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UNPACKING GROWTH: THE INTERPLAY OF TRADE LIBERALIZATION, FINANCIAL SYSTEMS, AND INSTITUTIONS IN DEVELOPING ECONOMIES

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Abstract
This research assesses the determination of financial cum institutional advancement on the economic progression of five developing nations, including Pakistan, emphasizing the role of trade liberalization. The research employs data spanning from 2005 to 2024. The data has been meticulously gathered and scrutinized, elucidating the intricate connections among trade liberalization, financial and institutional development, and economic growth. It notes that a robust institutional framework contributes to a more efficient financial sector; consequently, the advancement of institutions, alongside financial development, fosters economic growth, particularly in Pakistan. The correlation between economic growth, exemplified by GDP, and the quality of governance is clear, suggesting that improvements in government efficacy can play a significant role in combating corruption in Pakistan. The research findings indicate that the advancement of financial systems fosters economic growth and that such financial progress, in conjunction with the development of institutions, has a beneficial influence on economic growth in developing countries.

INTRODUCTION

This analysis indicates that financial literature identifies capital accumulation, productivity, technical innovation, and savings as the primary drivers of economic growth. These theories propose that discrepancies in living standards and global wealth may be elucidated by variances in these elements (Rajan & Zingales, 1996). The financial sector's expansion is designed to improve financial systems by reducing information and transaction costs. This regulation of expenses has a significant impact on capital accumulation, savings rates, and technological advancement. Consequently, if financial development leads to more effective capital awarding, improved choices of investment, and technical advancement, it is reasonable to expect a correlation between the expansion of the financial sector and economic growth.

On the contrary, opinions vary on how much the escalation in the financial sector causes economic expansion. According to some economists, financial institutions are essential for successfully distributing money, promoting investment, mobilizing savings, and improving risk management. According to Joseph Schumpeter (1912), healthy banks support entrepreneurs with new goods, appealing investment prospects, and efficient manufacturing methods. This promotes technical innovation, which is crucial for economic progress.

In the same way, Hicks (1969) says that England's economy did better than other countries' in the

1800s. This was mostly because its banking system was good at finding and funding profitable business chances. It fits with what Patrick (1966) calls the "supply-leading" pattern, in which banks open up ahead of time because entrepreneurs and investors in new industries expect them to need them in the future.

Conversely, other economists argue that there is no correlation between financial development and country economic growth. The evolution of financial systems is an essential outcome of economic expansion. Robinson (1952) asserts that "where enterprise leads, finance tracks," which is characterized as a "demand-following" tendency by Patrick (1966). This viewpoint holds that investors, business owners, savers, and other stakeholders' need for financial services drives the financial markets developments and intermediaries. According to the Keynesian theory of effective demand, financial development is thus seen as a byproduct of economic expansion.

Some economists opined that "financial development may actually impede economic growth." Larsson (2024) posits that the shifting of capital from savers to investors diminishes the overall source of domestic credit, which may result in credit catastrophe. Credit constraints can reduce investment and ultimately impede economic growth. Abad et al. (2024) and Wijnbergen (1983) examine the impact of credit crunches on the steady-state volume of capital stock that may subsequently hinder economic growth. Chigeto et al. (2024) demonstrated that financial developments currently drive both trade and growth, with trade primarily responding to financial development.

1. LITERATURE REVIEW

Schumpeter (1911) asserts that a robust financial system might promote hi-tech innovation and economic progress by offering financial facilities and funds to investors prepared towards fund innovative goods. The McKinnon-Shaw hypothesis (1973) builds on Schumpeter's reasoning. It serves as a policy analysis instrument for developing states and calls aimed at large amounts of investment to be accumulated and financial intermediation to be decentralized. According to McKinnon and Shaw (1973), the financial repression measures that were common in Developing Countries throughout the 1960s and 1970s frequently led to the wrong use of resources, interest rate limitations, bad investments, and inefficiency.

Aghion and Howitt (1992) create an endogenous developmental model in which vertical integration is the main driver of economic development. The idea is that new business advances make products better, which makes older ones useless. The amount of research and development (R&D) money spent in a sector has a direct effect on the expected growth rate of that sector's economy. The model achieves equilibrium at a juncture when the quantity of research conducted in a certain timeframe is contingent upon the anticipated level of research in the next era. The model indicates an inverse link between current and future research levels; specifically, as anticipated research in the subsequent era rises, the volume of research undertaken in the present time decreases. This inverse connection occurs when new breakthroughs diminish the profitability or rents of prior inventions, rendering older items obsolete. This occurrence is termed "creative destruction." This paradigm posits that economic development stems from technical advancement, defined as the ongoing capacity to manufacture new and enhanced products with more efficiency than before.

Economic theory posits that; the expansion of the financial industry impacts economic development by enabling long-run capital accumulation and fostering technological innovation. The financial industry directs cash generating from excess units to investors and assigns investments to high-return funds, thereby facilitating the efficient provision of capital, (Levine & Zervos, 1998). Effective fund allocation, especially towards high-return projects backed by robust institutional frameworks, accelerates technical innovation via finance sector growth. The *Financial Development Report* (2009) asserts that the institutional framework governing the "financial system" is a vital component of financial industry advancement, straightaway influencing economic development.

North (1989) characterizes institutions are the collection of laws, mechanisms of compliances, and values of moral cum ethical conduct intended to limit individual behaviors to enhance the capital or worth of principles. In some cases, term indicates

that the institutions remain crucial for enabling and regulating trades or transactions. Individuals may sometimes participate in exchanges and transactions to get personal benefits via unethical conduct or disregard for established regulations (North, 1989). Consequently, the existence of robust institutional structures is essential to curtail such conduct and guarantee efficient control of economic transactions.

Levine and Zervos (1998) look at real-world data to see how the growth of financial sector, especially money market and stocks market measurements, affects economic growth, the distribution of capital, and the increase in productivity. The study uses a lot of different ways to look at how the stock market is doing, how well the banking sector is doing, and how the economy is doing. This includes growth in real per capita GDP, progress in real per capita physical capital, increase in production, and the percentage of personal reserves to GDP. The results confirm' s that the liquidity of the stock market has a statistically significant and beneficial impact on economic development. Nevertheless, the growth of the banking sector is a key factor in both current and future growth rates.

Interest group theory provides an institutional perspective, suggesting that variations in interest rates reflect the competing pressures from different societal groups seeking to influence government policy. These variations serve as corrective mechanisms that sustain a balance essential for effective governance. The theory is esteemed for its analytical neutrality and conceptual simplicity, rooted in the classical economic principles of Adam Smith and subsequently developed by political theorists including Madison and Tocqueville (1824), Bentley (1905), Truman and Dahl (1950). This theoretical framework emphasizes the interaction between economic forces and institutional dynamics in influencing the outcomes of financial sector development (Levine & Zervos, 1998).

Khalfaoui (2016) examines the factors influencing financial growth by evaluating data from 15 industrialized and 23 developing nations from 1997 to 2013. The research reveals that the main factors of financial development are linked to the banking and financial sectors, together with the degrees of economic and human development in both categories of nations.

Ayadi and Baltaci (2013) investigate the correlation between corruption and financial sector developments, evaluating its effects on the whole financial system. This research analyzes panel data derived from 42 developing nations concerning 1996 and 2011 to evaluate the influence of corruption and banking sector growth on stock market performance. Their results demonstrate a substantial inverse correlation between corruption levels and financial system progress, suggesting that more corruption impedes financial growth.

Asiama and Mobolaji (2011) look at how financial openness, trade openness, and quality of institutions affect the growth of the financial sector. The study uses dynamic panel data methodologies to look at how these factors affect the Rajan-Zingales hypothesis. The results show that being open to commerce and finance is good for financial development in all areas. Nonetheless, the data indicate that inadequate institutional quality adversely affects financial sector growth in the examined locations.

2. RESEARCH METHODOLOGY

This study aims to analytically assess the influence of financial and institutional development on economic development in five developed countries of the world, quantifying these effects and analyzing the influence among financial development, institutional development, trade liberalization, and economic development. Current investigation further examines the wider ramifications for institutional financial performance, operational efficiency, and trade regime openness. This analysis employed secondary panel data spanning twenty years, from 2005 to 2024. The study's goals are met by using economic development as the dependent variable. Descriptive statistics are used to summarize the main features of the dataset, and the Pearson correlation test is used to find out how strong and in what direction the linear relationships are among the variables. The Johansen cointegration assessment is used to find out if there are stable long-term connections between economic growth, trade liberalization, institutional development, and financial development.

2.1 Data Description

The study looks at how trade liberalization, institutional development, and financial development affect economic growth. The empirical

research uses yearly data from five developing countries— Pakistan, India, Sri Lanka, Bangladesh, and Türkiye—for the years 2005 to 2024. The World Bank's Global Development database is where all of the data came from. The Money Multiplier (M1) and credit to the private sector (CPS) are two examples of indicators used to measure financial progress. Indicators including voice and accountability (VA), control of corruption (CC), government effectiveness (GE), and rule of law (RL) are utilized to judge institutional development. Trade openness (TOPEN) Financial openness (KOPEN) are two ways to quantify liberalization, and GDP is the variable that the response variable represents.

2.2 Model Specification

In this research, the ordinary least squares (OLS) method is used to examine the influence that trade openness metrics and key social advances indicators have on economic development.

The OLS (Ordinary Least Square) approach, which is often used by investigators, does not provide an explanation for the overall presentation of the distinct segment. It is possible to determine the relative individual influence. A pooled analysis has the capability of defining not only the individual results of particular variable, but also the inclusive influence of all the factors communally on a responder variable. This is a significant advantage. In addition, this model is flexible enough to be included for the goal of examining several additional objectives outside the factors that explain things.

$\Delta y_t = \alpha + \emptyset y_{t-1} + e$
If $\emptyset = 1$ Unit root
If $\emptyset <= 1$ No unit root If $\emptyset > 1$ Explosive
$\Delta y_t = \alpha + \emptyset y + 1 + .\varepsilon$
Adf with intercept
$\Delta y_t = \alpha + \emptyset y_{t-1}$
Adf with intercept and trend
$\Delta y_t = \alpha + B_t + \emptyset y_{t-1} + \varepsilon$

3. RESULT AND DISCUSSION

Table 1: Descriptive Statistic:

	GDPG	CPS	M1	VA	GE	CC	RL	KOPEN
Mean	5.36	50.28	49.13	-0.32	-0.28	-0.55	-0.48	-0.90
Median	5.45	47.42	47.76	-0.33	-0.20	-0.44	-0.74	-1.19
Maximum	11.11	77.92	80.15	0.45	0.41	0.17	0.32	0.02
Minimum	-5.96	25.11	25.63	-1.32	-0.86	-1.49	-1.02	-1.90
Std. Dev.	2.84	12.86	13.11	0.46	0.37	0.41	0.45	0.54
Skewness	-1.29	0.43	0.66	0.05	0.00	-0.29	0.43	1.07
Kurtosis	6.40	2.66	3.05	2.41	1.86	2.16	1.41	2.37
Jarque-Bera	75.90	3.62	7.38	1.27	4.58	3.69	11.63	20.83

The table above displays the descriptive data. The average GDP growth in emerging countries from 2005 to 2024 is 5.35, with a minimum of -5.96 and a maximum of 11.11. The analysis reveals that these nations are emerging with enhanced prospects for growth. The GDPG and CC exhibit negative skewness, as indicated by skewness values of -1.29 and -0.29, respectively. Additionally, the kurtosis value of 6.40 for GDPG suggests a leptokurtic distribution, while the kurtosis of 2.16 for CC indicates a platykurtic distribution. Additionally, the skewness for CPS and RL is identical at 0.43, whereas their kurtosis values are 2.66 and 1.41, indicating a significant difference in kurtic behavior. In a similar manner, GE exhibits a normal distribution, while VA is approximately normal. Both variables demonstrate significant kurtosis, as indicated by their values of 2.41 and 1.86, respectively. Furthermore, KOPEN exhibits a positive skewness with a value of 1.07, and it also demonstrates a high kurtosis with a value of 2.37. CPS and CC are noted to be approximately normal.

Table 2: Correlation Matrix:

	GDPG	CPS	M1	VA	GE	CC	RL	KOPEN	TOPEN
GDPG	1								
CPS	0.24	1							
M1	0.21	0.83	1						
VA	0.36	0.48	0.47	1					
GE	0.25	0.36	0.06	0.52	1				
CC	0.16	0.19	-0.1	0.48	0.87	1			
RL	0.04	-0.1	-.49	0.06	0.61	0.75	1		
KOPEN	0.01	0.02	-.31	0.04	0.42	0.6	0.75	1	
TOPEN	0.14	0.13	-0.08	0.24	0.35	0.56	0.71	0.69	1

Table 2 illustrates the findings about the interrelationships among the variables, indicating that all variables exhibited positive correlations. The association among Voice & Accountability and GDP shows positive, with a value noted 0.36. The correlation of GDP value is positive (r=0.24), just as it is for CPS. With a value of 0.21, the money multiplier is positively correlated with GDP. There is a positive relationship amongst government efficiency and GDP (r=0.25), as there is with other variables. A correlation coefficient of 0.04 indicates a significant positive relationship amongst GDP and the rule of law. A favorable link between financial openness and GDP (r=0.01) exists. With a value of0.14, trade openness is positively correlated with GDP. As a result, the hypothesis is supported by all factors.

Kao Residual Cointegration Test

t-Statistic	**Prob.**
ADF	-3.444150 0.0003

Residual variance	7.169415
HAC variance	5.332291

Augmented Dickey-Fuller Test Equation

Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
RESID(-1)	-0.948377	0.155838	-6.085650	0.0000
D(RESID(-1))	0.247723	0.123234	2.010193	0.0491

R-squared	0.417219	**Mean dependent var**	0.033239
Adjusted R-squared	0.407171	**S.D. dependent var**	2.836846
S.E. of regression	2.184240	**Akaike info criterion**	4.433178
Sum squared resid	276.7125	**Schwarz criterion**	4.502990
Log likelihood	-130.9953	**Hannan-Quinn criter.**	4.460485
Durbin-Watson stat	2.143376		

The Kao (1999) residual cointegration test was performed to ascertain the existence of a long-run equilibrium relationship among the panel data variables: GDP growth (GDPG), credit to the private sector (CPS), money supply (M1), voice and accountability (VA), government effectiveness (GE), control of corruption (CC), rule of law (RL), capital account openness (KOPEN), and trade openness (TOPEN). The test presumes the absence of a deterministic trend and evaluates the following hypotheses: The null hypothesis posits that there is an absence of cointegration among the variables. Alternative Hypothesis: A cointegration connection is present among the variables.

The ADF t-statistic of -3.44 demonstrates statistical significance at the 1% level ($p = 0.0003$). The outcome leads to the rejection of the null hypothesis, offering strong evidence for the existence of cointegration among the panel variables. This directs a long-term equilibrium link among the economic and institutional indices examined in the research. The negative and statistically significant coefficient of RESID(-1) verifies that the residuals from the long-term model are stationary. This is a necessary condition for cointegration and corroborates the ADF outcome. The Durbin-Watson value of 2.14 indicates that the residuals exhibit no serial correlation, hence affirming the test's validity. The R-squared score of 41.7% indicates that a considerable percentage of the variance in the first-differenced redsiduals is accounted for by the model.

4. Conclusion:

This study examines the impact of financial development, institutional growth, and liberalization on economic growth. Economic growth serves as the response variable to achieve the study's objectives. Explanatory variables include private sector credit, the money multiplier, financial openness, and trade openness (financial development), as well as government effectiveness, voice and accountability, control of corruption, and the rule of law. The analysis employs the Johansen co-integration test methodology.

The study utilizes secondary data, focusing on five developing countries—Pakistan, India, Sri Lanka, Bangladesh, and Turkey—over the period from 2005 to 2024. Empirical findings reveal that the explanatory variables account for economic growth, represented by the response variable (GDP). The results indicate that government effectiveness, control of corruption, and the rule of law (institutional development) are significant, while credit to the private sector, money multiplier (financial development), trade openness, and financial openness (liberalization) also exert a significant impact on economic growth.

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