Quantity and Quality Measures of Financial Development: Implications for Macroeconomic Performance

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Abstract

Financial development is often measured by financial depth such as the stock of private credit and market capitalization as a share of GDP. Such a measure focuses on the quantity aspect of financial development. In this paper, we propose measures that capture both the quantity and quality aspects of financial market development. For quantity measures, we construct a composite index with multiple variables which gauge the size and depth of the banking, equity, bond, and insurance markets. For quality measures, we create a composite index that reflects the degree of financial market diversity, liquidity and efficiency, and the institutional environment. The last factor captures the development of legal systems and institutions, human capital, and information and telecommunications infrastructure. We find that the quantity and quality measures are highly correlated with each other for advanced economies and Asian emerging market economies, but not for other economies. The disaggregated components of the quality measures suggest that it is the level of legal and institutional development that differentiates advanced economies from emerging and developing economies in terms of the quality measures. Compared to advanced economies, emerging and developing economies tend to have low levels of market diversity, liquidity, and efficiency. Our simple regression analysis shows that the quality measure of financial development has a positive effect on output growth and negative effects on output volatility and inflation for the sample of emerging and developing economies with relatively high-quality financial development. We also observe that a higher level of financial development, particularly in terms of quality, tends to lead to greater financial openness, and that greater financial openness tends to be associated with low growth, high growth volatility and high inflation for emerging and developing economies with low quality measures of financial development, while such undesirable impacts of financial openness can be mitigated by raising the quality of financial development.

I.　Introduction

Identifying the effect of financial development on macroeconomic performance has long been the subject of research in macroeconomics. The most oft-debated is the effect of financial development on economic growth. Many studies such as King and Levine (1993), Levine (1998), Levine, et al. (2000), and others, have tried to identify the link between the level of financial development and the rate of economic growth and its stability and have often found a positive link.[1] Further financial development tends to enhance output growth and stability by ameliorating information asymmetry, facilitating more efficient and smooth capital allocation and accumulation, and enabling further risk-sharing and portfolio diversification.

Despite likely positive effects of financial development on economic growth, further financial development can also expose economies to high-risk, high-return financial instruments, thereby possibly leading to aggressive risk-taking, boom-bust cycles, and amplified volatility. The impact of financial development on output or financial stability, or just simply economic stability, has also been studied in recent years, especially following the outbreak of the global financial crisis (GFC) of 2007-09. Studies such as Arcand, et al. (2015) and Cecchetti and Kharroubi (2015) show that over-extended financial sector development can cause a drag on real economic growth. Ambivalence continues to hold for the effect of financial development on macroeconomic performance.

The effect of financial development has also recently received much attention when many international economists debated the effect of a "global savings glut" on global imbalances—a situation where excessive savings in several emerging economies financed the profligacy of several advanced economies such as the United States and European countries. Some researchers believe that global imbalances eventually *caused* the GFC, although many other factors arguably played a role. Under the "global savings glut" hypothesis, the imbalances were ascribed to underdeveloped financial systems in some emerging economies, such as China, that essentially sent excess savings to the financial centers of the world, i.e., the United States and Europe. According to this view, financial development should lead to lower domestic savings and smaller current account surpluses.[2] This view is in contrast to the "financial deepening" view (Edwards, 1996) where financial development leads to greater depth and sophistication of financial markets and therefore higher savings.

Thus, financial development has come under the spotlight as one of the major determi-

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[1]　For reviews on the nexus between finance and economic growth, refer to Levine (2005).
[2]　Refer to Chinn and Ito (2007) and Chinn, et al. (2014).

nants of macroeconomic performance, such as economic growth, stability and savings, while empirical evidence of its impact has generated more debate and controversy. At the same time, different measures of financial development may have contributed to the mixed findings on the impact of financial development on the relevant macroeconomic variables.

Financial development is often captured by a quantity measure that gauges the depth of financial markets such as the stock of private credit created as a share of GDP, mainly because this kind of data series is readily available both by country and over time (private credit data go back to as early as the 1960s for many countries). Beck (2015, 2013) argues that high levels of private credit as a share of GDP do not necessarily mean high levels of financial development. In his argument, what is captured by private credit differs among countries at different income levels because the roles of banks differ. In low- or middle-income countries, bank assets tend more to be composed of low-risk assets such as government bonds and corporate lending, not of lending to small and medium-sized enterprises (SMEs) or consumers. For higher income countries, SME or consumer lending plays a bigger role. In high-income countries, banks' balance sheets are more diversified toward risky private lending such as mortgages for households. Hence, the meaning of private credit changes depending on the income level of a country.[3]

Financial development is a multifaceted concept. To capture the subtle complexities of financial development, instead of just focusing on banking sector development, we must look into different types of financial markets such as equity, bond, and insurance markets. Also, instead of merely paying attention to the size and activeness of the financial industry, we must look into the quality aspects of financial development, such as cost performance, the breadth of the industry, and market efficiency (e.g., Hasan, et al. 2009).

In this paper, we revisit the challenge of gauging the level of financial development and construct measures that capture both the quantity and quality aspects of financial development. For quantity measures, we create a composite index with multiple variables that capture the size and depth of different types of financial markets, such as banking, equity, bond, and insurance markets. For quality measures, we create a composite index by looking at the degrees of market diversity, in terms of available financial instruments, market liquidity, market efficiency and the institutional environment. The last factor represents: legal and institutional development; human capital development; and information and telecommunications infrastructure development. We create indexes for each of these categories by using a wide range of variables.

The paper is organized as follows. In Section 2, we carefully explain our method of creating various indexes to construct the quantity and quality measures of financial development. In Section 3, we examine the trend of the quantity and quality measures, compare them among countries and different income levels, and examine the correlations between the quantity and quality measures. In Section 4, we conduct simple analyses on the impacts

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[3] Beck (2013) also argues that private credit can often reflect business cycles even if it is normalized by the size of economic activity such as GDP. Hence, rapid increases in private credit can just be a reflection of a financial bubble, which does not necessarily imply long-term financial development.

of the quantity or quality measure of financial development on several key macroeconomic variables. We also extend our analysis to the relationship between financial development, both in terms of quantity and quality, and financial openness, and examine the impact of financial openness on the key macroeconomic variables conditional upon the level of quality in financial development. In Section 5, we conclude the paper.

II.   Construction of the Quantity and Quality Measures of Financial Development

One of the goals of this paper is to construct the quantity and quality measures of financial development. The former measure is often used for empirical studies on the impact of financial development on macroeconomic performance. The latter measure of financial development has not been constructed or utilized in earlier studies, and our contribution lies in the construction of such a measure and its use for macroeconomic analysis.

Hasan, et al. (2009) argue that it is the quality of financial intermediation that matters, not the quantity, and focus on the quality of financial intermediation in terms of profit and cost efficiency. Here, we take a much broader view, with the multi-dimensional aspects of financial development, to measure its quality.

We take the view that the "quality measure of financial development" has the following dimensions: market diversity or breadth; market liquidity; market efficiency; and the institutional environment, which is a composite index of legal and institutional development, human capital development, and information and telecommunications infrastructure development.

Market diversity or breadth is an important factor determining the quality of a financial market. The more diverse financial instruments a country's financial market can offer, the more means for risk-sharing and hedging are available in the economy, enabling greater risk-diversification of portfolios. Capital can be priced more efficiently and competitively, sending more appropriate signals from the financial markets and leading to more efficient and effective allocation and accumulation of capital. More diverse financial markets also make it easier for economic agents to smooth intertemporal consumption.

Market liquidity is a second factor determining the quality of financial market development. High levels of liquidity allow market participants to conduct asset transactions with little delay, at low cost and at a price close to the current market price. Thus high levels of liquidity enable efficient and competitive trading of assets, thereby facilitating the smooth exchange of goods and services.

Market efficiency is a third factor contributing to the quality of financial markets. An active financial market is not necessarily an efficient market, nor is a market with a high level of market capitalization. Generally, the efficient allocation of capital resources requires efficient financial markets. If an economy has a history of implementing active interventionist industrial policies as part of its growth strategy (e.g., East Asian economies), the role of the public sector in the financial sector tends to be significant, limiting market competition and, thus leaving the financial market inefficient. Demirgüç-Kunt and Huizinga (2001) find that

underdeveloped financial markets tend to have higher levels of profits and margins. The lack of competition can eventually lead to, or sustain, rent-seeking behavior by the financial industry, hindering the long-term development of both the industry and the economy. Hence, the degree of efficiency of a financial system is an important gauge for the quality of financial market development.

The institutional environment is a fourth factor affecting the quality of financial markets. This has three sub-components. The first sub-component is a country's legal foundations and institutions, which define the context where financial transactions and economic decisions are made. Levine, et al. (2000) find that cross-country differences in legal and regulatory systems influence the development of financial intermediation.[4] The literature identifies a number of channels by which legal and institutional development can affect investment and savings decisions. Whether the legal system clearly establishes law and order, minimizes corruption, or protects property rights efficiently, influences market participants' financial decision-making. In economies where the legal system does not clearly define property rights or guarantee the enforcement of contracts, incentives for loan activities can be limited. Legal protections for creditors and the level of credibility and transparency of accounting rules also affect financial decisions made by economic agents, including foreign market participants.[5]

Human capital is the second sub-component contributing to a country's institutional environment. The higher levels of education an economy achieves, the more positive externality or network benefits it can enjoy. In financial activities, processing information efficiently is an important consideration. Continuous technological advancement requires high levels of complex information processing, which would also require workers to attain certain levels of education. Hence, an economy that has accumulated high levels of human capital is expected to have a high-quality financial market.

Information and telecommunications infrastructure development is the third sub-component for a country's institutional environment. In order to process and share information pertaining to financial services and transactions efficiently, developing a strong information and telecommunications infrastructure is essential. Especially following the emergence of the Internet, the role of information and telecommunications infrastructure has become vital.

II-1.   *Algorithm for constructing indexes*

We construct two indexes to measure the degree of a country's financial development. The first measures the *quantity* aspect of financial development ("*Fin_quantity*") and the second measures the *quality* aspect of financial development ("*Fin_quality*"). *Fin_quantity* is a composite index constructed from the eight variables that capture the sizes and depths

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[4] See also Beck and Levine (2004), Johnson, et al. (2002), and Levine (2005), among others.
[5] Chinn and Ito (2006) find that financial openness leads to financial development, especially when a country is equipped with developed legal systems and institutions. Alfaro, et al. (2008) argue and find evidence that institutional quality is an important determinant of the direction and volume of international capital flows.

of different types of financial markets, i.e., banking, stock, bond and insurance markets. *Fin_quality* is composed of four subindexes: *diversity* for diversity and breadth of financial markets; *liquidity* for liquidity of financial markets; *efficiency* for financial market efficiency; and *inst* for institutional environment. Each of the subindexes is composed of several, more detailed variables (Table 1).

To construct these composite indexes, we take a bottom-up approach. The general rule or algorithm warrants some explanation.

First, all the original variables used to construct *Fin_quantity* and three of the subindexes used to construct *Fin_quality*, namely, *diversity*, *liquidity*, and *efficiency*, are winsorized with the 5th and 95th percentiles set as the cutoff levels. That is, extremely small values below the 5th percentile and extremely large values above the 95th percentile are taken out of the sample. This is to remove the outliers while not losing observations.[6]

Second, these variables are also normalized using the formula:

$$X\_n_{it} = \frac{X_{it} - X_{i,min}}{X_{i,max} - X_{i,min}} \tag{1}$$

where $X_{i,max}$ and $X_{i,min}$ are the global maximum and minimum of the winsorized variable X_i, respectively.

Then, for the construction of a composite index, if one of the variables used to construct

Table 1
Constructing Quantity and Quality Measures of Financial Development

Variable	Number of sample countries	Sample period	Definition
Fin_quantity1	49	1990 – 2015	Quantity measure of financial development 1: First principal component of 8 variables, namely, domestic credit to private sector by banks (*dcpsb*), stock market capitalization (*smkc*), stock market total values (*smtv*), private bond market capitalization (*pvbm*), international debt issues (*int_debt*), corporate bond issuance volume (*c_bond*), life insurance premium volume (*life*), and non‑life insurance premium volume (*nonlife*), all defined as % of GDP
Fin_quantity2	90	1990 – 2015	Quantity measure of financial development 2: First principal component of 6 variables, namely, domestic credit to private sector by banks (*dcpsb*), stock market capitalization (*smkc*), stock market total values (*smtv*), international debt issues (*int_debt*), life insurance premium volume (*life*), and non‑life insurance premium volume (*nonlife*), all defined as % of GDP
Fin_quantity3	112	1975 – 2015	Measure of financial depth 3: First principal component of 3 variables, namely, domestic credit to private sector by banks (*dcpsb*), stock market capitalization (*smkc*), and stock market total values (*smtv*), all defined as % of GDP
diversity	186	1990 – 2015	Measure of financial breadth/diversity: Defined by *dcpsb*, *smkc*, *pvbm*, *insurance_assets* (insurance company assets), and *int_debt*.
liquidity	115	1975 – 2015	Measure of liquidity: Stock market turnover (*smto*)
efficiency	188	1996 – 2015	Measure of financial efficiency: First principal component of 7 variables, namely, banks' return on assets (*bank_roa*), banks' return on equity (*bank_roe*), net interest margin (*net_int*), borrowing‑lending spread (*spread*), non‑interest income (*non_int_income*), overhead costs to total assets (*overhead*), and bank nonperforming loans to gross loans (*npl_n*)
gen_legal	193	1996 – 2015	Measure of general legal and institutional development: First principal component of 6 variables, namely, anti‑corruption measures (*anticorrupt*), corporate tax rate (*tax*), government effectiveness (*govt_eff*), rule of law (*ruleoflaw*), political stability and absence of violence/terrorism (*pol_sta*), and regulatory quality (*regulatory*), all taken from the World Bank's "Worldwide Governance Indicators" database
econ_legal	185	2005 – 2015	Legal development for general economic activities: First principal component of 6 variables, namely, enforcing contract (*enfr_cont*), starting a business (*business*), getting electricity (*electricity*), paying taxes (*paytaxes*), dealing with construction permits (*construction*), and trading across borders (*trading*), all taken from the World Bank's "Doing Business" database
fin_legal	185	2004 – 2015	Legal development for financial activities: First principal component of 4 variables, namely, getting credit (*get_credit*), protecting minority investors (*pro_minority*), registering property (*property*), and resolving insolvency (*insolvency*), all taken from the World Bank's "Doing Business" database
hc	188	1970 – 2015	Measure of human capital development: First principal component of tertiary school enrollment (% gross; *tertiary*) and secondary school enrollment (% gross; *secondary*)
info_tel	189	1990 – 2015	Measure of information and telecommunications development: First principal component of 4 variables, namely, percentage of individuals using the Internet (*indiv_internet*), fixed‑telephone subscriptions per 100 inhabitants (*fixed_tel2*), mobile‑cellular telephone subscriptions per 100 inhabitants (*cell*), and fixed‑broadband subscriptions per 100 inhabitants (*broadband*)
inst1	161	2005 – 2015	Measure of institutional development 1: First principal component of *gen_legal*, *econ_legal*, *fin_legal*, *hc*, and *info_tel*
inst2	171	1996 – 2015	Measure of institutional development 2: First principal component of *gen_legal*, *hc*, and *info_tel*
Fin_quality1	97	2005 – 2015	Quality measure of financial development 1: First principal component of *diversity*, *liquidity*, *efficiency*, and *inst1*
Fin_quality2	105	1996 – 2015	Quality measure of financial development 2: First principal component of *diversity*, *liquidity*, *efficiency*, and *inst2*

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[6] "Winsorize" means that extremely small values below a certain threshold (e.g., the 5th percentile) and extremely large values above a threshold (e.g., the 95th percentile) are replaced by the threshold values instead of being replaced by missing variables so that observations will be kept.

the index is severely limited in terms of the sample length of the time series, the composite index can be spliced using the other variables for the index. For example, if subindex *X* is composed of variables *A*, *B*, *C*, and *D*, but if the time series of variable *C* is available only for 2000-2015 while the others are available for 1995-2015, we create *X'* using all the four variables for the 2000-2015 period and *X''* using *A*, *B*, and *D* for the 1995-2015 period. Then, using the growth rates of *X''*, we retroactively extrapolate *X'* for the earlier years (i.e., for 1995-1999) to obtain subindex X.

All the subindexes, except for *diversity* and *liquidity*, are the first principal components of the original variables. *Fin_quantity* is the first principal component of the eight subindexes. *Fin_quality* is the first principal component of the four subindexes. Before the first principal component is computed, however, all four subindexes are winsorized at the 1st and 99th percentiles and normalized again to a range between zero and one.[7]

II-2.   *Subindexes for constructing the quantity measure of financial development*

In this subsection we explain the construction of the quantity measure of financial development and its underlying subindexes. Greater detail on data description and sources is given in Appendix 1.

The quantity measure of financial development (*Fin_quantity*) gauges the degree of financial development with a focus on the size and depth of financial markets. It is composed of the size indexes of the banking, stock, bond, and insurance markets. Namely, it is the first principal component of domestic credit to the private sector by banks, stock market capitalization, the total value of stocks traded, private bond market capitalization, international debt issues, the corporate bond issuance volume, the life insurance premium volume, and the non-life insurance premium volume, all of which are normalized by nominal GDP.

Because of the trade-off between the level of detail and nuance a variable can offer and the degree of its availability, we construct three types of quantity measures for financial development: *Fin_quantity1*, *Fin_quantity2*, and *Fin_quantity3*. They differ depending on the variables included in the first principal component calculation. Naturally, data availability differs among the three variables (Table 2).

"*Fin_quantity1*" is the quantity measure of financial development and is constructed as the first principal component of eight subindexes, that is, domestic credit to the private sector by banks (*dcpsb*); stock market capitalization (*smkc*); the total value of stocks traded (*smtv*); private bond market capitalization (*pvbm*); international debt issues (*int_debt*); corporate bond issues (*c_bond*); the life insurance premium volume (*life*); and the non-life insurance premium volume (*nonlife*), all as a ratio of GDP. As it involves eight variables in its construction, this measure is available for only 49 countries over the sample period 1990-

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[7] The thresholds for winsorizing depend upon the distribution of the original variable. When there are many outliers, we use the 5th and 95th percentiles (or sometimes the 10th and 90th percentiles) as thresholds. When there are relatively few outliers, we use the 1st and 99th percentiles as thresholds.

Appendix 1
Data Description

Variables			Availability	Source
1. Quantity Measure of Financial Development (Financial Market Depth)				
1.1	*dcpsb*	Domestic credit to private sector by banks (% of GDP)	1960 – 2015	World Development Indicators
1.2	*smkc*	Stock market capitalization (% of GDP)	1975 – 2015	Global Financial Structure Database, WDI
1.3	*smtv*	Stocks traded, total value (% of GDP)	1975 – 2015	World Development Indicators
1.4	*pvbm*	Private bond market capitalization (% of GDP)	1990 – 2015	Global Financial Structure Database
1.5	*int_debt*	International debt issues (% of GDP)	1980 – 2015	Global Financial Development Database
1.6	*c_bond*	Corporate bond issuance volume (% of GDP)	2000 – 2015	Global Financial Development Database
1.7	*life*	Life insurance premium volume (% of GDP)	1990 – 2015	Global Financial Structure Database
1.8	*nonlife*	Non-life insurance premium volume (% of GDP)	1990 – 2015	Global Financial Structure Database
F1_1	***Fin_quantity1***	**First principal component of 1.1 - 1.8**	**1990 – 2015**	
F1_2	***Fin_quantity2***	**First principal component of 1.1 - 1.3 and 1.6 - 1.8**	**1990 - 2015**	
F1_3	***Fin_quantity3***	**First principal component of 1.1 - 1.3**	**1975 - 2015**	
2. Financial Market Breadth or Diversity				
2.1 F2	*diversity*	Diversity of financial resources, defined as: $$\frac{1}{\sqrt{\left(\frac{dcpsb}{total}\right)^2 + \left(\frac{smkc}{total}\right)^2 + \left(\frac{pvbm}{total}\right)^2 + \left(\frac{insurance\_assets}{total}\right)^2 + \left(\frac{int\_debt}{total}\right)^2}} - 1$$ where *total = dcpsb + smkc + pvbm + insurance_assets + int_debt*	1990– 2015	
3. Financial Market Liquidity				
3.1	*smto*	Stock market turnover (% of GDP)	**1977 – 2015**	Global Financial Structure Database
F3	*liquidity*	**= smto**	**1977– 2015**	
4. Financial Market Efficiency				
4.1	*bank_roa*	Bank return on assets, before tax (%)	1996 – 2015	Global Financial Development Database
4.2	*bank_roe*	Bank return on equity, before tax (%)	1996 – 2015	Global Financial Development Database
4.3	*net_int*	Bank net interest margin (%)	1996 – 2015	Global Financial Development Database
4.4	*spread*	Bank lending-deposit spread (%)	1980 – 2015	Global Financial Development Database
4.5	*non_int_income*	Bank noninterest income to total income (%)	1996 – 2015	Global Financial Development Database
4.6	*overhead*	Bank overhead costs to total assets (%)	1996 – 2015	Global Financial Development Database
4.7	*npl*	Bank nonperforming loans to gross loans (%)	1998 – 2015	Global Financial Development Database
F4	***efficiency***	**First principal component of 4. 1 – 4. 7**	**1996 – 2015**	
5. Institutional Environment for Finance				
5.1 Legal and Institutional Environment for Business				
5.1.1	*anticorrupt*	Anti-corruption measures	1996 – 2016	Worldwide Governance Indicators
5.1.2	*totaltax*	Corporate tax rates	2005 – 2016	Worldwide Governance Indicators
5.1.3	*govt_eff*	Government effectiveness	1996 – 2015	Worldwide Governance Indicators
5.1.4	*ruleoflaw*	Rule of law	1996 – 2015	Worldwide Governance Indicators
5.1.5	*pol_sta*	Political stability and absence of violence/terrorism	1996 – 2015	Worldwide Governance Indicators
5.1.6	*regulatory*	Regulatory quality	1996 – 2015	Worldwide Governance Indicators
F511	*gen_legal*	**General legal and institutional environment for business: First principal component of 5.1.1 - 5.1.6**	**1996 – 2015**	
5.1.7	*enfr_cont*	Enforcing contract	2003 – 2016	Doing Business index
5.1.8	*business*	Starting a business	2003 – 2016	Doing Business index
5.1.9	*electricity*	Getting electricity	2009 – 2016	Doing Business index
5.1.10	*paytaxes*	Paying taxes	2005 – 2016	Doing Business index
5.1.11	*construction*	Dealing with construction permits	2005 – 2016	Doing Business index
5.1.12	*trading*	Trading across borders	2005 – 2016	Doing Business index
F512	*econ_legal*	**Legal and institutional environment for general economic activities: First principal component of 5.1.7 - 5.1.12**	**2005 – 2016**	
5.1.13	*get_credit*	Getting credit	2004 – 2016	Doing Business index
5.1.14	*pro_minority*	Protecting minority investors	2005 – 2016	Doing Business index
5.1.15	*property*	Registering property	2004 – 2016	Doing Business index
5.1.16	*insolvency*	Resolving insolvency	2003 – 2016	Doing Business index
F512	*fin_legal*	**Legal environment for financial activities: First principal component of 5.1.13 - 5.1.16**	**2004 – 2016**	
F51	*legal_institution*	**Legal and institutional development: First principal component of F511, F512 and F513**	**2005 - 2015**	
5.2 Human Capital				
5.2.1	*tertiary*	School enrollment, tertiary (% gross)	1970 – 2015	World Development Indicators
5.2.2	*secondary*	School enrollment, secondary (% gross)	1970 – 2015	World Development Indicators
F52	*hc*	**First principal component of 5.2.1 - 5.2.2**	**1990 – 2015**	
5.3 Information and Telecommunications Infrastructure				
5.3.1	*indiv_internet*	Percentage of individuals using the Internet	1990 – 2016	International Telecommunication Union (ITU)
5.3.2	*fixed_tel2*	Fixed-telephone subscriptions per 100 inhabitants	1965 – 2015	World Development Indicators
5.3.3	*cell*	Mobile-cellular telephone subscriptions per 100 inhabitants	2000 – 2016	International Telecommunication Union (ITU)
5.3.4	*broadband*	Fixed-broadband subscriptions per 100 inhabitants	2000 – 2016	International Telecommunication Union (ITU)
F53	*info_tel*	**First principal component of 5.3.1 - 5.3.4**	**1990 – 2015**	
F5_1	*inst1*	**Institutional environment1: First principal component of F51, F52 and F53**	**2005 – 2015**	
F5_2	*inst2*	**Institutional environment2: First principal component of F511, F52 and F53**	**1996 – 2015**	
6. Quality Measure of Financial Development				
F6_1	***Fin_quality1***	**First principal component of F2, F3, F4, and F5_1**	**2005 - 2015**	
F6_2	***Fin_quality2***	**First principal component of F2, F3, F4, and F5_2**	**1996 - 2015**	
7. Financial Market Openness				
F7	***Fin_openness***	Sum of external assets and liabilities (% of GDP)	1970 – 2015	Lane and Milesi-Ferretti (2017)

Table 2
Composition of *Fin_quantity*

	Fin_quantity1	*Fin_quantity2*	*Fin_quantity3*
Domestic credit to private sector by banks, % of GDP (*dcpsb*)	X	X	X
Stock market capitalization, % of GDP (*smkc*)	X	X	X
Stock market traded, total values, % of GDP (*smtv*)	X	X	X
Private bond market capitalization, % of GDP (*pvbm*)	X		
International debt issues, % of GDP (*int_debt*)	X		
Corporate bond issues, % of GDP (*c_bond*)	X	X	
Life insurance premium volume, % of GDP (*life*)	X	X	
Non-life insurance premium volume, % of GDP (*nonlife*)	X	X	
Number of sample countries	49	90	112
Sample period	1990 – 2015	1990 – 2015	1975 – 2015

2015.

"*Fin_quantity2*" is the first principal component of six subindexes, i.e., domestic credit to the private sector by banks (*dcpsb*), stock market capitalization (*smkc*), the total value of stocks traded (*smtv*), corporate bond issues (*c_bond*), the life insurance premium volume (*life*), and the non-life insurance premium volume (*nonlife*). This measure is available for many more countries than *Fin_quantity1*; it covers 90 countries for the period 1990-2015. We often use this measure in later data analyses.

"*Fin_quantity3*" is defined as the first principal component of three subindexes, i.e., domestic credit to the private sector by banks (*dcpsb*), stock market capitalization (*smkc*), and the total value of stocks traded (*smtv*). As it focuses on a smaller number of subindexes, it is available for more countries and for a longer sample period than the other two quantity measures. It covers 112 countries for the period 1975-2015.

II-3.   *Subindexes for constructing the quality measure of financial development: Diversity, liquidity, efficiency and the institutional environment*

The quality of financial development can be measured by four subindexes, i.e., financial market breadth or diversity, market liquidity, market efficiency, and the institutional environment.

Financial breadth/diversity

It is important to look at the extent of financial market development in terms of the breadth or diversity a financial market can provide. In other words, measuring how diversified a financial market is sheds light on the degree of availability of alternative financial instruments to investors, households and non-financial corporations. We measure the level of breadth or diversity of a financial market as:

$$diversity = 1 \Big/ \sqrt{\left(\frac{dcpsb}{total}\right)^2 + \left(\frac{smkc}{total}\right)^2 + \left(\frac{pvbm}{total}\right)^2 + \left(\frac{insurance\_assets}{total}\right)^2 + \left(\frac{int\_debt}{total}\right)^2}^{-1} \qquad (2)$$

where *dcpsb* is domestic credit to the private sector by banks; *smkc* is stock market capi-

talization; *pvbm* is private bond market capitalization; *insurance_assets* is insurance company assets; and *int_debt* is international debt issues. The higher the level of this value defined by (2)*,* the higher the degree of financial market diversity and breadth.

Liquidity

   The level of ease with which a financial asset can be converted to another type of asset is an important way of measuring the quality of financial market development. A liquid market allows investors to quickly purchase or sell a financial asset without causing large changes in the asset price. When a large volume of financial assets is traded by a large number of investors, the market tends to be more liquid than otherwise. Here, we use stock market turnover (as a share of GDP) as the "*liquidity*" measure for financial markets.

Efficiency

   Financial market efficiency (*efficiency*) is the first principal component of the following seven variables: banks' return on assets (*bank_roa*); banks' return on equity (*bank_roe*); banks' net interest margin (*net_int*); the lending-borrowing rate spread (*spread*); banks' non-interest income as a share of total income (*non_int_income*); banks' overhead costs as a ratio of total assets (*overhead*); and bank nonperforming loans as a ratio of gross loans (*npl_n*).

   We assume that all variables, except for *bank_roa* and *bank_roe*, indicate the market is less efficient when the variable of concern has a higher value. Hence, these variables are transformed in the following way so that a higher value indicates a more efficient market condition.

$$X\_t_{it} = 1 - \frac{X_{it} - X_{i,min}}{X_{i,max} - X_{i,min}} \tag{3}$$

Institutional environment for finance

   A country's institutional environment for financial market development is represented by its legal systems and institutions, human capital development, and information and telecommunications infrastructure development.

   Legal and institutional development: We have three types of indexes for the development of legal systems and institutions: general legal and institutional development (*gen_legal*), legal and institutional development for economic activities (*econ_legal*), and legal development for financial activities (*fin_legal*), depending on which aspect of legal or institutional development we wish to capture.

   General legal and institutional development (*gen_legal*) is the measure of overall legal and institutional development affecting business activities. It is based on the first principal component of six variables, i.e., anti-corruption measures (*anticorrupt*); the corporate tax rate (*tax*); government effectiveness (*govt_eff*); the rule of law (*ruleoflaw*); political stability and absence of violence/terrorism (*pol_sta*); and the regulatory quality (*regulatory*), all taken from the World Bank's "Worldwide Governance Indicators" database.

   Legal and institutional development for economic activities (*econ_legal*) is the first prin-

cipal component of the following six variables: enforcing contract (*enfr_cont*); starting a business (*business*); getting electricity (*electricity*); paying taxes (*paytaxes*); dealing with construction permits (*construction*); and trading across borders (*trading*), all taken from the World Bank's "Doing Business" database.

Legal development for financial activities (*fin_legal*) is the measure of legal development particularly relevant to financial market activities and is represented by the first principal component of four variables, i.e., getting credit (*get_credit*); protecting minority investors (*pro_minority*); registering property (*property*); and resolving insolvency (*insolvency*), which are also taken from the World Bank's "Doing Business" database.

Human capital development: The level of human capital development (*hc*) captures a country's tertiary and secondary education. It is the first principal component of tertiary school enrollment (% gross, *tertiary*) and secondary school enrollment (% gross, *secondary*).

Information and telecommunications infrastructure development: The level of information and telecommunications infrastructure development (*info_tel*) is represented by the first principal component of four variables, namely, percentage of individuals using the Internet (*indiv_internet*); fixed-telephone subscriptions per 100 inhabitants (*fixed_tel2*); mobile cellular telephone subscriptions per 100 inhabitants (*cell*); and fixed-broadband subscriptions per 100 inhabitants (*broadband*).

Two alternative measures of the institutional environment

For a country's institutional environment (*inst*), we define two measures depending on what is included in the first principal component calculation (Table 3). The first measure,

Table 3
Composition of *inst*

	inst1	*inst2*
General legal and institutional development (*gen_legal*)	X	X
Legal and institutional development for general economic activities (*econ_legal*)	X	
Legal development for financial activities (*fin_legal*)	X	
Human capital development (*hc*)	X	X
Information and telecommunications development (*info_tel*)	X	X
Number of sample countries	161	171
Sample period	2005 – 2015	1996 – 2015

Table 4
Composition of *Fin_quality*

	Fin_quality1	*Fin_quality2*
Financial market breadth or diversity (*diversity*)	X	X
Financial market liquidity (*liquidity*)	X	X
Financial market efficiency (*efficiency*)	X	X
Institutional development 1 (*inst1*)	X	
Institutional development 2 (*inst2*)		X
Number of countries	97	105
Sample period	2005 – 2015	1996 – 2015

inst1, includes all the variables pertaining to legal and institutional development, namely, development of general legal systems and institutions (*gen_legal*), legal and institutional development for economic activities (*econ_legal*), and legal development for financial activities (*fin_legal*), as well as human capital development (*hc*) and information and telecommunications infrastructure development (*info_tel*). The second measure, *inst2*, includes development of general legal systems and institutions (*gen_legal*) as well as human capital development (*hc*) and information and telecommunications infrastructure development (*info_tel*).

Again we face a trade-off between the level of detail and nuance a variable can offer and the degree of its availability. The first measure, *inst1*, includes the more detailed and nuanced variables of *econ_legal* and *fin_legal*, which makes *inst1* available for a shorter time period (2005-2015), whereas *inst2*, which excludes *econ_legal* and *fin_legal*, is available for a longer time period (1996-2015).

II-4.   *Quality measure of financial development*

We construct two measures for the quality of financial development: *Fin_quality1* and *Fin_quality2*. They differ from each other depending on which subindex is used for institutional environment, *inst1* or *inst2*, in the calculation of the first principal component.

Fin_quality1 is the first quality measure of financial development and is constructed as the first principal component of four subindexes, that is, financial market diversity (*diversity*), liquidity (*liquidity*) and efficiency (*efficiency*) as well as the first measure of institutional development (*inst1*). This quality measure is available for the sample period 2005-2015 and 161 countries. *Fin_quality2* is the second quality measure of financial development and is defined as the first principal component of four subindexes, namely, *diversity*, *liquidity* and *efficiency* as well as *inst2*. This measure is available for the sample period 1996-2015 and 171 countries. We often use *Fin_quality2* in later data analyses.

### III.   Graphical Illustration of Measures of Financial Development

This section presents the quantity and quality measures of financial development by using graphs for selected countries over time. This facilitates cross-country and time-series comparisons for the two measures.

III-1.   *Quantity measure of financial development*

Figure 1 illustrates the development of domestic credit to the private sector (as a share of GDP, *dcpsb*) and one each of our quantity and quality measures of financial development, i.e., *Fin_quantity2* and *Fin_quality2*, for Brazil, Chile, China, the Czech Republic, the Republic of Korea (ROK), and Malaysia.[8]

A comparison of the first two panels of Figure 1, i.e., for *dcpsb* and *Fin_quantity2*, illu-

Figure 1
Comparison of Different Measures of Financial Development
1.A Private Credit (*dcpsb*)
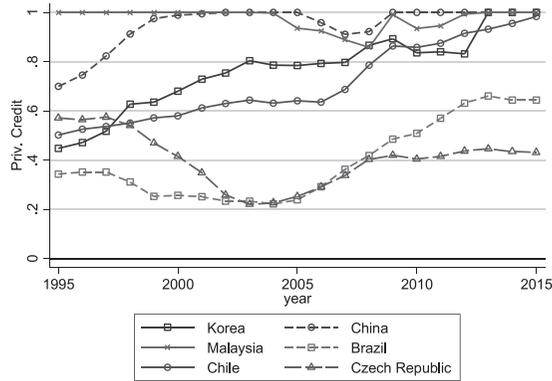
1.B: Quantity Measure of Financial Development (*Fin_quantity2*)
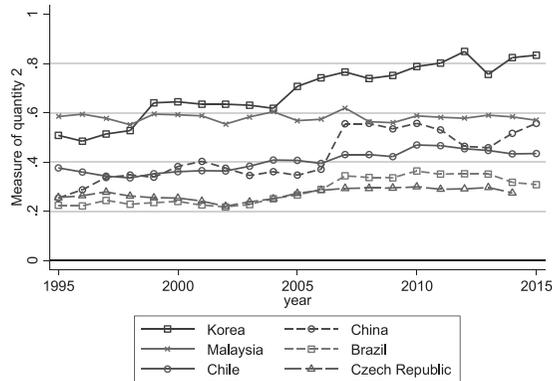
1.C: Quality Measure of Financial Development (*Fin_quality2*)

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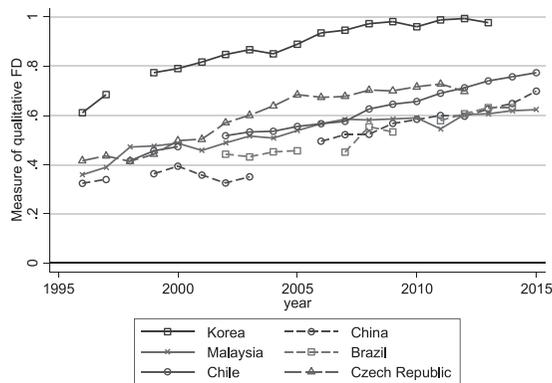
8 The same types of winsorization and normalization (as done to *Fin_quantity* and *Fin_quality*) are applied to *dcpsb* so that parallel comparisons can be made.

minates the difference between the measure purely focused on the banking sector (i.e., *dcpsb*) and the one accounting for different types of financial markets (*Fin_quantity2)*. For example, if we measure the level of financial development only in terms of private credit creation, for the last decade or so Chile, China, the ROK, and Malaysia appear to have achieved the "highest" level of financial development. However, once the depth of other types of financial markets is taken into account, only the ROK has achieved a high level of financial development in terms of quantity. Other than the banking sector, the other three economies do not have deep financial markets at the level the ROK enjoys. This example makes it clear that high levels of private credit creation do not necessarily reflect a high level of financial development.

Figure 2 illustrates the development of *Fin_quantity2* for many more countries, namely the groupings of the Asian economies, the Latin American economies, the advanced economies, and others.[9] We can observe that there is a wide variation across countries in terms of the quantity of financial development. However, the quantity measure of financial development tends to be stable for many countries, while some emerging economies in Asia tend to

Figure 2
Quantity Measure of Financial Development: *Fin_quantity2*

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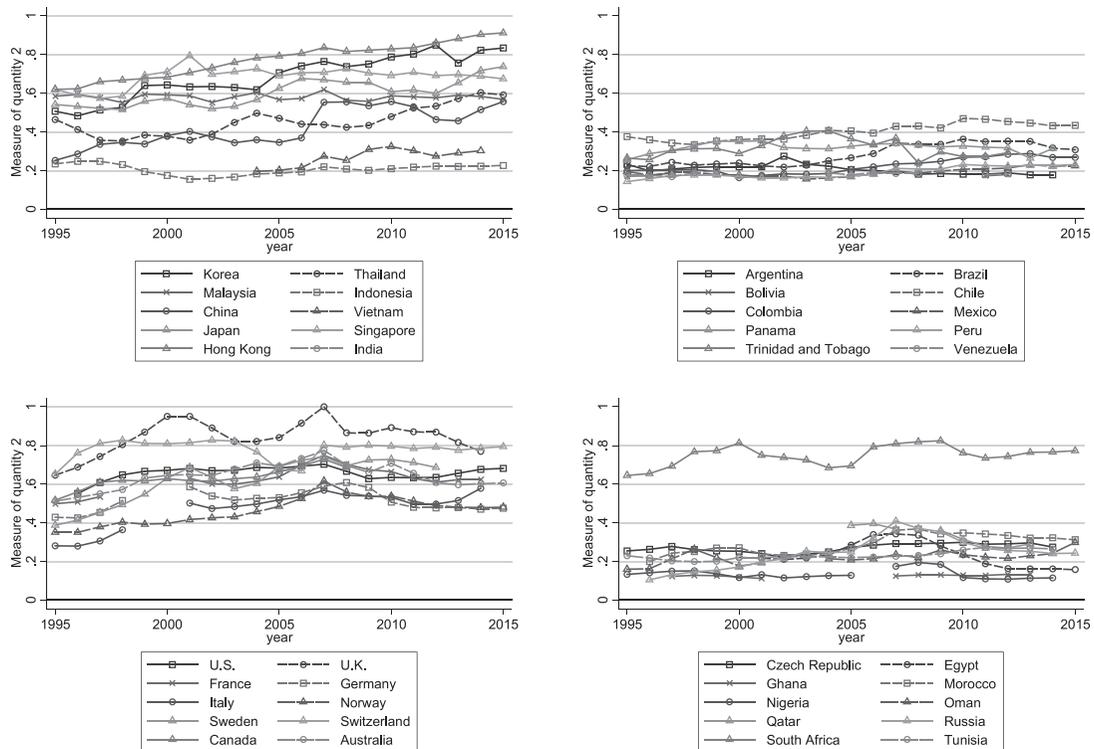
[9] The whole sample includes economies that are not shown in the figures. See Appendix 2.

Appendix 2: Country List*

Advanced Economies
Australia
Austria
Belgium
Canada
Cyprus
Czech Republic
Denmark
Estonia
Finland
France
Germany
Greece
Hong Kong
Iceland
Ireland
Israel
Italy
Japan
Korea, Rep.
Latvia
Lithuania
Luxembourg
Malta
Netherlands
New Zealand
Norway
Portugal
Singapore
Slovak Republic
Slovenia
Spain
Sweden
Switzerland
United Kingdom
United States

Emerging Economies
Brazil
Chile
China

Colombia
Egypt
Hungary
India
Indonesia
Malaysia
Mexico
Pakistan
Peru
Philippines
Poland
Qatar
Russia
South Africa
Thailand
Turkey

Emerging Asia
China
Hong Kong
India
Indonesia
Korea, Rep.
Malaysia
Philippines
Singapore
Thailand

Other Economies
Armenia
Bahrain
Bangladesh
Barbados
Bermuda
Bolivia
Botswana
Bulgaria
Côte d'Ivoire
Costa Rica
Croatia
Ecuador
El Salvador
Fiji
Georgia

Ghana
Guatemala
Guyana
Jamaica
Jordan
Kazakhstan
Kenya
Kuwait
Kyrgyz Rep.
Lebanon
Malawi
Mauritius
Moldova
Mongolia
Morocco
Namibia
Nepal
Nigeria
Oman
Panama
Paraguay
Romania
Saudi Arabia
Sri Lanka
St. Kitts & Nevis
Swaziland
Tanzania
Trinidad and Tobago
Tunisia
Uganda
Ukraine
Uruguay
Uzbekistan
Venezuela
Zimbabwe

* Note: This list is only for the economies for which "*Fin_quality2*" is available.

experience a steady rise in the quantity measure and advanced economies tend to experience cyclical movements. Unlike those in Asia, economies in Latin America and Africa, as well as Russia, tend to have low levels of financial development in terms of quantity.

III-2.   *Quality measure of financial development*

Figure 3 illustrates the *quality* aspect of financial market development, using *Fin_quality2* for the same economy groupings as in Figure 2. We can make several interesting observations.[10]

First, in the last two decades, most of the economies shown in Figure 3 have experienced financial development in terms of quality with a few exceptions. The trajectory of development is usually steady and not cyclical. Considering that the traditional quantity measures of financial development, such as private credit creation as a share of GDP, could have reflected credit bubbles rather than genuine improvements in the efficiency and quality of financial systems (Beck, 2015), the lack of cyclical movements in Figure 3 likely reflects the

Figure 3
Quality Measure of Financial Development: *Fin_quality2*

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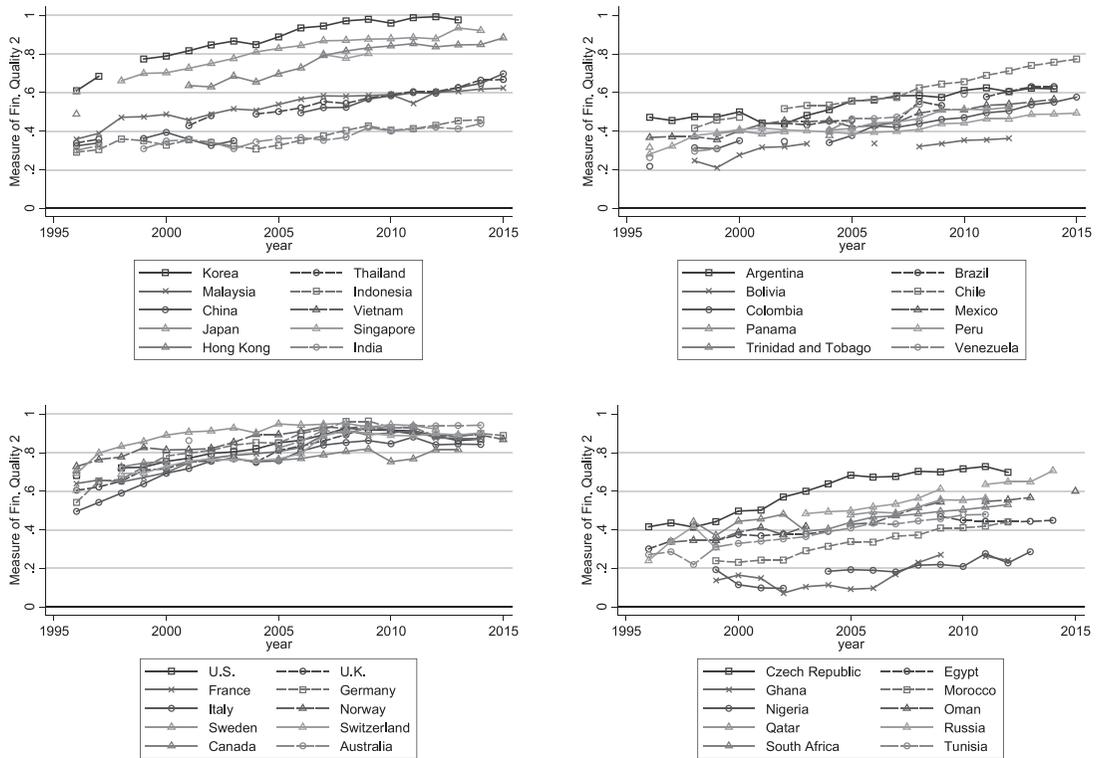
[10] Even when *Fin_quality1* or *Fin_quality2* is used, qualitatively similar observations can be made, although they are not reported here.

long-term development of financial markets.

Second, advanced economies appear to have already reached high levels of quality in financial development in the late 1990s, which is not observed among emerging economies.[11]

Third, the ranking of economies for different time periods appears to be relatively stable over time. This suggests that the quality of financial development improves gradually over time rather than rapidly and abruptly.

One major question is whether the *quality* measure of financial market development is correlated with the *quantity* measure. Figure 4, which uses scatter diagrams to see the relationship between the quality and quantity measures, suggests that the two measures are correlated.[12] However, at the same time, the extent of correlation varies depending on the level of income of the economy or the region to which the economy belongs.

Among advanced economies, the correlation coefficient is high, with a value of 0.84. The correlation coefficient for the group of emerging economies, however, is much lower, with a value of only 0.37, although that of developing economies is a little higher, at 0.49.

Interestingly, for emerging economies in Asia the correlation coefficient is very high, at 0.94.[13] In contrast, the correlation coefficients for Latin America and Eastern and Central Europe are lower, with values of 0.50 and 0.33, respectively. Geographical externality seems to play a role in the link between the quality and quantity measures of financial market de-

Figure 4
Correlation between Quantity and Quality Measures of Financial Development

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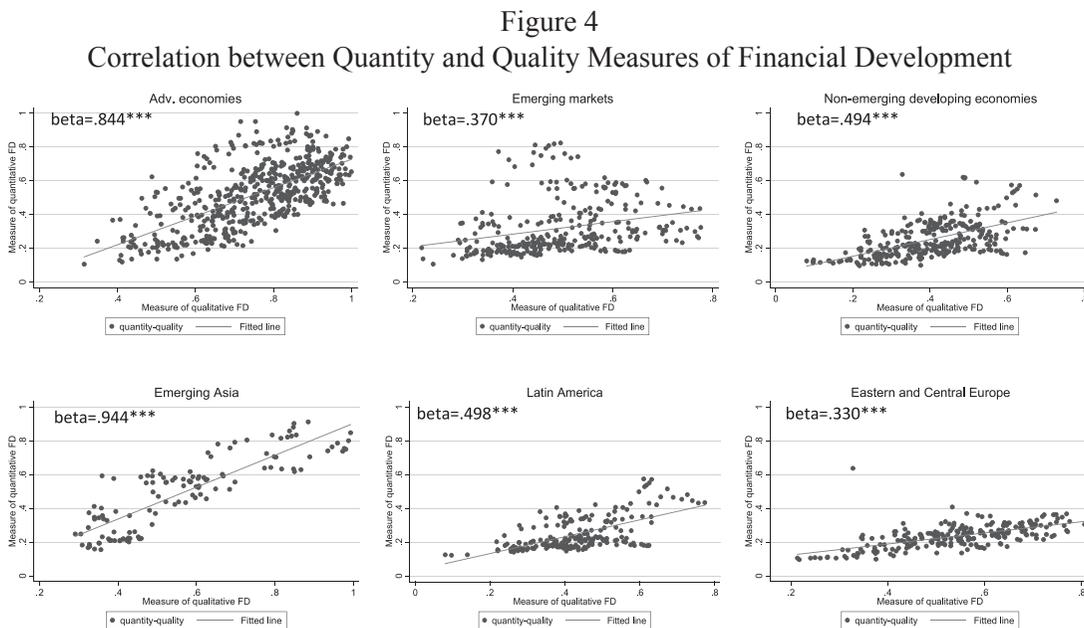
[11] The definitions of "advanced economies," "emerging economies," and "emerging and developing economies" are based on the IMF categorization.

[12] For the quality and quantity measures of financial development, we use *Fin_quality2* and *Fin_quantity2*, respectively.

[13] "Emerging Asia" includes China, Hong Kong, Indonesia, the Republic of Korea, Malaysia, the Philippines, Singapore, Thailand, and Vietnam. The result for emerging Asia is unaffected even when Singapore and Hong Kong are removed from the sample.

velopment.

In general, advanced economies and Asian emerging economies are different from other economies in that they have achieved high levels of financial market development from both the quantity and quality perspectives. That is, these economies have succeeded in expanding not only the size and depth of financial markets, but also in improving the quality of financial markets with higher levels of diversity (breadth), liquidity and efficiency, and in creating better institutional environments for financial activities.

As we have explained previously, the quality measure of financial development is composed of four subcomponents: financial breadth (*diversity*), market liquidity (*liquidity*), market efficiency (*efficiency*), and the institutional environment (*inst1* or *inst2*). The subcomponent for the institutional environment is composed of five variables (*gen_legal*, *econ_legal*, *fin_legal*, *hc*, and *info_tel*) in the case of *inst1* and three variables (*gen_legal*, *hc*, and *info_tel*) in the case of *inst2*. Given this construction, we can decompose the quality measure of financial development into several subcomponents and take a closer look at the evolution and cross-country differences of these subcomponents.

Figure 5 disaggregates *Fin_quality2* into six subcomponents, namely, financial market diversity (*diversity*), liquidity (*liquidity*), and efficiency (*efficiency*), as well as general legal and institutional development (*gen_legal*), legal and institutional development for economic activities (*econ_legal*), and legal development for financial activities (*fin_legal*) for 2005, 2009, and 2014.[14] In this construction, all the subcomponents are normalized in a range between zero and one. The value zero is shown as the center of the hexagon.

We can make several observations. First, what makes advanced economies stand out is that their level of legal and institutional development—whether it is general legal and institutional development or one pertaining to economic or financial activities—is consistently high. The hexagonal charts for Germany, Japan, Singapore, and the United States clearly show this tendency. Conversely, the level of legal and institutional development is lower for other economies. Emerging economies in East Asia, including China, and in Eastern and Central Europe have higher levels of legal and institutional development, while countries in Latin America and Sub-Saharan Africa have low levels of legal and institutional development.

Second, legal and institutional development appears to evolve only gradually. Looking at the hexagonal charts, the levels of legal and institutional development do not change much from 2005 to 2009, and to 2014. This is consistent with what we have observed for the quality measure of financial development in Figure 3. That is, the gradual evolution of the quality measure of financial development may partly be explained by the slow evolution of legal and institutional development.

Third, for emerging and developing economies, the levels of financial market diversity, liquidity, and efficiency tend to be low. This reflects the fact that these economies tend to

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[14] Two other subcomponents, *hc* and *info_tel*, are omitted from Figure 5 since these indexes usually show a general tendency of steady increase over time.

Figure 5
Disaggregated Subindexes for the Quality Measure of Financial Development
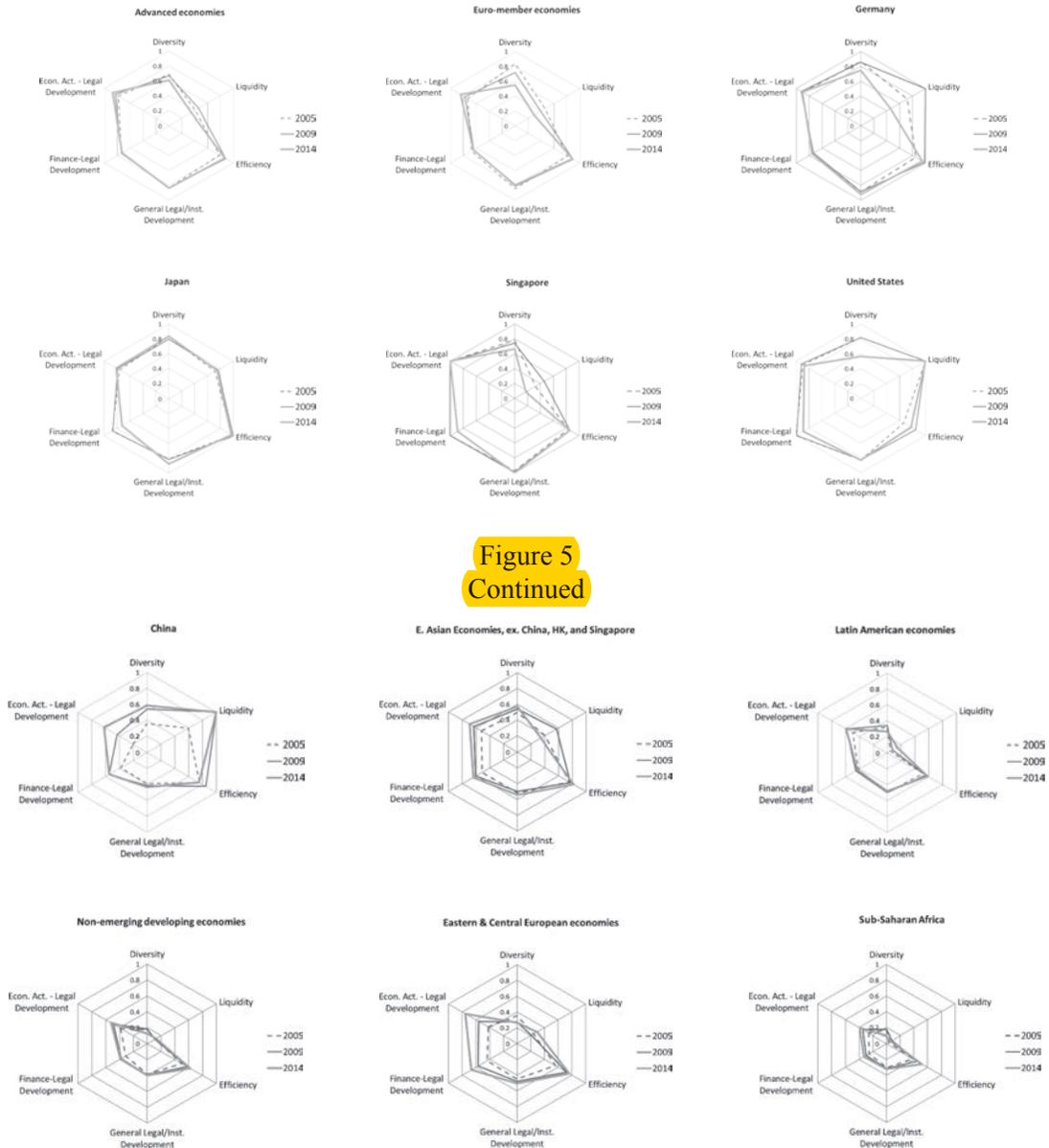
Figure 5
Continued

have more bank-dominant financial systems and that their financial markets tend to face tight regulatory controls, leading to less efficiency in the markets. Such economies would have less active capital markets and lower turnover ratios as seen in our measure of market liquidity.

Fourth, Japan and the United States stand out as economies with relatively well-balanced achievements in all subcomponents for the quality of financial development. Germa-

ny and Singapore also score well in most of the subcomponents except for liquidity levels, which fell significantly in the post-GFC period.

Last, the evolution among the different subcomponents of the quality of financial development in China is interesting. In the period from 2005 to 2014, the level of legal and institutional development was unchanged, while the levels of legal development related to general economic activities or financial activities were rising quite rapidly. The latter improvements reflect the government's efforts to create an environment friendly toward economic and financial activities. The levels of financial market diversity and liquidity rose rapidly as well. The level of liquidity is the highest in scale among all the economies, reflecting the active capital market development in China. However, the level of diversity remains low in comparison to advanced economies. For the quality of financial development in China to become like that of advanced economies, there is still much room for further improvement, especially in legal and institutional development and financial market diversity.

IV. Implications of Financial Development for Macroeconomic Performance

Now that we have constructed both the quantity and quality measures of financial development, we revisit the fundamental question regarding the impact of financial development on key macroeconomic variables. In other words, how does financial development, whether in terms of quality or quantity, affect macroeconomic conditions such as output growth, output volatility, and inflation? What is the impact of financial development on financial market openness and what is the relationship between financial openness and macroeconomic performance?

IV-1.   *Financial development and macroeconomic performance*

Financial development may lead to output growth paving the way for greater financial resource mobilization and/or more efficient resource allocation, by mitigating information asymmetry, smoothing exchanges of goods and services through reduced transaction costs, and enhancing and/or supplementing domestic savings. Better functioning financial markets may also allow economic agents to benefit more from the pursuit of sophisticated financial transactions, risk-sharing and portfolio diversification. These growth-enhancing effects will likely lead to output growth through more efficient financial intermediation, smoother capital accumulation and higher total factor productivity growth.

Financial development may also lead to macroeconomic stability. With the efficient allocation of financial resources and the mitigation of information asymmetry, the volatility of output growth tends to decline and inflation tends to become low and stable.

With both quantity and quality measures of financial development, we may be able to add more nuance to the discussions on the nexus between financial development and economic growth and stability.

*Financial development and output growth, growth volatility and inflation*

Figure 6 illustrates the impact of financial development on output growth. The upper panels plot the relationship between the quantity measure of financial development and output growth, i.e., the growth rate of real per capita GDP.[15] The left-hand panel is for the subgroup of advanced economies while the right-hand one is for the subgroup of emerging and developing economies. The lower panels plot the relationship between the quality measure of financial development and output growth. For the quantity measure of financial development, we use "*Fin_quantity2*," whereas for the quality measure we use "*Fin_quality2*."

The left-hand panels of Figure 6 show that, for advanced economies, higher levels of financial development tend to be statistically significantly associated with *lower* levels of per capita output GDP growth, whether financial development is measured by either quantity or quality. In contrast, the right-hand panels show that, for emerging and developing economies, there is no statistically significant association between financial development and per

Figure 6
Correlation between Financial Development and Output Growth - Quantity vs. Quality Measures
6.A: Quantity Measure of Financial Development
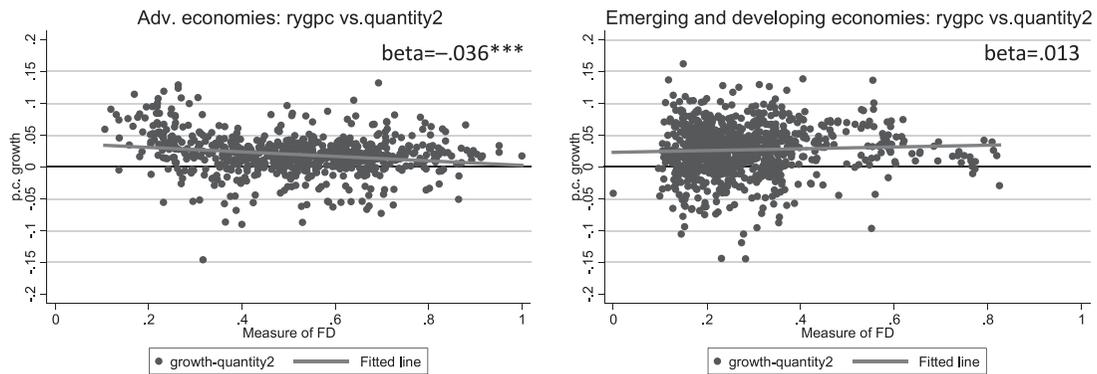

6.B: Quality Measure of Financial Development

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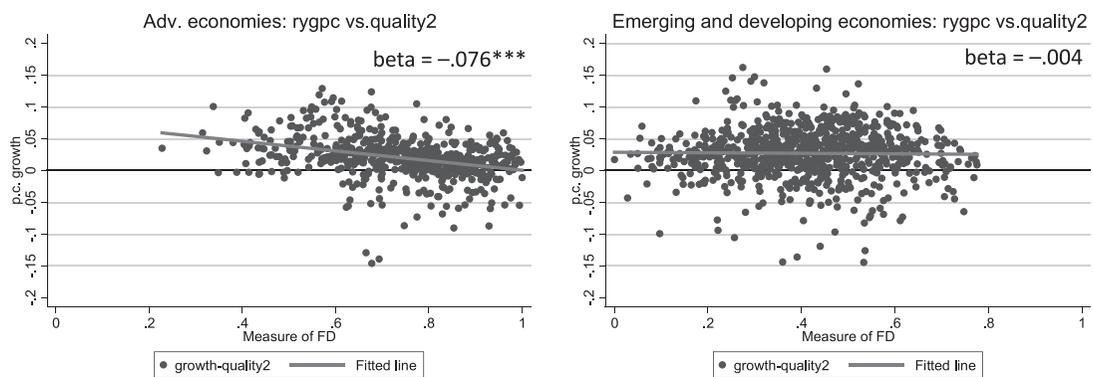
[15] To prevent outliers from dominating the results, we removed the outlying observations for output growth rates which are above the 99th percentile or below the 1st percentile.

capita GDP growth. The results for advanced economies are somewhat puzzling, but can be explained in three ways. First, the results are consistent with the finding of Arcand, et al. (2015) that economies with highly developed financial markets, in terms of quantity, tend to experience lower growth. Second, the quality measure of financial development, i.e., *Fin_quality2*, may reflect income levels, that is, the international convergence theory predicts that GDP growth tends to be lower for economies with higher levels of income and thus higher levels of *Fin_quality2*. Third, the results may be due to missing variables, which we will look into later.

Figure 7 suggests the impact of financial development on the volatility of output growth. Output growth volatility is measured by ten-year rolling standard deviations of per capita GDP growth rates.[16] Interestingly, financial development in terms of quantity is significantly and negatively correlated with output volatility for both advanced and emerging/developing economies. Thus, financial depth has an output-stabilizing effect. However, financial development measured by quality appears to be statistically significantly and negatively associat-

Figure 7
Correlation between Financial Development and Output Volatility - Quantity vs. Quality Measures
7.A: Quantity Measure of Financial Development
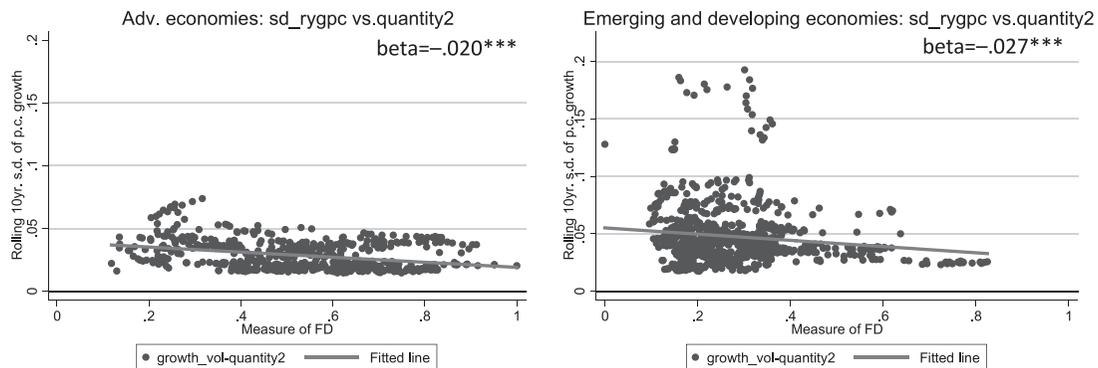
7.B: Quality Measure of Financial Development

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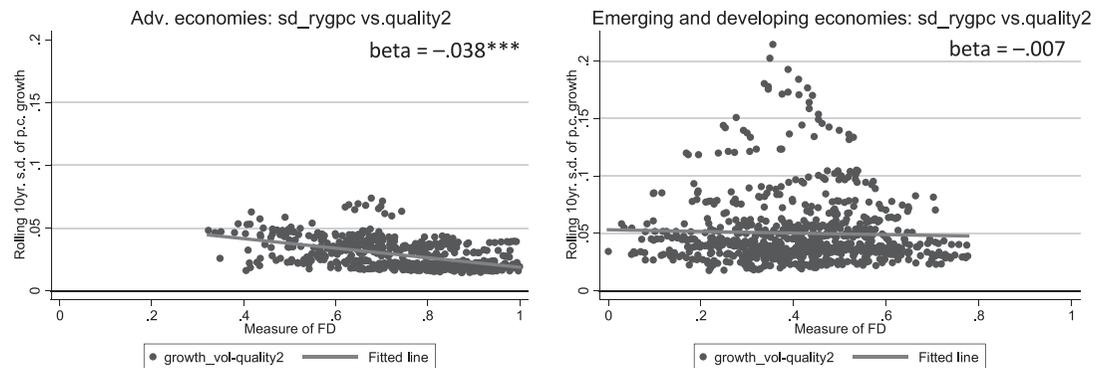
[16] The outliers above the 99th percentile or below the 1st percentile were removed.

ed with output growth volatility for advanced economies only.

Figure 8 illustrates the impact of financial development on inflation. The panels show that economies with more developed financial markets, whether measured by quantity or quality, tend to have lower inflation rates.[17] Interestingly, the estimated correlation coefficients between financial development and inflation are larger for emerging and developing economies than for advanced economies. Also, the estimates are larger when financial development is measured by quantity.

Quantity-quality interactions and macroeconomic performance

Thus far, we have obtained some evidence that greater financial development, measured by both quantity and quality, tends to be associated with lower GDP growth volatility and lower inflation. However, we have also obtained the puzzling result that greater financial development tends to be associated with lower GDP growth, particularly for advanced econo-

Figure 8
Correlation between Financial Development and Inflation - Quantity vs. Quality Measures
8.A: Quantity Measure of Financial Development
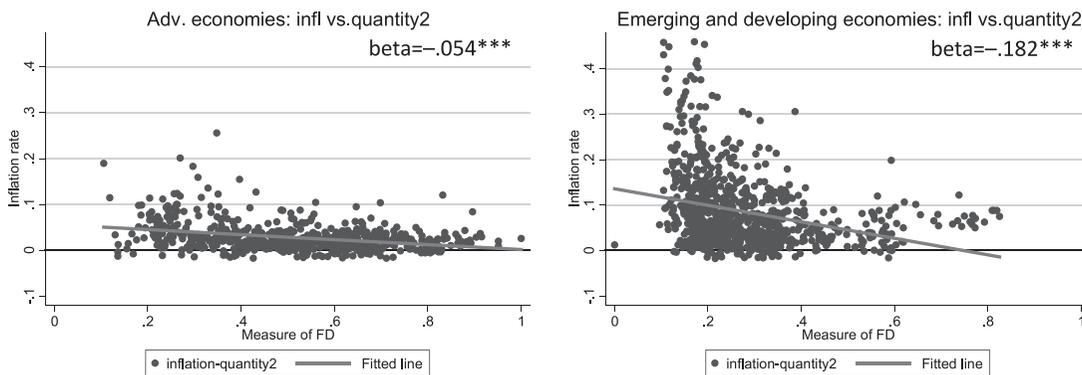
8.B: Quality Measure of Financial Development

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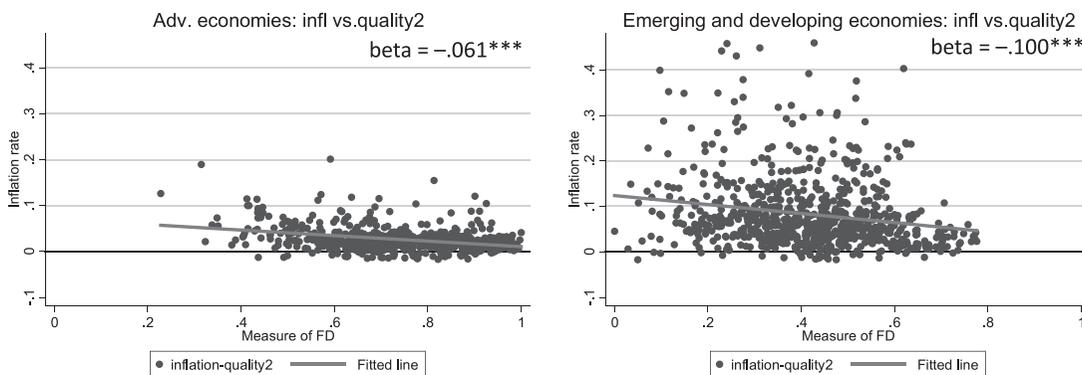
[17] The inflation rate is measured by the annual growth rate of GDP deflators. Outliers, above the 95th percentile or below the 5th percentile, were removed from the sample.

mies (while the association is not statistically significant for emerging and developing economies). Earlier, we have seen that the quantity and quality measures of financial development are correlated with one another, although the degree of correlation varies among countries, regions, and income levels. One natural question that arises is whether or not the quantity and quality measures of financial development have any interactive associations with macroeconomic conditions. For example, economies with higher quantity measures of financial development may face better macroeconomic conditions if they also have higher quality measures of financial development.

In Figure 9, we examine whether or not such an interaction between the quantity and quality measures of financial development (FD) exists. We first divide the sample into two subsamples of "high FD quality" and "low FD quality," depending on whether the quality measure of financial development is above or below the full-sample medium. Then, we examine the correlation between the quantity measure of financial development and such variables as GDP growth, GDP growth volatility, and the inflation rate for emerging and developing economies only.

Interestingly, the upper panels of Figure 9 show that the quantity measure of financial development is positively correlated with the per capita GDP growth rate for both high- and low-FD-quality countries, but that the positive correlation is statistically significant only for the subsample of high-FD-quality economies. This suggests that economies with more developed financial markets in terms of quantity (or financial depth) tend to have higher rates of economic growth, but only when their financial markets are developed in terms of quality.

Similarly, the middle and lower panels show that economies with more developed financial markets in terms of quantity tend to have lower GDP growth volatility and inflation rates only when their financial markets are also developed in terms of quality.

When the GDP growth rate is regressed against either the quantity or quality measure of financial development *alone*, we only identify a *negative* effect on output growth, which is puzzling. However, when the GDP growth rate is regressed against the quantity measure of financial development for the subsample of economies with high FD-quality, we identify a *positive* effect on GDP growth. Similarly when GDP growth volatility and the inflation are regressed against the quantity measure of financial development for the same subsample economies, we observe negative effects on GDP growth volatility and inflation. These results are consistent with Beck, et al. (2014) who find that financial intermediation activities increase growth and reduce volatility in the long run.

IV-2. *Financial development, financial openness and macroeconomic performance*

Thus far we have focused on the effect of financial development on macroeconomic performance. While most economies have seen financial market development as a trend over recent decades, they have also opened their financial markets to the rest of the world. In short, the world has been experiencing greater financial globalization.

Figure 9
Interactive Effects on Output Growth
9.A: Quantity Measure of Financial Development and Output Growth
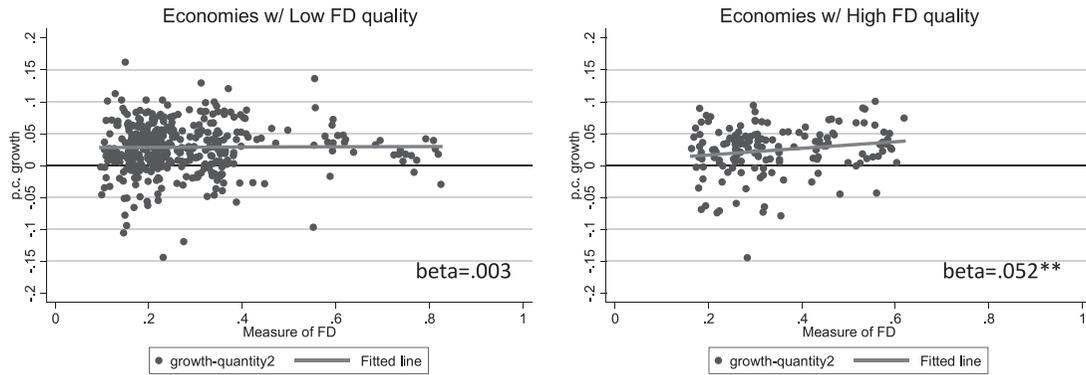
9.B: Quantity Measure of Financial Development and Output Growth Volatility
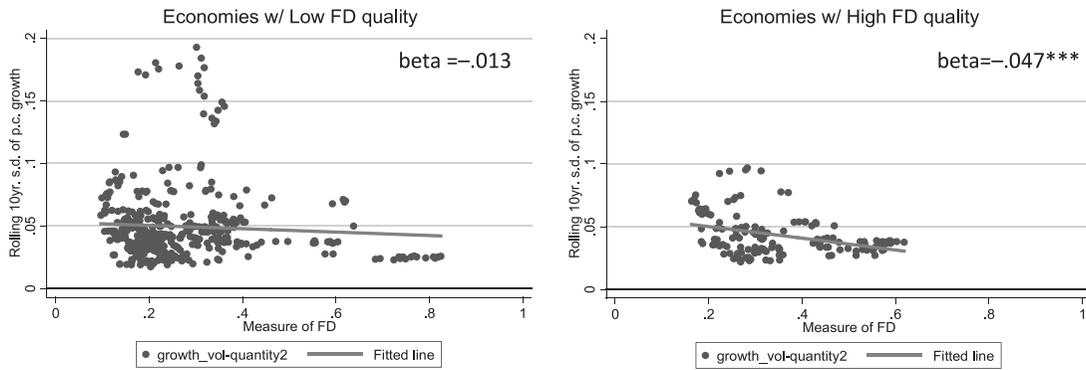
Figure 9
Continued

9.C: Quantity Measure of Financial Development and Inflation
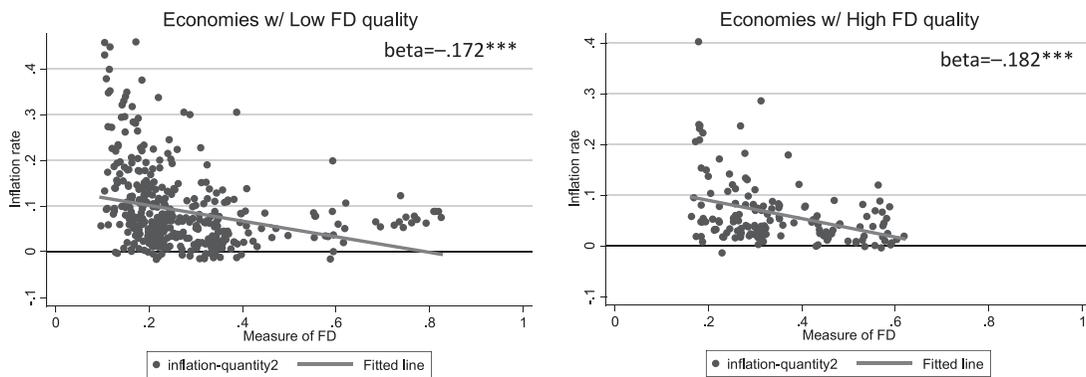
In fact, financial globalization is one of the most contentious and hotly-debated issues in recent years. The reason for this is that, like financial development, pursing financial openness is a double-edged sword. That is, while it can foster and stabilize output growth through supplementing and smoothing consumption and capital accumulation, financial globalization can also be destabilizing by exposing economies to volatile cross-border capital flows that can involve sudden stops or reversals of capital flows. Since Quinn (1997) found a positive link between financial liberalization and output growth, the effect of financial openness on growth has been actively debated in the literature.[18]

We examine the relationship between financial openness and macroeconomic performance as we did with financial development in the previous subsection. However, before examining this, we first consider whether and how financial development is correlated with financial openness. In our context, we are not just interested in the correlation between the two, but also interested in investigating whether and how the correlation varies depending on whether we look at the quantity or quality aspect of financial development.

We define the degree of financial openness as the sum of the total external assets and external liabilities divided by GDP. The data on total external assets and liabilities are obtained from the dataset on international investment positions developed by Lane and Milesi-Ferretti (2001, 2007, and 2017). However, the ratio of the sum of total external assets and liabilities to GDP can be very high, especially for economies with global financial centers (e.g., Hong Kong, Ireland, and Singapore). Therefore, we winsorize this ratio at the 10th and 90th percentiles (with both percentiles being calculated from a sample excluding all the financial-center economies), and normalize the ratio using the formula shown in Equation (1).[19]

Financial development and financial openness

Figure 10 illustrates the correlation between financial development and financial openness for advanced economies (left-hand panels) and emerging and developing economies (right-hand panels). In the upper panels, we measure financial development in terms of quantity, whereas in the lower panels we measure financial development in terms of quality. As in the previous section, for the measure of financial development we use *Fin_quantity2* and *Fin_quality2*. The measure of financial openness is denoted as *Fin_openness*.

In Figure 10 we observe that financial development is positively correlated with financial openness for both advanced and emerging and developing economies, whether we use either the quantity or quality measure of financial development. Interestingly, the estimated coefficient is greater when financial development is measured by quality rather than by quantity.[20] This observation suggests that while more developed financial markets in terms

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[18] For a review of the empirical literature pertaining to the effects of financial liberalization, refer to Edison, et al. (2004), Prasad, et al. (2003), Henry (2006), Kose, et al. (2006), and Prasad and Rajan (2008).

[19] The definition of financial centers follows that of Lane and Milesi-Ferretti (2017). They are: the Bahamas, Bahrain, Belgium, Cyprus, Hong Kong, Ireland, Luxembourg, the Netherlands, Panama, San Marino, Singapore, Switzerland, and the United Kingdom.

[20] Both the estimated coefficients and the fitted lines in the figure are based on the respective samples that *exclude* the observations of financial-center countries.

Figure 10
Correlation between Financial Development and Financial Openness - Quantity vs. Quality Measures
10.A: Quantity Measure of Financial Development and Financial Openness
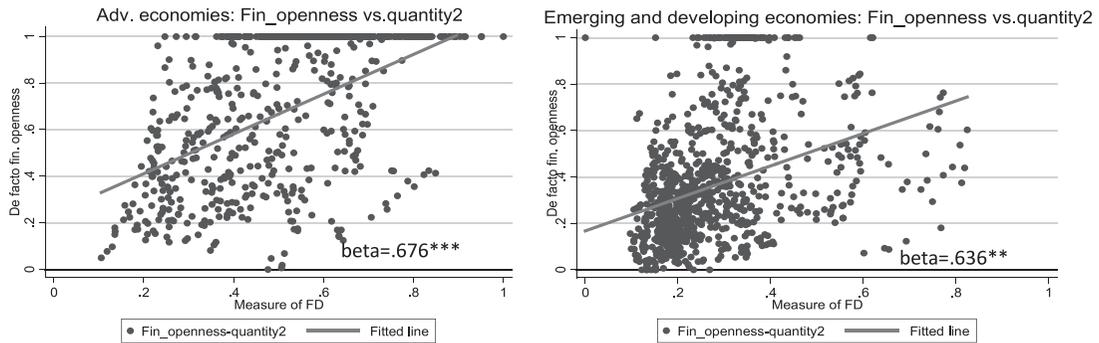
10.B: Quality Measure of Financial Development and Financial Openness
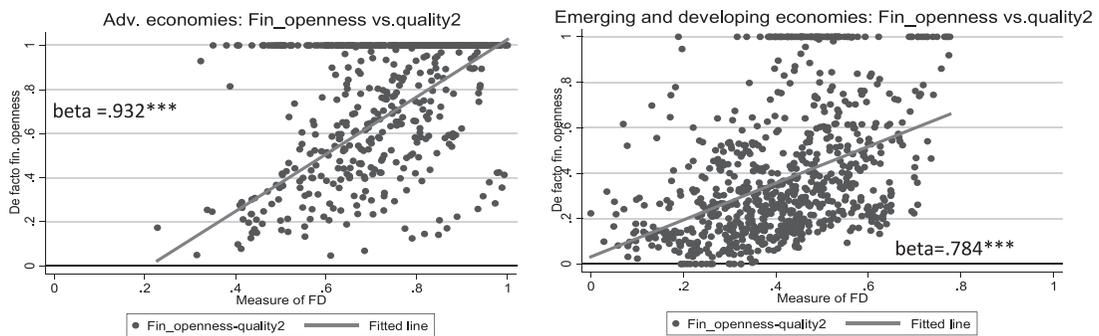
of both quantity and quality can lead to further financial openness, the quality measure of financial markets is more important.

Financial openness and macroeconomic performance

We now examine whether and how financial openness is correlated with macroeconomic performance, such as output growth, growth volatility and inflation rates. As in the previous analysis, we are interested in the interactive effect, albeit this time between financial openness and the *quality* of financial development. Several authors find that the effect of financial openness on macroeconomic performance depends on whether other third factors meet thresholds. For example, Kose, et al. (2011) find the effect of financial openness on output growth to be positive only when a financial or institutional variable meets a certain threshold.[21]

Here, we investigate whether and how financial openness is correlated with output growth, output growth volatility, and inflation, conditional upon whether the level of quality in financial development is high or low. Our prior expectation is that if an economy has a fi-

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[21] Refer to Kose, et al. (2011) for a comprehensive review of the literature on "threshold analyses."

nancial market with higher quality, its financial openness results in better macroeconomic performance, i.e., higher output growth, lower output growth volatility, and lower inflation.

Figure 11 plots the measure of each macroeconomic variable against the degree of financial openness for emerging and developing economies with low and high FD-quality. The upper panels of Figure 11 show that for emerging and developing economies with low FD-quality, financial openness and GDP growth are significantly *negatively* correlated with one another.[22] The negative correlation, however, is not statistically significant for economies with high FD-quality. The middle panels of the figure show that financial openness is *positively* and statistically significantly correlated with GDP growth volatility for emerging and developing economies with low FD-quality, while this correlation is negative, though not statistically significant, for economies with high FD-quality. Finally, the lower panels of Figure 11 show that financial openness is significantly *negatively* correlated with inflation whether the economy's financial market has high or low FD-quality. However, the magnitude of the absolute value of the estimated correlation coefficient is larger for the subsample of economies with high FD-quality.

These findings suggest that financial openness may introduce disturbance to emerging and developing economies by exposing them to volatile cross-border capital flows when the quality of financial development is low, although it tends to have dampening effects on inflation. For emerging and developing economies with low-FD quality, both the negative correlation between financial openness and output growth and the positive correlation between financial openness and growth volatility are statistically significant, while for economies with high-FD quality they become statistically insignificant. The correlation between financial openness and inflation is generally negative and the negative correlation is greater in absolute value for economies with high-FD quality than for those with low-FD quality. Thus financial openness tends to encounter low and unstable economic growth if emerging and developing economies have not achieved a high degree of quality in financial development.

V. Concluding Remarks

Researchers usually resort to a quantity measure of financial development such as private credit creation by banks as a share of GDP to assess the extent of financial market development. While the data availability of such a measure is high, it often fails to capture the nuances and subtleties of the development of financial markets. Such a bank-based measure also fails to capture the development of other types of financial markets such as equity, bond, and insurance markets. At the same time, more importantly, a quantity measure cannot capture the quality aspects of financial development, such as the diversity (breadth), efficiency and liquidity of the financial market and the institutional environment surrounding the financial markets.

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[22] Again, the fitted lines and regression estimations are illustrated for sample economies without observations for financial-center countries.

Figure 11
Interactive Effects of Financial Openness and FD Quality on Macroeconomic Performance
11.A: Financial Openness and Output Growth

Economies w/ Low FD quality　　　　　　　Economies w/ High FD quality

beta=−.026***　　　　　　　beta=−.017

11.B: Financial Openness and Output Growth Volatility

Economies w/ Low FD quality　　　　　　　Economies w/ High FD quality

beta =.057***　　　　　　　beta=−.008
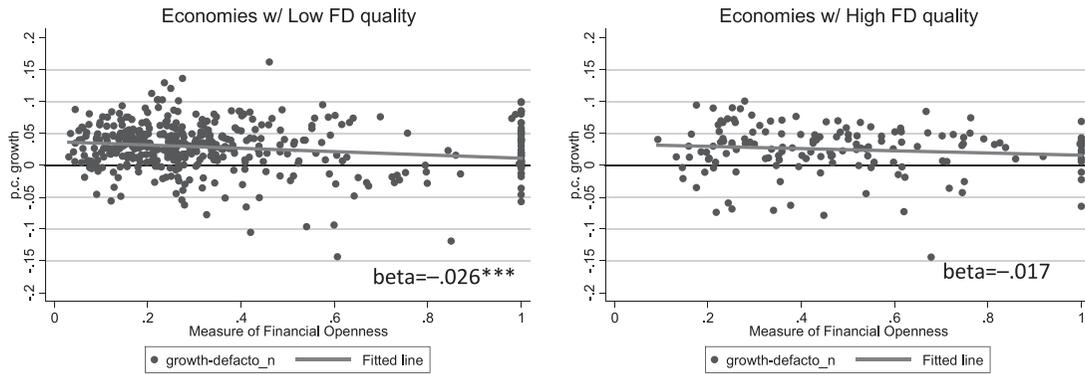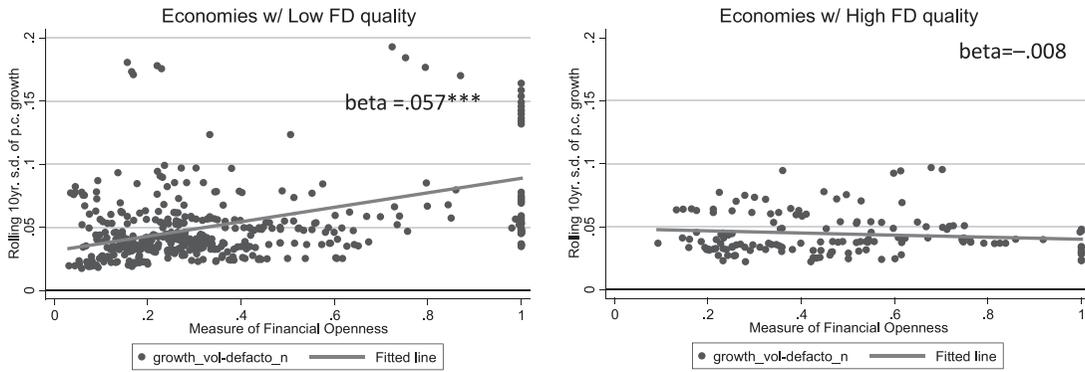
Figure 11
Continued
11.C: Financial Openness and Inflation

Economies w/ Low FD quality　　　　　　　Economies w/ High FD quality

beta=−.048**　　　　　　　beta=−.077***
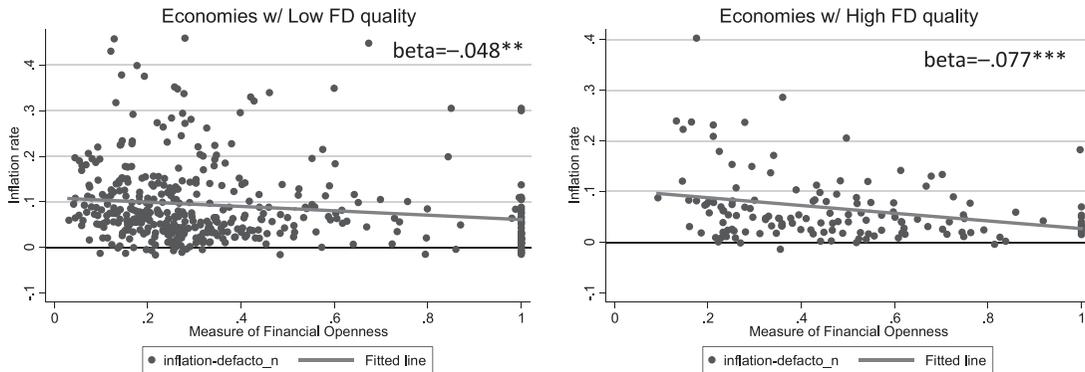
Note: Sample economies are emerging and developing economies.

In this paper, we constructed indexes that capture the quantity and quality aspects of financial market development. For the quantity measure, we constructed a composite index with multiple variables that captured the size and depth of different types of financial markets such as banking, stock, bond, and insurance markets. For the quality measure, we created a composite index that reflected the degrees of market diversity (breadth), liquidity, and efficiency, as well as the institutional environment. The last factor captures the extent of legal and institutional development, human capital development, and information and telecommunications infrastructure development.

We show that the quantity and quality measures of financial development can present more subtlety and nuance in terms of both cross-country and time-series variations than what could be captured by private credit as a share of GDP. We also find that the quantity and quality measures of financial development are highly correlated with each other for advanced economies and Asian emerging economies, while that is not the case for many of the other emerging and developing economies.

When we disaggregated the components of the quality measure of financial development, we saw that it is the level of legal and institutional development which differentiates advanced economies from emerging and developing economies in their quality measures of financial development. Since legal and institutional development evolves only slowly, it is difficult for emerging and developing economies to rapidly build high-quality financial markets resembling those in advanced economies. This observation applies to China, which, despite recent rapid improvements, still needs to strengthen its legal and institutional environment to become comparable to advanced economies in the quality of its financial development. Compared to advanced economies with highly-developed financial markets in terms of quality, such as Japan and the United States, emerging and developing economies tend to have low levels of financial diversity, liquidity, and efficiency. This has to be due to past, or current, government interventionist policies, which are usually oriented toward heavily bank-dependent financial development.

Our simple regression analysis finds that the interaction between the higher quantity and higher quality measures of financial development can lead to better macroeconomic outcomes. More specifically, we find that the quantity measure of financial development has a *positive* effect on output growth and negative effects on output volatility and inflation only when the sample is restricted to emerging and developing economies with higher quality measures of financial development.

We also find that while both the quantity and quality measures of financial development are positively correlated with levels of financial openness, the magnitude of the correlation is greater when we focus on the quality, rather than the quantity, aspect of financial development. Furthermore, emerging and developing economies with low quality measures of financial development tend to face more challenging macroeconomic conditions, i.e., lower economic growth and higher growth volatility, by achieving greater financial openness. With a higher level of quality in financial development, however, the undesirable impacts of financial openness can be mitigated.

Our simple exercise suggests the complexity of identifying the growth-enhancing effect of financial development. It would be more appropriate if we run a growth regression model to identify the interactive effects between the quality and quantity measures of financial development, or between financial development and financial openness, while controlling for other possible factors that may affect output growth. We shall save this for our future research agenda, however.

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