation is estimated through regression analysis. The study first regress the equation without governance then study takes the governance as separate independent variable on the right hand side of the equation. Governance is taken as separate independent variable in the study to find its direct impact on financial development. Lastly, study incorporates the second functional form (2) by capturing the endogeneity of financial liberalization whereby governance acting as an instrumental variable. The econometric techniques employed by the present study are explained in the following sub-sections.

The study uses the dummy variables to measure the legal origin. Legal origins are categorized into different categories but in this study only two categories of legal origin are used that are civil and mixed legal origin according to the data set used. The study takes the civil law as the benchmark and assigns the value of 1 to it and 0 otherwise.

Estimation Techniques

If regressors are not correlated with error term then the pooled OLS estimator is clearly consistent. For a given individual one expect considerable correlation in over time. This may lead to overstatement of the estimator precision. Depending upon the heteroscedasticity and correlation structure assumed for the errors and the panel structure either it is short or long, many corrections are possible. Pool OLS regression leads to an inconsistent estimator, if the individual effect is correlated with the regression.

An important assumption of the OLS regression model is that all the error terms should have the same variance. When this assumption is violated then there appears the problem of heteroscedasticity. Due to heteroscedasticity, unbiasness and consistency properties of OLS estimators are not disturbed but these estimators does no longer remain best, linear, unbiased estimators. The Breusch-Pagan Test (1979) is used to test the heteroscedasticity.

The fixed effects model allows for unobserved individual heterogeneity that can be correlated with regressors. The estimated parameters are panel-specific intercepts and therefore permit the conditional mean of the dependent variable to fluctuate across panels. The linear fixed effects estimator is consistent, even if the regressors are correlated with the fixed effects. Unlike the pooled OLS, the within estimator is an estimator which make use of the special feature of panel data. The modified Wald test is used to test the groupwise hetroscedasticity in fixed effect regression model. Its null hypothesis is constant variance for all cross sections/individuals. The Wooldridge Test (2002) is used to identify the presence or absence of autocorrelation in panel data.

PCSEs account for heteroscedasticity and cross-sectional correlation. This estimator is commonly used while working with time-series cross-sectional (TSCS) data. Panel corrected standard errors account for the contemporaneous correlation across the units and heteroscedasticity's deviations from the spherical errors and allow for the improved and better results from linear models estimated from TSCS data. The PCSE covariance shows some similarity with the heteroscedsticity consistent (HC) estimators but the estimators other than the PCSE do not explicitly incorporate the known TSCS structure of the data. This leads to important differences in implementation.

In some single equation models single dependent variable is influenced by single independent variable, that's why cause and effect relationship move from independent to dependent variables. Such a unidirectional relationship is not always meaningful in many other situations where not only dependent variable is influenced by independent variables rather some independent variables are also determined by the dependent variables. Such a two way relationship is called simultaneous equation model. In simultaneous equations to calculate the parameters of one equation, one has to take into account the information provided by other equations. When some regressors are correlated with error term means, they are termed as endogenous. The process of correcting this problem of endogenity involves search for such instruments which are correlated with the endogenous regressors but not correlated with the error term. For this purpose, the two-stage least squares (2sls) can be applied. This instrument should fulfill both conditions that it should be uncorrelated with error term but correlated with the endogenous variable.

Estimation of Single equation Model (With and Without Governance)

In Model 1 financial development is regressed upon financial liberalization, without taking into account the governance indicator. Following is the equation without the impact of governance.

Model1: $FDit = \alpha1i + \alpha2FLit + \alpha3INFit + \alpha4INTit + \alpha5LGOit + \varepsilon1it$ …………… (3).

In Model 2 financial developments is regressed upon financial liberalization in presence of governance. Here in model 2 of the study, governance is taken as an independent variable; to study its effect on the financial development.

Model 2: $FDit = \beta1i + \beta2FLit + \beta3GOVit + \beta4INFit + \beta5INTit + \beta6LGO1it + \varepsilon2it$ ………… (4)

Where FD is the financial development measured by domestic credit to private sector, FL is financial liberalization measured through Chinn-Ito index, GOV is the governance, INF is inflation, INT is interest rate and LGO is the dummy variable. The subscript i and t refers to the cross-sections and time period.

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Estimation of Model using Two-Stage Least Square (2SLS)

Following is the equations for the 2SLS model of the study where governance is used as endogenous variable effecting financial liberalization. The Model 3 is given as below:

$FL_{it} = \alpha_{10} + \beta_{11}Gov_{it} + \varepsilon_{1it}$ …………… (5)
$FD_{it} = \alpha_{20} + \beta_{21}FL_{it} + \beta_{22}INF_{it} + \beta_{23}INT_{it} + \beta_{24}LGO1_{it} + \varepsilon_{2it}$ …………… (6)
Substitute eq (5) into eq (6)
$FD_{it} = \alpha_{20} + \beta_{21} (\alpha_{10} + \beta_{11}Gov_{it} + \varepsilon_{1it}) + \beta_{22}INF_{it} + \beta_{23}INT_{it} + \beta_{24}LGO1_{it} + \varepsilon_{2it}$……….. (7)

By combining error terms $\beta_{21}\varepsilon_{1it} + \varepsilon_{2it} = \mu_{it}$

Model 3: $FD_{it} = \alpha_{20} + \beta_{21}\alpha_{10} + \beta_{21}\beta_{11}Gov_{it} + \beta_{22}INF_{it} + \beta_{23}INT_{it} + \beta_{24}LGO1_{it} + \mu_{it}$ …. (8)

Where FD is the financial development measured by domestic credit to private sector, FL is financial liberalization measured through Chinn-Ito index, GOV is the governance, INF is inflation, INT is interest rate and LGO is the dummy variable. The subscript i and t refers to the cross-sections and time period.

Some of the regressors, being endogenous in nature, are likely to be correlated with the disturbance or error term then the simultaneity problem arises. Therefore, simultaneity test is essential. For this purpose, Durbin Wu-Hausman Specification Test as specified by Hausman and Taylor (1981) is used. This is the test to check the consistency of an estimator when compared to a consistent alternative but less efficient estimator.

Table 1 shows the results of model 1 illustrating the impact of financial liberalization on financial development, while controlling for the variables such as inflation ,interest rate and legal origin, by using the Pooled OLS, Fixed effects and Panel corrected standard error techniques respectively. The results of the table shows that first of all pooled OLS is applied on the panel data of 48 countries. The summary statistics of this pooled regression indicate the negative impact of financial liberalization on the financial development. To check the nature of the data that either it is homoscedastic or hetroscedastic Breusch–Pagan (1979) heteroscedasticity test is applied. The result of the test shows the high value of chi-square which shows the presence of heteroscedasticity in the data; hence the null hypothesis of constant variance is rejected.

Due to the presence of heteroscedasticity, the study has to move towards the next technique of panel data that is fixed effects. The results of the fixed effects also indicate the negative impact of financial liberalization on financial development. For diagnostic purposes study apply heteroscedasticity test and autocorrelation test to conform the presence or absence of heteroscedasticity and autocorrelation in the data. For groupwise heteroscedasticity study apply Modified Wald test and for autocorrelation Wooldridge (2002) test is applied. The result statistics of the Wald test indicate the presence of the heteroscedasticity in the panel data, leading towards rejection of null hypothesis of constant variance. The result of the Wooldridge (2002) autocorrelation test leads to rejection of null hypothesis that is “no autocorrelation”, which means that autocorrelation is present in the model. After the detection of the heteroscedasticity and autocorrelation in panel data, the study moves further towards the panel corrected standard error (PCSE) technique to resolve these problems of autocorrelation and heteroscedasticity.

Table 1: Relationship of Financial Liberalization and Financial Development (Model 1)

Variable	Estimation Technique		
	Pool OLS	Fixed Effect	PCSE
FL	-0.817 (0.23)	2.396* (0.06)	0.357 (0.48)
INT	-0.949*** (0.00)	-0.376*** (0.00)	-0.268*** (0.00)
INF	-0.543*** (0.00)	-0.224*** (0.001)	-0.252*** (0.00)
LGO	3.702* (0.08)		5.524*** (0.00)
Intercept	39.563*** (0.00)	32.168*** (0.00)	24.368*** (0.00)
Diagnostics	Breusch-Pagan Test (Heteroscedasticity is present)	Wald Test (Heteroscedasticity is present) Wooldridge Test (Autocorrelation is present)	No Heteroscedasticity No Autocorrelation

Note: ***indicates that coefficients are statistically significant at 1% level of confidence
****indicates that coefficients are statistically significant at 5% level of confidence**
***indicates that coefficients are statistically significant at 10% level of confidence**

Third column of Table 1 indicates the results of the Panel Corrected Standard Error technique. The summary statistics of this technique indicate that most of the variables for the model 1 are statistically significant but the variable of financial liberalization is statistically insignificant. The results of this technique indicate that coefficient of financial liberalization is statistically insignificant but shows the positive impact on financial development. As the statistics shows that one unit increase in financial liberalization causes 0.357 units increase in the financial development and vice versa. The relationship of financial liberalization and financial development is ambiguous. Although much literature supports the positive impact of financial liberalization on financial development and growth but there is also much literature which contradict this opinion of positive impact. As many studies spill ink over the direct relation of financial liberalization and financial development such as, Fry (1995) , Klein & Olivie (1998), Arestis et al.,(2002), Ranciere et al.,(2006), Ozdemir & Erbil (2008), Baltagi et al.(2009) support the positive impact. In a paper researcher argues that financial liberalization leads to improvement in the financial sector growth which inturn increase the growth of the economy. Fry (1995) and Arestis et al.,(2002) support the fact that in financial repression financial fragility increases which is a heavy tax on the development of financial market and economy growth, as cited by the Ahmed (2013). Klein & Olivie (1998) examines that financial liberalization has a positive impact on financial sector deepening and development. Bumann (2013) support the positive and direct relation of financial liberalization on the growth and development of the financial sector and economy. Kose et al. (2010) also finds the positive and favorable impact of financial liberalization which is conditional upon macroeconomic policies. All these studies are in favor of positive relation of financial liberalization and financial development. The results of the current study also show the positive impact of financial liberalization and financial development; however this impact is highly insignificant. This

insignificance may be occurred due to financial fragility, information asymmetry, reduction of relationship lending etc. all these can be the reasons of insignificant nature of the relation of financial liberalization and financial development in developing countries. The coefficient of real interest rate is statistically significant and indicates the negative relationship of interest rate and financial development. As result shows that one unit increase in the interest rate causes 0.268 unit decrease in the financial development and vice versa. This relationship of real interest rate and financial development is also ambiguous as many theories support the positive impact of interest rate on financial development while much other literature contradict this and allude the negative impact of interest rate. De Gregorio & Guidotti (1993) claim that very low interest rate leads to financial disintermediation and due to this growth reduces. While on the other hand, very high interest rate does not improve efficiency of investment rather it moves the way to lack of credibility of economic policies or various forms of country risks cause lower investment as well as concentration in highly risky projects. As Udoh & Ogbuagu (2012) referred the work of Warman and Thirwall (1994) who criticize the interest rate liberalization hypothesis and support the fact that interest rate negatively impacts the investments and inturn the financial sector development. They argue that opportunity cost of consumption increases by the increase in interest rate after interest rate liberalization, due to this household will substitute some part of their consumption to savings and savings will increase. On the other hand wealth of the households increase due to increase in savings, this leads to more consumption pattern. This ambiguous substitution effect will produce counter effect and finally leading to overall negative impact on savings. This negative impact of interest rate will eventually impact the financial development. Gupta (1984) also argues the negative relation of interest rate, savings and development. Nonfinancial corporations enter the financial sector to earn high returns by financial speculative activities and lenders feel compelled to finance them for such speculative activities because of fear of loss of market share (Minsky, 1986). These speculations increase the risk and due to this financial development impedes. Arestis & Demetriades (1997) also support the opinion that countries such as Latin America faced the devastating and destabilizing effects of financial liberalization as financial liberalization unleashed the demand for credit by households by interest rate fluctuations. This high real interest rate did not improve the savings and investment; it just increases foreign savings which are external debts, leading the countries to vulnerable situation. Singh (1997) is also one of the proponents who argue the negative relation of interest rate and savings and financial development and claims that rapid growth of stock markets warns about the possible speculative pressure that may be generated.

The results indicates that coefficient of inflation is statistically significant and indicates that the relationship of inflation and financial development is inverse in nature. As summary statistics depicts that one unit increase in inflation causes 0.252 units decrease in the financial development and vice versa. As inflation is linked with savings as it is the base of financial intermediaries. Rousseau & Wachtel (2002) support the fact that high inflation rate reduces the financial development. Boyd et al. (2000) also examined the relation of inflation and financial market activities that inflation rate impacts adversely on credit market activities and have negative effects on the financial sector performance. Boyd et al. (2000) provide the evidence that inflation has significant important negative impact on development of banking sector and equity market activity. According to Karikari (2010) inflation is expected to have negative impact on financial development.

The coefficient of legal origin/dummy, i.e. civil law is statistically significant and indicates that civil law is working better than the mixed law. The result indicates that civil law is 5.524 times/units more efficient and better than the mixed law. The coefficient of the intercept is also

statistically significant and indicates the positive association with the dependent variable financial development. The intercept represents the other variables which can affect the financial development. The results indicates that one unit change in intercept value causes 24.368 units change in financial development and that change is directly related with the nature of change in intercept. This means that other variables directly affect the financial development. If intercept increases by one unit then financial development will also increases by 24.368 units and vice versa.

As governance plays a significant role in the financial sector development as proved by many studies. So in this study also analyzed the impact of governance on financial development. Model 2 depicts the relationship of financial liberalization and governance with financial development. In this model governance is also taken as independent variable along with financial liberalization. The variables used in the model 2 are examined, analyzed and the results are discussed below in table 2.

Table 2 gives the glimpse of summary statistics of results of model 2 which illustrates the impact of financial liberalization and governance on financial development, while controlling for the variables such as inflation, interest rate and legal origin, by using the Pooled OLS, Fixed effects and Panel corrected standard error techniques respectively.

Table 2: Relationship of Financial Liberalization, Governance and Financial Development (Model 2)

Variable	Estimation Technique		
	Pool OLS	Fixed effect	PCSE
FL	-1.925*** (0.002)	2.343* (0.08)	0.514 (0.23)
GOV	26.492*** (0.00)	10.332*** (0.002)	14.074*** (0.00)
INT	-0.817*** (0.00)	-0.259*** (0.004)	-0.251*** (0.00)
INF	-0.318*** (0.003)	-0.155** (0.02)	-0.197*** (0.00)
LGO	7.46*** (0.00)		3.982** (0.03)
Intercept	51.070*** (0.00)	36.976*** (0.00)	35.305*** (0.00)
Diagnostics	Breusch-Pagan Test (Heteroscedasticity is present)	Wald Test (Heteroscedasticity is present) Wooldridge Test (Autocorrelation is present)	No Heteroscedasticity No Autocorrelation

Note ***indicates that coefficients are statistically significant at 1% level of confidence
****indicates that coefficients are statistically significant at 5% level of confidence**
***indicates that coefficients are statistically significant at 10% level of confidence**

The summary statistics of this pool OLS regression signify that all variables of this regression are statistically significant and indicate the inverse relation of financial liberalization and

financial development. To check either data is homoscedastic or heteroscedastic study applies Breusch–Pagan/ Cook-Weisberg heteroscedasticity test. The result of the test shows the large value of chi-square which signals the presence of heteroscedasticity in the data; hence the null hypothesis of constant variance means homoscedasticity is rejected. Due to heteroscedastic nature of data, the study steps forward towards the next technique of panel data that is fixed effects.

The results of the fixed effects also point out the negative impact of financial liberalization on financial development. For diagnostic purposes study applies heteroscedasticity test to conform the nature of the data either it is homoscedastic or hetroskedastic and autocorrelation test to check autocorrelation in the data. To test group-wise heteroscedasticity study apply Modified Wald test and to test autocorrelation Wooldridge (2002) test is applied by the study. The summary statistics of the Wald test signify the presence of the heteroscedasticity in the panel data, leading towards rejection of null hypothesis of constant variance, means data is heteroscedastic not homoscedastic. The result of the Wooldridge (2002) autocorrelation test leads to rejection of null hypothesis that is "no autocorrelation" means autocorrelation is present in the model. After finding of the heteroscedasticity and autocorrelation in panel data, the study proceeds towards the next technique that is panel corrected standard error (PCSE), to wipe out these problems of autocorrelation and heteroscedasticity from the data.

Third column of table 2 shows the results of the Panel Corrected Standard Error technique. The results of this technique indicate that all variables for the model 2 are statistically significant. The summary statistics of this technique shows that coefficient of financial liberalization is statistically insignificant but reveals the direct and positive relation of financial liberalization and financial development. As the result depicts that one unit increase in financial liberalization causes 0.5141.925 units increase in the financial development and vice versa. As the relation of financial liberalization and financial development is ambiguous, financial liberalization can impact positively and negatively also. Both these negative and positive aspects of this relation are supported by the studies. Many studies such as Fry (1995) , Klein & Olivie (1998), Arestis et al.,(2002), Ranciere et al.,(2006), Ozdemir & Erbil (2008) supporting the positive relation of financial liberalization. Ahmed (2012) and Bumann et al. (2013) also advocate the work of others regarding the positive impact of financial liberalization on financial development. The results of this study are also inline with the studies supporting the inverse relation of financial liberalization and financial development.

Governance plays a vital role in the development of the financial sectors as in some economies financial liberalization alone cannot benefit the economy positively. Either governance is well functioning or it is malfunctioning impacts strongly on the financial sector and its development. Many studies support the fact that governance plays an important role in the development. According to Bashar and Khan (2007) developing countries cannot reap the benefits of financial liberalization until and unless preconditions of basic infrastructure and good governance are fulfilled. Karikari (2010) supports the role of governance and states that financial liberalization can impact positively on financial development and for this good governance structure and institutional development is required. Ahmed (2012) argues that institutional development and proper functioning institutions of governance are preconditions for getting the positive benefits of financial liberalization. The results of this study are also inline with the studies supporting the positive role of governance on the financial development. The results indicate that coefficient of governance is statistically significant and indicates the direct relationship of governance and financial development. As result depicts that one unit increase in the governance causes 14.074 unit increase in the financial

development and vice versa. As the results depict that governance not only itself enhance financial development but also leads the financial liberalization to improved financial development.

The coefficient of real interest rate shows that it is statistically significant and shows the inverse relationship of interest rate and financial development. As the summary statistics depicts that when interest rate increases by one unit causes 0.251 units decrease in the financial development and vice versa. The ambiguous relation of real interest rate, savings and financial development is eminent. Some researchers support the positive relation while many others are in favor of inverse relation of them. Hellman et al., (2000) argues that due to financial liberalization franchise value of banks fall down which leads towards financial disturbance and make them to face high risk for high profit earning purposes under pressure of low interest rate margin. Due to this pressure of interest rates, banks go for gambling strategies and pay more attention to profit than risks. This is disastrous for the financial sector.

The summary statistics of the inflation shows that coefficient of inflation is statistically significant and signify that the relationship of inflation and financial development is inverse in nature. As summary statistics depicts that when inflation increases by one unit causes 0.197 units decrease in the financial development and vice versa. Many studies support this inverse relation of financial development and inflation. The same inverse relation of inflation is advocated by the Boyd, Levine & Smith (2001).

The statistically significant coefficient of dummy variable indicates the efficiency of civil law over the mixed system. As the results indicate that civil law is performing better than the mixed law, civil law is 3.982 times/units more efficient than mixed law. The result of intercept shows that the coefficient of the intercept is also statistically significant and indicates the positive association with the financial development. The results indicates that when intercept changes by one unit causes 35.305 units change in financial development and that change is directly related with the nature of change in intercept. This means that if independent variables are kept zero then one unit increase in variables other than the independent variables will cause financial development to increase by 35.305 units and vice versa.

The model 3 illustrates the relationship of financial liberalization and financial development, where governance is taken as instrument of financial liberalization. This model is analyzed by using 2SLS or instrumental variable technique where governance is being endogenized in place of financial liberalization. Variables of this model 3 are analyzed, examined and results of this analysis are discussed below.

Table 3 illuminate the results of model 3 depicting the impact of financial liberalization on financial development, while controlling for the variables such as inflation, interest rate and legal origin, by using 2SLS technique where governance is taken as instrumental variable.

Here in this model governance is not taken as independent variable as taken in model 2 , rather it is taken as an instrument of financial liberalization. The summary statistics of this technique are shown in the table 5.3. As the result shows that all the variable of this model are statistically significant. The coefficient of financial liberalization depicts the direct relation of financial liberalization and financial development means there is positive relation between both of these variables. By the increase or decrease of financial liberalization, financial development also respectively increases or decreases.

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Table 3: Relationship of Financial Liberalization and Financial Development, using 2SLS/IV Technique (Model 3): Governance as endogenous variable

Variable	Coefficients
FL	69.757** (0.02)
INT	-3.465*** (0.005)
INF	-1.632** (0.02)
LGO	-35.125* (0.07)
Intercept	74.956*** (0.00)
Diagnostics	Durbin Wu-Hausman Test (Variables are endogenous)

Note: ***indicates that coefficients are statistically significant at 1% level of confidence, **indicates that coefficients are statistically significant at 5% level of confidence, *indicates that coefficients are statistically significant at 10% level of confidence

Here in this model governance is not taken as independent variable as taken in model 2 , rather it is taken as an instrument of financial liberalization. The summary statistics of this technique are shown in the table 5.3. As the result shows that all the variable of this model are statistically significant. The coefficient of financial liberalization depicts the direct relation of financial liberalization and financial development means there is positive relation between both of these variables. By the increase or decrease of financial liberalization, financial development also respectively increases or decreases.

The results depict that financial development increases by a greater value when governance is endogenized in the model. If governance is used as instrument of financial liberalization, it impact positively on the financial development. This change in the relation appears due to governance and institutional development as it is already provided by many studies that due to good governance financial development increases. So governance plays a vital role in financial development either directly or indirectly. As Bashar and Khan (2007) and Karikari (2010) support the positive impact of governance on financial liberalization and financial development. By the increase of one unit of financial liberalization, financial development also increases by the 69.757 units and by one unit decrease in financial liberalization, financial development also decreases by the 69.757 units.

The results suggest that due to governance and institutional development, relation of financial liberalization and financial development has been changed and financial liberalization is impacting positively on financial development. The results of real interest rate depict that interest rate is negatively associated with the financial development, as when interest rate increase financial development decreases and vice versa. According to result statistics of interest rate, by one unit increase in interest rate financial development decreases by 3.465 units and vice versa. Udoh & Ogbuagu (2012) and De Gregorio and Guidotti (1993), Warman and Thirwall (1994) and Hellman et al. (2001) support the opinions that real interest rate is inversely related with financial development. Similarly results of inflation also show that financial development decreases by the 1.632 units with one unit increase in the inflation and vice versa. Boyd et al. (2000) and Karikari (2010) are in favor of inverse relation of inflation

and financial development. These studies support the negative relation of inflation and financial development.

The study uses two systems of the legal origin; civil and mixed systems according to the nature of the data. The results of legal origin indicate that civil law is less efficient than the mixed system. The results depict that civil law is 35.125 times less efficient than the mixed origin. This result is in accordance with the theories which suggest that mixed law is most efficient to accept changes in law, regulation and changes in policies. Mixed system is more adaptive to the change than the civil law (Karikari, 2010).

Intercept is also statistically significant and signify direct relation with financial development. The coefficient of intercept indicates that if dependent variables are kept zero then by one unit change in intercept, financial development will change by 74.956 units in the same direction as intercept changes. If intercept increases, financial development will also move in the same direction and will increase but if intercept decreases, financial development will also decreases. To test either variables are endogenized or not, Durbin, Wu-Hausmann test also named as Hausmann specification test is applied on it. The result of the test shows that value of chi-square is significant which leads to rejection of null hypothesis of exogenous variables. This indicates that variables are endogenous. To test the presence of heteroscedasticity in the data, after 2SLS has been applied, several tests are applied.

In 2SLS after applying Hausmann specification test variables appear to be endogenous , the study apply many tests for heteroscedasticity in presence of instrumental variables ,as the data appears to be heteroscedastic in nature when pool OLS and Fixed effects were applied. To test either data is still heteroscedastic or not study applies many tests for it such as Pagan-Hall general test statistic, Pagan-Hall test w/assumed normality, Breusch-Pagan/Godfrey/Cook-Weisberg etc. The test statistics of Pagan-Hall general test indicates that value of chi-square is 7.729 and its p-value is 0.102 which appear statistically insignificant. This insignificance of chi-square leads to acceptance of null hypothesis that is “disturbance is homoscedastic”. This means now data is homoscedastic, there is no heteroscedasticity in the data.

Table 4: Heteroscedasticity tests in presence of instrumental variable (IV)

IV heteroscedasticity tests using levels of IVs only			
Null Hypothesis (H_0) Disturbance is homoscedastic			
Tests	Statistics	Notations	P-value
Pagan-Hall general test statistic	7.729	$\chi^2(4)$	0.102
Pagan-Hall test w/assumed normality	2.717	$\chi^2(4)$	0.606
White/Koenker nR2 test statistic	7.453	$\chi^2(4)$	0.113
Breusch-Pagan/Godfrey/Cook-Weisberg	3.407	$\chi^2(4)$	0.492

Source: Author’s own calculation

CONCLUSIONS

This empirical study finds the impact of financial liberalization and governance on the financial development of the developing countries by utilizing panel data of forty eight developing countries for time period ranging from 2000 to 2013 with limitation of data availability. The study analyzed this impact by using three different models in the study. The Model 1

specification finds the impact of financial liberalization on the financial development while controlling for inflation, real interest rate and legal origin. Specification of Model 2 relates also governance with financial development and finds the impact of financial liberalization and governance on the financial development while controlling for the control variables. According to Model 3 specifications, the study instrumented the governance in the model for financial liberalization. The study endogenizes the governance in place of the financial liberalization and finds the impact of instrumental variable on the financial development, where inflation, real interest rate and the legal origin are the control variables.

The empirical study first imply pooled OLS technique both on model 1 and model 2 but according to diagnostics due to the presence of the heteroscedasticity in the data, the study moves further for fixed effects technique for both models. Here again the Wald heteroscedasticity test and Wooldridge (2002) autocorrelation test were applied by the study. The study found the presence of heteroscedasticity and autocorrelation in both models. Then the study used the panel-corrected-error technique (PCSE) for both the models to correct the problems of heteroscedasticity and autocorrelation. The results of the PCSE technique conforms that most of the variables of both models are statistically significant upto 10 % level of confidence. The statistics of the model 1 indicates the direct relation of financial liberalization and financial development. The relation of financial liberalization and development is ambiguous because some theories suggest the positive relation while some are proponent to it and suggest the inverse relation. This impact is although positive but highly insignificant. According to theories this ambiguous relation of financial liberalization and development may be due to other factors such as institutional quality, policy reforms that can be called as governance. Financial liberalization can be helpful in sustained financial development if well-behaving institutions of governance are working. As many empirical studies support the view of presence of governance for reaping the positive benefits from financial liberalization that's why this study uses the governance variable in the second model. The study finds that the governance impact positively on the financial development and relation of financial liberalization and financial development is also positive but insignificant. This insignificant relation may be due to the reason of increased risk of speculative attacks, capital flight and instability of banking industry after the financial markets get liberalized. These can be the reasons of insignificant relation of the financial liberalization and financial development. To get thorough insight of the role of governance , the study in the third model instrumented the governance in place of financial liberalization, to see how governance impact the development if it is used as instrument of financial liberalization. The statistics of third model reveal that governance impacts positively to financial liberalization which inturn impact the financial development positively. The relation of financial liberalization and financial development appear direct, when governance was instrumented against financial liberalization. This leads to conclude that good governance directs the financial liberalization to financial development of the country. So the study concludes that due to good governance and improved institutional quality, financial liberalization brings fruitful outcomes for the development of economy and its financial sector. So to reap the fruitful results from liberalization, economies should implement good governing policies and improved institutional quality should be encouraged and maintained.

Based on the empirical results, the study concludes that financial liberalization alone cannot give the expected positive results as the institutions also matter. That's why institutions should be developed properly and also should be managed accordingly. Means there should be a proper system of check and balance for these institutions so that they can perform better and also should be elastic to changes and reforms in the policies and institutions.

Stable political government and good governing policies also matter for the development, as the safer the economic and financial environment of the country will be, it will be a better platform for the investment. So countries with stable political environment can attract more capital inflow which can be used in the financial stream of the country. To get the benefit of financial liberalization countries should have safer and stable government and better policies.

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