The Effect of Political Stability and Financial Liberalization on Financial Growth of Developing Countries with High Income

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Summary
Financial development is referred to a situation where financial services are enhanced by financial institutions and if these institutions have sufficient efficiency, they transfer capital from depositors to those who receive loans. Therefore, resources are directed toward productive investments and lead to optimal allocation of resources. Generally, there are many factors that affect the financial development which can be divided into two categories of economic and non-economic factors. Using descriptive and analytical method, this study aimed to investigate political stability and financial liberalization during 1996-2013 in developing countries with dynamic panel method. The index of interest for liberalization was capital account restriction. The results showed that political stability and financial liberalization have significant positive effect on financial development that is consistent with theoretical and empirical expectations.

Keywords:
financial liberalization, dynamic panel, financial development, political stability

1. Introduction

Financial markets have a vital role in economic growth and it can be said that they are the center of economic system. An efficient financial system transfers investments from depositors to those who receive loans. Therefore, resources are directed toward productive investments and lead to optimal allocation of resources. Thus, if financial systems are efficient and lead to financial development, they can facilitate economic growth. For this reason, due to the importance of financial development in economic growth that is considered the most important goal in each economy, studies on financial development context will be important. Generally, there are many factors that affect financial development and can be divided into economic categories such as liberalization, economic growth, and inflation and non-economic factors such as good governance, property rights, legal system, and political pressures that are referred as institutional factors.

One of the most important factors that determines financial performance is the existence of suitable institutional infrastructures, so that economic performance of companies is dependent on their economic, institutional, and legal environments and these policies and institutions specify good governance quality.

Regarding financial development, liberalization policies can create improvement, so that the openness degree can lead to the development of the country. Because, whenever country's economic system is dynamic, economic exchanges will increase and country will take advantage of innovation and technology of other countries and provides drivers for investment through increasing returns. Therefore, financial liberalization is important.
The purpose of this study is to investigate the effect of political stability and financial liberalization on financial development of developing countries with high income that despite its importance, only a few empirical evidences can be found in this regard. Therefore, researchers have taken it into consideration. This study aims to investigate the effect of non-economic institutional factors on financial stability and financial liberalization on financial development.

2. Theoretical Foundations of the Study

In this section, financial development will be described. Then, the concept of financial liberalization is clarified and finally, governance is defined.

2.1 Financial Development

In financial development, financial services are increased by financial institutions and all people of the society take advantage of numerous services. Capital accumulation is one of the most important economic growth sources of a country and through financial markets, it is possible to facilitate capital formation process and financial development in [1].

Manuscript received August 5, 2025
Manuscript revised August 20, 2025
https://doi.org/10.22937/IJCSNS.2025.25.8.5

2.2 Financial Liberalization

Economic liberalization means deregulation and reducing bureaucracy, liberalization of prices, and breaking monopolies. Economic liberalization investigates different areas in terms of theoretical and empirical aspects that include price liberalization, trade liberalization, exchange rate liberalization, investment liberalization, capital liberalization, and financial liberalization that according to the research purpose, financial liberalization will be explained. According to the international institutions such as International Monetary Fund, World Bank, and World Trade Organization, any activity to decrease control over free trade is considered a measure for economic liberalization. However, if liberalization takes place at financial sector and services related to it, it is considered financial liberalization.

2.3 Political Stability

Political stability is referred to concepts such as social unrest, executions, coups, civil unrest, ethnic tensions, and transition at high levels. Political uncertainty is accompanied by political instability and probably increases time preferences for venture capitalists. In response to this, replacement rate of long-term investments and probably with high efficiency increases by short-term investment plans with low efficiency. Moreover, productive inefficiency by political instability decreases final productions corresponding production data in [2].

2.4 The Effect of Financial Liberalization and Financial Development

According to the definition of financial openness that is a referred to foreign assets and liabilities as a percent of GDP, it can be said that by financial liberalization, the context for foreign assets will be created and this facilitates the development of financial markets.
Financial liberalization can affect financial development in several ways. First, financial liberalization may reduce financial repression through increasing the rate of interest in financial markets. Second, failure to control capital inflows motivates domestic and foreign investors for investment in various portfolios; therefore, cost of capital decreases and stock of capital increases. Third, liberalization of financial market not only increases the efficiency of financial system through excluding inefficient financial organizations and increasing pressure on financial restructuring, but can decrease information asymmetry in [3].

2.5 The Relationship between Political Stability and Financial Development

Political instability not only prevents the formation of necessary institutions for financial development, but decreases economic activities that lead to decreased demand for financial services in [5].

3. Review of Literature

In this section, some issues are reviewed that are related to previous studies on this context. Lin investigated the effects of policies and regulations on economic development in 49 countries in [4]. The findings of this study showed that the measured index of economic development explains financial development very well. Moreover, the results showed that countries with French or Spanish legal origins do not have high financial development rate. However, countries with German legal origin have positive financial development rate and as expected, their institutional and financial developments have positive correlation. Another result of this study was that democracy is a good factor for financial development. Also, economic liberalization has a positive relationship with financial development.

Roe and Siegel investigated the effect of political institutions on the financial development, in [5]. This study showed that political instability prevents financial development. They believed that to understand financial development, policies can be used, because policies cause political instability. Moreover, most of institutional factors are key points in financial development or backwardness.
Huang investigated the relationship to improve political institutional policy and financial quality, [6]. In this study, this question was proposed that can political institutions enhance financial development? For this reason, data from 90 developing countries between 1960 and 1999 were used. The results showed that improving the quality of financial institutions in short-term has a positive effect on financial development. Also, the primary evidences in this study showed that democratic transformation led to increased financial development.

Singh investigated the effect of institutional quality on financial development in African countries during 1992-2006, in [7]. They showed that the difference in institutional quality is the main reason for change at financial development level of these countries. Kim and Wu using panel data in 52 emergent countries during 1995-2003, investigated the effect of factors such as good governance on financial development. In this study, bank indices such as private credit with deposit money and share of domestic credit provided by banks from GDP and bank system were used from in [8].

Das investigated the effect of regulatory and control governance on stability in financial system and data were extracted from Financial Sector Assessment Program (FSAP), in [7]. The results of regression showed that control governance has a significant positive effect on increasing financial system health.

4. Methodology

In previous studies on financial context, empirical methods were almost based on time series techniques or cross-sectional statistics. These studies were almost involved in statistical problems such as heterogeneity of variance and autocorrelation. For this reason, combined data have been taken into consideration in recent years. One of the advantages of combined data is that it limits variance heterogeneity. Also, the combination of time series observation and cross-sectional observations leads to access to more data, variability, less linearity between variables, higher degrees of freedom, and more efficiency. Moreover, to solve or decrease endogenous problem of good governance index or correlation between other explanatory variables, model was estimated using Generalized Method of Moments (GMM). In this section, research methodology and procedures will be explained.

4.1 Combined Time Series and Cross-Sectional Data Model (Panel)

Combined data are a set of data by which observations are investigated by a large number of sectional variables (N) during a specific period of time (T). In this condition, T×N is considered as combined data of cross-sectional and time series data. Combined data include both time series and cross-sectional data and the use of suitable explanatory models that can describe variables is more complicated that models used in cross-sectional data with time series.

4.2 Unit Root Test in Combined Data

Unit root tests of combined data were designed in [9,10]. These studies were completed by other researchers as shown in [11,12,13]. We start these investigations by studying in [11].

- Lin and Levin Test (LL): Lin and Levin (LL) showed in [11], that in combined data, unit root test related to data has more power compared to unit root test for each section separately. [14],[15],[16] and [17] showed that the use of unit root tests in combined data such as Dicky-Fuller test and Philips and Perron test has low statistical power compared to unit root test of combined data in [18,19]. As showed in [1], unit root test as follow:

$$\begin{array}{l}\Delta x_{i,t} = \rho_i X_{i,t-1} + \sigma_t + \alpha_i + \varepsilon_{i,t} \\ i = 1,2,...,N \\ t-1,2,...,T\end{array} \quad (1)$$

- where N is the number of sections, T is time period, P is autocorrelation parameter for each time section, α_i is fixed coefficient for each section, and $\varepsilon_{i,t}$ is disruption that has normal distribution with the mean of zero and variance of σ^2.

Im, Pesaran, and Shin Test (PPS): In H1 of this test, ρ_i s have different values. In other words, the hypotheses of this test are as follow:

$$\begin{array}{l} H_0 : \rho_i = 0 \qquad i = 1,2,...,N \\ H_1 : \begin{cases} \rho_i < 0 & i = 1,2,...,N_1 \\ \rho_i = 0 & i = 1,2,...,N \end{cases} \end{array} \quad (2)$$

According to these hypotheses, some sections can have unit roots. Therefore, unit root tests are used separately for each section and these statistics are calculated as $\bar{t}_{NT}$. If we have $t_{iT}(\pi_i, B_i)$, it shows t-statistic for unit root test of the ith section with the interval of π_i and coefficients of Bi test in [20,26,27].

4.3 Sargan Test

Sargan, asymptotically had x^2 distribution that is defined, [21] as follow:

$$S = \hat{\varepsilon} \sum_{i=1}^{N} z' H_i z_i)^{-1} z' \hat{z} \quad (3)$$

In this test, $\hat{\varepsilon} = Y - X\hat{\delta}$ matrix $K \times 1$ is $\hat{\delta}$ ، estimated from the coefficients, z is the matrix of instrumental variables, and H square matrix (T-q-1) where T is number of observations and q is number of explanatory variables of the model. If null hypothesis is not rejected in this test, the defined instrument variables are valid and the model does not need to define more instrument variables. However, if the null hypotheses is rejected, the defined instrument variables are not sufficient and suitable and it is necessary to define more suitable instrument variables for the model in [20].

4.4 Bond Test

This test is used to investigate validity of instrument variables. Arlando and Bond believed that in GMM estimation [22,24,25], disruptions should have AR (1) without AR (2), [23].

4.5 Research Variables and Model

The economic model used in this study is as follow:

$$FD_t = \beta_0 + \rho FF + \sum \alpha_i G_{it} + \sum \gamma_i Z_{it} + FD_{t-1} + FD_{t-1} + \sum \varepsilon_i G_{it} = VA + PSNV + GE + RQ + RL + CC + AVE \quad (4)$$
$$Z_{it} = GDP + INF + TO + \ldots \qquad i = 1, \ldots, 7$$

that is homogenized to prevent bias in estimating countries in terms of income and was used to estimate developing countries with high income. Research models have been developed as follow:

$$FD_t = \beta_0 + \rho FF + \alpha PSNV + \kappa GDP + \mu INF + \theta TO + \delta FD_{1,t-1} + \varepsilon_2 \quad (5)$$

Financial Development (FD) index: this index is resulted from direct demands of banking sector from the private sector to GDP. If the share of debt of private sector to banking system regarding GDP is studies, it can explain the efficiency of banking system in using the facilities of private sector regarding economic growth.

Gross Domestic Product (GDP): includes the values of services and goods that are produced during a certain period of time in a country. Inflation (INF): is changes in cost index that is customer price index. Financial Liberalization (FF): any measure to decrease control over free trade and movement towards free economy. Trade Liberalization (TO): trade liberalization means decreasing or eliminating trade barriers in international trade. Political Stability No Violence (PSNV): indicates concepts such as social unrest, political executions, urban unrest, ethnic tensions, and power transmission at higher levels.

5. Results

The first step in empirical estimations is to investigate the stability of model variables. For this purpose, Lovin, test that is known as LCC in [11,28,29], and Im test that is known as IPS were used in [12,30]. The results of these tests for developing countries with high income are presented in Table 1. The null hypothesis points to the existence of unit root in variables. However, the following hypothesis indicates the stability of variables. According to the following table, the results obtained from tests show that research variables for developing countries are viable, that means null hypothesis is rejected. The results show that some variables re viable and some became viable by single-time differencing. According to these tests, all variables are viable and it is possible to estimate pattern parameters using GMM. Table I shows the results of unit root tests for developing counties with high income.

Here, the results of Sargan test for developing countries with high income rejected null hypothesis and confirmed the validity of instrument variables in [21,31,32]. The results in Table (II-IV) show that instrument variable is valid at the importance level of 5% that shows the appropriateness of instrument variable in developing countries with high income.

Table 2: The results of Sargan test for developing countries with high income

Research model	
(0.0416)*	AR(1)
(0.4035)***	AR(2)

Table 2 shows The results of Sargan test for developing countries with high income, in [21,33] .The results for developing countries with high income are significant in AR (1), because AR (1) is smaller than 0.05 that indicates AR (1) is confirmed at the significance level of 95%, that is first-order autocorrelation exists and in AR (2) is larger than 0.05 that shows it is not significant at the significance level of 95%, that means we do not have second-order autocorrelation.

Table 3: The results of Bond test for developing countries with high income

Research model	
(0.0416)*	AR(1)
(0.4035)***	AR(2)

6. Model Estimation

After the relevant tests, the model parameters are estimated using econometric method. As was mentioned in methodology, the parameters of model are estimated according to GMM. Research model: in this model, PSNV was used as an index for good governance. According to Table (IV-V), it is clear that GDP variables, political stability, and financial liberalization had positive effect on financial development of developing countries with high income. In developing countries with high income, with one unit increase, financial development of the previous period, GDP, and political stability increase by 0.81, 0.0008, and 0.58, respectively. Here, financial development of previous period has the largest effect and GDP has the smallest effect. Table IV shows the results of estimating the effect of political stability and financial liberalization on financial development during 1990-2013 for developing countries with high income.

Table 4: The results of estimating the effect of political stability and financial liberalization on financial development during 1990-2013 for developing countries with high income

Research model		*Variable*	
0.81		Coefficient	*FD(-1)*
133.53		T-statistic	
(0.0000)*		Prob.	
0.0008		Coefficient	*GDP*
6.47		T-statistic	
(0.0000)*		Prob.	
-0.001		Coefficient	*Inflati*
-0.44		T-statistic	
***(0.6555)		Prob.	
0.64		Coefficient	*KO*
1.59		T-statistic	
***(0.1119)		Prob.	
0.09		Coefficient	*TO*
0.32		T-statistic	
***(0.7487)		Prob.	
0.58	Political Stability No Violence	Coefficient	*Institutional Variable*
1.90		T-statistic	
**(0.0569)		Prob.	

7. The Results of Analysis

According to the findings, political stability has a significant positive effect on financial development that is consistent with theoretical and empirical expectations. It is obvious that political stability is one of the characteristics of good governance. Political instabilities such as riots, assassinations, and wars are among the factors that inhibit financial activities such as investors' skepticism that weaken financial markets. On the other hand, support levels decrease and supporting institutions such as regulations and courts cannot act well in political environments. Moreover, investors are faced by risk in investments and this leads to decreased investment and financial development. Also, when we have political instability, authorities aim to solve it and they ignore domestic policies, capital flight, and experts who leave the country that are the infrastructures of financial market. On the other hand, political instability decreases economic activities that this leads to decreased financial services and downturn of financial markets. Therefore, it can be stated that political stability has a direct relationship with financial development and the results of this study confirm this issue.

Liberalization has a significant positive effect on financial development of developing countries with high income. Regarding trade and financial liberalization with financial development, it can be concluded that with dynamic relationship between economy and countries, not only trade exchanges increase, but it leads to technology transmission and achieving modern technologies and innovation that the efficiency of economic activities increases and this can be a driver for investment and brings motivation for financial development.

Financial liberalization can be an important factor for those investors that deal with political considerations and by financial liberalization can increase investments and provide the condition for financial development and the results of this study confirm this point. Those countries that have inefficient government systems, will encounter barriers for financial liberalization that prevents financial development. Lack of financial transparency can disrupt financial liberalization procedure and financial development. Also, regulations can limit financial liberalization and prevent financial development.

On the other hand, trade liberalization can make problem for financial development procedure, because trade liberalization in these countries increases demands for financial services and fi countries do not have suitable financial markets, not only the demand are not provided, but domestic markets to will not be satisfied and most of financial facilities that were efficient for financial development will be wasted. Therefore, the most important economic factors of economic infrastructure are financial markets that should be enhanced before liberalization. Moreover, only a few studies are conducted on factors affecting good governance such as financial development and financial liberalization where regarding financial liberalization, it is likely that according to the trade infrastructures, maybe different results will be obtained, but in general, financial liberalization has a positive effect on financial development and the results of this study confirm that.

Inflation has a significant negative effect on financial development of developing countries, inflation disrupts decision-making process and high inflation limits assets that is considered a threat for financial markets and leads to disruption in financial development. On the other hand, high inflation decreased financial intermediation. In developing countries, it can be sated that inflation rate is the cost of money maintenance and since in developing countries, financial resources are moving to a large extent, the inflation rate affects the maintenance of various assets, so that if the inflation rate is high, investors prefer to increase real assets; because, if the inflation rate is high, the money value decreases, but real assets such as gold maintain their purchasing power. Therefore, this hypothesis has been confirmed in developing countries with high income for models with good governance. Different countries have different strategies against inflation. Regarding the model for developing countries that the hypothesis is rejected for, the reason can be this

fact that the government has provided a context that covers the risks resulted from inflation and for this reason, investors are interested in investment in inflation condition. GDP has a significant positive effect on financial development of developing countries that has been confirmed. Per capita GDP is an economic index and according the perspective of Patrik, change in financial markets is created as the result of economic growth. In other words, economic growth is the reason for financial development. Demand for financial services is dependent on the growth of product in different sectors of economy. Therefore, development of financial institutions and increased financial assets are reactions against investor and depositors.

8. Political Recommendations

Before implementing different liberalization policies such as decreasing restrictions on international capital inflow and outflow, decreasing interest rate, and decreasing barriers to enter financial sector to increase competition, it is necessary for countries to reform institutional infrastructures; otherwise, the suggested policies will not be effective. Without institutional reforms, it is less likely that financial liberalization can lead to financial development. If there is no suitable infrastructure, capital will be excluded. It is suggested that if developing countries have necessary infrastructure, they should act on financial liberalization and witness financial development. In this framework, increased private sector's share of credits and market development and advanced financial instruments will be helpful. Liberalization leads to the transmission of technology to countries and this can be a shock for markets and attract many investors and pave the way for financial development.

Governments should do their best to create security and political stability. At least, it is better to prevent internal tensions by brainstorming sessions and establishing security and stability. Moreover, these countries can provide a condition in which people can freely comment on different issues. Therefore, people will not state their problems with protests and this may not disrupt security and political stability that influence internal security. Also, principles should be observed regarding neighboring countries to avoid military threat; because, these threats influence public that lead to insecurity in society and this will affect financial markets and financial development.

As pointed out, in most of cases, inflation leads to decreased financial development; therefore, it is better to have logical relationship between financial policies and monetary policies. According to the necessity to improve and develop financial sector to have active role in economic growth, optimal allocation of financial resources is recommended. The government supports banking system and helps optimal allocation of financial resources and facilitates financial development procedure. Moreover, increased private investment can increase economic growth and due to economic growth, credits for this sector increase and financial development will be improved. Therefore, it is suggested by strengthening fiscal discipline, private sector should have access to banking resources by lower costs that can continue their activities to facilitate economic growth and financial development. Since trade liberalization policies increase financial development, it is suggested that developing countries should take roles in this regard such as accession to World Trade Organization (WTO). Indeed, trade development policies for countries that have necessary infrastructures for trade liberalization, not only are not limitations in this sector, but can lead to development of this sector, so that increased trade in developing countries can lead to exports by sectors with large scale economies and this increases the requirements of these countries and creates financial development. It is suggested that researchers should investigate the present issue using other indices of financial development and liberalization or investigate the effect of political stability on various economic liberalizations.

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