

# The Roles of Political Regime and Financial Liberalisation in Shaping Financial Sector Development: Evidence from ASEAN-5 Countries

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## Abstract

Previous literature has consistently demonstrated the significant and favourable impact of financial development on economic growth. Nevertheless, the effects of political regime changes and financial liberalisation on financial system remain inconclusive. To address this gap, this study investigated the impact of political regimes and financial liberalisation on the development of the financial sector among five ASEAN countries namely, Indonesia, Malaysia, Singapore, the Philippines, and Thailand between 1997 to 2021. The study employs a panel dataset and a fixed effect estimator to measure how the variations in political regimes and their financial openness influenced the financial sector of each country. By applying the four categories of political regimes as introduced by Lührmann et al. (2018) and the financial openness index developed by Chinn and Ito (2006), this study found that electoral autocracy regimes provide greater advantages to financial development than democracy regimes. However, liberalizing financial system in these five countries does not help in developing the financial sector. This study provided new insight into the political economy of the financial systems in these countries.

**Keywords:** Political Regime, Financial Openness, Financial Development, ASEAN-5

## Introduction

Western scholars have examined the relationship between finance and economic growth since the seminal works of Bagehot (1873) and Schumpeter (1911). Since then, this topic has garnered substantial scholarly interest with findings consistently supporting a

positive link between financial development and economic growth (King & Levine, 1993; Levine & Zervos, 1998; Kar et al., 2011; Beck et al., 2014; Puatwoe & Piabuo, 2017; Taiwo, 2020). A well-functioning financial sector enables individuals and firms to access financial services at lower costs, facilitating productive activities and improving the economy.

Although the relationship between finance and growth is evident, the level of financial development varies across countries that necessitate further investigation into why these differences exist. Thus, this study would like to identify whether political and openness facilitate financial development. This issue is at the heart of contemporary social science debates. On one hand, proponents of democracy argue that institutions of accountability and constraint are prerequisites for deep and stable financial markets (Jensen, 2008). On the other hand, literature focusing on the efficacy of non-democratic (autocratic) regimes suggests that under certain conditions can mobilise capital more effectively and direct financial resources toward national development goals that bypassing the short-term political pressures inherent in democracies (Pond, 2017). This study contributes directly to this debate by empirically investigating two key questions within the critical ASEAN-5 region, firstly, which regime type has been more conducive to financial development and secondly the influence of financial liberalization on the development of the financial sector.

Furthermore, this problem is heightened by the parallel debate on financial liberalisation. While conventional theory posits that openness promotes competition and efficiency, however, recent scholarship increasingly highlights the risks, especially for developing economies. The central question is whether the benefits of financial openness are contingent on institutional quality (Panigrahi et al., 2024). Political instability, often linked to regime type, can disrupt policy continuity and amplify the risks of liberalisation and leading to financial backwardness rather than development (Qureshi & Ghafoor, 2024). This study's significance, therefore, lies in its attempt to untangle these two interconnected factors namely political regime and financial openness to explain the divergent financial trajectories of the ASEAN-5 nations.

The ASEAN-5 nations present a compelling natural experiment for examining this relationship. Their political trajectories and financial systems have evolved distinctly, especially in the aftermath of the 1997 Asian Financial Crisis, which profoundly impacted all five economies (Chorbaco & Peiris, 2018). Singapore has long operated as a stable electoral autocracy with a dominant party fostering a world-class international financial hub through consistent and long-term policy implementation (Rodan, 2004). In contrast, Indonesia and the Philippines transitioned to electoral democracies, yet their financial sectors have contended with periods of political instability and complex institutional reforms. Malaysia whom sharing characteristics of an electoral autocracy for much of the study period developed a robust and dual-track financial system incorporating a world-leading Islamic finance sector. Thailand's political landscape has been marked by volatility, alternating between democratic governments and military coups, which has inevitably influenced its financial sector reforms (Gomez & Jomo, 2007). This study focuses on the ASEAN-5 is thus partly motivated by the potential for their developmental experiences to offer insights for their less-developed neighbours.

Mainstream arguments on the political economy of development often advocate for democracy as a system that could encourage economic well-being. These characteristics are argued to foster stable institutions and governance based on trust, providing citizens with the freedom to participate in economic activities. This environment, in theory, should encourage savings and increase demand for credit from financial institutions. Autocracy, in contrast, is characterised by a concentration of power within a small group of leaders, which may allow for arbitrary policy execution that could either repress or strategically develop the financial sector to meet state objectives (Gasiorowski, 1990).

This study contributes to the literature in two significant ways. First, it focuses on the expanding body of research concerning the political factors that influence financial development, specifically within the under-examined context of the ASEAN-5. Second, moving beyond traditional single-proxy measures like domestic credit this study adopts a more comprehensive approach by employing a multidimensional financial development index. This index includes both financial markets and institutions, and it measures the depth, accessibility, and efficiency aspects of financial development to present a more holistic overview of the financial system.

Past research has established that the economic activities of a country require the implementation of effective government systems to regulate the activities and individuals involved. Against the backdrop of a government that encourages freedom and safeguards human rights, scholars widely acknowledge democracy as a regime that helps the financial sector flourish. Furthermore, many political theories contend that democracy positively influences the political sphere and economic development. Mainstream arguments on the political regime advocate democracy as a system that could encourage economic well-being. According to Dahl (1971) a democratic regime must meet eight criteria, namely freedom of organisation and expression, the right to vote, run for office, compete for political support, the presence of alternative sources of information, free and fair elections, and institutions that develop policy in the public interest. These characteristics foster stable institutions and governance based on trust and provide citizens with the freedom to participate in economic activities. This environment will encourage savings and increase demand for credit from financial institutions. Moreover, the value of freedom and individual rights limit the government's monopolistic power, lowering the likelihood of financial repression and allowing for a more competitive environment (Jensen, 2008; Li, 2009).

Autocracy in contrast, is characterised by one or a small group of leaders who oversee the state's administration. The system limits the possibility of pluralism (the absence of a multi-party system) lacks a coherent ideology to guide the administration thus, does not seek or authorise widespread political mobilisation, and may exercise power in ambiguous or arbitrary ways (Gasiorowski, 1990). This suggests that the debate on whether political regimes influence financial development across these five ASEAN countries is worthwhile, as government policies and regulations play a crucial role in determining the level of financial sector repression.

This study investigated the roles of political regimes in promoting the development of the financial sector and how financial system liberalisation might encourage financial sector development. During the Asian financial crisis of 1997, these five Asian countries were among

the most affected. Since then, these countries have recognised the importance of financial stability and resilience in mitigating the impact of uncertainties in the financial sector (Chorbaco & Peiris, 2018). Notably, this study filled a gap in the literature and contributed significantly to it. First, this study contributed to the expanding body of research on the political factors and institutions that influence financial development and focusing on which political regimes promote financial development particularly among these five ASEAN countries. This is because most of these sample countries, except for Singapore, possess lower levels of financial development. Furthermore, these five countries are also governed by various political regimes with Singapore leading the sample of electoral autocracies while having a high financial development index in comparison to the other countries. Countries such as the Philippines and Indonesia, which were classified as electoral democracies, experience a lower level of financial index. Using panel data analysis, this study examined the roles of political regimes on financial development.

Second, while the concept of financial development is complex in definition and dimension, many past studies have employed traditional measures of financial development such as domestic credit to the private sector. Nevertheless, utilising a single measure might not adequately represent the overall financial system. For this reason, this study adopted a more comprehensive approach by employing a financial development index that reflects the multidimensional nature of financial development. This index includes both financial markets and financial institutions, and it measures the depth, accessibility and stability aspects of financial development to present a more comprehensive overview of the financial system.

The rest of the paper is structured as follows: Section 2 reviews past literature on the relationship between political regimes on financial development, and the roles of financial openness in supporting the financial development of a country. Section 3 explains the methodology by describing the data, model estimation and measurement techniques employed. Section 4 presents the results, discusses the findings, and draws a conclusion.

### **Literature Review**

While early studies on the determinants of financial development focused on macroeconomic variables such as productivity and inflation, recent decades have seen the role of institutions gain considerable attention. This shift is driven by the recognition that the financial sector is governed by political institutions and systems rather than functioning autonomously. The financial sector operates within the framework of rules and regulations established by governments, making the nature of the political regime a critical yet empirically ambiguous. (Williams, 2016; Menaldo & Yoo, 2015).

Theoretically, democracy is often presumed to foster a more sophisticated financial system than non-democratic regimes. The principles of accountability, protection of property rights, and limits on executive power are thought to create a business-friendly climate conducive to financial contracting and investment (Jensen, 2008). This perspective suggests that democratic institutions can reduce the risk of financial repression and promote a competitive environment that benefits both investors and intermediary institutions.

However, empirical findings have been varied and often contradictory. Yang (2011) found mixed results on the influence of democracy on the financial sector, suggesting that

the adoption of a democratic system does not guarantee financial development. Conversely, Williams (2017) discovered that democracy positively influenced the credit market in emerging countries. This ambiguity may arise because different democratic models and varying levels of institutional quality can produce different outcomes (Haber, 2009). Moreover, empowering the majority voice may lead to populist policies that favour redistribution over financial deepening, potentially limiting the sector's growth.

This study thus, builds on this inconclusive debate by integrating more recent empirical work. The "democracy vs. autocracy" question in financial development remains highly contested. For instance, recent panel data analysis across Asian countries suggests that while democracy can play a positive role, its effect on economic growth hence financial development is critically dependent on maintaining political stability (Akram & Ratho, 2023). This aligns with broader studies on developing countries which find that political instability is a factor that can plague both new democracies and unstable autocracies which can be a primary determinant of financial backwardness as it disrupts policy continuity and investor confidence (Qureshi & Ghafoor, 2024). Conversely, other recent research challenges the idea of a simple linear relationship, arguing that the quality of institutions and the state's research capacity (which can be high in certain autocracies) are more significant drivers of financial development than the political regime type itself (Jedidia & Hamza, 2024). This study therefore, challenges existing work by moving beyond a simple democracy/autocracy dichotomy and using the four-category regime classification from Lührmann et al. (2018) to explore this relationship within the specific institutional context of ASEAN-5.

In an autocratic society, authority is concentrated among political elites who are less constrained and can regulate the financial system to their advantage. This can lead to cronyism and financial repression, but it can also allow for decisive, state-led initiatives to rapidly develop financial infrastructure to achieve specific economic goals, bypassing the political gridlock that can occur in democracies (Pond, 2017). Given these competing theoretical arguments and inconclusive empirical findings, this study addresses the following research question: Does political regime and financial openness influence the development of the financial sector in these five ASEAN countries?

## **Methodology**

In this section, the study adopted panel data analysis using the fixed-effect model. This model was selected following a series of specification tests, including the Hausman test on competing models such as Pooled OLS and the Random-effect model which indicated that the fixed-effect estimator was the most appropriate. This model was particularly suited for the study as it can control for unobserved time-invariant heterogeneity across countries such as legal origins or cultural factors and provided a comprehensive analysis across both cross-country and time-series dimensions. The fixed-effect model allowed for an analysis of within-country variation, specifically how variation in the financial development of countries was relative to political regimes and financial openness

### *Model*

Panel data was utilised to assess the impact of political regimes and financial openness on the financial development of ASEAN-5 countries. Following the baseline specification of Yang (2011) this study estimates the following model:

$$\begin{aligned}
 Findex_{it} = & \beta_0 + \beta_1 Pol\_reg_t + \beta_2 FO_{it} + \beta_3 svg_{it} + \beta_4 ldebtgr_{it} + \beta_5 fdi_{it} + \\
 & \beta_6 irp_{it} + \beta_7 INF_{it} + \beta_8 lgdpc_{it} + \mu_i + \varepsilon_{it}
 \end{aligned}
 \tag{1}$$

Based on this model, the dependent variable is financial development (Findex), whereas the independent variables of interest are political regime (Pol\_reg) and financial openness (FO). This model also includes control variables which are savings (svg) government debt (ldebtgr) foreign direct investment (fdi) interest rate payment (irp), inflation (inf) and GDP per capita (lgdpc)  $\mu_i$  country-specific unobserved heterogeneity and  $\varepsilon_{it}$  idiosyncratic error term.

### Data Description

This study utilised Findex as a measure of financial development, which was adapted from Svirydzienka (2016) and updated by IMF.  $Pol\_reg_t$  represented the political regimes, while  $fo_{it}$  measured financial openness. Other variables included  $svg_{it}$ , which represented savings over the percentage of GDP,  $irp_{it}$  represented interest rate payments,  $fdi_{it}$  represented foreign direct investment per GDP,  $inf_{it}$  represented inflation,  $ldebtgr_{it}$  represented a debt-to-GDP ratio, and  $lgdpc_{it}$  represented gross domestic product per capita.  $i$  denoted selected sample countries, and  $t$  denoted time series. All additional variables were derived from the WDI and IMF websites. The independent variables of interest in this study were types of political regimes and financial openness. In this analysis, the political regimes were measured using Luhrmann et al.'s (2018) categorisation and estimations by V-Dem experts.

The political regimes were categorised and rated on a scale of 0 to 3, with 0 representing closed autocracies in which citizens have no freedom or rights to choose the head of government and the political system is based on a single-party system. The second political regime represented by 1 is an electoral autocracy, in which citizens have the right to vote for their head of government from a variety of parties; yet lack the freedom to express their views and participate in the association. As a result, the election process had lost its meaning. 2 refers to electoral democracy, in which citizens have the right to participate in a meaningful, free, and fair multi-party system. 3 refers to liberal democracy, in which the rights of every individual and minorities are upheld, everyone is treated equally before the law, and the law and legislative constraints limit the executive's actions. Financial openness was measured using a de jure measurement introduced by Chinn & Ito (2008).

### Results and Discussion

Prior to conducting the fixed-effect analysis, several assumptions were identified to ensure the data adhered to certain assumptions to improve model prediction and interpretability. Few tests were conducted to ensure the data was free from heteroscedasticity, heterogenous and multicollinearity issues before proceeding with the estimation. The descriptive result revealed that the financial development of these five countries was at a moderate level, which was 0.529 (refer to Table 1). A financial development index of a country close to one indicates a more developed financial sector. The variation in financial development between countries is more significant than within countries, indicating that the development of their financial sector varies by country. Three competing models were estimated to determine the best model for explaining the empirical model of this study,

namely the POLS model, the fixed-effect model, and the random-effect model (refer to Table 1). After estimating a few tests to evaluate whether to utilise the POLS or fixed-effect model, the result showed that FE was best suited for this model.

Using FE estimation, the result revealed that both independent variables of interest, namely political regime and financial openness, were statistically significant at 5%. Conversely, the correlation between the two independent variables was negative, indicating that as the government becomes more democratic, financial development will decrease by 4.7%. Correspondingly, the more open the financial system is, the lower the financial sector development. Similarly, other variables, such as savings and foreign direct investment (FDI), were also statistically significant at 10%. These variables likewise showed a negative relationship between increases in savings and FDI. Inflation, interest rate payments, government debt and GDP per capita were all statistically insignificant.

The finding that less democratic regimes are associated with higher financial development in the ASEAN-5 context aligns with a strand of political economy literature that emphasizes the state's role in economic development (e.g., Pond, 2017; Yang, 2011). In this specific sample, electoral autocracies like Singapore and Malaysia may have possessed the state capacity to implement consistent and long-term financial policies. The stability offered by such regimes might have been more conducive to building financial institutions than the political turbulence sometimes associated with democratic regime. This finding should be carefully contextualized, as it may not be generalizable. For instance, several of the less-developed Southeast Asian countries such as Lao PDR, Myanmar and Vietnam also have autocratic political structures, yet their financial development is significantly hampered by weak institutional capacity, underdeveloped legal frameworks, and a slow adoption of global regulatory standards (Lim & Reyes, 2014). This suggests that state capacity not just regime type is a critical variable.

Equally striking is the negative and significant coefficient on financial openness. This result contradicts the conventional view that demonstrating financial openness improves financial development because open financial system encourages greater competition and increases demand for the local financial sector (Baltagi et al., 2009). However, resonates with the lessons learned from the 1997 Asian Financial Crisis. For emerging economies, rapid financial liberalisation without sufficiently robust domestic regulatory institutions can increase vulnerability to capital flight and financial instability (Stiglitz, 2002). This result also contributes to a growing body of literature that challenges the "openness is always good" hypothesis. Recent work suggests that the benefits of liberalisation are contingent on institutional thresholds without strong regulatory quality and control of corruption, financial openness can fail to translate into meaningful development and may even increase volatility (Panigrahi et al., 2024).

Regarding the control variables, GDP per capita is positive and highly significant, confirming the well-established demand-side hypothesis that economic growth drives financial development. This finding is consistent with other regional studies such as Anwar et al. (2023), who also find a significant positive long-run relationship between economic growth and investment in the ASEAN-5. It also aligns with comparative studies showing that for ASEAN-5 nations, developing an efficient banking system remains a critical component for raising GDP

per capita, perhaps even more so than for other developed economic blocs (Lo, 2022). Government debt is negative and significant, suggesting a potential "crowding-out" effect.

### **Conclusion**

Drawing on panel data from five major ASEAN nations from 1997 to 2021, this study has examined the intricate relationship between political regimes, financial openness on financial sector development. The findings challenge conventional wisdom in two important respects. First, contrary to the widely held belief that democracy universally promotes economic and financial development, this research found that within the ASEAN-5 context, autocratic regimes outperformed democratic countries in fostering financial sector growth. This suggests that the capacity for long-term, stable policymaking, often associated with electoral autocracies may have been a more critical factor in this region's post-crisis development.

Second, this study finds that greater financial liberalisation has been associated with lower levels of financial development among the ASEAN-5 countries. This counterintuitive result underscores the risks of premature or poorly regulated openness, a lesson seared into the region's collective memory by the 1997 financial crisis. It implies that the benefits of financial openness are not automatic and are highly contingent on the strength of domestic institutions to manage the associated volatility. The policy implication is not that democracy and openness are undesirable, but that a "one-size-fits-all" approach to institutional reform is misguided. The sequencing and quality of reforms are paramount.

This study while providing new insights, has its limitations. The use of a composite index for financial development, while comprehensive, may mask differing impacts on its sub-components (e.g., banking sector versus stock markets). Future research could disaggregate this index to provide a more granular analysis. Furthermore, future studies could incorporate direct measures of institutional quality as a potential mediating variable to explore the channels through which political regimes affect financial outcomes. Despite these limitations, this paper contributes to another perspective to the political economy of finance that highlighting the unique developmental trajectories within the ASEAN region.

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