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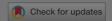
Financial openness and financial development: an analysis using indices

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Pages 620-649 | Received 02 May 2014, Accepted 27 Apr 2015, Published online: 22 Jun 2015

66 Cite this article

A https://doi.org/10.1080/02692171.2015.1054366



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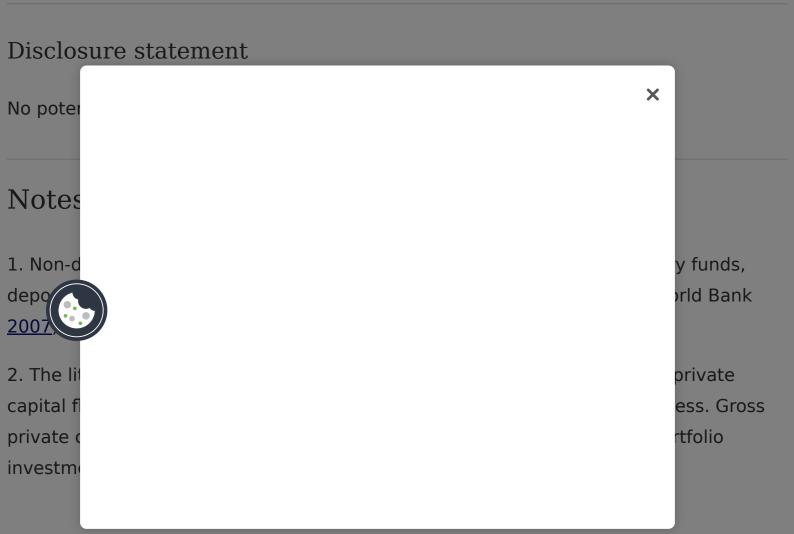
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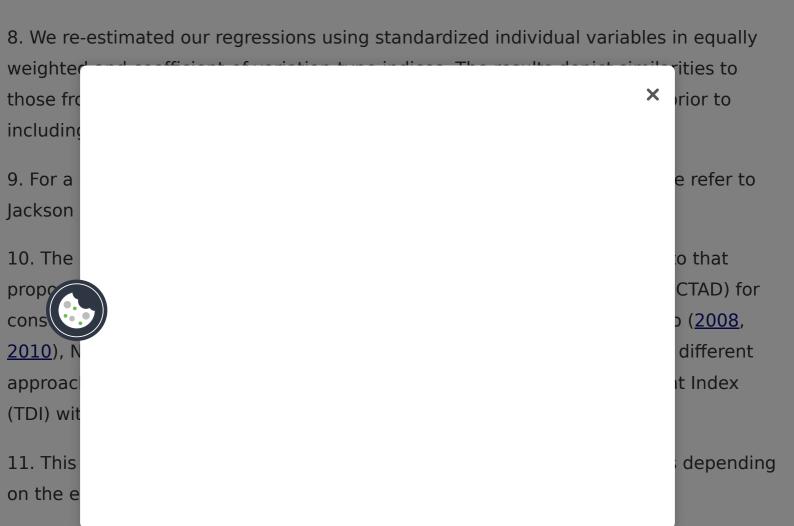


Acknowledgements

This paper was previously circulated under the name 'Breaking the misconceptions: an analysis of the effects of financial openness on financial development using index measures'. I am grateful to Klaus Desmet for his invaluable help. I further thank Juan José Dolado, Matthias Kredler, Ricardo Mora, Carlos Velasco and Ulrich Wagner for useful comments and suggestions. I would also like to thank the editor and the anonymous referee for many helpful comments.



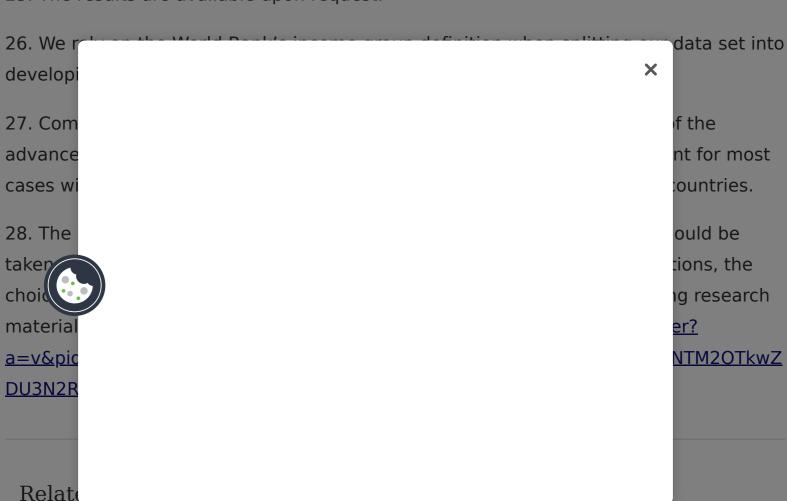
- 3. We only report the results for one of the most frequently used de jure type indices; the Chinn and Ito index of capital openness, for comparison reasons. We believe that these results guide in demonstrating the strength of our de facto type financial openness index in comparison with the individual de facto measures by the literature.
- 4. Chinn and Ito (2006) argue that the logarithm of GDP per capita is important in accentuating the link between financial deepening and rising income levels.
- 5. Given the close linkages between different dimensions of financial openness, excluding some variables and choosing one individual variable to portray a relationship can severely bias the coefficients of the estimated regression (Dreher 2006). The need for an overall measure of financial openness as well as financial development calls for the use of index measures.
- 6. By using an index measure for financial openness we can represent the gradual process of financial integration rather than the degree of overall openness in the financial markets. As Chinn and Ito (2008) express, individual variables used to measure financial openness do not fully account for the complexity of the problem.
- 7. For more information please refer to Ullah and Giles (1998) and Sheret (1984).

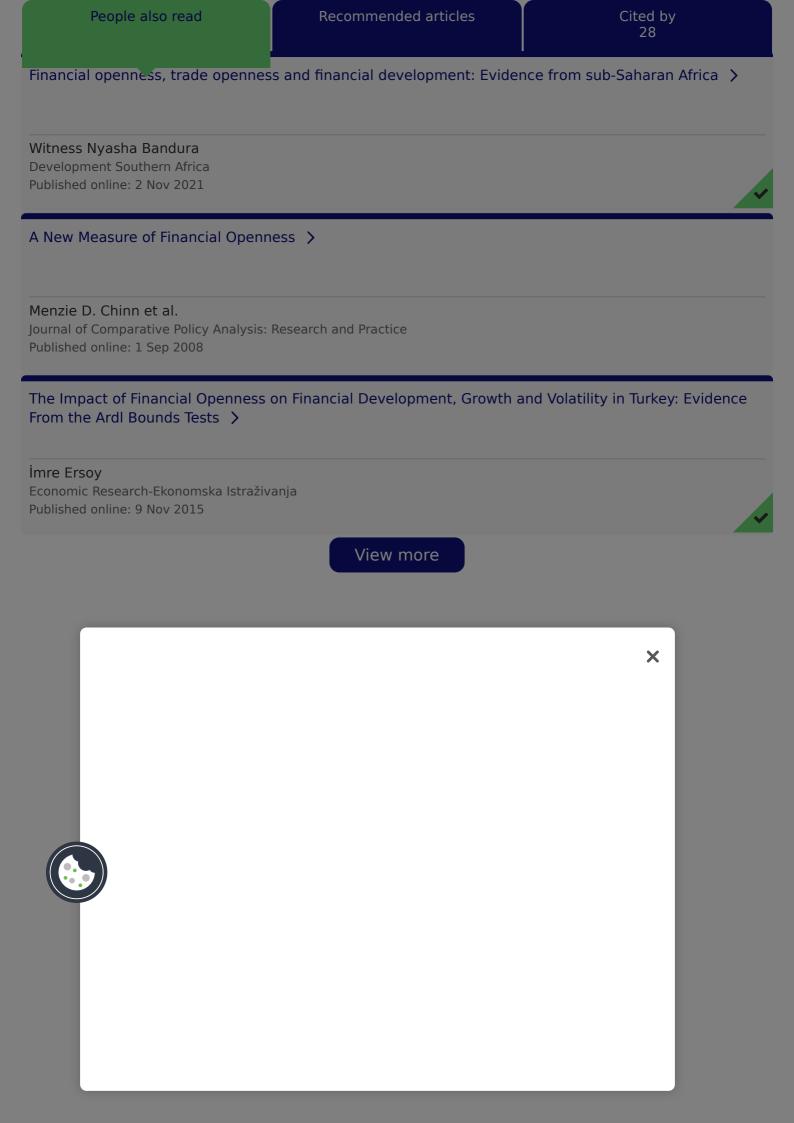


- 12. We restrain from using the system GMM estimator due to the weak instruments problem. The number of instruments used in the estimations is large enough to create weak results for the serial correlation tests and the Sargan test of overidentification when using the system GMM estimator. Therefore, we rely on our first difference GMM estimates.
- 13. Any influence of financial openness is now conditioned on the history controlled by the first differenced lagged dependent variable (Huang 2006). This model is a restricted version of the static fixed effects specification and it includes dynamic effects through the lagged dependent variable that is included as a right-hand-side regressor.
- 14. To test for overidentifying restrictions we perform Sargan tests. We do not include the lag of the dependent variable as an instrument. We utilize the Arellano-Bond two-step estimator to avoid any panel-specific autocorrelation and to obtain better diagnostics results.
- 15. In the benchmark dynamic GMM estimations, all variables other than the lags of the dependent variable are treated as exogenous.
- 16. The missing observations for bond market development indicators could be the reason behind the non-significant results.



- 21. One pitfall is that the link between financial openness and bond market development disappears as in the case with equally weighted indices.
- 22. Depending on the choice of the individual banking sector development indicators, Baltagi, Demetriades, and Law (2007) find altering coefficients for the interaction term. This agrees with our finding of a positive coefficient using comprehensive indices, which are composed of various individual measures used in the literature for financial openness and banking sector development.
- 23. The same partial derivative evaluated at the minimum level of financial openness index is 0.005, and evaluated at the maximum value is 0.006. Alternatively at the minimum level of trade openness, the partial derivative of financial development index with respect to financial openness index is 0.48 and it is 0.489 at the maximum level of trade openness.
- 24. The long-run coefficient for financial openness using the banking sector development index is 0.643. The coefficients for financial openness using the bond and stock market development indices are 0.505 and 0.107 whereas for the overall financial development index, the coefficient is 0.715.
- 25. The results are available upon request.





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