

# What are the mechanisms linking financial development and economic growth in Malaysia?

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## Abstract

This paper estimates a six-equation model of financial development and economic growth for Malaysia to shed light on the mechanisms linking these two variables. The results indicate that financial development leads to higher output growth via promoting both private saving and private investment. The findings also provide some support for the hypothesis of endogenous financial development and growth models that finance leads to higher growth through improved efficiency of investment. There is evidence that repressionist financial policies, such as interest rate controls, high reserve requirements and directed credit programs, have contributed positively to financial development. However, other direct government interventions in the economy, such as resource allocation through the operation of a broad-based employee provident fund (EPF) scheme and various public investment programs, seem to have impacted negatively on economic development in Malaysia.

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## 1. Introduction

Every economy requires a sophisticated and efficient financial system to prosper since a healthy financial system is integral to the sound fundamentals of an economy. A more efficient financial system provides better financial services, and this enables an economy to increase its GDP growth rate. Conversely, a weakened financial system spills over unfavourably into the economy. An inadequately supervised financial system may be crisis-prone, with potentially devastating effects. The important role of financial intermediaries and financial markets therefore merits more attention from researchers and policy makers.

Empirical studies on the relationship between finance and growth have been dominated by cross-country studies until recently due to the lack of sufficient time series data for developing countries. These studies have consistently

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demonstrated that financial development is an important determinant of economic growth.<sup>1</sup> Although the findings of these studies provide a useful guide on the finance–growth relationship, it is difficult to see how the results can be generalized since such a causal link is largely determined by the nature and operation of the financial institutions and policies pursued in each country (Arestis and Demetriades, 1997; Demetriades and Andrianova, 2004). Against this backdrop, only one country is chosen here as a case study as opposed to the conventional broad comparative examination that involves a much larger sample.<sup>2</sup>

It is interesting to take Malaysia as a case study for this subject for several reasons. Firstly, with rapid economic growth following the industrial transformation that took place in the 1970s and 1980s, Malaysia has evolved in recent years to be a leading country in the developing world. Accompanying this development, there has been a significant improvement in its financial system. While one may wonder how financial development and economic growth are related, little attention has been paid to understanding the evolutionary development process of Malaysia's financial system. Secondly, Malaysia has a rich history of financial sector reform. Various financial restructuring programs that aim to achieve a better financial system have been launched since the 1970s (Ang, *in press-a*; Ang and McKibbin, 2007). However, there is little empirical evidence providing policy makers with the necessary information as to whether these reforms have had any impact on the financial system, and hence on economic growth. Thirdly, Malaysia has a relatively good database by the standard of developing countries. This provides an added incentive for the research. The availability of a set of sufficiently long time series data allows for a meaningful time series investigation.

Studies in this field have mainly focused on either testing whether financial development plays a positive role in stimulating economic growth or examining the direction of causality between these two variables. Notwithstanding the limitations of the existing econometric techniques that do not allow the issue of causality to be satisfactorily addressed, a large body of empirical evidence has overwhelmingly shown that financial development has a positive impact on economic growth. While this positive role of finance has become a stylized fact, little attention has been paid to examining the mechanisms that link these two variables. To this end, this paper is an attempt to fill the void. The present study seeks to provide some insight into how financial development and economic growth are related in the context of Malaysia. The central issue is how, and to what extent, improvement in Malaysia's financial system contributes to the process of economic development. It is hoped that this analysis will add to our understanding of the evolutionary role of financial system, and the interacting mechanisms between financial development and economic growth.<sup>3</sup>

The paper is divided into six sections. Section 2 discusses some conceptual issues in the finance and growth literature. An analytical framework linking financial development and economic growth is provided in Section 3. Section 4 sets out the econometric procedures adopted in this study. Section 5 provides and discusses the findings. Some policy simulations, under the counterfactual condition that financial liberalization is stable, are provided in Section 6. Finally, Section 7 concludes.

## 2. Conceptual issues

The important role of financial development in the process of economic development has long been recognized in the literature. Schumpeter (1911) contends that entrepreneurs require credit in order to finance the adoption of new production techniques. Banks are viewed as key agents in facilitating these financial intermediating activities and promoting economic development. Hence, well-developed financial systems can channel financial resources to the most productive use. The alternative explanation initiated by Robinsons (1952) suggests that financial development does not lead to higher economic growth. Instead, financial development responds passively to economic growth as a result of higher demand for financial services. When an economy expands, households and firms demand more financial services. In response to this increased demand, more financial institutions, financial products and services emerge, thereby leading to expansion of financial systems.

The notable early works on finance and development along the Schumpeterian lines include Gurley and Shaw (1955), Goldsmith (1969) and Hicks (1969). They argue that development of a financial system is crucially important

<sup>1</sup> See, e.g., King and Levine (1993a), Rajan and Zingales (1998), Levine et al. (2000), Rioja and Valev (2004) and McCaig and Stengos (2005).

<sup>2</sup> For the other individual country case studies, see, e.g., Demetriades and Luintel (1996), Thangavelu and Ang (2004), Ang (*in press-b*) and Ang and McKibbin (2007). These studies mainly focus on testing the Granger causal relationship between financial development and economic growth. See Ang (*in press-c*) for a detailed survey on these studies.

<sup>3</sup> While testing the mechanisms that link financial development and economic growth is conducted at the aggregate level in the present study, as highlighted by one of the referees, it would also be interesting to perform the analysis at the industry-level using disaggregated data.

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