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Impact of financial development, money, and public spending on Malaysian national income: an econometric study

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Abstract

The objective of this paper is to estimate an econometric model for analyzing the impact of financial development, money, and public spending on Malaysian national income. Selection of variables is made in accordance with the literature on financial sector development and economic growth and the monetarist and Keynesian views on the relative effectiveness of monetary and fiscal policy. After determining the time series characteristics of the dataset, a vector error-correction model (VECM) is estimated. The results show an unambiguous support for the 'supply-leading' view of financial development, implying the importance of financial sector development in Malaysia. The findings provide some support for the McKinnon–Shaw repressionist proposition. But there is no noticeable support either for the monetary policy or for the fiscal policy effectiveness in case of Malaysia. © 2002 Elsevier Science Inc. All rights reserved.

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1. Introduction

Malaysia is an example of an economically impoverished nation achieving remarkable economic success in a relatively short period of time. There exists an enormous theoretical literature on the temporal behavior of income and output spanning such areas as

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macroeconomic modeling, public finance, monetary economics, international trade, and development economics. Due to its spectacular performance, Malaysia presents an excellent case for evaluating the relevance of this literature to Malaysia. More precisely, this paper examines the relevance of (1) supply-leading role of financial development, (2) repressionist view on financial liberalization, and (3) monetarist-Keynesian views on money, public expenditure and economic growth. To the best of author's knowledge, no attempt has been made to estimate an inclusive model for testing the relevance of these propositions to the Malaysian case. The results of this study are expected to shed some light on the Malaysian macroeconomic dynamics. These insights may prove useful to other developing countries in formulation of their own goal-consistent set of policies.

The macroeconomic relationships underlying these propositions are complex and multifaceted. Due to potentially strong feedback effects, there is little *a priori* basis for assuming the exogeneity of any of the variables in the system. For this and many other reasons, a vector autoregressive (VAR) framework has been chosen as the appropriate methodology, with the exact specification to be determined by the time series characteristics of the dataset. Ideally, the study should have used quarterly data, but data unavailability on some key variables has made it necessary to use annual data instead. The sample period runs from 1960 to 1996, generating 37 observations. The year 1996 has been chosen as the cutoff period to avoid the effect of Asian contagion which started in 1997. The rest of the paper is organized as follows. Section 2 provides a summary of the theoretical literature. Section 3 presents main features of the Malaysian economic development highlighting its macroeconomic stability. Section 4 provides a brief account of financial sector development in Malaysia. Section 5 presents a discussion of the model, data, and the methodology. Empirical results are presented and analyzed in Section 6. Section 7 consists of some concluding remarks.

2. A summary of theoretical literature

In this section, a brief summary of the theoretical literature, as it relates to each of the issues stated above, is presented. This, by no means, should be construed as a complete survey.

2.1. Financial development and economic growth

The idea that financial sector development promotes growth was first put forth by Joseph Schumpeter as early as in 1911 (see, King & Levine, 1993b). Since then, the relationship between financial sector development and economic growth has been investigated in numerous studies. Many economists hold the view that financial development is a necessary condition for achieving high rate of economic growth (see, e.g., Goldsmith, 1969; McKinnon, 1973; Shaw, 1973).[1] This is what Patrick (1966) calls the 'supply-leading' role of financial development. Financial development is seen contributing to economic growth in the following ways: (1) financial markets enable small savers to pool funds, (2) savers have a wider range of instruments stimulating savings, (3) efficient allocation of capital is achieved

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