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Does Financial Liberalization Cause Economic Growth? A Meta-analysis Review

Noor Aznaim Abd Latib, Siti Nor Amira Mohamad

Senior Lecturer, Academy Contemporary of Islamic Studies (ACIS) UiTM Shah Alam, Selangor

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Abstract

This study examines the impact of financial liberalization on developing countries' growth rates and the relationship between the variables using the fixed effects least squares approach for five developing countries from 1990 to 2021. Based on the results, financial liberalization and economic freedom are the driving factors underlying economic growth in five Asean members (Thailand, Singapore, Indonesia, Malaysia, and the Philippines). Secondly, financial liberalization puts the financial system at risk, but it plays an important role in the growth of economies.. Financial system deregulation is a key driver of economic growth in Asean member countries. Policymakers should evaluate and strengthen existing financial transparency standards.

Keywords: Financial, Liberalization, Economy Growth, Developing Countries, Index, Panel Data Analysis

Introduction

The phrase "financial liberalization" initially debuted in the writings of McKinnon and Show in 1973, who characterized it as the best way to depart the state of financial limitation and economic rates, as well as a simple and effective means to enhance the pace of economic growth. Murat Ucer (2000) defined it as a set of activities used to eliminate constraints put on the financial and banking industries, such as lowering interest rates, raising capital expenditure limits, and accomplishing internal and external financial sector reform (Murat, 2000).

Theoretical study emphasizes the importance of financial liberalisation in the process of economic growth and development. Financial liberalization occurs when the financial markets of neighboring, regional, or global countries become inextricably linked. It entails removing obstacles to cross-border financial operations so that financial institutions can operate freely, firms may borrow or raise funds directly, and equity and bond investors can easily invest across borders. It includes financial institutions exchanging information, best practices, and technologies; cross-border capital flows; direct access of firms to funds and investors for investment in international capital markets; trading of domestically innovated financial products in international capital markets; and foreign investor participation in domestic financial markets. As a consequence, several developing and emerging economies have benefited

As a result, many developing and emerging economies have undertaken a rapid process of fi nancial integration in recent decades (Kizito, 2019).

This happens because financial liberalization has the power to enhance capital allocation, production specialization, international consumption risk sharing, and economic progress (Acemoglu & Zilibotti, 1997; Gehringer, 2015; Obstfeld, 1994; Saafi, 2016). Furthermore, financial deregulation promotes economic growth by enhancing resource allocation efficiency and facilitating access to investment opportunities (Edison et al., 2002; Gehringer, 2013; Giannetti, 2002). Furthermore, financial integration may speed the development and operation of the local financial sector and encourage growth by enhancing competition and the importation of financial services.

Many developing countries have gradually but obviously liberalized their financial sectors in order to attain economic buoyancy, owing to the numerous benefits of financial liberalization. The state-dominated development paradigm has given way to a more market-driven development strategy. East Asian nations are accelerating growth through a market-determined development model, owing to the relatively moderate growth rate of earnings, industrial production, and recurring balance of payments difficulties in the state-dominated paradigm in recent years, as well as Japan's extraordinary success (Nair, 2004).

Financial liberalization in developing countries has been recognized as a critical and fundamental component of the "Washington Consensus" economic policy package for more than a decade (Ghosh, 2005). To revitalize their economies, developing countries used the Bretton Woods Institutions' (World Bank and International Monetary Fund) "Structural Adjustment Programme," which sought to liberalize prices in fragile and crisis economies. The execution of this program marks the end of the economy's financial restraints.

Malaysia was interested in financial growth and economic deregulation as part of the globalization movement. During the previous four decades, it has achieved great progress in human and economic development, becoming one of the first industrial countries in the Islamic world, as well as in South-East Asia in terms of exports and imports. Since the country's founding. Malaysia significantly expanded its economy and transformed itself from an agricultural to an industrial country, with 62% of its exports being manufactured products, resulting in a drop in poverty rates from 52% in 1970 to 5% in 2002. Furthermore, the median annual income increased from $1,200 in 2002 to $10,000 in the same year (Barry, 2009). Malaysia swiftly progressed from a raw material exporter to one of the world's leading technology and scientific exporters. Malaysia has developed to become the fourth biggest economy in Southeast Asia in terms of industrial products. In 2007, it ranked 34th in terms of GDP, 16th in terms of foreign investor competition, and ninth in international commerce (Amani, 2021).

Several academics, however, contend that financial liberalisation measures have been chastised for their possible involvement in triggering financial and economic disasters. Several survey studies have taken an empirical look at this idea. In a recent study, Jafarov (2019) revealed that financial restraint has a considerable detrimental influence on growth. They observed that interest rate limits lowered economic growth by 0.4-0.7 percentage points, with the impacts being greater in bigger financial systems (Jafaroy, 2019).

Ijaz (2016) discovered unfavorable relationships between financial liberalization indices and economic development. Using an error correction approach, the influence of financial deregulation on economic development was investigated. A negative and significant link between economic development and financial liberalization was observed, showing that Bangladesh's financial liberalization was unsuccessful. The findings agree with those of

Qamruzzaman and Jianguo's study. Both studies concluded that financial openness had a detrimental influence on the economy, regardless of the causes or time periods considered (Ijaz and Idrees, 2016; Qamruzzaman, 2017)

While Caporale (2015) found significant positive correlations with economic development. The SGN bank was drawn to reform implementation. So the priv privatisation state-owned banks have hasced transaction costs and increased credit availability. This has improved the efficiency of the bag which has played an important role as an engine of growth.

Another result from this research is that the majority of empirical studies found no direct substantial beneficial effect of single currency adoption on capital accumulation, productivity, or economic growth, despite indications that it may stimulate commerce. This suggests that there was no significant change in economic development amongst EMU members following the introduction of the Euro (for example), indicating the absence of an increase in international price rivalry. However, the benefits of a currency union may be realised through the acceleration of commerce (Edison, 2004).

In light of this gap, this paper undertakes analysis of the link between financial liberalization and economic growth (rather than just capital account liberalization) to give a more systematic examination of the current data.

Financial Liberalization and Economy Growth in Literature

In this part, we review the important research on the effect of financial liberalization on economic development in a nutshell. These research, we discovered, either theoretically or practically assess the impact processes. The following arguments have been offered to support the positive relationship between financial deregulation and economic growth. In contrast to the previously stated reasons in favor of financial liberalization, more negative opinions have pointed out that financial liberalization has frequently resulted in unsatisfying outcomes, and in some cases, economic and financial disasters. The following are a few prior studies on the effects of financial liberalization on developing countries:

Bailliu (2000) used the dynamic GMM approach to assess the influence of financial liberalization on economic development in 40 nations. It was discovered that financial liberalization promotes economic growth, albeit the effect varies depending on the extent of financial development (Bailliu, 2000). Similarly, Reisen and Soto (2001) investigated the impact of financial liberalization on economic growth in 44 countries. Using the dynamic GMM approach, the researchers demonstrated that financial integration promotes long-term economic growth. They concluded that emerging nations should promote international capital inflows rather than rely entirely on domestic savings for economic growth. Shen (2010) used OLS, fixed effect, and random effect estimators on data from 80 countries to explore the link between international financial integration and economic development within a framework that accounted for conditional variables. They discovered evidence that financial integration boosts economic growth, whereas foreign portfolio investment has the opposite effect. They found that banking liberalisation, human capital, and a higher income level reduce the favourable impact of financial integration on economic growth, but effective shareholder protection and a middle-income level increase it (Shen, 2010).

Liberalization also increases the risk of a deflationary bias in government policy, which is exacerbated by high debt costs in a context where real interest rates frequently exceed growth rates. With little financial sector liberalization, the market will determine the allocation of investible resources, directing capital towards more profitable segments of the economy, resulting in a detrimental impact on employment-intensive industries such as

agriculture and small-scale businesses. This, in turn, has significant social consequences in terms of job loss and more unpredictable material situations for the majority of individuals (Ghosh, 2005)

The financial crisis of 2007-2009 is often recognized as the worst since the Great Depression of 1929-1933. Many US financial institutions failed, went bankrupt, or were taken over, while others were saved and survived owing to assistance from the Federal Reserve Banks and the Treasury (Thomas, 2013). Numerous financial crises around the world have provided valuable lessons and increased the overall awareness in developing countries when it comes to coordinated regulation and supervision of financial institutions.

This situation is supported by Wyplosz's (2001) investigation of the risks connected with financial liberalisation. He examined the liberalisation experience of 27 countries (including established and emerging economies), aiming to determine whether exchange rate volatility and the risk of a full-fledged currency crisis are common effects. The findings revealed that the consequences of financial liberalisation are significantly more disruptive for developing nations than for industrialised ones. The findings suggested that, while liberalization is beneficial in the long run, it is extremely dangerous in the short to medium term. The chances of success are increased with the proper, appropriate political infrastructure and an adequate setup for protecting and assisting individuals who may be adversely affected by potential financial meltdowns and unanticipated negative consequences. (Wyplosz, 2001).

Yee (2001) discovered that financial liberalisation (captured by a dichotomous variable), bank lending rates, and the ratio of M2 to foreign exchange reserves all played a significant role in the 1997 Malaysian banking crisis. She examined firm-level data of Malaysian domestic banks to assess the allocative efficiency of the banking sector and macroeconomic data to see if financial liberalization resulted in unusually high credit growth and to assess the contribution of financial liberalization to the 1997 banking crisis (Yee, 2001).

But, some recent studies have found that there is a positive association between financial liberalization and economic growth. Nyasha (2018); Shahbaz (2015) have emphasised the critical role that financial liberalisation can play in boosting economic growth. Research was conducted in Turkey to determine the relationship between financial development, financial liberalisation, and the financial crisis from 1980 to 2010 using Granger causality tests and co-integration. This study showed a link between financial progress, financial openness, and financial liberalization. As a result, Mohammed (2017) discovered that financial openness in Iran improves economic growth. In the regression model, the researcher includes variables such as reserve requirement ratio, domestic credit, GDP, the index of financial liberalisation, human knowledge accumulation, and development technology.

The last section of the literature review is based on research investigations that have been conducted in both established and emerging economies. According to certain research, financial openness has a favourable impact on the economy. Research was undertaken on 45 rising economies, including Chile, Poland, and Malaysia. Indonesia, Singapore, the Philippines, Thailand, and Korea are among the countries represented. The generalised technique of moments was used by the researchers. It was discovered that financial liberalisation had a favourable impact on the GDP. From the literature review result, it was discovered that financial liberalisation had a favourable impact on the GDP.

Because of these gaps, this study adds to the body of knowledge on financial liberalization and growth by offering fresh cross-country empirical evidence on the threshold impacts of liberalization throughout five ASEAN countries. Furthermore, rather than concentrating just on the direct impact of financial liberalization on growth, this research investigates various

avenues via which financial liberalization might influence economic progress, such as governance, financial development, and education.

Model and Econometric Issues

To identify the impact of financial liberalization on economy growth, we estimate using modification of the models in Kasekende and Atingi-Ego (2003), Faria et al. (2009), and Akpan (2004). Our empirical results financial liberalization, Inflation, Official exchange rate, Trade, are based on provincial-level panel data from 1990 to 2022. The rate of inflation, K-open index, foreign direct investment inflows, trade openness, and financial deepening, were used in order to express financial liberalization. Table 1 presents a list of the dependent and independent variables used in this study, including their sources. Our final sample consists of panel data with 151 observations and 5 countries.

Table 1
Description of The Variables

Dependent variable	Definition	Source
Gross Domestic Product (GDP) per capita	Growth of per capita GDP	WDI for the period 1990 to 2022
Inflation	Rate of change in price level	WDI for the period 1990 to 2022
K-open Index	KAOPEN is based on the binary dummy variables that codify the tabulation of restrictions on cross-border financial transactions reported in the IMF's Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER).	WDI for the period 1990 to 2022
Trade openness	The sum of exports and imports as a share of GDP (TRADE)	WDI for the period 1990 to 2022
Financial Deepening	Dividing the total monetary mass (time deposits, current deposits, and liquidity) by the Gross Domestic Product (M2/GDP).	WDI for the period 1990 to 2022

The model of the study consists of a dependent and independent variable as follows:

GDP = f (INF, KOP, TD, FD)….. (1)

Where;
GDP = Economy Growth
INF = Inflation Rate
KOP= K-open Index
TD= Trade Openess
FD = Financial deepening

The econometric form of equation (1) is represented as

$$\mathbf{Y = \beta_0 + \beta_2 INF + 2KOP + \beta_3 FD + \beta_4 TD + \beta_5 FP + e \ldots\ldots\ldots (2)}$$

Where;
B0 = Intercept of relationship in the model/constant
B1-B5 = Coefficients of each independent or explanatory variable
e= Stochastic or Error term

Economy Growth

Economy growth is taken as a dependent variable and is represented with the log of GDP in terms of per capita. Gross Domestic Product (GDP) is one of the commonest measure for determining the financial liberalization and economic growth (Sadalia et al., 2019; Andabai et al., 2019; Bauzid, 2016). Therefore, the following hypotheses are proposed:

H_1: Financial liberalization has a positive influence on economy growth.

Infalation

Inflation is seen as the primary impediment to economic progress, and it has been the focus of much concern in many nations. Inflation's influence on economic growth is a critical and difficult issue, whether for the government, investors, or lenders, because it distorts the operation of price systems and leads to incompetence in delivering resources (Mohammed et al, 2014). Because it reduces people's faith in the money. The steady decline in the value of money results in the loss of its occupation as a storehouse of value. Thus, we propose the following hypotheses:

H_2: Inflation is influenced positively by economy growth

K-open Index

The K- open index indicates financial liberalisation, which is characterised by the density and level of constraint put on capital transactions; it is the outcome of the work of Chinn and Ito (2002). (Menzie and Hiro, 2006). It includes four main components, these are: limitations on current account transactions, regulations for product delivery in international market, multiple exchange rate, and constraints of capital account movements. As a result, the bigger the value of this index, the better the financial openness. According to the literature, financial liberalization has a good impact on economy (Okafor et al., 2016). Financial liberalization give benefits the economy in a variety of ways, including risk diversification and risk sharing, increased investment activity, and improved capital allocation efficiency (John, 2016; Norlida, 2017). The data for net FDI inflows is then used to perform the robustness test. Because it monitors foreign investors' inflows of external capital funds into the local economy, FDI is considered as a proxy variable for financial openness. Furthermore, a research aimed to assess the relevance of FDI as a vital source of economic development.

H_3: Capital Liberalization is influenced positively by economy growth

Trade Openness

The amount of trade openness on the external world is expressed by trade openness. It is significant because it reflects the economy's sensitivity to external swings and the extent to which it is influenced. The following equation is commonly used to determine trade openness:

$$\frac{\text{Exports + Imports of goods and services}}{\text{GDP}}$$

Timo (2015) has found a positive impact of trade on the country's ECNG, which confirmed that higher levels of trade brings improvement in the economic development. A country's import and export activities provide beneficial outcomes in the form of expansion in production, support to the local business, expansion in job opportunities, and increase in national income which directly contribute to the economy. Therefore, a positive relationship is expected to exist between financial liberalization and economy growth.

H_3: Trade Openness is influenced positively with economy growth

Financial Deepening

Financial intermediation is measured by dividing the total monetary mass (time deposits, current deposits, and liquidity) by the Gross Domestic Product (M2/GDP). This ratio reflects the amount of "cash" utilised in the economy and hence shows the size of the financial sector in the economy and consequently the level of financial depth through market size. An increase in this percentage indicates the growth in the volume of financial intermediation (Nwadiubu et al., 2014). It was introduced by King and Leving in 1993 and measures the depth of the financial market in relation to the entire economy (Onwumere, 2012).

H_4: Financial Deepening is influenced positively with economy growth

Data and Methods

This research used balanced panel data for the five ASEAN economies of Malaysia, Singapore, the Philippines, Thailand, and Indonesia. These economies are important in the ASEAN area, hence they are included as samples in this study (World Bank, 2017). Data for the control variables (economic growth) and the independent variable (financial openness) were obtained from the World Development Indicators (WDI). Other control variables, such as the official exchange rate, inflation, and GDP, were collected from the IMF. The following are the justifications for using a panel estimate approach (Baltagi et al., 2005; Basheer, 2018).

Firstly, it offers panel data that reduces bias, or unobserved heterogeneity, that can exist when using cross-sectional datasets. Second, panel data display dynamics that are difficult to detect in cross-sectional datasets. Third, panel data includes rich content and a huge number of observations. Finally, panel data displays less collinearity between set of variables, offer more variability, increased efficiency intime series, and higher degrees of freedom. As a result, this study used a panel estimation technique to compute ASEAN saving models. Panel-standard Corrected Standard Errors and Two-Stage Least Squares Instrument Variables are used in these procedures. It appears to outperform FGLS in terms of performance. It also handles any abnormalities caused by spherical inaccuracies, allowing significant inferences to be drawn from the TSCS calculations.

Basheer (2019) employed the panel corrected standard error approach in conjunction with Seemingly Unrelated Regression analysis in a number of recent studies.

To handle the problem of heteroscedasticity, White's approach is used to overcome the problem of heteroscedasticity. If the estimation results for OLS and TSLS are similar, it indicates that OLS provided unbiased and consistent estimates and that there is no concurrent relationship between income growth (per capita income) and savings, indicating that endogeneity is not an issue when estimating relationships between variables. Furthermore, various tests are carried out in order to select the best model from RE, FE, and OLS. One of the OLS assumptions is that the cross-sectional data displays no time-specific effects over a certain period of time.
However, the presence of such effects during estimation results in inadequate OLS estimators for forecasting units from cross-sectional data for a certain time period. Furthermore, a FE test was performed to test the hypothesis that no effects exist in the estimates obtained by time series cross- sectional data, followed by a Hausman test to determine if the RE approach is consistent and acceptable, and should be chosen over FE estimation. Under the null hypothesis, there is no substantial difference in estimates for the RE and FE models. Acceptance of Ho, i.e., the null hypothesis, suggests that RE estimates are right and preferred over FE estimates, whereas rejection of Ho indicates that FE estimates are correct and preferred over RE estimates. The econometric model is described further below.

Results and Discussion

Correlation Analysis

This section highlights the results of the study. The correlation matrix shown in Table 1 confirms that the variables used in this study are highly correlated (Table 2).

Table 2
Correlation Analysis

	GDP	KOPEN	INF	TD	FD
GDP	1.000				
KOPEN	.270*	1.000			
INF	.043	.110	1.000		
TD	.585*	.212	-.075	1.000	
FD	-.444*	-.210	.153	-.844	1.000

Dependent Variable: Economy Growth

The finding in Table 1 indicates that higher financial liberalization enhances the GDP. There is a strong relationship between financial liberalization and economic growth in Malaysia, where Analysis of Pearson correlation shows a positive relationship between the variable of trade open and economy growth in five ASEAN countries. More interestingly, the economy growth strongly positive correlated with trade open. These result suggest that trade open is a significant factor leading to economy growth. More over, the result indicates a positive but insignificant relationship between financial deepening and economic growth. It shows that financial deepening is not the factor for economic growth in five ASEAN countries (Thailand, Singapore, Indonesia, Malaysia anMalaysia,d Philippines) between the period of 1990 and 2021. This finding is in line with the previous study by (Ardic and Damar, 2006). Finally, this

study examines the impact that thestandard financial sector is having on economic development in ASEAN countries. The findings reveal that there is a considerable negative link between public and private financial deepening and economic development. According to the study, financial development may not always contribute to economic growth, and the conditions under which such a contribution occurs should be examined further (Ardic and Damar, 2006).

Table 2
Regression Analysis

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
	(CONSTANT)	2.082	.468		4.452	.000
	KOPEN	.175	.115	.152	1.525	.001
	INF	.028	.052	.052	.529	.599
	TD	.174	.045	.704	3.895	.000
	FD	.003	.003	.174	.950	.345

Dependent Variable: Economy Growth

The estimation findings have an influence on the growth of the economy. When financial liberalization is higher, the good impact of increased economic growth is stronger. This outcome is also consistent with past research (Law, 2013; Naveed, 2019). Financial openness leads to greater efficiency in capital allocation, which improves the financial market and raises GDP. Furthermore, financial integration, according to Levine (2022), can enhance economic development by stimulating changes in the local financial sector (Levine, 2022). Furthermore, a liberalized financial system would help countries by encouraging new ventures, financial development, risk sharing, risk diversification, and improving investment activity (Marshal, 2016).

Finally, we investigate if there is a link between economic development and trade openness. Table 2 shows an average association between trade openness and economic development in five ASEAN countries with b = 0.045, p 0.01. The more the trade openness, the greater the favorable impact on ASEAN economic growth. As a result, alternative hypothesis (H3) is supported, demonstrating a positive association between trade openness and economic development. Grossman and Helpman (1991) demonstrate in previous research that trade openness increases the transfer of new technologies, hence encouraging technical innovation and productivity improvement, and that the degree of economic openness determines these advantages. This agreement is founded on the idea that trade creates economic incentives that boost productivity through two mechanisms: in the short run, trade reduces resource misallocation, and in the long run, trade allows for the transfer of technological innovation. Trade liberalization, under the pressure of international competition, can also drive governments to commit to reform measures, therefore increasing economic progress (Sachs and Warner, 1995, Rajan and Zingales, 2003). As a result, trade liberalization in emerging countries is commonly done to stimulate growth.

Conclusion

Financial liberalization is one initiatives have received widespread attention in recent decades. Financial openness is described as the free movement of cross-country investments resulting

from government rules that have been liberalized. According to Norlida (2017); John (2016), financial openness improves risk sharing and risk diversification activities, which reduces investors' total investment risk. Furthermore, financial liberalization improves the efficiency of capital allocation, which may improve the functioning of the financial market. According to Nyasha and Odhiambo (2018); Shahbaz et al (2015), financial liberalization boosts investment and savings by removing government investment regulations.

This study has investigated two research aims, which are to examine the association between financial liberalization and economy growth in five ASEAN nations (Thailand, Singapore, Indonesia, Malaysia, and Philippines) from 1990 to 2021. Furthermore, a descriptive analysis is performed to explain the characteristics of variables utilized in regression models. To evaluate the association between financial liberalization and control variables, the panel OLS is used (K-open index, inflation, trade open and financial deepening). The first regression model is created by utilizing the KAOPEN index as a financial openness indicator. The results suggest that financial openness, as evaluated by the KAOPEN index, improves the economy growth. According to Naveed and Mahmood (2019), increased financial openness enhances capital allocation, lowers investment risk, and promotes investment and financing activities, all of which contribute to greater economic development. Levine (2022) financial integration can promote economic development by encouraging improvements in the domestic financial system. Moreover, liberalized financial system would also benefits the countries by promoting venture opportunities, financial development, risk sharing, risk diversification and improves the investment activities (Marshal, 2016).

The study's conclusions have minimal ramifications. Policymakers in the five ASEAN nations (Thailand, Singapore, Indonesia, Malaysia, and the Philippines) might benefit from the information offered by this study by bolstering tactics for expanding financial openness activities for the benefit of the economy. Furthermore, by focusing on utilizing the devaluation of the native currency, the countries may gain from it.

This study has a number of limitations. For example, this research only looks at five ASEAN countries (Thailand, Singapore, Indonesia, Malaysia and Philippines). As a result, the results are only applicable to the nations that were chosen. Furthermore, it is suggested that future studies cover a diverse range of nations, including both developed and developing countries, in order to investigate the link between financial openness and economy growth in greater depth. Secondly, this study exclusively uses four types of financial openness indicators: the KAOPEN index, trade open, inflation and financial deepening. As a result, complete indices of financial liberalization might be used in future studies. Third, future research might extend the study period to 20 to 30 years in order to include more economic events, such as financial crises, in the regression models. Finally, the panel OLS regression model is the sole one used in this work. Future research might build on this work by applying more sophisticated statistical approaches to examine the association between financial openness and economy growth. Furthermore, the short-run and long-run impacts may be used in the study. Future research might look at the bidirectional link between financial liberalization and economy growth.

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