Journal of Applied Economics. Vol XX, No. 2 (November 2017), 373-394

RE-EXAMINING THE FINANCIAL DEVELOPMENT-OPENNESS NEXUS: NONPARAMETRIC EVIDENCE FOR DEVELOPING COUNTRIES

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Submitted November 2015; accepted April 2017

This paper re-examines the nexus between financial development and openness in developing countries. Specifically, we test whether both financial and trade openness explain financial development and its variations across 44 developing economies. Questioning the functional specifications in previous studies, we propose a fully nonparametric modelling approach to validate the simultaneous openness hypothesis. Our findings from the parametric approach suggest that both openness dimensions positively impact financial development, providing a loose support for the simultaneous openness hypothesis. The results based on the nonparametric approach suggest a negative effect of closed economies (economies with relatively closed trade and capital accounts) on financial development, supporting the strong version of the simultaneous openness hypothesis. Correct model specification test results support the nonparametric model relative to the parametric model as appropriate for the sampled data. Our conclusion is therefore based on the nonparametric finding, which supports the simultaneous openness hypothesis for the selected developing countries.

JEL classification codes: C23, C51, F13, G29

Key words: financial development, financial openness, trade openness, nonparametric analysis, developing countries

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I. Introduction

There are two strands in the literature on the role of trade openness and capital account openness (financial openness) in financial development. One strand of the literature, especially the work by Rajan and Zingales (2003), argues that for financial development to take place, a country needs liberalization in both the trade and capital accounts; this is the "simultaneous" hypothesis on financial development. Having one of the openness dimensions without the other will mean that interest groups, especially industrial and financial incumbents as argued by Rajan and Zingales, will not be convinced to push for financial development. This simultaneity hypothesis proposed by Rajan and Zingales is in sharp contrast to the sequencing literature (e.g. McKinnnon, 1991) that argues that trade liberalisation should precede financial liberalisation. Though the argument put forward by Rajan and Zingales in support of their hypothesis is very interesting and intuitive, their paper lacks sound and robust empirical analysis to assess the validity of their hypothesis due to lack of data, aim of the paper and econometric methodology as argued in Baltagi et al. (2009).

Providing further empirical evidence on the openness hypotheses appears to be important in itself, helping to understand financial development. Furthermore, the policy implications depend on which of the two hypotheses is supported by the data. Baltagi et al. (2009) tested the openness hypothesis by proposing a model that incorporate the time series dimension that was not accounted for in Rajan and Zingales (2003). Using a dynamic panel GMM approach, Baltagi et al. (2009) find partial evidence to support the Rajan and Zingales hypothesis. Their study finds evidence for both openness dimensions and that "relatively closed economies stand to benefit most from opening up their trade and/or capital accounts". Irrespective of this, the authors indicate that banking sector financial development in relatively closed economies can still gain from opening up trade or capital accounts without the other.

Another strand of the research on financial development tends to focus on the political economy dimension rather than the openness hypothesis. Previous research in this area includes Clague et al. (1996), Pagano and Volpin (2005), Beck et al. (2000), Girma and Shortland (2008), and Huang (2009, 2010) among others. Assessing the role of political economy factors on financial development, Girma and Shortland (2008) examine the effect of a country's democratic characteristics and regime change on financial development for a panel of developed and developing countries. The empirical evidence from their study indicates that both regime stability