FINANCIAL DEVELOPMENT AND ECONOMIC GROWTH IN MALAYSIA: THE STOCK MARKET PERSPECTIVE

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ABSTRACT

Understanding the causal relationship between financial development and economic growth is important in enhancing the economy of a nation. Using the autoregressive distributed lag (ARDL) bounds test approach, this study finds that stock market development is cointegrated with economic growth in the context of Malaysia. Moreover, this test also suggests that stock market development has a significant positive long-run impact on economic growth. Granger-causality test based on vector error correction model (VECM) further reveals that stock market development Granger-causes economic growth. Hence, this study provides robust empirical evidence in favor of finance-led growth hypothesis for the Malaysian economy.

Key words: Financial development, economic growth, cointegration, causality, stock market

INTRODUCTION

The causality relationship between economic growth and financial development is a controversial issue. Basically, the debate has been centered on whether it is the financial development that leads the economic growth or vice versa[1]. This "financial development-economic growth puzzle" is complicated by another view that the relationship is dynamic in nature. To date, there is no-clear cut solution in which policy-makers could rely upon. We find that related researches done in the past three decades mostly focused on the role of financial development in stimulating economic growth, without taking into account of the stock market development.

It is particularly true that in the emerging economies, the evolution of stock market has great impact on the operation of banking institutions (Levine and Zervos, 1998; Khan and Senhadji, 2000). Thus, domestic stock market development is expected to have significant relationship the economic growth. The principle objective of this study is thus to re-examine the "financial development-economic growth puzzle" from the perspective of stock market development. The newly developed autoregressive distributed lag (ARDL) bounds test and the Granger-Causality (GC) test based on vector error correction model (VECM) are employed to investigate the cointegration and causality relationships between stock market development and economic growth in Malaysia – a small and open emerging economy.

This paper is organized as follows. The next part of this paper gives a brief account regarding the three competing hypotheses on the financial and economic developments. This is followed by a discussion on the methodology of this study. Results and interpretations are presented just before we conclude this paper in the final part.

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[1] Patrick (1966) provides further details.