UNIVERSITI PUTRA MALAYSIA

EFFECTS OF CAPITAL ACCOUNT OPENNESS AND TRADE OPENNESS ON ECONOMIC GROWTH

MOHD FAIZAL BIN ABDULLAH

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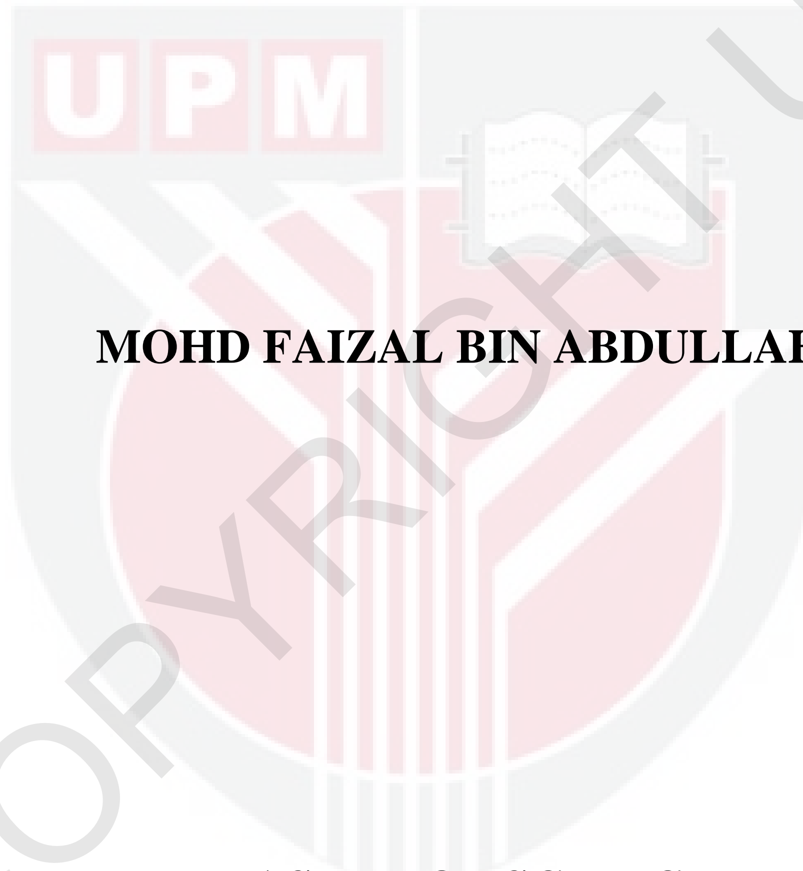

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MASTER OF SCIENCE

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EFFECTS OF CAPITAL ACCOUNT OPENNESS AND TRADE OPENNESS ON ECONOMIC GROWTH

By

MOHD FAIZAL BIN ABDULLAH

Thesis Submitted to the School of Graduate Studies, Universiti Putra Malaysia, in Fulfillment of the Requirements for the Degree of Master of Science

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Abstract of thesis presented to the Senate of Universiti Putra Malaysia in fulfillment of the requirement for the degree of Master of Science.

EFFECTS OF CAPITAL ACCOUNT OPENNESS AND TRADE OPENNESS ON ECONOMIC GROWTH

By

Mohd Faizal bin Abdullah

January 2012

Chairman: Associate Professor Law Siong Hook, PhD

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This study examines the effects of capital account openness and trade openness on economic growth. Consequently, this study investigates the effect of openness on economic growth based on country income level namely, high–income countries, upper–middle income countries, lower–middle income countries and low–income countries. The dataset consist of 52 countries over the period 1990–2007 using a dynamic panel Generalized Method of Moments (GMM) estimation technique.

In order to estimate the effect of capital account openness, this study employs three different indicators namely, capital openness (KAOPEN) constructed by Chin and Ito (2009), Quinn index developed by Quinn, (1997) and gross private capital flows. The

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findings suggest that capital openness (KAOPEN) and Quinn index have positive sign, while gross private capital flows variables has negative sign but these indicators are statistically insignificant. Nevertheless, in terms of sub income country level, capital account openness, through Quinn index has positive effect on economic growth in high–income countries, upper–middle income countries, and lower–middle income countries but has an adverse effect on growth in low–income countries.

This study also employs three different indicators of trade openness namely, trade intensity, real trade intensity and new adjusted trade intensity in order to investigate the effect of trade openness on economic growth. Through trade intensity and real trade intensity, trade openness has negative impact on economic growth. However, the new adjusted trade intensity shows the positive effect of trade openness on economic growth. Trade openness has positively effect on economic growth in high–income countries, upper–middle income countries and lower–middle income countries. However, the new adjusted trade intensity demonstrates the adverse effect of trade openness on economic growth.

Some contingent variables namely, institutions, financial development and foreign direct investment allegedly would influence the effects of capital account openness and trade openness on economic growth. This study also investigates whether the effect of openness is subject to these three contingent variables by including the interaction term in the model specification. The interaction terms highlight that institutional quality plays a greater role in ensuring the positive effects of capital account openness and trade openness on economic growth.

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In high–income countries, all these three interaction terms are crucial in influencing the positive effect of capital account openness and trade openness on economic growth. In upper–middle income countries and lower–middle income countries, institutions play a greater role in fostering the positive effect of capital account openness while, institutions and financial development are crucial in influencing the positive impacts of trade openness on economic growth.

However, the interaction terms between capital account openness and trade openness with foreign direct investment are insignificant in influencing capital account openness and trade openness in upper–middle income countries and lower–middle income countries. This finding suggests that they should well–managed foreign direct investment before open capital accounts and trade markets, in order to maintaining the greater benefits of capital account openness and trade openness on economic growth.

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Abstrak tesis yang dikemukakan kepada Senat Universiti Putra Malaysia sebagai memenuhi keperluan untuk ijazah Master Sains.

KESAN–KESAN KETERBUKAAN AKAUN MODAL DAN KETERBUKAAN PERDAGANGAN TERHADAP PERTUMBUHAN EKONOMI

Oleh

MOHD FAIZAL BIN ABDULLAH

January 2012

Pengerusi: Prof. Madya Law Siong Hook, PhD

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Tesis ini mengkaji kesan keterbukaan akaun modal dan keterbukaan perdagangan terhadap pertumbuhan ekonomi. Ia mengkaji pengaruh keterbukaan terhadap pertumbuhan ekonomi berdasarkan kepada tingkat pendapatan negara iaitu, negara berpendapatan tinggi, negara-negara berpendapatan sederhana atas, negara berpendapatan sederhana rendah dan negara-negara berpendapatan rendah. Set data terdiri daripada 52 negara bagi tempoh 1990 hingga 2007 dengan menggunakan kaedah panel dinamik Generalized Method of Moments (GMM).

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Untuk meneliti kesan keterbukaan akaun modal, kajian ini menggunakan tiga penunjuk yang berbeza iaitu KAOPEN indeks daripada Chin dan Ito (2009), Quinn indeks daripada Quinn, (1997) dan aliran modal swasta kasar. Keputusan menunjukkan bahawa KAOPEN dan indeks Quinn mempunyai kesan positif, sedangkan aliran modal swasta kasar mempunyai kesan negatif namun keputusan ini secara statistik tidak signifikan. Namun demikian, merujuk kepada tingkat sub pendapatan negara, keterbukaan akaun modal, melalui indeks Quinn memberi kesan positif terhadap pertumbuhan ekonomi di negara-negara berpendapatan tinggi, negara-negara berpendapatan sederhana atas, dan negara berpendapatan sederhana bawah tetapi mempunyai kesan buruk terhadap negara berpendapatan rendah.

Kajian ini juga menggunakan tiga penunjuk keterbukaan perdagangan yang berbeza iaitu intensiti perdagangan, intensiti perdagangan nyata dan intensiti perdagangan baru untuk mengetahui pengaruh keterbukaan perdagangan terhadap pertumbuhan ekonomi. Melalui intensiti perdagangan dan intensiti perdagangan nyata, keterbukaan perdagangan mempunyai kesan negatif terhadap pertumbuhan ekonomi. Namun, intensiti perdagangan baru menunjukkan kesan positif terhadap pertumbuhan ekonomi. Keterbukaan perdagangan membawa kesan positif pada pertumbuhan ekonomi di negara-negara berpendapatan tinggi, negara-negara berpendapatan sederhana atas dan negara berpendapatan sederhana bawah. Namun, intensiti perdagangan baru menunjukkan kesan buruk keterbukaan perdagangan terhadap pertumbuhan ekonomi.

Beberapa pembolehubah penting iaitu, institusi, pembangunan kewangan dan pelaburan langsung asing dipercayai mempengaruhi kesan keterbukaan akaun modal dan keterbukaan perdagangan terhadap pertumbuhan ekonomi. Kajian ini juga menyelidiki

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kesan ketiga–tiga pembolehubah ini dengan memasukkan interaksi dalam spesifikasi model. Interaksi membuktikan bahawa tahap institusi yang tinggi memainkan peranan yang lebih baik dalam memastikan kesan positif daripada keterbukaan akaun modal dan keterbukaan perdagangan terhadap pertumbuhan ekonomi.

Di negara-negara berpendapatan tinggi, ketiga–tiga pembolehubah ini sangat penting dalam mempengaruhi kesan positif keterbukaan akaun modal dan keterbukaan perdagangan terhadap pertumbuhan ekonomi. Di negara berpendapatan sederhana atas dan negara berpendapatan sederhana bawah, institusi memainkan peranan yang lebih besar dalam mendorong kesan positif keterbukaan akaun modal, sementara institusi dan pembangunan kewangan sangat penting dalam mempengaruhi kesan positif daripada keterbukaan perdagangan terhadap pertumbuhan ekonomi.

Namun, interaksi antara keterbukaan akaun modal dan keterbukaan perdagangan dengan pelaburan langsung asing tidak signifikan dalam mempengaruhi keterbukaan akaun modal dan keterbukaan perdagangan di negara berpendapatan sederhana atas dan negara berpendapatan sederhana bawah. Penemuan ini menunjukkan bahawa mereka harus mengurus dengan baik pelaburan langsung asing sebelum membuka akaun modal dan pasaran perdagangan, untuk memgekalkan kebaikan dari keterbukaan akaun modal dan keterbukaan perdagangan terhadap pertumbuhan ekonomi.

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I certify that a Thesis Examination Committee has met on **17 JANUARY 2012** to conduct the final examination of **Mohd Faizal Bin Abdullah** on his thesis entitled **"Effects of Capital Account Openness and Trade Openness on Economic Growth"** in accordance with the Universities and University Collages Act 1971 and the Constitution of the Unuversiti Putra Malaysia [P.U.(A) 106] 15 March 1988. The committee recommends that the student be awarded the Master of Science.

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DECLARATION

I declare that the thesis is my original work except for quotations and citations which have been duly acknowledged. I also declare that it has not been previously, and is not concurrently, submitted for any other degree at Universiti Putra Malaysia or at any other institution.

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MOHD FAIZAL BIN ABDULLAH

Date: 17 January 2012

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LIST OF ABBREVIATIONS

AREAER	Annual Report on Exchange Arrangements and Exchange Restrictions
FD	Financial Development
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GMM	Generalized Method of Moments
GROSS	Gross Private Capital Flows
ICRG	International Country Risk Guide
IMF	International Monetary Fund
INS	Institutions
KAOPEN	Capital Account Openness Indicator developed by Chinn and Ito (2009)
OECD	Organization of Economic Co–operation and Development
PHY	Physical Capital
POP	Population Growth
PRS	Political Risk Services
QUINN	Capital Account Openness Indicator developed by Quinn (1997)
RGDPC	Real Gross Domestic Product per Capita
TFP	Total Factor Production
TI	Trade Intensity
TO	Trade Openness Indicator
WDI	World Development Indicator
WGI	Worldwide Governance Indicators

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CHAPTER ONE

INTRODUCTION

The first section of this chapter discusses the background of the study and section two presents the roles of institutions, financial development and foreign direct investment in influencing the effects of capital account openness and trade openness on economic growth. Section three presents the problem statement and section four is earmarked for the objectives of this study. Section five explains the significance of this study. Finally, section six explains the organization of the study.

1.1 Background of the Study

In the current globalised setting, most developed countries practise openness in their capital accounts and liberalized their trade markets. Several developing countries are trying to open their capital accounts and trade markets as well. Most economists argue that capital account openness and trade openness would help to expand investments and generate positive effect on economic growth. According to Prasad and Rajan (2008), capital account openness means allowing a free flow of capitals in and out of a country's economy and is viewed as an important step in the economic development process. David et al. (2007) defines capital account openness as a policy by which a government gives

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the right to foreign investors to purchase shares and bonds in domestic markets and at the same time granting domestic investors the rights to trade in foreign securities.

Capital account openness is seen as an inevitable step along the path to economic development for poor countries. Broadly speaking, capital account openness is a government's decision to move from a closed capital account system, where capital may not move freely in and out of the country, to an open system in which capital can enter and leave at will. The theory was invented by Solow (1956), namely the theory of Allocative Efficiency. Generally, allocative efficiency refers to the capacity of a government to allocate resources on effective programs in meeting its strategic objectives. In the neoclassical model, this theory suggests that openness in capital accounts produces a more efficient international allocation of resources and generate all kinds of positive effects. According to the theory, resources flow from capital–abundant developed countries, where return to capital is low, to capital scarce developing countries, where return to capital is high.

Figure 1.1 depicted the effect of capital account openness on economic growth via traditional perspective. In general, capital account openness affects economic growth through several channels, namely international risk sharing, capital deepening and efficient in allocation of capital.

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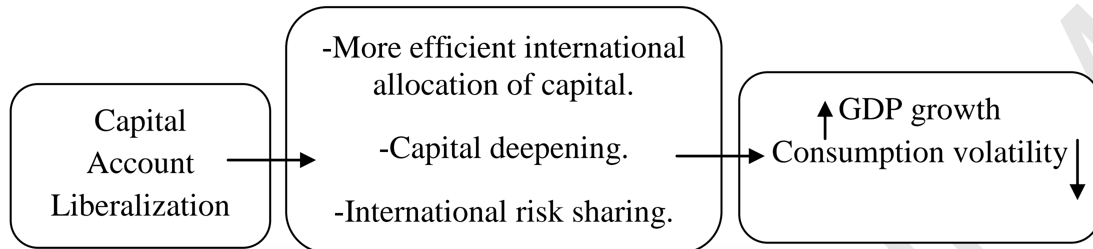
Figure 1.1: The Traditional View of the Effect of Capital Account Openness on Economic Growth.



(Source: Prasad and Rajan, 2008)

However, this traditional view omitted some of the contingency variables that influence the effect of capital account openness on economic growth. Most researchers argue that capital account openness is more beneficial if a number of other economic conditions are well developed and regulated. For example, Prasad and Rajan (2008) pointed out that conditional variables such as financial development system and institutional quality must be well–regulated prior to opening capital accounts to stimulate positive economic growth. These conditions could explain why the effect of capital account openness on economic growth varies with different economies. The other conditional variables are as depicted in Figure 1.2.

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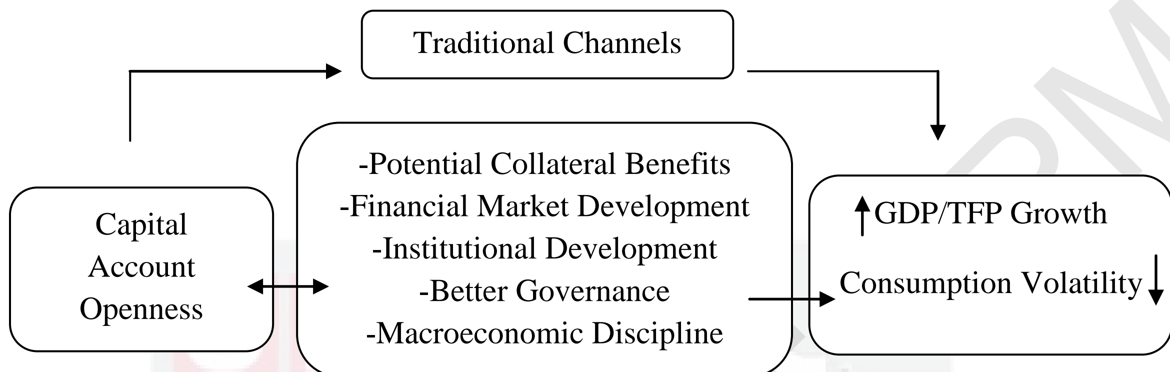
Figure 1.2: The Different Perspective of the Effect of Capital Account Openness on Economic Growth.



(Source: Prasad and Rajan, 2008)

Besides capital account openness, trade openness is also seen as an important policy that will help stimulate economic growth. Most developing countries and emerging market economies have open their trade flows by reducing tariff and non tariff barriers. Trade openness is allegedly more stable than capital account openness. The classical trade theory suggests that trade openness would affect economic growth through (i) gains from exchange, (ii) gains from specialization and (iii) gains from economies of scale (see Figure 1.3). Based on the gains from exchange, while trade barriers are eliminated, consumers benefit directly from lower prices of imports. At the same time, producers also benefit from lower prices of primary and intermediate inputs, consequently reducing the cost of production.

Via gains from specialization, firms are encouraged by trade openness policy, to direct resources away from previously protected sectors towards those that have highest value

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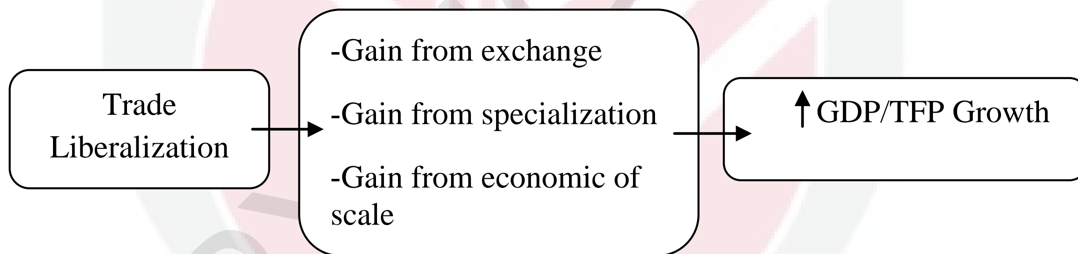
added. Industries and sectors with comparative advantages in production are allowed to expand their output and thus, enlarge their market. Consequently, countries with specialization may focus on production that bring optimum advantage to their income and thus, enhancing economic growth. The other channel is gains from economies of scale. Trade openness boosts pro–competitive effect on firms. Marginal firms will be forced out of business, allowing surviving firms to increase output and lower average total costs, promoting greater efficiency in use of resources and output.

Figure 1.3: The Traditional View of the Effect of Trade Openness on Economic Growth.



Similar to capital account openness, the effect of trade openness also depends on contingency variables, namely institutions, financial development and foreign direct investment. Trade openness alone is unlikely to be sufficient to boost economic growth significantly. Reaping the full benefit of trade openness requires other strong incentives, such as property rights that provide an encouraging business environment.

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1.2 Openness and Growth: The Roles of Institutions, Financial Development and Foreign Direct Investment.

The contributions of openness to capital accounts and trade markets depend upon the existence of other determining factors in an economy including high institutional quality, well–developed financial system and well–managed foreign direct investment. Hence, institutions, financial development and foreign direct investment are the crucial determining factors that contribute to the success of openness on economic growth. Rodrik (1998) however highlighted that openness to international capital flows may pose danger if appropriate control, regulation and macroeconomic frameworks were not in place.

1.2.1 Institutions

Institutional quality plays an important role in influencing the effects of capital account openness and trade openness on economic growth. Most studies suggest complete development of institutions before opening their capital accounts and trade markets to foreign investors. Economists find that countries with well–developed institutions stand to gain more from capital account openness and trade openness. Governments are encouraged to develop strong institutional quality in order to manage monetary policy and exchange rates before liberalizing because high capital mobility may pose negative

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effects on the effectiveness of different instruments meant to achieve monetary policy objectives. Apart from this, strengthening the exchange rate is important in order to improve competitiveness.

Establishing well–functioning institutions also important to attract savings and thus, channel them into the more productive investment projects. Besides attracting investment from domestic investors, institutions also help to attract capital inflow from foreign firms and transfer into highly profitable projects, consequently generating positive economic growth through higher return on investment.

Corruption prevents effective capital inflows distribution into the most productive and profitable projects, causing lower return on investment. The loss in income eventually results in stunted economic growth. Through liberalizations, open economies face greater losses from corruption compared to less open ones, due to its disproportionate impact on foreign transaction. Thus, curbing corruption is important in order to spur positive effect of openness on economic growth. When corruption is kept in check, foreign investors would feel that their investment are well–protected and managed efficiently , ensuring an optimum level of return on their investment.

In addition, well–defined and enforced rules greatly reduce transaction cost faced by economic agents, consequently lead to outcomes that are most efficient. Meanwhile, on free trade, contract enforcement is a crucial determinant of the effect of openness on growth. The volume of trade in differentiated and homogenous goods are affected by contract enforcement. Thus, the volume of trade in goods which quality issues are important, can be reduced by perfecting the enforcement of contracts. Contract

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enforcement is also important to foreign investors in order to protect their capital invested in the country.

Besides, weak institutions can reduce the total factor productivity (TFP). They may also distort economic decision making leading to lower rates of return than otherwise prevail. For example, if governent failed to create an environment that supports productive activities and encourage capital accumulation, invention, skill acquisition and technology transfer, the rate of return on investment in emerging economies may not be much higher than in the developed countries.

Poor investor protection may lead to a constant return differential between rich countries and poor countries. Henry (2003) highlights that where accounting standards and enforcement bodies is lacking, capital invested in a company may be wasted on unnecessary managerial perks or an outright embezzlement. In normal circumstance, insiders are made of controlling shareholders who might be the founding family members, top managers, or both. Since outsiders are less knowledgable in terms of the firm's prospects and reliability of the managers, they demand for higher returns for the high risks they expose themselves into or simply refrain from investing. As a result, investors stay away from countries in which investor protection is weak.

The other institutions that need attention include a legal structure to ensure private property and contract enforcement, transparency in government, legitimate bankruptcy laws, flexible labor markets, an independent judiciary, an insurance markets to minimize risks, and a competiton policy.

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1.2.2 Financial Development

The interaction between openness and well developed financial system reduces the inefficiency in the production process and positively influence economic growth. Financial sector itself improve economic growth by raising (i) the proportion of savings channeled to investment, (ii) allocate resources, and (iii) the ratio of saving to gross domestic product. Well–developed financial system generates growth and improves economic performance to the level that facilitates the transfer of funds to the best firms where the funds may yield the greatest return. Thus, enhancement of the domestic financial system is crucial in managing monetary policy as well as sustaining lower exchange rate fluctuation as well as maintaining inflation target. Stability in foreign exchange rate is essential in order to generates surplus in trade account and thus, promotes positive economic growth.

Openness to capital accounts allows foreign banks existence in the host country. Foreign bank is associated with improvement in the efficiency of financial intermediaries and the quality of financial services. Besides, the efficiency of the domestic financial services may improved by exposure to the foreign banking systems through the introduction of international standards as well as their home financial system quality posed by foreign intermediaries. Well–estabished financial intermediaries in host country is also crucial in open capital accounts policy because of such huge and massive inflows that need to be managed efficiently.

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Other than that, access to the domestic financial intermediaries by foreign banks may improve the effectiveness of the intermediation process between savers and borrowers, lowering markup rates in banking system. Consequently, it reduces cost of investment, attracts more capital inflows and promotes growth of the economy.

1.2.3 Foreign Direct Investment

Capital account openness boosts foreign direct investment inflows provided that favourable conditions are in place. Such favourable conditions include a complete package of contingent contracts, access to relevant information, and a less competitive market.

The effects of capital account openness and trade liberalization on economic growth are also influenced by foreign direct investment. Suppose a country decided to open their capital accounts to foreign investor, yet flows of investment is nearly negligible, the decision proved to be worthless. Foreign direct investment is clearly a key driver to economic growth, not only by increasing capital, but also by producing externalities in the form of technology transfers and spillovers.

Another way foreign direct investment determines the effects of capital account openness and trade openness on economic growth is through exchange rate system. The explanation is that foreign direct investment is a long–term alternative to exporting from

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the source country and the strength of the host country's currency is an important factor in the foreign direct investment decision.

Through trade openness, higher trade implies higher demand for skilled labors, inducing unskilled labors to acquire human capital. Therefore, greater abundance of skilled labors would increase the economy's attractiveness to foreigners. Higher trade tend to, over time, increase the demand and later on the supply of skilled labors, thereby increasing future attractiveness of the country to multinational corporations.

Because of the crucial role of foreign direct investment, governments tried to develop better policy that offers much more benefits to foreign investors. For example, China set up unique economic zones with high class infrastructure and less red tape by exempting foreign investors from local labor laws. Malaysia too provides zone of free tariff as ways to attract capital inflows. Multiple restriction on foreign direct investment will only generate negative effect on economic growth. Study by Desai et al. (2002) demonstrated a reduction in the size of local multinational affiliates by roughly 20 percent as well as a distorted assets allocation, financing, transfer pricing and dividend policies.

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1.3 PROBLEM STATEMENT

Based on the theory of Allocative Efficiency, openness significantly generates positive effect on economic growth especially for developing countries and poor countries. At the end of 1980s right through the early 1990s, there were explosive growth of international financial transaction, rightfully deemed as the most rapid period of growth in the developing countries. Eichengreen et al. (1998) pointed out that Asian countries especially attracted almost half of the total capital inflow into developing countries and experienced high economic growth. This was shown in previous findings (Quinn (1997), Stiglitz, (1998) and Karras, (2003)) demonstrating how openness to capital accounts and trade markets bring significant positive effect on economic growth. Openness, through foreign direct investment, improves efficiency and productivity, creates jobs for domestic labor and consequently, reduce the rate of poverty. Openness also enhances quality in the domestic financial market, through greater competition in the banking system.

Although openness is one of the main contributors to economic growth, it can potentially harm economic growth. There is controversy over the benefits of openness reflecting diverging views. The issues revolve around whether free capital movements can deliver an efficient allocation of resources and whether removing trade barriers does promote economic growth. In addition, the capital flight that occurred during the financial crises in 1997 highlighted the potential harm capital account openness may pose on an economy. Rodrik (1998) went even further by citing zero effect of openness on economic growth. He concluded that there is no evidence to suggest that country with fewer

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restrictions grow faster than countries with full of restrictions. Traditionally, financial crises result in an abrupt stop in foreign direct investment and thus, plummeting exchange rate. While exchange rate depreciated, it becomes difficult for a country to repay its foreign currency denominated borrowing, which can leads to the collapse of the banking sectors. Openness is also often associated with a rapid monetary expansion, an inflationary pressure and a wide current account deficit. If anything, financial crises in Asia, Russia, and Latin America managed to raise the issue of whether a yet-to-open economy should liberalise after all.

Economists also argue that the effect of capital account openness and trade openness on economic growth is different based on country's level of economic development. Capital account openness and trade openness are not necessary appropriate policies for all countries. Countries with weak policies and institutions, should not make liberalization their priority. A number of researchers (Quinn and Toyoda (2008), Klein (2003), Baliamoune (2007) and Dollar (1992)) found that capital account openness and trade openness may positively effect economic growth in high income and upper–middle income countries, whereas in lower–middle and low–income countries, openness may in fact harm economic growth. Although openness has been associated with high growth rates in developed countries, there were developing countries and poor countries that experienced periodic collapse in growth rates. Neoclassical model predicts that capital account and trade openness have different impact on developing countries compared to developed ones.

The different effects of capital account openness and trade openness on economic growth allagedly caused by several environmental conditions. Previous literature (Klein, (2005)

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and Dollar and Kraay (2003)) highlighted that capital account openness and trade openness work poorly in a country where corruption looms, and works well in situations where bureaucracies are practised. While the institutional quality is good, openness could be an effective development strategy, and thus better institutions may be a condition for successful liberalization. There was some evidence that the positive impact of openness are stronger in countries with stronger institutions.

In addition, theory demonstrates that advanced financial system may relieve risks of credit constraints, thereby fostering growth through technological change. Therefore, economists suggest that financial development as well as institutional quality should be strong enough and well regulated before opening their capital accounts to absorb capital flows into the country. High level of financial development generate positive effect on openness but certain researchers pointed out that at a higher level of financial development, openness brings no significant effect on economic growth.

Foreign direct investment is also significantly brings positive effect on economic growth. Thus, the inflows of FDI is determined by the extent of capital account openness and trade openness on economic growth. For example, Aizenman and Noy (2006) pointed out that capital controls have no impact on aggregate capital flow volume and thus, it may harm economic growth. Otherwise, Makki and Somwaru (2004) highlight that trade openness interacts positively with FDI and stimulate domestic investment. They suggest that trade and FDI are important sources of economic growth, especially for developing countries.

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1.4 OBJECTIVES OF THE STUDY

The general objective of this study is to investigate the effects of capital account openness and trade openness on economic growth. More specific, this research tends to:

1. examine the effects of capital account openness and trade openness on economic growth at various stages of economic development namely high–income countries, upper–middle income countries, lower–middle income countries and low–income countries.

2. investigate the effects of capital account openness and trade openness on growth in relation to institutions, financial development and foreign direct investment.

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1.5 SIGNIFICANCE OF THE STUDY

This study is expected to serve as guidelines for government in making decisions whether to open capital accounts or trade market or both in order to generate positive economic performance. Not all countries may benefit from openness to capital accounts and trade markets. Thus, we know that the effects of capital account openness and trade openness on growth vary with different level of economic development. Rich countries might benefit from capital account and trade openness, whereas poor countries and less developed countries might face adverse effects from such policies. Different country should employ different ways to boost higher economic growth by formulating appropriate policy.

Three factors namely institutions, financial development system and foreign direct investment are considered key determinant to the effects of capital account openness and trade openness on growth. Previous findings suggested strengthening these three conditional variables while liberalizing capital accounts and trade markets due to their significance in promoting openness subsequently economic growth. For example, a high institutional quality provides conducive environment for foreign investors and traders. A highly organized and supervised domestic financial system is essential in managing huge capital flows and allocating resources so as to yield the highest return on investment.

Thus, it is important to examine the role of institutional quality, financial development and foreign direct investment in minimizing the risks of liberalization and maximizing the positive effect of capital account openness and trade openness on economic growth.

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Governments are encouraged to maintain other determining factors, while strengthening other contingency factors. This additional information also serves as a guideline for foreign investors in making decisions on investing their capital and trade their goods and services in any country.

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1.6 ORGANIZATION OF THE THESIS

The study report is organized into five chapters. The first chapter is an introductory, which includes the roles of institutions, financial development and foreign direct investment. This chapter also includes problem statement, objectives of the study and the significance of the study. The second chapter contains the effects of capital account openness and trade openness on economic growth. Empirical literature is divided into two parts: the relationship between capital account openness and economic growth and the relationship between trade openness and economic growth. The third chapter contains the methodology, which is divided into four parts: the model, the dynamic panel generalized method of moments (GMM), measuring openness and sources of data. The fourth chapter contains estimation results, which is divided into two parts. The first part of the chapter discusses the effect of capital account openness on economic growth. The second part of the chapter discusses the effect of trade openness on economic growth. The fifth and final chapter includes summary of the study, the major findings, policy implications and recommendations for future study.

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