# FINANCIAL DEVELOPMENT AND ECONOMIC VOLATILITY: DO OPENNESS AND INSTITUTIONAL QUALITY MATTER IN THE ASEAN-5 COUNTRIES?

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# FINANCIAL DEVELOPMENT AND ECONOMIC VOLATILITY: DO OPENNESS AND INSTITUTIONAL QUALITY MATTER IN THE ASEAN-5 COUNTRIES?

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# Abstract

This thesis examines the impact of greater openness and institutional quality on financial sector development and its further implications for economic volatility in the long run in case of ASEAN-5 countries namely Indonesia, Malaysia, Philippines, Singapore and Thailand. As revealed in the literature, sustainable long-run economic growth is largely determined by the level of financial sector development and has been well documented (Beck and Levine, 2002; 2004; Bekaert et. al., 2005; Ang and McKibbin, 2007; Ayadi et. al., 2013). Therefore, a study through which channel financial sectors are likely to be developed is an important issue. This is where the issue is still vibrant and subjected to less discussion. In this present study, it is highlighted that openness and institutional quality should be critical for financial development  as has been reported in Klein and Olivei (1999), Beck et al. (2000), Do and Levchenko (2004), Demetriades and Rousseau (2011) that such linkages exists. There has been a gap in these literatures in relation to less-developed economies who shared a meaningful economic arrangement such as the ASEAN-5 which this thesis fills.

It is also further believed that all of these variables might have an additional effect on the level of economic volatility. As past experience has shown, economic volatility has become more persistent in recent decades, especially after economic opening and financial and institutional reform (Hnatkovska and Loayza, 2003). This had led to a questioning of the openness policy, the role of institutions, and financial sector development, and has added fuel to the debate. Very few empirical investigations have been done to address these issues. This is another gap in the literature filled by this thesis.

By utilizing a time series analysis based on Autoregressive Distributed Lag (ARDL) and the bound test approach as proposed by Pesaran et al. (2001) and Narayan and Smyth (2006) with data ranging from 1970 until 2011 at an individual country level, these gaps in the literature are filled.

Based on the findings, it is stressed that the long run relationship between openness and institutional quality on financial sector development and its further implications on economic volatility exists. This means that openness and institutional quality matter for financial development in less developed economies of ASEAN-5, and all of the variables are responsible in explaining the variations in economic volatility in the long run. In particular, the finding suggests that financial openness may not harm financial development in the long run. There is also no evidence greater financial openness may trigger economic volatility. However, in the short run, the reverse is true, which indicates that the

magnifying effect on economic volatility due to greater financial openness is merely a short run phenomenon.

The concept becomes complicated in terms of trade openness in the long run, where the findings offer a mixed effect on banking sector development. Meanwhile, trade openness ultimately enhanced stock market sector development. In the short run, only weak evidence exists, whereby trade openness dampens both financial sector developments. This also shows that greater trade openness may favour the stock market sector more than the banking sector development in the long run. However, the economies have to compensate with higher level of economic volatility as a result of greater trade openness (weak evidence is found in both the long and short run).

On the other hand, there is no evidence that strengthening institutional quality dampens banking sector development in the long run, while no significant impact is observed in the short run. This is in contrast with its implications on stock market development, where strengthening institutional quality tends to offer mixed conclusion in longer term. Other than that, it seems that strengthening institutional quality may worsen stock market development in the short run. In terms of the implications for economic volatility, mainly there is no direct effect observed in both the long and short run. This shows that the effects of institutional quality are rather absorbed by both financial development variables, hence explaining the lack of evidence on the effect of institutional quality on economic volatility (Acemoglu et. al., (2003).

The effect of financial development on economic volatility also seems to offer mixed conclusion in both the long and short run, hence is best explained accordingly to each specific country. This suggests that a certain unique characteristic and the manner each financial policy is being designed, and the diversity of economic background and the unique experience they have had at each country level is important in explaining the diversity in the findings. With this information at hand, it may provide useful information particularly at policy making level in designing pre-emptive strategy in promoting financial sector development and sustaining prominent economic stability.



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