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THE INFLUENCE OF THE QUALITY OF POLITICAL INSTITUTIONS ON THE LEVEL OF FINANCIAL DEVELOPMENT: A PANEL ANALYSIS OF THE BALKAN COUNTRIES

Abstract

Through the allocation of scarce financial resources and the selection of investment projects, the financial system plays a major role in the economic growth of the country. Modern economic science, on the other hand, recently recognized the importance of institutional factors in shaping economic dynamics. The question arises whether there is and what is the influence of political institutions on the level of financial development of the country. Although there is an extensive literature in this area, there is a lack of research that deals only with the Balkan countries. Due to their specific historical heritage, most of these countries started developing a market-based financial system only in the last decade of the 20th century. The aim of the paper is to examine the influence of the quality of institutions measured by World Governance Indicators (WGI) on the level of financial development expressed by the share of domestic loans to the private sector in GDP.

Key words: *financial development, financial system, Balkan countries, institutions, WGI, panel data*

JEL classification: *B52, P19, 016*

УТИЦАЈ КВАЛИТЕТА ПОЛИТИЧКИХ ИНСТИТУЦИЈА НА НИВО ФИНАНСИЈСКОГ РАЗВОЈА: ПАНЕЛ АНАЛИЗА БАЛКАНСКИХ ЗЕМАЉА

Апстракт

Кроз алокацију оскудних финансијских средстава и селекционисање инвестиционих пројеката финансијски систем игра велику улогу у привредног расту земље. Модерна економска наука је, са друге стране, релативно скоро препознала значај институционалних фактора у обликовању економске динамике. Поставља се питање да ли постоји и какав је утицај политичких институција на ниво финансијске развијености земље. Иако постоји обимна литература у овој области, примећен је недостатак истраживања које се

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бави само балканским земљама. Због свог специфичног историјског наслеђа већина ових земаља је са развојем финансијског система на тржишним основама кренула тек у последњој деценији 20. века. Циљ рада је да испита какав је утицај квалитета институција мерених WG индикаторима на ниво финансијске развијености изражен уделом домаћих кредита приватном сектору у БДП-у.

Кључне речи: *финансијска развијеност, финансијски систем, Балканске земље, институције, WGI, панел подаци*

Introduction

At the beginning of the last century, Schumpeter pointed out the importance of the financial system for the economic growth of the country, because it provides entrepreneurs with the necessary financial resources for the realization of investment projects, which have an expansive effect on the dynamics of the capitalist economy. Through the allocative function, the financial system ensures that scarce funds are allocated to exactly those projects that have the highest return and give the greatest impetus to economic growth. Hicks (1969) emphasized the importance of the financial system for starting the industrial revolution in England. The development of statistical instruments made it possible to confirm the positive relationship empirically (Levin, 1997). By reducing the costs of external financing for companies, the developed financial system becomes an important factor in economic growth (Rajan & Zingales, 1998). In addition, the modern financial system promotes investments by identifying and financing attractive projects, mobilizing savings, controlling the performance of managers, enabling trade, hedging and risk diversification (Bekana, 2023).

On the other hand, only at the end of the 20th century, after several decades of dominance of the neoclassical approach, economic science started recognizing the fact that economic activity does not take place in a kind of vacuum, but that it is the result of numerous and complex processes and flows that have an institutional character. North (1991) defines institutions as rules created by men, which shape political, economic and social interactions. They are reflected through formal and informal systems of rules and customs that represent a landmark for human action. Acemoglu et al. (2001) point out that institutions are one of the main determinants of long-term economic growth. Institutions create an environment that can both stimulate and disincentivize economic and social activities (Frunza, 2011).

Based on that, the question arises as to what is the influence of socio-political institutions on the level of financial development of the country? De Soto (2000) points out that the lack of property rights represents a significant obstacle to the financial development of the country. The capital market requires the existence of protection of property rights over time and the absence of the ability of the government to seize one's property or change its value (North, 1991). If economic subjects do not have legal certainty regarding the realization of rights as creditors, they will avoid entering into such transactions (Fergusson, 2006). The importance of institutional factors and compliance

with the law for the development of financial markets stems from the nature of the business that is performed there. Namely, the conditioning of the operation of the entire financial system by trust between two parties is constantly burdened by the impossibility of the one who is in the role of creditor to know the intentions and monitor the behavior of the borrower. The consequence is that in financial markets information asymmetry and distribution of information has greater implications for resource allocation compared to other markets (Capasso, 2004). Also, Roe and Siegel (2011) emphasize the importance of democracy and political stability on the development of the financial sector, because they can also shape political institutions.

The influence of institutions is not limited only to the size measured by the volume of transactions, but also to the structure of the financial system. Depending on the method, i.e. channels through which economic subjects acquire missing financial resources, the financial system can be classified as dominantly market-oriented or bank-oriented. The profiling of these systems in one direction or another is often conditioned by centuries of exposure to the system of rules and laws in the country, primarily those that concern the protection of investors' property. The development of a market-oriented system, as in Great Britain and the USA, is linked to the application of common law, while the civil law in the continental part of Europe favored financing through banks (La Porta et al, 1997). Namely, the civil code gives investors fewer rights compared to the common law system, regardless of the level of economic development, which is why financing through banks is more frequent and common (La Porta et al, 1998). In addition, the positive impact of customary law can be linked to greater adaptability of this system to the real circumstances and needs of economic agents (Back & Levine, 2003).

Confirmation of the previous statements can be found by analyzing the historical development of the financial systems of developed Western countries. North and Weingast (1989) in a study of the achievements of the Glorious Revolution from the 17th century state that institutional changes aimed at protecting the property rights of the people and preventing the arbitrariness of the crown provided the basis for the development of the private capital market. The certainty and security of creditors made it possible to multiply the mobilization function of the state for the necessary financial resources, which in turn encouraged the development of private markets. Under different socio-historical circumstances, different legal systems were created (Common Law, French, German and Scandinavian civil code systems), with different impacts on the general economic and financial system performance (La Porta et al, 1997; 1998; Back & Levine, 2003). According to Acemoglu et al. (2001), the quality and character of institutions in developing countries is a function of their colonial past. By building institutions, including those that regulate the financial system, the colonizers tried to maintain the extractive nature of those economies, and prevent the development of modern states that could compete with them on the international level at a certain moment, which resulted in the general underdevelopment of these countries even today.

The modern approach in development economics highlights the benefits and necessity of liberalizing economic flows for the sake of greater development performance, which also applies to the financial sector. However, there are empirical confirmations that good institutions and public management are a prerequisite for the positive effects of financial liberalization on the development of the financial sector to manifest (Karikari, 2010; Chin & Ito, 2002). Liberalization in the conditions of a system in which there is

no sufficient articulation of the protection of property rights, and the security of creditors will not result in the desired effects. Also, the influence of financial development on economic growth can depend on the quality of institutions in the country (Law et al, 2018). The influence of the financial system on economic growth is most pronounced in medium-developed countries with quality institutions, while in low-income countries without good institutions, financial development may not ensure long-term economic growth (Demetriades & Law, 2006).

The aim of this paper is to examine the nature and character of the influence of institutional factors on the level of development of the financial system of the Balkan countries in the period 2000-2023. The World Governance Indicators (WGI) were used as an indicator of institutions, while the level of financial development was shown through the share of domestic loans to the private sector as a share of GDP. In the first part of the paper, a review of the existing literature was carried out, where the focus was on research that used the same indicators. In the second part of the paper, descriptive statistics of the data used are given, while the research with the conclusion is in the third part of the paper.

Review of Existing Literature

There is extensive literature on the relationship between the institutional environment and the level of financial development of the country. The authors used various statistical models such as random and fixed effects to more demanding ones such as GMM and ARDL. Samples range from large groups of more than a hundred countries to time series analysis of single country data. However, the absence of research dealing with this issue on the sample of Balkan countries was noticed, which represents the main scientific novelty of this paper.

In a panel of 189 countries in the period 2002-2017, using OLS, random and fixed effects, but also the dynamic GMM model, the influence of institutional quality on financial development was examined (Khan et al., 2020). The variable *domestic credits to private sector by bank (% of GDP)* was used as an indicator of financial development, while WGI were used for the quality of institutions. Of the six indicators, *Political stability*, *Control of corruption* and *Regulatory quality* had a positive, and *Rule of law* had a statistically negative impact on financial development.

Dividing the group of 131 countries into developed and developing countries, Lisbinski and Burnquist (2024) applied GMM to examine the influence of institutions on the level of financial development expressed through the share of domestic loans to the private sector in GDP. On the other side, WGI and the index of economic freedom were used. In the group with developed countries, institutional factors were not statistically significant, while in the other group they were. Due to the already high level of institutional development in developed countries, there is insufficient variation in these factors, so other factors such as technological innovation and human capital gain importance (Lisbinski & Burnquist, 2024).

Law and Azman-Saini (2012) recognized the fact that the financial system can be market- and bank-oriented, and therefore used separately *credits to private sector by bank (% of GDP)* as an indicator of the development of the banking system and *stock*

market capitalization as an indicator of the development of the financial market. In order to check the robustness of the research, the authors also used alternative indicators of the quality of institutions and public management from the WGI and ICRG[4] (International Country Risk Guide). The positive influence of the quality of institutions on the banking sector has been confirmed, while the relationship between institutions and the capital market is in the form of the Latin letter U, i.e. up to a certain level, the quality of institutions has a negative effect, and only at higher levels it has a positive effect on the growth of the capital market.

On a sample of 120 countries, where 32 are high-income and 88 are low-income, Ondoa and Seabrook (2020) used the CCEMG method to examine the relationship between the WGI and the level of financial development in the period 2002-2017. The depth of financial institutions was used as the main indicator of financial development (Svirydzenka, 2016), while an additional check was made by the share of loans to the private sector in GDP. The variables *political stability* and *regulatory quality* had a positive impact, while *voice and accountability* and *government effectiveness* had a negative impact. The choice between alternative dependent variables was not associated with significant differences in results.

In addition to research with a very broad, even global sample, there are also studies that deal with the relationship between institutions and financial development at the regional level. Feng and Yu (2020) examined the role of institutions on the financial development of 11 East Asian countries in the period 1996-2017 using panel and data for each individual country. The impact of the six subcomponents of the IEF (Index of Economic Freedom) published by the Heritage Foundation and the six WGI were separately considered, with the former representing the quality of economic institutions and the latter the quality of legal and political institutions. Different institutions had different roles in different countries; however, the influence of legal-political ones was more pronounced because five out of six were statistically significant, compared to three for economic ones.

Bekana (2023), on an example of 45 African countries, in the period 1996-2018. examined how the quality of institutions affects the development of the financial sector at different levels of financial development using the quantile regression method. Based on six WGI, a composite indicator of the quality of institutions was created, while the share of domestic loans to the private sector in GDP was used as the dependent variable. The research confirmed the positive influence of institutions on the dependent variable, where it was shown that at higher observed quantiles, i.e. at higher levels of financial development, the influence of institutions becomes more pronounced.

On the other hand, there are studies in which the influence of institutions on financial development has not been confirmed (Fagbemi & Ajibike, 2018). Using the ARDL and bound test, the authors examined the influence of institutions, trade openness and the level of economic development on the size of the financial sector expressed by the share of loans to the private sector in GDP and the share of money supply M2 in GDP on the example of Nigeria in the period 1984-2015. The control variables were statistically significant, while the quality of institutions was not statistically significant either in the short or long term. This is

[4] In the model using WGI, the number of observed countries is 63 and the time period is 1996–2004, while in the model using ICRG, 51 countries are included and the period is 1984–2004.

explained by the fact that the quality of institutions in Nigeria in the observed period was at a very low level, as a result of which it could not achieve a positive effect.

Also, Cherif and Gazdar (2010) observed 14 MENA (The Middle East and North Africa) countries in the period 1990-2007 ICRG indicators (International Country Risk Guide) were used as indicators of institutions, while the level of capital market development as a share of market capitalization in GDP is an independent variable. The research did not confirm the statistically significant influence of institutions on the development of the capital market.

Overview of Used Variables and Descriptive Statistics

The paper used panel data, which actually represent a combination of cross-sectoral and temporal data. Hsao (2003) and Klevmarken (1989) state a number of reasons why panel data should be used in econometric research, such as control of individual heterogeneity, greater information content, the possibility of testing more complex models, etc. The research covers a group of ten Balkan countries in the period 2000-2023. All data are taken from the WDI (World Development Indicators) and WGI databases of the World Bank. An overview of the variables used is given below in Table 1.

Table 1. Overview of used variables

Variable	Source	Description
Domestic credits to private sector (% GDP)	WDI	The amount of financial resources provided to the private sector by financial corporations in the form of loans, bond purchases, trade credits, etc., expressed as a share of GDP. Financial corporations include the monetary authority, depository credit banks, but also other organizations such as leasing corporations, insurance institutions, pension funds, etc...
Rule of Law	WGI	It represents the perception of public trust and the extent to which agents obey the rules of society. Enforcement of contractual obligations, protection of property rights, independence of judiciary and police...
Government Effectiveness	WGI	It measures the perception of the quality of public goods, public service services, the degree of its independence from political pressures, the quality of public policies and the government's consistency in their implementation.
Regulatory Quality	WGI	It represents the public's perception of the government's ability to formulate and implement sound policies and create regulations that promote private sector growth.
Control of Corruption	WGI	The perception of the extent to which public position is used for personal gain, including grand and petty corruption, as well as the degree to which the state is captured by elites and private interests.

Voice and Accountability	WGI	The perception of the degree to which the citizens of a country are able to participate in the election of the government, the degree of freedom of expression, association and freedom of the media.
Political Stability and Absence of Violence/ Terrorism	WGI	It measures the perception of the likelihood of political instability and/or politically motivated violence, including terrorism.
Trade (% of GDP)	WDI	The sum of exports and imports of goods and services expressed as a share of GDP.
GDP per capita (constant 2015 dolars)	WDI	The total value of goods produced on the territory of one country within one year.

Source: created by the authors based on data from the World Bank website

There are different ways to measure the level of financial development; however, the volume of loans and the size of the capital market are most often used in the literature (Rajan & Zingales, 1998). Considering the general underdevelopment of the capital market in the Balkans, the authors' decision is to use the variable *Domestic credits to private sector (% GDP)*, while WGI was used as indicators of the quality of institutions.

The level of economic development in the form of GDP per capita and the country's trade openness shown as a share of the country's total imports and exports in GDP were used as control variables. A higher level of development of the country and greater freedom of exchange with foreign countries implies a larger volume of financial transactions, and in this case, it can also mean a larger volume of loans. Regarding the country's trade openness, Ryan and Zingales (1998) provide a seductive explanation, according to which certain interest groups deliberately inhibit the development of the financial system, because it facilitates the emergence and development of competition that can threaten their position and the rent they earn. Opportunities for such activities are more difficult if there are trade and financial openness of the country.

Probably the most frequently used indicators of the quality of institutions and public management are the WGI. These indicators cannot be considered completely independent of each other (Kaufmann et al., 2010). Namely, in a country where there is a strong rule of law, it will be more difficult to carry out corrupt activities, thus the level of corruption itself will be low. An effective government capable of creating and implementing effective policies will ensure that legislation is good. Lack of transparency will favor the spread of corruption, which can cause political instability, etc. Considering the strong correlation that exists between these indicators, the recommendation of their creators is to use them individually in research (Kaufmann et al., 2010). Accordingly, the paper will use the average value of these indicators, as a summary expression of the quality of institutions (Karikari, 2010).

Table 2. Descriptive statistics of the data used

Variables	Arithmetic mean	Std. dev	Min	Max
Credits to private sector	49.98	22.083	7.125	120.147
Gdpvpervcapita	9292.5	6301.42	1991.91	25708.87
Trade openness	93.178	27.403	21.109	186.22
Institutions	51.96	16.981	0	82.192
Government effectiveness	54.38	15.94	11.89	84.76
Political stability	51.02	16.94	7.93	93.65
Regulatory quality	60.78	11.92	19.02	79.04
Rule of Law	53.06	14.26	10.44	84.28
Voice and accountability	58.99	12.41	30.34	87.02
Control of corruption	50.17	13.93	9.04	83.25

Source: created by the authors

Table 3. Overview of average values by country

Country	Domestic credits	GDP per capita (dollars)	Institutions	Trade openness
Greece	85.6	19991	65.3	64.1
Croatia	58.24	12542.5	63.51	87.45
Slovenia	57.5	20834.4	79.27	137.8
B&H	57.5	4281.8	36.5	87.9
N. Macedonia	51.3	4715.5	46.3	108.9
Montenegro	48.3	6115.2	46.8	105.5
Bulgaria	47.9	6710.4	57.02	111.8
Albania	36.7	3625.5	44.02	72.9
Serbia	35.03	5716.8	41.94	82.9
Romania	25.8	8391.6	55.9	72.3

Source: created by the authors

Table 2 shows the descriptive statistics of the data used, and Table 3 shows the average value for the observed countries. The average value of the share of domestic loans to the private sector in the observed period was 49.98% of GDP, with the highest average value in Greece 85.6, and the lowest in Romania 25.8. The average value of GDP per capita was 9293.5 USD. The most economically developed country is Slovenia with an average value of GDP per capita of 20,834.4 USD, ahead of Greece, which has 19,991 USD. Albania was the least developed with an average value of GDP per capita of only 3625.5 USD. Slovenia has the highest average score of the WGI in the observed period, 79.27, while B&H has the lowest score in the group, 36.5. Slovenia also achieved the largest relative volume of foreign trade, i.e. has the highest trade openness, averaging as much as 137% of GDP, while Greece achieved the lowest, only 64.1% on average.

Research

Although the application of GMM represents a recent trend in the literature, the sample size does not allow the application of this method, which is why the static linear regression model was used. In accordance with the set goal of the research to examine the existence and nature of the influence of the institutional environment and the quality of public management on the level of financial development of the Balkan countries, the specification of the used linear regression model was set. Variables are logarithmized to control for heteroskedasticity and autocorrelation, and the specification is given in terms of Green (2002).

$$logFD = \beta_1 + \beta_2 INS + \beta_3 loggdppercapita + \beta_4 logTRADE + \varepsilon$$

The data was first checked for the existence of a unit root, i.e. whether all observed variables are stationary. According to the theory, a variable can be considered stationary if its probability distribution does not change over time (Wooldridge, 2013). The Levin-Lin-Chu (2002) and Im-Pesaran-Shin (2003) test was used in the study, and the used decision criterion was α=0.05. The null hypothesis (H0) of the tests used assumes that the observed variable is not stationary, i.e. to have a unit root.

Table 4. Summary of values of LLC and IPS unit root tests

Variable	LLC test		IPS test	
	t-stat	p-value	t-stat	p-value
logFD	-	-	-2.98	0.000
logINS	-6.884	0.000	-2.265	0.010
loggdppercapita	-3.76	0.0036	-2.048	0.025
logTRADE	-4.692	0.0469	-4.138	0.000

Source: created by the authors

The obtained values are shown above in Table 4. Since all values are less than the decision criteria, it can be concluded that all variables are stationary at level I(0), that they are of the same order of integration, and that the regression analysis can be continued on that basis.

Checking the existence of multicollinearity was performed by calculating Pearson's correlation coefficients. If the correlation coefficient of the observed variables has a value greater than 0.8 or 0.9, it is considered that there is a problem of multicollinearity (Senaviratna & Cooray, 2019). The results obtained are shown below in Table 5.

Table 5. Overview of Pearson's correlation coefficient values

	logcredits	loginstitutions	loggdp	logtrade
logcredits	1.00	-	-	-
loginstitutions	0.39	1.00	-	-
loggdp	0.44	0.76	1.00	
logtrade	0.16	0.31	0.15	1.00

Source: created by the authors

Within the obtained matrix of correlation coefficients, no value indicates the presence of multicollinearity between the variables. The highest value between the independent variables *loginstitutions* and *loggdp* is 0.76, which confirms the assumption that there is a better institutional environment in more developed countries.

After the initial checks, the regression analysis was started. Below in Table 6 are the values obtained by applying the pooled model and regression with fixed effects.

Table 6. Overview of values using pooled and fixed effects

Variable	Pooled	Fixed effects
loginstitutions	0.888***	0.986***
	(0.174)	(0.173)
logtrade	-0.045	-0.212
	(0.135)	(0.153)
loggdppercapita	0.334***	0.565***
	(0125)	(0.158)
R-squared	0.275	

Note:***α=0.01;**α=0.05; *α=0.01

Source: created by the authors

The variables that represent the quality of political institutions *loginstitutions* and the level of economic development of the country *loggdppercapita* are statistically significant at the statistical significance level of 1%. The country's trade openness *logtrade* in the model is not statistically significant. In both models, the quality of institutions has a greater influence on the level of financial development than the level of economic development. In the model with group effects, the coefficient values are 0.888 and 0.334, which indicates that institutions have almost two and a half times greater influence than the level of GDP per capita. The difference decreases in the model with fixed effects, in which the coefficients are 0.986 and 0.565. This implies that a 1% improvement in political institutions, as measured by the WGI, will result in a 0.986% increase in domestic credit to the private sector, while a 1% increase in economic growth will lead to a 0.565% rise in the dependent variable.

In order to verify the correctness of the obtained values, the research follows the assumptions of linear regression, namely the homoscedasticity of the data and the absence of autocorrelation (Greene, 2002). Homoscedasticity of the data means that the variance of the random error in the model is constant, while failure to respect this assumption may lead to an unreliable estimate (Gujarati, 2003). The check was performed using the Wald heteroskedasticity test, and the obtained values are shown below in Table 7.

Table 7. Wald test values

Chi2	9932.25
Prob>Chi2	0.000

Source: created by the authors

According to the H0 test hypothesis, the variance of the random error is constant for each value of the independent variable. The obtained *p* value is less than the critical value of the test α=0.05, which is why the H0 hypothesis is rejected, and it is concluded that there is a problem of heteroskedasticity in the model.

The next check concerns the existence of autocorrelation through the Wooldridge test (2002). Ignoring the autocorrelation problem will still result in consistent but inefficient coefficient estimates and biased standard errors (Baltagi, 2005). An overview of the obtained values is given below in Table 8.

Table 8. Wooldridge test values

F(1,9)	1013.76
Prob>F	0.000

Source: created by the authors

In the used Wooldridge test, the *H0* hypothesis is that there is no autocorrelation, and the alternative *Ha* hypothesis is that there is. Given that the obtained *p* value (0.000) is less than α=0.05, the H0 hypothesis is rejected and *Ha* is accepted.

Through the Pesaran test (2004), the existence of cross-sector data independence was examined. The obtained test value is 0.000, which is also less than the decision criterion α=0.05. Therefore, it is concluded that there is a problem of cross-sectoral correlation in the model.

Due to the shortcomings, the results shown in Table 6 cannot be accepted, and a more adequate statistical model should be used. The STATA program allows calculating the standard error robust to the problems of autocorrelation, heteroskedasticity and cross-sectoral correlation through the option *xtsccza* coefficients (Hoechle, 2007). The module is based on the calculation of Driscoll and Kraay (1998) standard error. The results obtained by this model are shown below in Table 9.

Table 9. Overview of model values with Driscoll and Kraay standard error

Variable	**I**	**II**
loginstitutions	0.986*** (0.297)	-
logtrade	-0.212 (0.286)	-0.01 (0.241)
loggdppercapita	0.565 (0.498)	0.826* (0.449)
R-squared	0.27	0.186

Source: created by the authors

The quality of institutions *(loginstitutions*) proved to be robust to the correction of autocorrelation, heteroscedasticity and cross-sector correlation problems, and preserved

the level of statistical significance of 1%, but the level of economic development (*loggdppercapita*) is no longer statistically significant. However, this should not be understood as an assertion that it has no influence on the level of financial development, because if we exclude institutions from the model (see column II), the variable becomes statistically significant again, at the 10% level. Institutions are of greater importance than the mere expansion of material production. If economic growth is achieved without corresponding progress in this area, the financial development of the country will be hindered.

Examining the Influence of Individual Indicators

After the positive influence of institutions on the financial development of the country was confirmed in the previous part of the paper, there was a need to examine the separate influence of each of the six WGI and determine which aspect of the institutional environment has the greatest influence. In view of the mentioned problems of multicollinearity between WGI, six separate models were created, in each of which only one indicator was taken as a dependent variable. The results are shown below in Table 10.

Table 10. Overview of values of individual WGI

Variable	I	II	III	IV	V	VI
logcorruption	0.195 (0.126)	-	-	-	-	-
loggovernment	-	0.061 (0.101)	-	-	-	-
logruleoflaw	-	-	0.574** (0.211)	-	-	-
logregulatory	-	-	-	0.722*** (0.164)	-	-
logpolitical	-	-	-	-	0.078 (0.08)	-
logvoice	-	-	-	-	-	-0.024 (0.226)

Note:***α =1%; ** α = 5;* α = 10%

Source: calculated by the authors

Of all the variables, only the rule of law (*logruleoflaw*) and quality of regulation (*logregulatoryquality*) proved to be statistically significant at the level of 5 and 10% respectively. The quality of regulation with a coefficient value of 0.722 has a greater influence than the rule of law with 0.574. Compliance with laws and regulations that protect private property and enable its efficient utilization is more conducive to financial development. The security and certainty associated with contract enforcement enjoyed by financial market participants outweigh the importance of political stability, freedom of expression, the government's capacity to design and implement effective policies, and even the level of corruption.

Conclusion

The main novelty of this research comes down to the selection of the observed sample - the Balkan countries. There is extensive literature that deals with the study of the relationship between institutions and the level of financial development, but the Balkan region has not been the subject of separate consideration until now. The results obtained are in accordance with what the theory dictates, which was also achieved in another research. The positive influence of the quality of the institutional environment on the level of financial development of the country was confirmed, and it proved to be more important than the level of economic development itself. Among all institutional aspects, only the quality of legislation and the rule of law have a statistically significant impact. Legal certainty and adaptation of the law to the real needs of economic actors are important determinants of the size of the country's financial system. Nevertheless, it is difficult to imagine that progress can be achieved in only one area, as institutional advancement is generally realized simultaneously across all institutional dimensions. Although the World Bank publishes them as separate indices, these dimensions are closely related and deeply interconnected.

As a recommendation for future research, the inclusion of additional control variables, such as quality of life, the level of human capital, inflows of foreign direct investment, and the effects of crisis-related events, appears warranted. Furthermore, the application of more advanced cointegration techniques could enable the distinction between short-run and long-run effects, as well as the examination of bidirectional causal relationships between the variables.

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