

Department of

1. Introduction

The relationship between financial development and international trade has been analysed extensively in the literature. However, despite the fact that the causal linkages between these two variables could be bidirectional, most studies have focused mainly on the impact of the former on the latter and on whether or not a well-developed financial system can

the European countries. For this purpose, a state-of-the-art econometric method designed for heterogeneous panels is employed

Finally, countries importing finance-dependent goods will see their financial system deteriorate, with access to finance becoming more difficult for domestic firms.

Huang and Temple (2005) instead examined whether higher openness has a positive effect on financial development by using cross-section and panel data for 88 countries over the period 1960-99. They found strong support for this hypothesis, especially in the lower-income group. Their results suggest that increases in goods market openness are typically followed by sustained increases in financial depth. Kim et al. (2010) also analysed the dynamic effects of trade openness on financial development using a sample of 88 countries over the period 1960–

and financial openness on financial development and produces evidence that both types of openness are statistically significant determinants of financial development. Thus, relatively closed economies stand to benefit most from opening up their trade and/or capital accounts; however, opening up one without the other can still generate gains in terms of banking sector development. Therefore, these results provide only partial support for the Rajan and Zingales's (2003) hypothesis. Zhang et al. (2015) investigated

4.1 Data

Our panel consists of annual data for 35 European countries (see the list of variables in the Appendix) over the period 2001–2019. The series were obtained from the World Bank database, including the World Governance Indicators (WGI) constructed by Kaufmann et al. (2010), and from the International Monetary Fund (Finance and Development- Ahir et al., 2018) (see the Appendix for more details). The governance index (IQ) includes six dimensions of governance, namely voice and accountability, political stability, government effectiveness, regulatory quality rule of law and control of corruption; it is averaged for each country over the sample. For each dimension of governance, the estimated value is between -2.5 (weak) and 2.5 (strong) governance performance; higher values of IQ indicate a high governance performance and better quality of institutions and thus should boost trade and financial development

appear to be negative short-run effects of trade on financial development and positive and significant long-run ones. A possible explanation is that in the short run these countries experience more frequent economic shocks resulting from their higher trade openness, which is associated with greater risk and increased exposure to foreign competition. Instead in the long run higher trade openness, followed by restructuring and more investment and lending to cope with increasing competition, creates demand for external finance and thus has

5. Conclusions

This paper analyses the impact of trade

long run when

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	(2.38)**	(5.12)***	(0.93)
INFL	-0.145	-0.290	-0.667

APPENDIX

Table A1: List of Countries

Albania	Denmark	Luxembourg	Romania
Austria	Finland	Malta	Russia
Belgium	France	Moldavia	Serbia
Bulgaria	Greece	Macedonia	Switzerland
Bosnia	Germany	Montenegro	Sweden
Belarus	Hungary	Nederland	Spain
Cyprus	Ireland	Norway	Ukraine
Czech Republic	Iceland	Poland	United Kingdom
Croatia	Italy	Portugal	

Table A2: List of variables

Code	Variables	Source
DCPS _{it}	Domestic Credit to the private sector as share of GDP	World Bank-World Development Indicators (WDI)
TO	Trade openness as share of GDP	World Bank-World Development Indicators (WDI)
RGDPC	Real income per capita, (current international \$)	World Bank-World Development Indicators (WDI)
INF	Inflation, consumer price index	World Bank-World Development Indicators (WDI)
IQ	World Governance index	World Bank-World Development Indicators (WDI) Authors' calculations based on the WDI database
UI	Uncertainty index	IMF database

