Financial Integration and Economic Growth: The Case of the GCC Countries (1981-2019)

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ARTICLE INFORMATION

Original Research Paper
Received:13/11/2021
Accepted:02/02/2022
Published:21/03/2022

Keywords:
Keyword.1: Financial integration
Keyword.2: Economic growth
Keyword.3: GCC countries
Keyword.4: Panel data
Keyword.5: Financial sector
JEL Clkassification Codes: F36, F43

Abstract :

There no consensus on the relationship between financial integration and economic growth. Studies of this nexus have shown underwhelming results. In one hand, some of the studies have indicated that the liberalization of the capital account have been positive for the economical growth; and in the other hand, other studies results were not conclusive. Thus the main objective of this work is to examine, theoretically and empirically, the character of the link between financial integration and economic growth by using panel data from 1981-2019 period. In the following studies; we will focus on gulf counties(Bahrain, Kuwait, Qatar, Oman, Saudi Arabia and united Arab emirates). The results of the study show a positive and significant link between the financial integration and the economic growth in these counties under some financial, macroeconomic and institutional condition.

Mots clés:
Mot clé.1: Intégration Financière
Mot clé.2: Croissance Economique
Mot clé.3: pays du golfe
Mot clé.4: l'économétrie des données de panel
Mot clé.5: Secteur financier

Codes de classification JEL: F36, F43

Résumé :

Il n'y a pas de consensus sur la relation entre intégration et croissance économique. Les études de cette relation ont montré des résultats décevants. D'une part, certaines études ont indiqué que la libéralisation du compte de capitale a été positive pour la croissance de ce travail est d'examiner, théoriquement et empiriquement, le caractère du lien entre intégration financière et croissance économique en utilisant des données de panel des périodes 1981-2019 . Dans les études suivantes, nous nous concentrerons sur les pays du golfe (Bahreïn, Koweït, Qatar, Oman, Arabie saoudite et émirats arabes unis). Les résultats de l'étude montrent un lien positif et significatif entre l'intégration financière et la croissance économique dans ces pays dans certaines conditions financières, macroéconomiques et institutionnelles.

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Introduction :

The last two decades have seen profound financial changes. Indeed, the industrialized countries followed by a set of emerging and developing countries liberalized their capital accounts during these years. This phenomenon can be explained by the fact that financial openness was seen by these countries as being beneficial for countries receiving foreign capital.

In the economic sense of the term, integration refers to either a process or a result. As a process, financial integration is a set of measures intended to gradually eliminate discrimination between economic units in different countries. As a result, financial integration should lead to the disappearance of national capital markets and the formation of a global financial market.

Economic theory suggests that financial integration can promote more efficient allocation of resources, facilitate risk diversification, increase production specialization, contribute to financial system development, improve investment rates and stimulate growth.

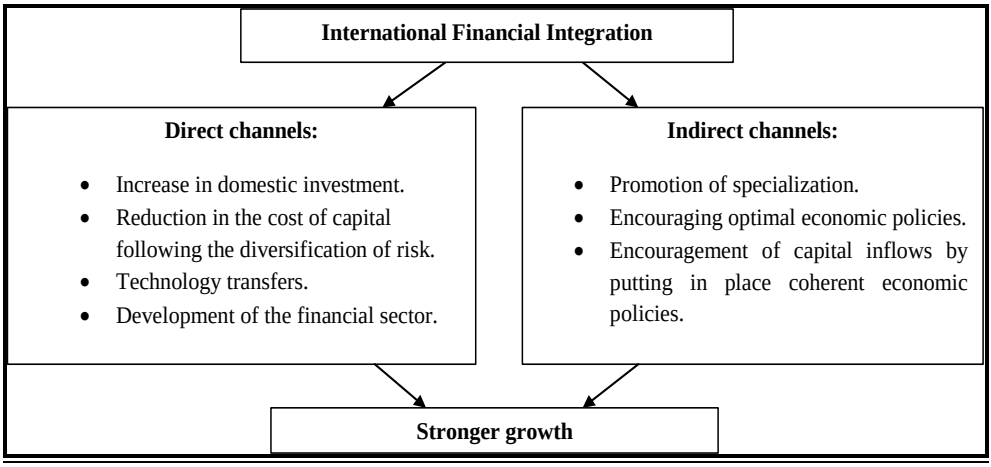
Authors such as S. Fischer (1998), M. Obsfeld and K. Rogoff (1998), L. Summers (2000), B. Eichengreen (2001) argue that financial integration can be beneficial and can positively affect (directly or indirectly) economic performance in countries receiving foreign capital. However, other authors like D. Rodrik (1998), J. Bhaghwati (1998), J. Stiglitz (2002) consider that financial openness, in some cases, can be very dangerous, in fact, these authors consider the liberalization and financial integration as one of the causes of crises.

Faced with these limitations of the literature, it seemed interesting to us to analyze this relationship in depth. In fact, the aim of this work is to highlight the nature of the link between financial integration and economic growth. More specifically, this work attempts to examine the effect of financial integration on economic growth, and this, in the case of the Gulf countries. To answer this problem, our work will be divided as follows: The first section identifies the channels of transmission of the effects of integration financial support on economic growth. The second section presents a review of the empirical literature related to the subject. The third section is devoted to the empirical analysis of the relationship between financial integration and growth in these countries.

1-Financial integration and economic growth: the transmission channels

Economic theory generally assigns an important role for integration financial in the growth of countries. Indeed, theoretical models have identified a number of channels through which international financial

integration can help promote economic growth in developing and transition countries. The following diagram presents a schematic summary of these possible channels.



Source : E. Prasad et al (2003).

1-1 direct channels:

Theoretically, financial integration can contribute to economic growth through the following direct channels:

Increase in domestic investment: theoretically, financial integration should be accompanied by a disconnection between savings and domestic investment. In fact, with financial openness, domestic savings can be invested abroad and should flow to the regions of the world that offer the best returns, and conversely, domestic investment can be financed by foreign savings. . Indeed, this transfer of capital flows between developed countries and developing and / or transition countries allows these countries to achieve higher levels of well-being and stronger growth.

Reduction in the cost of capital as a result of risk diversification: Theoretical models claim that increasing the possibilities of risk sharing between resident and foreign investors can promote risk diversification. This possibility of diversification in turn encourages companies to increase their total investment, thereby enhancing growth. As capital flows increase, the stock market becomes more liquid, which could further reduce the risk premium, thus lowering the cost of raising capital for investment.

Technology transfers: Access to technology is another channel through which opening the capital account can have a favorable impact on growth. Financially integrated countries seem to attract an "astronomical" share of FDI flows. This type of capital is likely to lead to technology transfers, transfers of know-how and best management practices.

Financial Sector Development: According to a large body of work, international financial flows serve as a catalyst for the development of the local financial market. Indeed, international portfolio investment flows can make domestic stock markets more liquid, and increased foreign participation in local banks can in turn provide significant benefits: it can facilitate access to international capital markets. and, in addition, can introduce a variety of new financial instruments and techniques, in addition, the entry of foreign banks tends to increase competition

Indirect channels:

Financial integration can have important indirect benefits for economic growth in three areas:

Promotion of specialization: The argument that specialization in the production structure increases productivity and economic growth is intuitive. However, in the absence of any risk management mechanism, a highly specialized production structure could cause high instability in production and, as a result, high volatility in consumption this risk of increased instability may deter countries from undertaking specialization activities beneficial to growth. According to economic theory, by helping countries to exercise international risk sharing, financial integration could thereby decrease the volatility of consumption in countries. Specifically, risk sharing at the international level would directly encourage specialization which, itself, would increase the rate of growth.

The incentive for better economic policies: A major benefit of financial integration is that it somehow obliges governments to engage in credible macroeconomic policies. Indeed, the discipline imposed by financial integration could alter the dynamics of a country's national investment to the extent that it leads to a more efficient allocation of capital. In other words, a reallocation of capital to more productive sectors in response to changes in macroeconomic policies.

Encouraging capital inflows: The removal of restrictions on capital movements may cause an increase in capital inflows and, therefore, an increase in the level of investment in the country. L. Bartolini and A. Drazen (1997) indicate that the removal of restrictions on capital movements can, by its signaling effect, cause an increase in capital inflows and, therefore, an increase in the level of investment in the country. is necessary for GDP growth.

2. Financial integration and economic growth: empirical evidence

Empirically, while analyzes of the costs associated with liberalizing capital movements are scarce, there is a significant body of work that examines its potential benefits and influence on long-term growth and

development. In other words, some studies point to a positive effect of financial integration on economic growth while there is other work that does not support this proposition.

We will successively present a brief review of the empirical literature, starting with the studies that have found a positive link between financial integration and economic growth, then we examine those that question this relationship.

Studies showing a positive link between financial integration and economic growth:

Quinn's study (1997) is one of the first to find a favorable link between financial integration and economic growth. The author added, in the regression of his growth equation, a new measure of the liberalization of the capital account which varies between 0 and 4. The results of D. Quinn's estimations indicate that the variation of the liberalization of the capital account has a significant effect on the growth of real GDP per capita, in a sample of 58 countries over the period between 1960 and 1989.

In their study **M. Klein and G. Olivei (1995/2006)** adopt a slightly different method compared to other work done in this field. They first look at the role of financial integration on financial development and then analyze the impact of this development on economic growth. For a sample of 80 developed and developing countries over the period 1986 - 1995, the liberalization indicator used is "Share", the authors observe that the liberalization of capital movements positively affects financial development, as far as the economy is concerned. effect of financial integration on economic growth, they conclude that the liberalization of capital movements has a beneficial effect on economic growth, but only for industrialized countries.

The study by **M. Schularick and T. Steger (2007)** assesses the impact of financial integration on economic growth using historical data (1880 - 1914) for 24 developed and developing countries, and then compares the results to the results obtained for the period (1980 - 2002) for a sample of 54 developed and developing countries. for the period (1880 - 1914) the authors use UK capital inflows (as a percentage of GDP) as an indicator of the financial integration of an individual country, and for the period (1980 - 2002) they have used the FDI / GDP and IPI / GDP ratios. The results suggest that international financial integration promotes economic growth significantly in the historical period, but this is not the case for the recent period. According to the authors, among the possible explanations for these ambiguous results is the difference in the composition of capital flows, as well as the differences in the institutional and legal framework of the overall financial market during these two eras.

More recently**, J. Butkiewicz and H. Yanikkaya (2008)** show that the full opening of the capital account positively and significantly affects economic growth in developed countries. In contrast, in the case of developing countries, the results show that financial openness has no effect on growth. Like S. Edwards (2001), the authors underline that the effects on growth depend on the economic development of countries and, on their capacity to attract long-term capital flows (in particular FDI), and they put forward the importance of the "quality" of human capital. In their study, the authors used data for one hundred and fourteen developed and developing countries (excluding transition countries from their sample and considering them as oil-exporting countries) and the period from 1970 to 1997. .

In his study **Honig (2008)** also shows a significant effect of the liberalization of the capital account on economic growth, and this, using a variety of indicators to measure financial integration such as (the IMF indicator, de Quinn, de Chinn and ito, the measurement of capital flows and those of capital inflows) and for a sample of 122 countries over a period from 1970 to 2005.

The aim of **Mougani's (2012)** study is to provide an empirical analysis of some effects of financial integration on economic activity and macroeconomic volatility. For the case of African countries and for the period 1976 to 2009, the author concludes that the effect of external capital flows on growth seems to depend mainly on the initial conditions and the policies implemented to stabilize foreign investments. , increase domestic investment, financial system development and other measures aimed at stimulating growth and reducing poverty.

Arin et al (2020) found that there are significant spillover effectsfrom the largest market of Saudi Arabia to Qatar and the two markets in the UAE, which confirms that market capitalization is a more important determinant of financial integration than belonging to a federal union. Moover, spillovers from the larger markets have become stronger as a result of the 2014 oil crisis. Finally, there is also evidence of spillovers from the smaller to the larger markets.

Studies questioning the negative effects of financial integration on economic growth:

Among the earliest empirical studies to demonstrate the lack of a relationship between financial integration and economic growth is that of **V. Grilli and G, M. Millessi Ferretti (1995).** These authors worked on a sample of 61 countries, and for the period from 1966 to 1989. They found negative results in the relationship between financial integration and economic growth.

In his study **Kraay (1998)**, uses several indicators of financial integration (notably Share, the Quinn indicator and an indicator based on real net capital flows). Kraay's study concerns a variable sample of countries (64, 94 and 117) each of whose indicators is associated with a sample of different size, and that during the period 1985 - 1997, the dependent variable is GDP growth. The author also concludes that there is no significant relationship between financial integration and economic growth.

The study by **H. Edisson, R.Levine, L.Ricci and T.Slok 2002** "International Financial Integration and Economic Growth" examines the impact of financial integration on economic growth, and also assesses whether this relationship depends on the level of economic and financial development, legal system, level of corruption and macroeconomic policies. Using a large selection of measures of international financial integration on 57 developed and developing countries during the period 1980 - 2000. The results of this study do not support the idea that financial integration accelerates economic growth, even when using control variables such as (variables of economic development, financial and macroeconomic policies…).

In his article **Xuan Vinh Vo (2005)** studies the link between financial integration and economic growth, using a sample of 79 developed and developing countries with data covering the period 1980 - 2003. The main results of this study indicate a weak and fragile link between international financial integration and economic growth, the author specifies that this result should not be interpreted in a way that financial integration is not associated with economic growth, but rather, that this relationship is not robust. He also finds that this link is not significantly different under different economic, political and institutional conditions.

Benbouziane and Benamar (2010), found that the GCC countries are still far away from an OCA. The success of such a union is conditional on a lot of measures including the removal of domestic and cross-border distortions that are regarded as a hamper to trade and foreign investments, the coordination of national policies that ensure macroeconomic stability, the deepening of regional integration, the development of the nonoil economy, and realization of a large degree of political integration.

The interest of the study by **Abdullahi D. Ahmed (2011)** is to analyze a certain number of measures of financial integration on economic performance by choosing a sample of 25 countries of Sub-Saharan Africa over the period 1976 -2008. The results of the study show a weak link between financial openness and economic growth in this region. This work also studies the effect of international financial integration within the framework of different national policies and economic environments, the results indicate that good institutions, a high level of human capital and a

stable macroeconomic environment participate in the mitigation of the effects. negative effects of the liberalization of capital movements.

The various empirical works have revealed a disparate nature of the results. In fact, the very heterogeneous nature of the results can probably be explained by the differences between the studies. Indeed, the sample of countries studied varies according to the studies, with some authors focusing their analysis on industrialized countries, others on developing countries, and still others on a composite group of countries. In addition, the observation periods are different, which may be particularly important for developing countries, given that capital account liberalization is a recent phenomenon for a number of them. The empirical method applied (cross-sectional data, time series or panel data) and the estimation technique such as OLS (Ordinary Least Square), IV (instrumental variables) or GMM (Generalized method of moments) differ from one analysis to another. Finally, the measure of financial integration (de facto or de jure) chosen by the authors, can also be at the origin of these divergent conclusions.

3- Financial integration and economic growth: an empirical analysis essay

The objective of this section is to estimate, from panel data, the impact of financial integration on economic growth in the Gulf countries, during the period 1981-2019. The advantage of estimations carried out on panel data compared to instantaneous cross-sectional estimations or from time series analysis is to take into account the temporal and individual dimensions of the data.

1 / description of the data:

The data used in our econometric analysis come mainly from: the databases "UNCTAD", "UNCTADstat", "Statistical, Economic and Social Research and Training center for Islamic countries (SESRIC)", "world development indicators", "The African Development Indicators, World Bank ", and" the World Economic Outlook Database (IMF), 2020 ",", "Open data for Africa Index of economic freedom, 2020" .

2 / The study methodology:

In this section, we will deal econometrically with the relationship between financial integration and economic growth. To do this, we will use the estimation methods on panel data. Indeed, there are several methods of estimating panel data, namely, an estimate by ordinary least squares; an estimate with fixed effects; or an estimate with random effects. Since the technique (OLS) can be biased if the inherent heterogeneity of countries is neglected, tests have shown that generally fixed or random effects models

provide a better fit. It is therefore necessary to know which model is the right one for our sample (fixed effect or random effect model). For this, we will proceed to an analysis of the Hausman specification test.

Hausman test: The Hausman test (1978) compares the estimators by the fixed-effects model with those obtained with the random-effects model. The divergence of the estimators indicates the presence of a correlation between the explanatory variables and the individual effects. This correlation is tested by the following hypothesis:

$$\begin{cases} H_0 : E(\propto_i / X_i) = 0 \\ H_1 : E(\propto_i / X_i) \neq 0 \end{cases}$$

H_0 indicates that the model can be specified with individual random effects and in this case the MCG estimator is used.

The alternative hypothesis H_1, indicates that the model must be specified with fixed individual effects and we then retain the Within estimator.

3 / specification of the econometric model:

We build our empirical approach based mainly on the work of H.J. Edison et al (2002), M. Schularick and T. Steger (2007), and A. Honig (2008).

The basic equation that will estimate the effect of financial integration on economic growth takes the following form:

$$Growth_{it} = \square + \beta \cdot IFit + \delta\, Xit + uit$$

The meaning of the variables used is as follows:

Growth: this is the dependent variable of our model, it is measured by the growth rate of real GDP per capita.

FI (financial integration): in order to analyze the effects of financial integration on economic growth in the Gulf countries, we have chosen to measure financial integration by the Lane and Milesi-Ferretti indicator. This indicator is measured by the sum of foreign assets and liabilities in relation to GDP. Theoretically, the level of financial integration should be positively correlated with the rate of economic growth. So the expected sign of this variable is positive.

X: represents the matrix of control variables. Indeed, the model is completed by a series of macroeconomic control variables usually introduced in this kind of estimate. It is :

Trade openness: we use the trade exchange rate to GDP to measure the degree of openness of the economy. This variable corresponds to the sum of exports and imports compared to GDP. The expected sign of the estimated coefficient is positive

The inflation rate (inf): is approximated by the annual rate of change of the consumer price index, this variable represents the macroeconomic policy of the country.We expect this variable to have a negative impact on the economic growth.

Credit granted to the private sector (% GDP) (dcps): this variable reflects the level of financial development of the country. In fact, the more developed the financial system, the higher the growth. The expected sign of this variable is positive.

Corruption (corr): this variable measures the degree of corruption within a political system. It reflects the level of institutional development of the country. According to Mauro (1995) corruption is harmful to growth. Indeed, corruption creates distortions in the economic and financial environment, reduces the efficiency of government and business. The expected sign of this variable is negative.

Uit: the error term.

4- Results of estimates and interpretations:

In this section, we present the results of the estimations of our growth equation. First, we carried out the Hausman test using the software EViews 10. The following table gives the main results of the Hausman test.

Table 01 : Hausman specification test

P-Value	(Chi-Square.Statistic) Test value
0.0000(*)	9095.349

(*)denotes the level of significance at the threshold of 5 %

Source : personal elaboration from the estimation results

According to the estimation results, the statistics of the Hausman test indicate that X^2 (6) = 9095.349 the *P-value* is lower than the 5% confidence level, therefore the estimates used, for the model of our study, will be those of the model with individual fixed effects.

Then we move on to the fixed effect model estimation which is written as follows:

$$Growth_{it} = \square + \mu_i + \beta \cdot IF_{it} + \delta X_{it} + u_{it}$$

where:

Growth : represents Economic Growth

IF : represents Financial Integration

X : represents the matrix of control variables
α, δ and β are parameters to estimate
μi = individual effect of the country.
uit = the error term.
The table below presents the estimation results of the fixed effect model :

Table 2: Results of the panel estimation with specific fixed effects

Depe,dant variable : growth in real GDP per capita (GDP)

Explanatory variables		Regression
Constant		2.49 (27.4129)
IF		5.23 (2.6762) ***
INF		-5.12 (-1.9230) **
DCPS		1.54 (2.4952) ***
CORR		-2.90 (-36.338) ***
OPEN		2.95 (6.085) ***
Number of observations		186
R- squared		0.9247
Adjusted R- squared		0.9240
Prob (F- statistic)		0.00000
Fixed Effect	Bahrain	-1.12E+11
	Kuwait	-4.52E+10
	Oman	-5.96E+10
	Qatar	-1.66E+10
	Saudi Arabia	1.60E+11

	United Arab Emirates	7.32E+10

Notes : t statistics are in parentheses. *** Significant at the threshold of 1% at most, **Significant at the threshold of 5% at most, and * significant at the threshold of 10% at most.

• The correlation coefficient (R-squared) is very strong (close to 1), which explains why the relationship between the explanatory variables and the endogenous variable is very strong;
• The value of the probability of the Fisher statistic is 0.0000, it means that the model is globally significant.

The results of the model show that:

"Financial integration appears with a positive and significant sign. This result supports the hypothesis that capital account liberalization stimulates economic growth, and is in line with the work of Quinn (1997), honig (2008) and mougani (2012).

The significantly positive sign of this indicator indicates that financial integration in the Gulf countries has a positive influence on the economic growth of these countries, in fact, The 1% increase in financial integration leads to a 5.23% increase in economic growth in these countries. This result can be explained by the success of the strategy of the various reforms (economic, financial, macroeconomic and institutional) applied in these countries within the framework of the Gulf Cooperation Council (GCC).

- ✓ "Trade openness appears with a positive and significant sign. This explains why trade openness positively affects economic growth in the Gulf countries, more precisely, a 1% increase in trade openness improves the growth of these countries with 2.95%. This result can be explained by the creation of a customs union between the countries of the region, the elimination of non-tariff barriers and the establishment of common standards, as well as numerous free trade zones with external countries. These trade agreements hold promise for enhancing new trade opportunities in the GCC region.
- ✓ "Inflation appears with a negative and significant sign. These results are in the same line with the theoretical work done in this area. In fact, the significantly negative sign of inflation means that the latter is negatively correlated with economic growth. Specifically, a 1% drop in inflation improves the growth rate, respectively, to 5.12%. Indeed, this result suggests the relative presence of macroeconomic stability in the Gulf footsteps.

- ✓ The coefficient associated with credits granted to the private sector is positive and significant. This result is consistent with various econometric studies conducted to determine the link between financial development and economic growth (Hermes and Linsink 2003, Aghion et al 2005, Dornbusch 2001, Levine 2004). The results indicate that a 1% increase in the ratio of private sector credit to GDP leads to a 1.54% increase in economic growth in the Gulf countries. The positive and significant sign of this variable indicates that the banking sector of these countries has succeeded in channeling the funds collected in productive investments, which positively influences the growth of these countries.
- ✓ Our results prove that corruption is negative and significant. In other words, a 1% decrease in corruption improves economic growth with 2.90%. These conclusions are consistent with theoretical predictions. Indeed, it is generally accepted that corruption hinders growth by discouraging private investment. The negative sign indicates the presence of a relatively healthy and developed institutional framework in the Gulf countries.

Conclusion

Over the past two decades, the world economy has undergone major economic and financial transformations imposed by financial liberalization and integration into the international financial system. Its macroeconomic implications are crucial for the economic growth of countries, which remains the ultimate goal of each country.

The objective of this paper is to study, using panel data, the nature of the relationship between financial integration and economic growth, for the case of the Gulf countries over the period 1981-2019. The results of this work show overall a positive relationship between the two phenomena. In other words, financial integration can under certain conditions be advantageous for the Gulf countries, because of the various reforms (economic, financial, macroeconomic and institutional) applied in these countries.

The policy implications of our analysis suggest that financial integration must be accompanied by a set of conditions that seem necessary to be able to access the macroeconomic financial system in order to support economic growth, indeed, the absence of fundamental conditions can discourage economic growth. realization of the benefits of the financial integration process, while making the country more vulnerable to economic and financial crises.

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