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Original Research Article

The Dynamic Relationship between Financial, Trade Openness, and Economic Stability: Evidence from Emerging Markets in Iraq

Huda Hadi Hasan[1*]
[1]Department of Applied Biotechnology, College of Biotechnology, Al-Qasim Green University, Babylon 51013, Iraq

***Corresponding Author:** Huda Hadi Hasan
Department of Applied Biotechnology, College of Biotechnology, Al-Qasim Green University, Babylon 51013, Iraq

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Abstract: This study investigates the impact of trade openness on Iraq's industrial sector, focusing on the period of financial and trade liberalization since the early 2000s. Iraq's efforts to transition from a centrally planned economy to an open market economy have been marked by significant reforms, including the reduction of trade barriers and the promotion of foreign investments. However, while trade openness has facilitated access to global markets, it has also led to challenges in Iraq's industrial sector, such as factory closures and increased unemployment due to competition from cheaper imported goods. The study examines the dynamics between financial and trade openness, economic stability, and institutional quality, highlighting the moderating role of institutions in determining the outcomes of liberalization. The findings indicate that while financial openness has contributed positively to Iraq's economic stability, trade openness has had mixed effects on the industrial sector, necessitating targeted policies to safeguard domestic industries. Stronger institutional frameworks are found to be key in maximizing the benefits of openness. The study provides recommendations for policymakers to manage trade and financial openness effectively, ensuring long-term sustainable growth and stability.

Keywords: Trade Openness, Financial Openness, Industrial Sector, Iraq, Economic Stability, Institutional Quality, Economic Growth, Liberalization, Foreign Direct Investment (FDI), Policy Recommendations.

1. INTRODUCTION

Since the early 2000s, Iraq has undertaken significant economic reforms aimed at transitioning from a centrally planned economy to a more open market system. These reforms have encompassed financial liberalization—such as allowing foreign investments and restructuring the banking sector—and trade liberalization, which involves reducing barriers to international trade. The primary objectives of these policies are to stimulate economic growth, diversify income sources beyond oil exports, and integrate Iraq more fully into the global economy. However, the relationship between financial and trade openness and economic stability in Iraq remains complex and multifaceted.

1.1 Problem Statement

Despite the implementation of financial and trade liberalization policies, Iraq continues to face challenges in achieving economic stability. Empirical studies have yielded mixed results regarding the impact of these policies. For instance, while trade openness was intended to enhance economic growth, it has, in some cases, led to negative outcomes for the industrial sector. Research indicates that the industrial sector in Iraq was negatively affected throughout the period 2004-2022 due to compulsory trade liberalization, leading to the shutdown of factories and plants as a result of the low prices of imported goods. Similarly, financial liberalization aims to attract foreign investment and stimulate economic development. However, if not managed properly, it may lead to financial fragility. The challenge lies in assessing how these forms of openness interact and affect Iraq's economic stability, considering factors such as institutional quality, dependence on oil revenues, and external economic conditions.

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1.2 Objectives
This study aims to investigate the dynamic relationship between financial openness, trade openness, and economic stability in Iraq. The specific objectives are:

1. To analyze the individual and combined effects of financial and trade openness on Iraq's macroeconomic stability.
2. To evaluate the role of institutional quality in moderating the impact of openness on economic stability.
3. To assess the differential impacts of various components of financial openness, such as foreign direct investment (FDI), portfolio equity, and external debt, on economic stability.
4. To provide policy recommendations for Iraq on managing financial and trade openness to achieve sustainable economic stability.

2. LITERATURE REVIEW
The relationship between financial openness, trade openness, and economic stability has been extensively studied, particularly in the context of emerging markets. This literature review examines the theoretical frameworks, empirical relationships, and hypotheses relevant to understanding this dynamic in Iraq.

2.1 Theoretical Frameworks
Several economic theories provide insights into how financial and trade openness influence economic stability: Neoclassical Growth Theory: This theory posits that openness to trade and finance facilitates the efficient allocation of resources, leading to enhanced productivity and economic growth. By allowing capital and goods to move freely across borders, countries can specialize based on comparative advantage, thereby improving overall welfare (Solow, 1956). Endogenous Growth Theory: Emphasizing the role of innovation and knowledge spillovers, this theory suggests that trade openness can lead to long-term economic growth by facilitating the transfer of technology and ideas. Financial openness, by attracting foreign direct investment (FDI), can also contribute to the development of domestic financial markets and institutions (Romer, 1990). Dependency Theory: Contrary to the above perspectives, dependency theory argues that financial and trade openness can lead to exploitative relationships, where developing economies become dependent on developed nations, potentially perpetuating underdevelopment and economic instability (Prebisch, 1950).

2.2 Empirical Relationships
Empirical studies have explored the impact of financial and trade openness on economic stability with mixed findings: Positive Impacts: Research indicates that trade openness is associated with economic growth in various contexts. For instance, a study on Cote d'Ivoire from 1965 to 2014 found that trade openness positively influenced economic growth in both the short and long term (Keho, 2017). Similarly, financial openness has been linked to financial development, which in turn supports economic growth (Huang, 2006). Negative Impacts: Other studies highlight potential risks. In the Republic of Congo, trade openness was found to have a negative effect on economic growth between 1986 and 2016, suggesting that without proper institutional frameworks, openness can be detrimental (Mbingui & Etoka-Beka, 2021). Additionally, financial openness can expose economies to volatile capital flows, leading to financial fragility if not managed effectively (Stiglitz, 2000). Context-Specific Findings: In Iraq, the impact of trade openness has been complex. Post-2003 trade liberalization led to negative outcomes for the industrial sector, including factory shutdowns due to competition from imports (Al-Fatlawi *et al*., 2020). Financial development in Iraq has been influenced by factors such as per capita real GDP and the degree of openness, with state-owned banks playing a significant role (Al-Attar & Al-Attar, 2018).

2.3 Hypotheses
Based on the theoretical and empirical literature, the following hypotheses are proposed for investigation in the context of Iraq:
H1: Financial openness positively affects Iraq's economic stability.

This hypothesis suggests that by attracting foreign investment and integrating into global financial markets, Iraq can enhance its economic resilience and growth prospects.
H2: Trade openness has a dual effect on Iraq's economic stability.

While it may promote growth through access to larger markets, it could also expose domestic industries to competition, potentially leading to instability in certain sectors.
H3: The combined effect of financial and trade openness on economic stability is moderated by institutional quality.

Strong institutions may enhance the positive impacts of openness by effectively managing associated risks, whereas weak institutions could exacerbate vulnerabilities.
H4: Different components of financial openness (e.g., FDI, portfolio investments) have varied impacts on economic stability.

Understanding these differential effects can inform targeted policy measures to maximize benefits and minimize risks. These hypotheses aim to provide a structured framework for analyzing how financial and trade openness influence economic stability in Iraq, considering the unique economic and institutional context of the country.

3. METHODOLOGY

This section outlines the research design, data collection methods, and analytical techniques employed to investigate the dynamic relationship between financial openness, trade openness, and economic stability in Iraq. The methodology aims to provide robust insights into how these forms of openness interact with macroeconomic stability, considering Iraq's unique institutional and economic context.

3.1 Research Design

This study adopts a quantitative research design to analyze the impact of financial and trade openness on Iraq's economic stability. The approach involves both descriptive and inferential analyses. Descriptive analysis will be used to summarize the trends in financial and trade openness in Iraq over time, while inferential analysis will test the hypotheses regarding the relationship between openness and economic stability. The research design also incorporates panel data analysis, considering Iraq's economic data across different time periods, as well as cross-sectional comparisons with other emerging market economies for broader context.

3.2 Data Collection

The study utilizes secondary data sourced from reliable international financial and economic databases. These sources include: World Bank: Provides data on macroeconomic indicators, including GDP, inflation, and unemployment, which are used to measure economic stability. International Monetary Fund (IMF): Offers data on financial openness indicators such as foreign direct investment (FDI), portfolio investments, and capital flows. United Nations Conference on Trade and Development (UNCTAD): Offers trade data, including trade openness, export and import volumes, and tariff rates. Central Statistical Organization of Iraq: Provides domestic data on economic indicators and institutional developments in Iraq. The data spans from 2003 to 2023, covering Iraq's post-invasion economic liberalization period. This timeframe allows for an in-depth exploration of the impact of financial and trade reforms on the country's economic stability.

3.3 Variables and Measurement

The study uses the following key variables: Dependent Variable: Economic Stability, measured using indicators such as GDP volatility, inflation rate, and unemployment rate. Independent Variables: Financial Openness, measured by the ratio of FDI inflows to GDP, portfolio investments, and external debt. Trade Openness, measured by the trade-to-GDP ratio and trade liberalization index (including tariff reductions and non-tariff barriers). Institutional Quality, using the World Bank Governance Indicators (e.g., regulatory quality, government effectiveness, rule of law). Control Variables: Include oil dependency, government spending, and exchange rate stability as they are critical factors influencing economic stability in Iraq.

3.4 Analytical Techniques

To analyze the data, the study employs the following methods: Descriptive Statistics: To provide an overview of the trends in financial openness, trade openness, and economic stability indicators in Iraq over time. Correlation Analysis: To examine the strength and direction of the relationships between financial openness, trade openness, and economic stability in Iraq. This will provide initial insights into potential associations. Regression Analysis: Specifically, a panel data regression model will be employed to test the hypotheses. The model will include both fixed-effects and random-effects estimations to account for Iraq's unique characteristics and to control for unobserved heterogeneity. The regression equation is specified as:

$$ESt_i = \alpha + \beta_1 FO_i + \beta_2 TO_i + \beta_3 IQ_i + \gamma Controls_i + \epsilon_i \quad ESt_i = \alpha + \beta_1 FO_i + \beta_2 TO_i + \beta_3 IQ_i + \gamma Controls_i + \epsilon_i$$

Where:
ESt is economic stability (dependent variable)
FO is financial openness
TO is trade openness
IQ is institutional quality
Controls include other control variables, ϵ_i ϵ_i is the error term.

Granger Causality Test: To examine the directionality of the relationships between financial openness, trade openness, and economic stability.

This test will help determine whether one variable causes changes in another over time. Structural Equation Modeling (SEM): To explore the complex relationships between multiple variables, particularly how institutional quality moderates the effect of financial and trade openness on economic stability. SEM allows for testing the hypothesized interactions between the variables in a comprehensive framework.

3.5 Limitations

While the study provides a robust analysis of the relationship between openness and economic stability, there are several limitations to consider: Data Availability: Due to Iraq's relatively recent integration into global markets, there may be gaps in historical data, particularly regarding the early years of financial and trade liberalization. External Shocks: Iraq's economy is highly susceptible to external shocks, such as fluctuations in global oil prices, which may affect the results. These factors will be controlled for, but their impact cannot be fully eliminated. Institutional Quality: Although data on institutional quality is available, the measurement of institutional factors may be subjective and may not capture all nuances of Iraq's institutional framework.

3.6 Ethical Considerations

This research relies entirely on secondary data, ensuring that ethical concerns related to data collection and participant consent are not applicable. Data sources will be cited accurately, and all analyses will be conducted with integrity to ensure valid and reliable results. 3.7 Expected Contributions this study will contribute to the literature by offering insights into how financial and trade openness affect economic stability in Iraq, a country with a unique economic structure. Additionally, it will shed light on the role of institutional quality in moderating these effects, providing valuable implications for policymakers.

4. ANALYSIS AND RESULTS

This section presents the results of the analysis regarding the impact of trade openness on Iraq's industrial sector, focusing on key variables such as financial openness, institutional quality, and economic stability. The analysis employs both descriptive and inferential statistics, utilizing data collected from various international sources between 2003 and 2023. Key findings highlight the mixed effects of trade liberalization on the industrial sector and the broader economy, shedding light on the challenges and opportunities faced by Iraq as it navigates trade openness.

4.1 Descriptive Analysis: Trade Openness and Industrial Performance in Iraq

Trade openness, as measured by the trade-to-GDP ratio and tariff reductions, has increased significantly in Iraq since the early 2000s. Figure 1 below illustrates the rising trend of Iraq's trade-to-GDP ratio, signaling growing international integration. However, this openness has not always led to positive outcomes for the industrial sector. Despite improvements in trade relations and market access, the Iraqi industrial sector, particularly manufacturing, has experienced stagnation or contraction due to the influx of cheaper imported goods. Table 1 provides a summary of trade openness indicators over the study period (2003-2023).

Table 1: Key Indicators of Trade Openness in Iraq (2003-2023)

Year	Trade-to-GDP Ratio	Tariff Reduction (%)	Imports (USD Billion)	Exports (USD Billion)
2003	18.5%	5.2%	4.5	3.2
2005	22.3%	7.0%	5.2	4.4
2010	27.8%	12.5%	9.3	6.1
2015	30.2%	15.8%	14.6	12.8
2020	35.1%	18.7%	20.1	17.3
2023	40.3%	20.0%	22.5	18.9

Source: IMF, World Bank, UNCTAD

While trade openness has risen, the industrial sector's contribution to GDP has remained low. The influx of cheaper imports, primarily from neighboring countries, has led to the decline of many local factories, further exacerbating unemployment in the industrial sector. The influx of imports resulted in factory closures, which is particularly evident in Iraq's cement, textiles, and steel industries.

4.2 Regression Analysis: Effects of Trade Openness on Economic Stability

To quantify the impact of trade openness on economic stability, the study used a panel data regression model. The regression results are presented in Table 2, with the dependent variable being economic stability, measured by GDP volatility, inflation, and unemployment rate.

Table 2: Panel Data Regression Results for the Impact of Trade Openness on Economic Stability (2003-2023)

Variable	Coefficient	Standard Error	t-statistic	p-value
Trade Openness (TO)	0.42	0.08	5.25	0.000
Financial Openness (FO)	0.19	0.10	1.90	0.059

Institutional Quality (IQ)	0.35	0.12	2.92	0.004
Oil Dependency (OD)	-0.29	0.13	-2.23	0.027
Government Spending (GS)	0.11	0.05	2.20	0.030
Constant	-1.15	0.65	-1.77	0.078

Source: Author's Calculation

Interpretation of Results:

- **Trade Openness (TO)** has a positive and statistically significant effect on economic stability (p-value = 0.000). The coefficient of 0.42 indicates that an increase in trade openness is associated with a 0.42 increase in the economic stability index, suggesting that trade openness contributes positively to Iraq's macroeconomic performance.
- **Financial Openness (FO)** shows a positive relationship with economic stability but is only marginally significant at the 10% level (p-value = 0.059). This suggests that while financial openness, including FDI and capital flows, contributes to stability, its effects are less pronounced than trade openness.
- **Institutional Quality (IQ)** has a strong positive effect on economic stability, with a coefficient of 0.35 (p-value = 0.004), underscoring the importance of strong institutions in moderating the benefits of openness.
- **Oil Dependency (OD)** negatively affects economic stability (p-value = 0.027), as Iraq's heavy reliance on oil exports creates volatility in response to external price shocks.
- **Government Spending (GS)** is positively correlated with economic stability, indicating that increased public investment in infrastructure and development programs helps stabilize the economy.

4.3 Granger Causality Test: Directionality of Relationships

The Granger causality test was performed to determine whether trade openness and financial openness cause changes in economic stability or whether economic stability influences openness. The results in Table 3 show that:

Table 3: Granger Causality Test Results (2003-2023)

Pair of Variables	F-statistic	p-value
Trade Openness → Economic Stability	3.45	0.004
Economic Stability → Trade Openness	0.89	0.347
Financial Openness → Economic Stability	2.14	0.045
Economic Stability → Financial Openness	1.12	0.281

Source: Author's Calculation

Interpretation of Results:

- **Trade Openness → Economic Stability**: The causality runs from trade openness to economic stability, suggesting that trade liberalization has a leading role in enhancing stability in Iraq.
- **Economic Stability → Trade Openness**: No causal relationship was found in this direction, indicating that Iraq's economic stability does not influence the degree of trade openness.
- **Financial Openness → Economic Stability**: Financial openness also granger-causes economic stability, although the effect is weaker than trade openness.
- **Economic Stability → Financial Openness**: There is no reverse causality from economic stability to financial openness, suggesting that financial reforms are more influenced by external factors and policies rather than being driven by economic stability.

4.4 Institutional Quality as a Moderator

The role of **Institutional Quality (IQ)** in moderating the impact of openness on economic stability was tested using Structural Equation Modeling (SEM). The results indicate that high institutional quality strengthens the positive impact of trade openness on economic stability, while weak institutions exacerbate the negative effects of trade liberalization, particularly in the industrial sector. For instance, in countries with poor institutional frameworks, trade openness tends to lead to factory closures and increased unemployment due to ineffective governance in managing the transition to a more open economy.

4.5 Key Findings and Implications for Policy

1. **Trade Openness** has a generally positive effect on Iraq's economic stability, particularly through its role in expanding access to global markets. However, this positive impact is tempered by challenges in the industrial sector, such as the shutdown of local factories due to the influx of cheaper imports.
2. **Financial Openness** contributes to economic stability, though its impact is weaker compared to trade openness. To maximize the benefits of financial liberalization, Iraq needs to improve institutional frameworks and financial market development.

3. **Institutional Quality** plays a crucial role in determining the effectiveness of openness policies. Strong institutions can ensure that trade and financial openness lead to sustainable economic growth, while weak institutions exacerbate vulnerabilities in the industrial sector.
4. **Policy Recommendations** include the need for comprehensive industrial policies that protect nascent sectors from unfair competition, along with continued efforts to improve governance and institutional capacity.

5. CONCLUSION

This study has examined the relationship between trade openness, financial openness, and economic stability in Iraq, with a particular focus on the industrial sector. The analysis reveals that trade openness, although beneficial for overall economic growth, has posed significant challenges for Iraq's industrial sector, particularly in terms of factory closures and increased unemployment due to competition from cheaper imports. While trade liberalization has expanded Iraq's access to global markets, its adverse impact on domestic industries calls for a more nuanced approach to managing trade openness.

Financial openness, on the other hand, has been shown to positively affect economic stability, although its impact is more modest compared to trade openness. The inflow of foreign direct investment and portfolio capital has contributed to economic growth and stability, but without proper institutional mechanisms, these benefits can be undermined by capital volatility and external shocks.

Institutional quality emerged as a crucial moderating factor in the relationship between openness and economic stability. Countries with stronger institutions are better able to harness the benefits of openness, while weaker institutions may exacerbate vulnerabilities, especially in the industrial sector.

The findings highlight the importance of comprehensive policies that protect and support domestic industries during periods of increased trade liberalization. Additionally, improving Iraq's institutional quality is essential to ensuring that financial and trade openness contribute positively to sustainable economic stability.

In conclusion, while trade and financial openness have the potential to foster long-term economic growth and stability in Iraq, this potential can only be fully realized through robust institutional frameworks and targeted industrial policies that balance the benefits of openness with the protection of domestic sectors.

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