

## Financial Openness and Capital Market Development: Empirical Review of Selected West African Countries

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### Abstract

This study empirically determines the main effects of financial openness on capital market development for a group of West African Countries. The three countries selected - Nigeria, Ghana and Ivory Coast - have the most developed capital markets that could be said to be open and integrated at a reasonable level with external markets. The panel data regression technique was applied to annual data from the respective countries covering the period 1988 to 2010. Moreover, both the Fixed Effects and Random Effects estimations were carried out in the empirical analysis to investigate the relationships. The findings from the study indicate that higher financial openness in the sub-region would enhance the development of domestic capital markets. However, the pattern of foreign capital inflow to a country as well as the structure of external assets and liabilities appears to play a role in explaining the impact of financial openness on domestic capital markets within the West African sub-region. In this study, foreign liabilities that have direct link with domestic capital markets were shown to contribute more to capital market development in the domestic economy.

**Keywords:** Financial openness, capital market development, Panel data, West Africa

### 1. Introduction

The pursuit of sustainable development among developing countries has engendered issues of international collaborations especially in areas of capital accumulation. Indeed, a major feature of the global economy in the last decade is the rapid expansion of developing economies to accommodate advanced economies in terms of international capital markets. This is in response to encouragement of the developing economies to liberalise their financial systems under the notion that this would lead to greater financial development (Greenidge and Moore, 2007). In this direction, Calderon and Kubota (2009) have extensively documented a rapid increase in cross-border asset trade for both industrial economies and emerging economies in recent years.

In addition to promoting transfer of technology and know-how as well as improving institutions, financial openness may foster productivity through its effects on the development of domestic financial markets (Kose, Prasad and Terrones, 2008). As a direct consequence of the globalization of capital markets, financial markets have deepened in both industrial countries and emerging markets, thus generating tight linkages across several financial markets where asset trading (in bonds, stocks or currencies) among banks, corporations and governments has risen considerably. Also, financial innovation seems to have increased among these countries in response to pressures generated from increased financial openness and savings have been mobilized in order to accumulate capital; thus, leading to higher growth rates (Levine, 2005).

From the foregoing analysis, the implications of financial integration of developing economies may have very strong linkages with the pattern of development of the capital market. Moreover, Calderon and Kubota (2009) have noted that the purported benefits of increased financial openness in the financial sector notwithstanding, there still remains a great deal of heterogeneity in financial development across countries. Individual market as well as regional issues ranging from institutional (e.g Schneider and Tornell, 2004) or other specific factors may render the effects of financial openness less generalized than is considered in literature.

To the best of our knowledge, there is paucity of empirical evidence on the relationship between financial openness and financial sector development in Sub-Saharan African countries, especially in the West African Sub-region. In this study, we investigate the effects of financial openness on capital market development in three West African countries. We argue that increased capital inflow can improve capital market development, depending on the nature of the capital. Moreover, this study is undertaken in order to expand the frontier of knowledge in this direction by asking questions like: what is the effect of financial openness on capital market development in Sub-Sahara Africa? What explains the persistence of underdevelopment in the domestic capital markets in developing countries? Our goal is to examine the relationship between financial openness and financial development, as well as the impact of the latter on the former in some selected West African countries and using the capital market as an indicator.

This study is organized as follows: in section two we review the major theoretical and empirical issues regarding financial liberalization and financial sector and capital market development. Then, in section three, the theoretical framework is set out by specifying the model in the study. The empirical analysis is carried out in section four while we conclude in section five.

## 2. LITERATURE REVIEW

McKinnon (1973) and Shaw (1973) provided the theoretical basis for evaluating the relationship financial openness and general financial sector development. The accumulation of financial capital is considered a necessary prerequisite for investment activities to occur under the financial liberalization thesis (Greenidge and Moore, 2007). Both McKinnon and Shaw stipulated that real interest rate is a critical factor in determination of financial capital in any financial system. In this direction therefore, placing controls on interest rates tends to artificially lower the real rate of returns on deposits thereby discouraging the accumulation of financial capital and inhibiting financial sector growth or development. Although recent arguments in favour of financial liberalization have given less focus on the real interest rate, the initial formulations by McKinnon and Shaw provided the necessary instrument to back the for call for more financial openness, especially among developing economies in recent times.

Stiglitz (2000) argued that the case for capital market liberalization is “largely based on standard efficiency arguments, employing a conventional neoclassical model and ignoring the special ways in which financial and capital markets differ from markets for ordinary goods and services.” The proponents focus on efficiency effects that may emanate from improved informational activities in the market as well as widening the activities of the market. For instance, Bae *et al.* (2006) find that financial liberalization indeed improves the local environment for disclosure, information production, and the analysis of information in 25 emerging stock markets. On the theoretical front, Froot and Perold (1995) show that the slow dissemination of market-wide information results in positive serial correlations in stock index returns. Consistently, the behavioral model of Hong and Stein (1999) also predicts that stock price under-reaction is the outcome of gradual dissemination of information across the investing public.

In the same vein, it has been shown that capital market liberalisation provides the background for increased investment in domestic securities by foreign investors and guarantees domestic investors the right to in foreign equity securities. Bekaert *et al* (2005) found these results and then argued that improved risk sharing post-liberalization should decrease the cost of equity capital and increase investment. Capital market inefficiency often leads to financing constraints (Hubbard, 1997) making external finance more costly than internal finance and cause investment to be sensitive to cash flows. Equity market liberalization directly reduces financing constraints in the sense that more foreign capital becomes available, and foreign investors may insist on better corporate governance which indirectly reduces the cost of internal and external finance. Hence, the cost of capital may go down because of improved risk sharing or because of the reduction in financing constraints or both (Bekaert *et al.*, 2005).

International financial integration may lead to a faster development of domestic financial intermediaries through different channels. Financial openness may increase the depth and breadth of domestic financial markets and improve the efficiency of financial intermediation by eliminating financial repression and shifting interest rates to clearing-market competitive levels, thus reducing the cost of capital (Calderon and Kubota, 2009). It may also improve the quality and availability of financial services in the domestic market by increasing the degree of bank competition and enabling the application of more sophisticated banking techniques and technology, which may improve efficiency by reducing the cost of acquiring and processing information on potential borrowers (Levine, 1996; Caprio and Honohan, 1999). Rising financial openness would lead to a more efficient financial system by displacing inefficient financial intermediaries and creating pressure for the implementation of reforms in the financial infrastructure so as to reduce problems of information asymmetry, adverse selection and moral hazard (Claesens *et al.* 2001; Chinn and Ito, 2006).

Financial liberalization, as we argued above, may foster the better functioning of financial markets. However, it may lead to risky behavior by banks (Schneider and Tornell, 2004) and trigger boom-bust cycles in economies with imperfect capital markets (Tornell and Westermann, 2005). Agency problems may encourage borrowers to use bank loans to buy risky assets during lending booms and, the resulting bubbles may burst into banking crisis and recessions (Allen and Gale, 2000). This phenomenon was evident in the Nigerian stock market boom of 2004 to 2008 and inter alia precipitated the stock market crash of 2008 to 2010. Kaminsky and Schmukler (2008) find that financial liberalization in emerging markets generates short run tensions but provides a market stabilization role in the long run. They also argue that financial deregulation may not only trigger short run problems and crisis if it occurs in economies with weak institutions and agency problems but also long-run gains arise as financial liberalization deepens and institutions improve.

Understanding the effects of higher cross-border asset trade on the development of financial intermediaries stock markets and bond markets is crucial due to the impact of financial market development on growth (Levine, 2005) and, especially, on the direction of capital flows and the persistence of global imbalances (Chinn and Ito, 2007). In a seminal paper, Rajan and Zingales (1998) find that *ex ante* financial market development may help boost the *ex post* growth of “external-financially-dependent” sectors by reducing their cost of raising funds

abroad. Guiso *et al* (2004) argue that domestic financial market development still matters for growth even in economies that are highly integrated to world capital markets

This paper complements existing evidence that more intense financial linkages between a developing country markets with the international markets may lead to deeper domestic financial markets after, with respect to West African markets. Baltagi *et al.* (2009) use four different data sets since the 1980s to test the linkages between financial openness and financial development. They find that: (a) trade and capital account openness may have a significant impact on financial development in countries that are relatively closed, and (b) trade and financial openness may be substitute mechanisms of promoting financial development rather than complements as suggested by Rajan and Zingales (2003).

This research improves upon the evidence presented in previous research by: a) presenting evidence for a sample period with respect to developing economies only, and b) presenting panel data evidence with measures of financial openness that capture the degree of financial openness instead of the absence of restrictions on cross-border asset trade.

### 3. Methodology and Data

#### 3.1 The Model

The model specified in this section is based on the panel regression analysis procedure that is adopted in this study. The basic class of models that can be estimated using panel techniques may be written as:

$$Y_{it} = f(X_{it}, \beta) + \delta_i + \gamma_t + \epsilon_{it} \quad (1)$$

The leading case involves a linear conditional mean specification, so that we have:

$$Y_{it} = X_{it}'\beta\delta_i + \gamma_t + \epsilon_{it} \quad (2)$$

Where  $Y_{it}$  is the dependent variable, and  $X_{it}$  is a -vector of regressors, and  $\epsilon_{it}$  are the error terms for  $i = 1, 2, \dots, M$  cross-sectional units observed for dated periods  $t = 1, 2, \dots, T$ . The  $\alpha$  parameter represents the overall constant in the model, while the  $\delta_i$  and  $\gamma_t$  represent cross-section or period specific effects (random or fixed).

In this study, Y is the capital market development variable which is considered as market capitalization to GDP ratio.

X is the vector of all the independent variables used in the estimation including:

- Capital account balance as a ratio of GDP (CABYR)
- Ratio of private capital inflow to GDP (FPCYR)
- Number of listed companies in the capital market (NLS)
- External finance through foreign capital market (FCMF)

The use of panel data analysis is justified in this study based on the fact that a panel data set (i.e., cross section of three West African Countries and time series of 23 years) is used in the analysis. The countries included in the study are Ivory Coast, Ghana and Nigeria. These are the countries with the most developed capital markets in West Africa and for which data is available on capital market structures. Moreover, these markets represent the leading capital markets in the West African sub region (ASEA, 2010). The purpose for this is to be able to isolate other country-specific factors that determine capital market development. Data used in this study is panel data covering the period 1988 to 2010. These data are sourced from the World Bank World Development Indicators Database for 2011.

#### 3.2 Variables in the Model

The variables used in our model to capture financial openness are similar to those adopted in Bekaert (1995), Stiglitz (2000), and Edison and Warnock (2003).

**Capital account balance as a ratio of GDP (CABYR)** is the generally used measure of financial openness in an economy. This variable captures the proportion of the economy that is made up of net capital flows in that economy. The more financially open an economy is the larger will be the capital account balance. This variable is linked with the capital market because most of the capital transactions are carried out using the capital market instruments.

**Ratio of private capital inflow to GDP (FPCYR)** measures the inflows of private capital into the economy. This aspect of the capital flow is relevant since it shows the component of net capital flows that result from the inflow from abroad. The ratio of this variable to GDP also indicates the level of financial accessibility of a financial system or the economy in general.

**External finance through foreign capital market (FCMF)** refers to the proportion of external supply of finance to the domestic economy that is channeled through the source country's capital market. This variable has a direct link with domestic capital market since it tends to expose the domestic market to the activities of the source country's market. This variable is particularly relevant for capital market development in emerging economies.

**Number of listed companies in the capital market (NLS)** is total number of companies (or stocks) listed in the stock market. It is the basic measure of the strength of a stock market by indicating both the width and the depth of the market. More listed companies effectively indicate more developed capital markets.

### 3.3 The Hausman Test for Correlated Random Effects

A central assumption in random effects estimation is the assumption that the random effects are uncorrelated with the explanatory variables. One common method for testing this assumption is to employ a Hausman (1978) test to compare the fixed and random effects estimates of coefficients.

## 4. Empirical Analysis

As mentioned in the previous section, the panel data regression technique is used for the analysis. In order to present a robust investigation and analysis of the study, two general methods are used in the empirical analysis. First, in order to provide a background to the empirical analysis, statistical examination is carried out on the data so as to generate the initial characterization of the data used in the study. Second the presentation and analysis of the regression results is performed. As stated in the previous section, the Eviews 7 Econometric software is used for the summary statistics as well as the Econometric estimations.

### 4.2 Descriptive Statistics

Table 1 presents annualized mean, annualized standard deviation and other summary statistics on capital market development and financial openness factors for the countries. The result shows that market capitalization rate is higher in Nigeria than any other country in the sample. Capital market has a share of 14.6 percent for Nigeria, 14.49 percent for Ivory Coast and 12.78 percent for Ghana. It can therefore be inferred that Nigeria is more financially developed than the other countries in the sample. However, Ivory Coast is shown to be more open in terms of the capital account. The average net capital account balance for the period is 0.76 percent of the GDP for the country. Nigeria, on the other hand, seems to be the least open in terms of the capital account.

**Table 1: Descriptive Statistics**

Variable	Mean			Std. Dev		
	CIV	GHA	NIG	CIV	GHA	NIG
MCR	14.49	12.78	14.54	14.49	12.78	14.54
CABYR	0.76	0.70	0.42	1.54	1.03	2.38
FPCYR	1.58	2.60	4.07	1.21	2.52	1.80
FCMF	0.16	4.22	0.31	0.30	3.33	0.49
NLS	33	21	182	6.38	10.27	32.72

In terms of ease of financial inflows, Nigeria has the highest ratio, followed by Ghana. It seems more financial resources flows into Nigeria than any of the other countries, perhaps due to the more developed capital market. With an average of 182 listed companies, the Nigerian capital market is the largest among the countries in the sample. Moreover, Figure 1 below shows the extent of capital market development in each of the markets. The Ghanaian market seemed to have developed more rapidly in the 1990s but it has tailed out in recent years. Since 2005, the Nigerian market and that of Cote d'Ivoire have developed more extensively with market capitalization of both markets reaching over 30 percent of GDP in 2007.

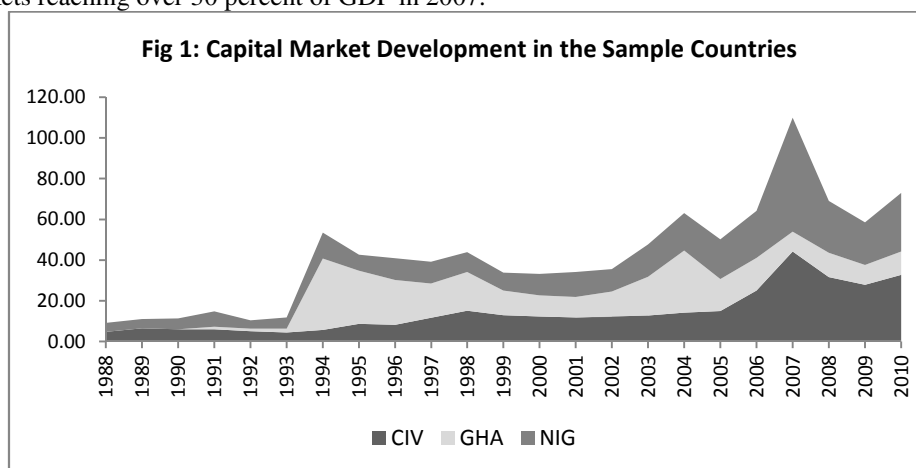
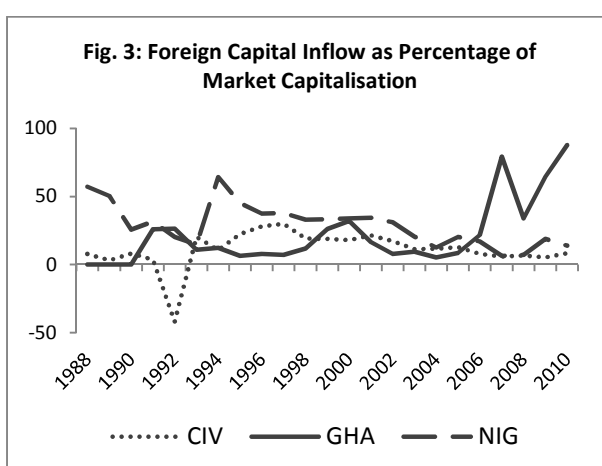
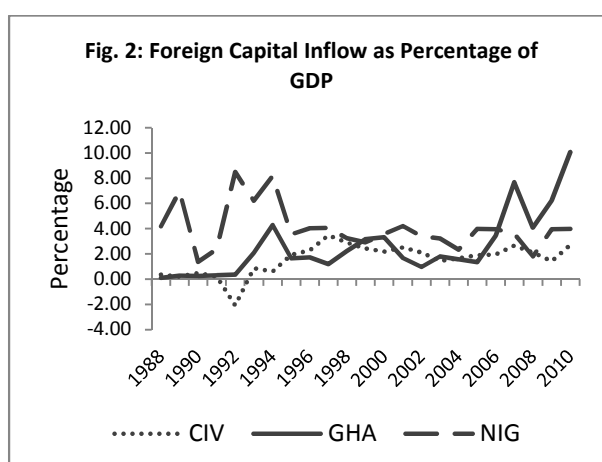


Figure 2 and 3 show the level of international financial integration of the three capital markets which is determined by the ratio of capital inflow to GDP and to market capitalization respectively. In the 1980s and early 1990s, the ratio was highest for Nigeria but there was a sharp decline in the integration level for Nigeria (and Ghana) perhaps due to structural issues in the domestic market. In recent times, the Ghanaian market has been more internationally integrated than the other markets in the region. Apparently, financial services in the Ghanaian economy has consisted more of foreign resources in recent times and the capital market has consisted more foreign capital in since the financial crises that started in 2008.



#### 4.3 Empirical Results on the Panel Analysis

We conduct our econometric analysis to test whether more financial openness promotes the development of domestic financial intermediaries in terms of the capital markets in developing economies. Our dependent variable is the level of domestic financial development proxied by the capital market development. Our interest is the extent of responses of domestic countries' capital markets to international financial systems proxied by foreign assets as well as liabilities.

##### 4.3.1 Least Squares Estimation

We begin by presenting the general OLS estimation of the relationship for the pooled data for the three countries. Table 2 reports the coefficient estimate of capital market development where we apply least squares to our baseline regression for measures of capital account openness and ease of capital inflow. The control variable is number of companies listed in the stock market. The result possesses a small R-squared value. This is to be expected in the case of panel data analysis. However, the F-value of 3.48 is significant at the 5 percent level, indicating that a significant relationship exists between the dependent variable and all the independent variables combined. The coefficients of CABYR and FPCYR fail the significance test while those of NLS and FCMF pass the test.

**Table 2: OLS Result**

Variable	Coefficient	T-ratio	Probability
C	8.974	4.075	0.00
CABYR	0.637	0.909	0.36
FPCYR	-0.584	-0.899	0.37
NLS	0.047	2.495	0.01
FCMF	1.540	3.068	0.00
	$R^2 = 0.179$	Adj. $R^2 = 0.127$	F = 3.48

As stated in the previous section, the standard test for the method of panel analysis to adopt is the Hausman test for random effects. The result of the test is reported in table 3 below. The Chi-Square statistic for the random

sections argument is zero, implying that the null hypothesis holds which effectively rejects the random effect result as the best method to capture the relationships in the panel.

**Table 3: Hausman Test for Correlated Random Effects the**

Test cross-section random effects				
Test Summary		Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random		0.00	2	1.0
Cross-section random effects test comparisons:				
Variable	Fixed	Random	Var(Diff.)	Prob.
CABYR	0.584534	0.6691	-0.02961	NA
FCMF	2.496518	1.944713	0.047256	0.0111

#### 4.3.2 Fixed Effects Results

From our results, the statistic provides little evidence against the null hypothesis that there is no misspecification when the random effect model is employed. Hence, the best method to apply is the Fixed-effect strategy. In this study, we report the result of both the Fixed-effect model and the Random-effect model for comparison purposes.

It is seen in the result that the diagnostic tests for the Fixed-effects model are much better than those of the Random-effects model. The R-squared value indicates that over 39 percent of the systematic variations in capital market development across the sections is explained by the four explanatory variables. The F-statistic value also passes the 1 percent test and implies that a strong relationship exists between the dependent variable and all the independent variables combined. Considering the individual coefficients of the explanatory variables, the findings of the study are:

Capital account openness does not have a significant impact on capital market development among the selected countries. The coefficient of the CABYR variable is pervasive and fails the significance test the 5 percent level.

- 1) Ease of inflow of financial capital into the economy does not have any significant impact on capital market development among the selected countries.
- 2) Financial capital inflow that emanates from the source countries' capital market has a significant positive impact on domestic capital market of the selected countries. The coefficient of FCMF is significant and positive. This variable seems to be the most closely linked with the capital market since it does not only make financial resources available to the domestic capital market, but it also aids market efficiency through the monitoring of such resources.
- 3) The type of foreign financial resources flowing into a developing economy matters for its capital market development. This has implications for the pattern of financial openness adopted by West Africa countries. A guided openness framework which scrutinizes financial inflow by source is advocated in this study.

**Table 4.4: The Panel Results**

Variable	Fixed Effects		Random Effects	
	Coefficient	T-ratio	Coefficient	T-ratio
<b>C</b>	-6.526	-1.397	11.836	8.738
<b>CABYR</b>	-0.402	-0.606	0.807	1.202
<b>FPCYR</b>	-0.249	-0.433	-	-
<b>NLS</b>	0.229	3.941	-	-
<b>FCMF</b>	2.149	3.671	1.023	2.391
	R <sup>2</sup> = 0.393	F = 6.69	R <sup>2</sup> = 0.096	F = 3.52

## V. Conclusion

The relevant goal of this study was to empirically determine the main effects of financial openness on capital market development for a group of West African Countries. In order to study this relationship, three countries were selected to represent that entire sub-region. These countries (Nigeria, Ghana and Ivory Coast) have the most developed capital markets that could be said to be integrated at a reasonable level with external markets. The empirical strategy adopted in this study is the application of the Panel Data Regression technique to annual data from the respective countries covering the period 1988 to 2010. Moreover, both the Fixed Effects and Random Effects estimations were carried out in the empirical analysis. The findings from the study indicate that higher integration in world capital markets would enhance the development of domestic financial markets. This

may occur through resultant increases in stock market capitalization and total value traded while improving the capitalization of private bond markets. Second, the pattern of foreign capital inflow to a country as well as the structure of external assets and liabilities appears to play a role in explaining the impact of financial openness on domestic capital markets. In this study, liabilities that have direct link with domestic capital markets were shown to contribute more to capital market development in the domestic economy.

There is therefore need for emerging countries, especially in the West African sub-region to be more selective in terms of inflow of foreign capital into the capital their markets. For instance, as (Calderon and Kubota, 2009) have shown the accumulation of risky assets (i.e. direct investment and portfolio equity) may lead to an expansion in capital market volatility. Shielded the capital market from easy transmission of foreign market volatility should be a basic arrangement for foreign capital receipt in the markets. Finally, although assumed in this study, more foreign capital inflow may not directly imply higher integration of capital markets. Thus, further research could be pursued in the area of examining whether the liberalization of domestic financial markets leads to higher integration of countries to world capital markets. In this respect, we may need to assess whether the causal relationship from financial openness to domestic financial development dominates the dynamic correlation between these two variables or the other way around.

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