THE LIBERALIZATION OF FINANCIAL SECTOR
DEVELOPMENT TOWARDS ECONOMIC GROWTH IN
MALAYSIA

Chong Siat Lee

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THE LIBERALIZATION OF FINANCIAL SECTOR DEVELOPMENT
TOWARDS ECONOMIC GROWTH IN MALAYSIA

CHONG SIAT LEE

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Statement of Originality

The work described in this Final Year Project, entitled “The Liberalization of Financial Sector Development towards Economic Growth in Malaysia” is to the best of the author’s knowledge that of the author except where due reference is made.

(Date Submitted)  
Chong Siat Lee  
16107
ABSTRACT

THE LIBERALIZATION OF FINANCIAL SECTOR DEVELOPMENT
TOWARDS ECONOMIC GROWTH IN MALAYSIA

By

Chong Siat Lee

This study aims to examine the relationship between financial sector development, real effective exchange rate, trade openness (sum of import and export), foreign direct investment (FDI) and economic growth in Malaysia from 1976 to 2005. Five types of methods include Augmented Dickey-Fuller (ADF) Unit Root Test, Johansen and Juselius Cointegration Test, Normalized Equation, Granger-Causality Test, and Cumulative Sum of Recursive Residuals (CUSUM) Stability Test are conducted in this study. The results show that financial sector development and trade openness were greatly improving economic growth. However, the real effective exchange rate and foreign direct investment (FDI) were negatively affecting growth of Malaysia’s economy. Overall, the empirical results support that well-developed financial sector plays significant role in leading domestic economy expansion. In addition, economic growth was found to Granger-cause financial development in the short run.
ABSTRAK

LIBERALISASI PEMBANGUNAN BIDANG KEWANGAN KE ARAH PERTUMBUHAN EKONOMI DI MALAYSIA

Oleh
Chong Siat Lee

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CHAPTER ONE
INTRODUCTION

1.0 Introduction

Over the last few decades, Malaysia has experienced rapid structural transformation and the performance of Malaysian economy has witnessed a remarkable growth. Since the early 1970s, many efforts on financial reformation programs had been launched to improve the financial system and to ensure the stability of the economy in order to stimulate economic growth. In Malaysia, financial liberalization proceeded progressively over the years in meeting the robust financial system to achieve an improved version of the financial sector. Thus, various measures of financial liberalization that aims on strengthening financial sector development have been gradually developed in developing countries including Malaysia.

The manufacturing sector had played an important role for economic growth during the last few decades. However, the growth in this sector decreased due to subdued demand of the global economy since the financial crisis in 1997-1998. This condition caused Malaysia’s economy to experience massive losses in economic sectors which led to declination in the real GDP (Gross Domestic Product) in 1998. Additionally, sub-prime turmoil such as the United States economic recession in 2001 has negatively influenced the domestic economy as the United States is the main trading partner of Malaysia. As a result, the government commenced to look for new sources of
domestic growth engine to meet the challenges of this rapidly changing global economic environment. The government has been developing the service sector to expand the economic base of Malaysia’s economy. More importantly, the service sector has the potential to be fostered to further drive economic growth by counteracting weaknesses of the export-oriented manufacturing industries.

Nowadays, Malaysia has successfully transformed from an agriculture-based to a significant manufacturing-based economy with greater emphasis on development of the service sector. Malaysia’s economy growth is mainly led by the resilient domestic demand of both public and private sectors. Therefore, the service sector need to be further strengthened to become a competitive sector. The Malaysia’s economy remained strong with a growth of 6.3 percent in 2007 compared to 5.9 percent in 2006 (Bank Negara Malaysia, 2007).

In recent years, the service sector has become the leading role of Malaysia’s economy. The government has increased their efforts in preparing service sector led growth development plans such as the Third Industrial Master Plan (2006-2020). With increased efforts geared by emphasizing the role of financial sector development coupled with political stability for gradual financial liberalization, the rising contribution of the service sector to GDP growth was higher than other priority sectors. During the period of 2001 to 2005, the growth of the financial service sector has largely increased Malaysia’s economic growth with an average rate of 8.1 percent per annum and its share to GDP grew 3.4 percent from 12.7 percent in 2000 to 15.1 percent in 2005 (Economic
Planning Unit, 2006). In 2006 and 2007, the service sector’s growth has surpassed the growth in both the manufacturing sector and agriculture sectors (see Table 1.1).

In 2007, the manufacturing and service sectors drove the Malaysia’s GDP growth, tremendously. However, the service sector is the fastest growing domestic-oriented sector. This is in relation to the performance of both manufacturing and agriculture sectors (Bank Negara Malaysia) that are mainly affected by the slow external demand growth. The service sector continued to increase from 7.2 percent in 2006 to 9.7 percent in 2007 and became the largest contributor to the GDP (see Table 1.1). The development of service sector was largely supported by the growth in finance, insurance, real estate, and other service sub-sectors. Financial service sector which consists of finance, insurance, and business services have the highest growth. The finance and trade sub-sector were recorded with highest growth of 12.2 percent and 11.2 percent respectively in 2007 (Ministry of Finance, Malaysia). Therefore, financial sector development today plays an increasingly important role in driving the economic growth.

Table 1.1: Gross Domestic Product (GDP) by Economic Sector (% change)

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<tr>
<th>Economic Sector</th>
<th>2007</th>
<th>2006</th>
</tr>
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<tbody>
<tr>
<td>Agriculture</td>
<td>2.2</td>
<td>5.2</td>
</tr>
<tr>
<td>Mining</td>
<td>3.3</td>
<td>-0.4</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>3.1</td>
<td>7.1</td>
</tr>
<tr>
<td>Services</td>
<td>9.7</td>
<td>7.2</td>
</tr>
</tbody>
</table>

Source: Department of Statistics and Ministry of Finance, Malaysia
In the following years, additional new policies of deregulation and development plans were implemented to increase the competitiveness of the financial sector. The Financial Sector Master Plan (FSMP) was established to develop domestic financial sector for the purpose of economic expansion during the period of 2001 to 2010. Both the FSMP and the Capital Market Master Plan were launched to sustain development of financial intermediations by providing strategic framework in liberalizing financial sector and promoting economic stability in competitive markets.

The prosperity in Malaysia today very much depends on efforts made by the financial sectors. Financial liberalization measure is an important determinant which contributes greatly to economic growth. The liberalization of financial sector development is defined as deregulation of interest rate, elimination of restraints of foreign capital flow, and removal of other various restrictions (Ansari, 2002). This was proved by some empirical works that has been carried out which showed that financial sector development is an essential circumstance in driving economic growth (McKinnon, 1973; Shaw, 1973; King and Levine, 1993). According to McKinnon (1973) and Shaw (1973), the development in financial sector can be improved by utilizing resources and mobilizing savings into the most productive investments.

In other words, more enhanced policies on the financial sector are needed to strengthen the financial system. In the recent study by Ang and McKibbin (2005), efficient financial intermediation helps a country to increase high return investments by facilitating allocation of resources and transfer of household savings. On the contrary,
high cost of financing projects will decelerate economic growth as it is caused by an inefficient process of channel available funds and retained earnings. Therefore, this viewpoint definitely reflects that poorly developed financial system will contribute negatively towards development in the financial sector and it subsequently influence economic growth of a country.

Accordingly, it is argued that effective financial liberalization measures play a crucial role in accelerating the financial sector development to stimulate economic growth in Malaysia. Generally, Malaysia has much interest in adopting financial liberalization policies because Malaysia is aware of the importance of financial sector development that hinges significantly towards economic growth. Therefore, the relationship between the liberalization of financial sector development and economic growth in Malaysia will be analyzed in this study. At the same time, a few financial indicators which results in different implications in influencing Malaysia’s economic growth will also be further discussed in this study.

1.1 Financial Sector Development in Malaysia

1.1.1 The Evolution of Financial Sector after Independence until 1980s

After independence, the Bank Negara Malaysia as the Central Bank of Malaysia was established in 1959 to promote financial stability and sustain the growth of financial framework. In the 1960s, the government embarked on the progress of financial intermediation through development of domestic financial institutions and markets that
would be suitable for rapid structural changes of the economy. These included the establishment of the first Kuala Lumpur Stock Exchange (KLSE), Agricultural Bank, and Malaysian Industrial Development Finance (Okposin et al., 1999).

In the 1970s and 1980s, Malaysia had gradually liberalized the financial system by removing excessive regulations and controls. Later in 1973, capital account was relaxed since abolishment of exchange controls was able to promote free flow of foreign exchange transactions. Besides, interest rate liberalization occurred in 1978. At the end of the decade, Malaysia had a comparatively well-developed financial system which complemented the effective foreign exchange market and is able to increase economic growth. In 1980s, major forms of financial liberalization were introduced to develop a robust financial system that is more effective in allocation and mobilization of financial resources. The government introduced the Base Lending rate (BLR) in 1983. There was an obligation for all banks to peg lending rates to Base Lending rate. The economy was severely affected during world trade recession. The second oil shock during 1979-1980 and the sharply falling commodity prices led to significant adverse effects on Malaysia’s economy. Therefore, the prudent supervision of interest rates and exchange rates regime is important to confront challenges amidst the 1985-1986 deteriorating economic situation. This triggered the government to impose control on interest rate from 1985 to 1987 to mitigate negative effect of economic depression that would jeopardize Malaysia’s economic growth. In 1987, interest rate regime was resumed and the economy continued to grow. The Base Lending rate (BLR) was used to control interest
rates until 1991. Moreover, exchange controls initiatives became more liberalized in 1987 which allowed investors more access into international markets (Ibrahim, 2007).

1.1.2 The Evolution of Financial Sector during the 1990s until the Present

In early 1991, the restriction of Base Lending rate (BLR) was completely eliminated to increase effectiveness of banking industries. The government also focused on developing Kuala Lumpur to be the key domestic financial centre that concentrates on onshore financial systems. Furthermore, the International Offshore Financial Center in Labuan and the Security Commission were established in 1990 and 1993 respectively to enhance efficiency of private sectors and banking industries for economic growth. Later in 1994-1996, exchange control measures were more relaxed to sustain financial development. Capital account liberalization and the leading growth of manufacturing sector were significant contributions to economic growth. The strong economy growth during the period of 1991 to 1996 was mainly due to government incentives on improvement of the private sector and foreign direct investment (FDI). Following the Asian financial crisis in 1997 and 1998, capital controls were imposed in 1998 that aimed specifically at hindering capital outflows and revitalize economy from contamination impacts of external shock. The government has pegged the ringgit at an exchange rate of RM3.80 to US$1.00 in 1998 and introduced the National Economic Recovery Plan (NEAC) to recover the economic growth (Okposin et al., 1999). The liberalization process was reversed when capital controls and pegged exchange rate system were imposed in 1998 to minimize exchange rate risks. Since various
macroeconomic and financial sector policies were formulated when Malaysia experienced a negative growth rate, performance of the economy recovered rather quickly in 1999 (Ang, 2007b).

Moreover, the National Vision Policy (2001-2010) has been launched in the beginning of the new century and focuses on establishing a competitive country. In conjunction with the efforts of Malaysia to promote financial liberalization policies, Malaysia has decided to ended policy of pegging the ringgit at a fixed rate of RM3.8/US$1.0 in 2005. Additionally, the government is promoting the widening of investment and trade regime to develop financial sector in order to become a global Islamic financial hub. The Malaysia’s Islamic Capital Market (ICM) is the first to issue global Islamic bonds (sukuk) in 2002 and expanded as the largest ‘sukuk’ market in 2007. Moreover, the Malaysia International Islamic Financial Centre (MIFC) was launched to strengthen linkage between international Islamic financial market by expanding Islamic financial and business activities into new markets (Ministry of Finance, Malaysia).

1.1.3 Malaysia’s Prospect on Financial Sector for the Future

Malaysia today is a high middle-income country with a more diversified structure in multi-sector economy, which was successfully transferred from a primary commodity producer to manufacturing export-oriented and service-led economy. The development of a resilient financial sector leading to economic growth will continue to be more
challenging in the coming years since the global environment’s challenges arise from external shocks such as instability international prices of fuel, gas, and electricity. Large fluctuations of the global financial market will also restraint Malaysia’s trade growth and flows of FDI. Nevertheless, Malaysia remains confident to stimulate economic growth in 2008 in accordance with the implementation of various development plans that will emphasize on enhancing the growth of the financial sector.

With the current rapid growth of the economy, financial service sector will continue to lead the economic growth. A number of orderly liberalization policies in the financial system will be launched in order to enhance the efficiency, stability and resilience of the financial sector in order to become an important role in leading towards positive economic expansion. The government continues to improve domestic demand for service sector and manufacturing sector by formulating various flexible policies such as facilitating the tax rule and exchange control for development in both these sectors (Economic Planning Unit, 2006). Besides, the Third Industrial Master Plan (2006-2020) will continue to place top priority in developing the service sector. The government is expecting this sector to contribute to economic growth and simultaneously assist Malaysia into becoming a fully industrialized nation by 2020. Furthermore, financial stability is an essential factor in attaining the confidence of both local and foreign investors since massive international trade earnings and FDI inflows greatly increase exchange inflows into Malaysia.
1.2 Problem Statement

Financial liberalization today has led to many challenges and benefits on economic growth in this rapid growing environment (Ibrahim, 2007). The positive and negative impacts of financial liberalization are important in determining financial sector development as these can subsequently influence Malaysia’s economic growth. Nowadays, the economic environment is often challenging. For example, the impetus of financial turmoil\(^1\) in the global markets could retard Malaysia’s economic growth. Thus, the improvement of liberalization policies that has been implemented for domestic financial sector development is critical to aid the economic performance.

In the past, various financial restructuring programs such as capital account opening, interest rate liberalization, greater opening of domestic financial intermediaries and markets were practiced along with economic expansion to meet the challenges of globalization. Hence, well-developed liberalization of financial sector development has a significant importance on the economic growth. According to Christopoulous and Tsionas (2004), financial development brings significant and positive implications on the economic growth of developing countries. Consequently, well-functioning financial system must be carefully prepared to carry out liberalization programs (Ang and McKibbin, 2005).

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\(^1\) See for example: Ang and McKibbin, 2005.
However, financial liberalization may turn out as an obstacle to propel development of the financial sector as this result in financial volatility in the market. Financial instability tends to be accompanied by fragile financial intermediaries and loss of confidence of investors. It was evidenced that financial liberalization has adverse repercussion on economic growth (Ibrahim, 2007). Besides, external risks are vulnerable to the open economy which will result in a financial crisis and lead to economic recession (Diaz-Alejandro, 1985). The emergence of the Asian financial crisis in 1997-1998 has greatly affected the level of economic growth. This was largely due to high vulnerability to external risk when liberalization policies were adopted in Malaysia (Ang and McKibbin, 2005).

Recently in 2008, financial tsunami has also hit the global economy and severely affected developing countries. As a result, the availability of stable economic and political conditions are significant for economic growth (Ang and McKibbin, 2005). This is because favorable political environment of a country is fundamental in order to further stimulate financial development. Moreover, it will be difficult to identify the most relevant financial development indicators that will contribute more towards the economic growth in Malaysia. Hence, the liberalization of financial sector development on economic growth has been investigated in this study.
1.3 Objectives of the Study

The objective of this study is to examine the relationship between liberalization of financial sector development and the real gross domestic product (GDP) from 1976 to 2005. Variables that were used in this study included monetary liquidities (M2), three-month Treasury-bill interest rate, real effective exchange rate, trade openness (sum of import and export), foreign direct investment (FDI) inflow, and real gross domestic product (GDP) in Malaysia.

1.3.1 General Objective

The general objective of this study is to apply different determinants to examine the relationship between the liberalization of financial sector development and the real GDP from 1976 to 2005.

1.3.2 Specific Objectives

The specific objectives are:

i. To investigate whether the liberalization of financial sector development leads to economic growth in Malaysia.

ii. To investigate the granger causality between the liberalization of financial sector development and economic growth in Malaysia.
iii. To examine both the short run and long run relationship between dependent variable and independent variables.

### 1.4 Significance of the Study

The significance of this study is to examine the relationship between the liberalization of financial development and economic growth from 1976 to 2005. There is a growing importance in financial sector development which influences the economic growth even though there are existences of potential dangers as a result of financial liberalization programs such as the Asian financial crisis in 1997/98. This study may assist the Malaysian government in the implementation of prudent policies that could further develop liberalization of the financial sector and minimize external risks on economic growth. Nowadays, a strong financial system is essential in mitigating financial instability and to sustain economic growth. In the late 1980s, a series of steps towards the process of financial openness were adopted in Malaysia which aimed at encouraging international capital flows to diversify risks of financial intermediation due to international capital flows which led to technology transfer, increased international trade opportunities, and contribution to economic growth.

In addition, the adoption of financial development measures will have significant implications on development policies such as bank-based financial system that is concerned in promoting economic growth in Malaysia. Thus, the government focuses more on banking supervision to strengthen the financial system during the Asian