Journal of Economic Cooperation, **29**, 1 (2008), 61-82

DOES FINANCIAL DEVELOPMENT MATTER FOR ECONOMIC GROWTH IN MALAYSIA? *AN ARDL BOUND TESTING APPROACH*

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By employing battery of time series techniques, the paper empirically examines the short- and long-run finance-growth nexus during the post-1997 financial crisis in Malaysia. Based on the ARDL [2, 1, 2, 1] model, the study documents a long-run equilibrium between economic growth, finance depth and inflation. Granger causality tests based on the VECM further reveals that there is a unidirectional causality running from finance to growth in Malaysia, thus supporting "the finance-growth led hypothesis" or "the supply-leading view". Based on the VDCs and IRFs, the study discovers that the variations in the economic growth rely very much on its own innovations. To promote growth in the country, priority should be given for long run policies, i.e., the enhancement of existing financial institutions both in the banking sector and stock market and the preservation of low rate of inflation below two digits.

1. INTRODUCTION

In the aftermath of the 1997 financial turmoil hit the Asian countries; the economy of Malaysia has now been virtually recovered. Based on the IMF Report (2006), the growth rate of the Malaysian is 5.9 percent. The growth rate of Malaysia is above the ASEAN average growth rate which is 5.8 percent. Comparing to other larger emerging economies such as India and China, the growth rates of the Malaysian economy is however slightly higher (Mussa, 2006). Why does the economic growth of the country grow at different rates? Although this fundamental question has been raised by researchers in the area of economic development for the case of developed economies since early 1930s, but it is still relevant in today's context of the Malaysian economy. The empirical growth

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literature has come up with numerous plausible explanations of cross-country differences in growth, including the degree of macroeconomic stability, international trade, resource endowments, legal system effectiveness, religious diversity and educational attainment. The list of likely factors continues to expand, apparently without limit (Khan and Senhadji, 2000).

Of those possible factors contributing to economic growth, the role of financial sector has begun to receive attention more recently. Initially, the recognition of a significant relationship between financial development and economic growth dates back as least to the *Theory of Economic Development* by Schumpeter (1912). However, the question of whether financial development preceded economic growth or *vice versa* has been debated in the historical literature on economic growth and finance. The pioneering studies on this area such as Goldsmith (1969), Schumpeter (1932) and more recently of McKinnon (1973) and Shaw (1973) documented positive relationship between financial development and economic growth. Robinson (1952) found that financial development follows economic growth. Lucas (1988) argued that financial development and economic growth are independent and not causally related. Finally, Demetrides and Hussein (1996) and Greenwood and Smith (1997) postulated that the two variables are mutually causal, that is they have a bidirectional causality.

Notwithstanding voluminous studies on finance-growth nexus in the advanced economies, the similar studies on the Malaysian economy are inadequate considering the vast-growing economic activities in the country. Among the studies on finance-growth nexus focused on the Asian economies have been conducted by Al-Yousif (2002), Choong et al. (2003), Vaithilingam et al. (2005) and Habibullah and Eng (2006). Taking 30 developing countries (including Malaysia) as the case study, Al-Yousif (2002) documented that financial development positively affects economic growth based on the panel data and time series analyses. For Malaysian case, Choong et al. (2003) and Vaithilingam et al. (2005) examined the finance-growth nexus from the perspectives of the stock market and banking sector, respectively. By adopting similar approach, ARDL technique the former study found that the stock market tends to stimulate growth during the period 1978-2000, while the positive effect of the banking sector on growth is found by the latter study during the period 1976-1999. Finally, by employing GMM

technique on their panel data of 13 Asian developing countries for the period 1990-1998, Habibullah and Eng (2006) found the existence of the supply leading growth hypothesis. Their finding generally implies that financial intermediation promotes economic growth; thereby the policy of liberalization and financial reforms adopted by these Asian countries has improved economic growth.

Referring to earlier studies conducted either in the emerging or advanced economies on finance-growth nexus, economists hold different views on the existence and direction of causality between financial development and economic growth. Earlier empirical studies on this issue documented mixed and inconclusive findings. This could be partly due to a number of reasons. Examining the finance-growth nexus by adopting different methods, sets of data, and samples of the study may lead to the inconsistent findings. This study is, therefore, aimed at empirically re-examining the short- and long-run relationships between financial development and economic growth in the Malaysian economy during the post-1997 Asian financial turmoil by adopting the latest technique, autoregressive distributed lag (ARDL) bound testing approach to test for cointegration. It also attempts to investigate the finance-growth nexus using multivariate causality tests within a vector error correction model (VECM). Finally, the paper also seeks to explore the relative strength of the variables in affecting economic growth using the variance decompositions (VDCs) and the impulse-response functions (IRFs) based on the structural vector autoregression (VAR) framework. Although the two-first objectives of this study have been examined by Al-Yousif (2002), Choong et al. (2003), Vaithilingam et al. (2005) and Habibullah and Eng (2006) using different approaches, but the last objective of the study is beyond their scope of studies.

The rest of the paper is organized as follows. Section 2 discusses the theoretical issues on the finance-growth nexus. The empirical framework and data used in the study is in turn explained in Section 3. The empirical results and discussion of the finding are presented in Section 4. Finally, Section 5 summarizes the main findings and provides some policy implications.

2. THEORETICAL UNDERPINNINGS

The connection between the financial development and economic growth has been a subject of considerable interest in the development of economic and finance literatures in recent years. In this framework, financial development is considered to be the principal input for economic growth. It is an important element to affect the rate of economic growth by altering productivity growth and the efficiency of capital. It also affects the accumulation of capital through its impact on the saving rate by altering the proportion of saving (Pagano, 1993; and Levine, 1997). The theoretical support can be traced back to the work of Schumpeter (1912) where he argued that financial intermediaries sector alter the mobilizing of saving for the successful projects by managing risk, monitoring managers, and then facilitating transaction which are essentially improve technological innovation and economic development. In their seminal works, McKinnon (1973) and Shaw (1973) believed that the financial liberalization will increase savings, capital accumulation which finally to be invested and therefore enhance growth.

Of late, the development theory of economic growth has been widely used as literature in the study of economic development, macroeconomic and other related subjects. Some of these theories were introduced by Rostow (1960), Harrod (1939), Domar (1946), Lewis (1954) and Solow (1956). However, only few of these theories focussed explicitly on the role of financial development in promoting economic growth. On one hand, Harrod (1939) and Domar (1946) opined that to increase a growth rate, new investments representing net additions to the capital stock are necessary, thus the national saving ratio and national output ratio determine the rate of growth.[2] On the other hand, in his neoclassical theory of growth, Solow (1956) expanded the Harrod-Domar's theory of growth by adding a second factor, labour, and introducing a third independent variable, technology, to the growth equation.[3]

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[2] The model explains the economies must save and invest a certain proportion of their GNP, the more saving and investment, the faster economies can grow. The model also has received some critics. For a more detailed explanation, see Todaro (2000).

[3] In this model, Solow (1956) used the standard aggregate production function in which $Y=Ae^{\mu t}K^{\alpha}L^{1-\alpha}$, where Y is gross domestic product, K is stock of human and physical capital, L is unskilled labour. A is a constant that reflects the base level of technology,

Later studies, both theoretical and empirical, have attempted to deepen our understanding of the different aspects of the finance-growth nexus by exploring the existence of relationship, the direction of causality between the variables, and the channel of transmission between them. Although there have been many papers written on this issue focusing on the advanced economies, but no similar studies has been done on the Malaysian economy. In their surveys on the existing literature, Thakor (1996) and Levine (1997) found that there have been different streams of thought on the issue of the finance-growth nexus. Generally, there have been four different views on the existence and direction of causality between financial development and economic growth. The first one is "the finance-led growth hypothesis" or "the supply-leading view". The finance-led growth hypothesis postulates the supply-leading relationship between financial and economic developments (Patrick, 1966). According to this view, the existence of financial sector, as well-functioning financial intermediations in channelling the limited resources from surplus units to deficit units, would provide efficient allocation resources thereby leading other economic sectors in their growth process. This view has received considerable support from recent empirical studies (Greenwood and Jovanovic, 1990; Habibullah and Eng, 2006, to name a few).

The second one is "the growth-led finance hypothesis" or "the demand-following view". This view was advanced by Robinson (1952) and it states that financial development follows economic growth or where enterprise leads finance follows. Accordingly, as the real side of the economy expands, its demand for certain financial instruments and arrangements and the financial markets increases, leading to the growth of these services. Empirical support for this second view can be found, for examples, in the studies of Friedman and Schwartz (1963) and Demetrides and Hussein (1996).

The third view is "the feedback hypothesis" or "the bidirectional causality view". This view postulates that the finance and economic developments are mutually causal, that is they have bidirectional causality. In this hypothesis, it is asserted that a country with well-developed financial system could promote high economic expansion

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and e^{μ} reflect the constant exogenous rate at which technology grows over time t. For a more detailed explanation, see Todaro (2000).

through technological changes, product and services innovation (Schumpeter, 1912). This in turn, will create high demand on the financial arrangements and services (Levine, 1997). As the banking institutions effectively response to these demand, then these changes will stimulate a higher economic achievement. Both financial and economic developments therefore are positively interdependent and their relationships could lead to bidirectional causality (Choong et al., 2003). Empirical support for this view can also be found, for examples, in the works of Greenwood and Smith (1997) and Luintel and Khan (1999).

Lastly, the fourth view is "the independent hypothesis". This view was originally put forward by Lucas (1988), who argued that financial and economic developments growth are not causally related or in the words of Lucas (1988), "*economic badly overstress the role of financial factors in economic growth*". Meanwhile, Chandavarkar (1992) noted that "*none of the pioneers of the development economics….even list finance as a factor of development*".

From the above brief exposition of different streams of thought on the relationship between financial and economic developments, it is obvious that the literature on this issue is mixed and inconclusive. Accordingly, it is appropriate and timely to empirically re-examine the financial development and economic growth relationship in the Malaysian economy. Does the finance-growth nexus in the country supports the first view (the finance-led growth hypothesis or the supply-leading view), the second view (the growth-led finance hypothesis/the demand-following view), the third view (the feedback hypothesis/the bidirectional causality view), or the last view (the independent hypothesis)? To what extent the financial development is significant in promoting economic growth in the economy? By adopting the ARDL bound testing approach, VECM, VDCs and IRFs, this study aims at probing this issue in the Malaysian economy during the post-1997 financial crisis period.

3. DATA AND EMPIRICAL FRAMEWORK

This study is carried out in the context of the Malaysian economy during the post-1997 financial crisis period on the quarterly basis from 1998 –

2006.[4] All the data employed in this study are obtained from the International Financial Statistic (IFS) report published by the International Monetary Fund (IMF). As for the financial development measurement, the study uses financial depth (FD), following the study of Christopoulos and Tsionas (2004). The finance depth (FD) is the ratio of total bank deposits liabilities to nominal GDP. The study also includes share of investment (SI) as ancillary variable. The share of investment (SI) is the share of gross fixed capital formation to nominal GDP. Meanwhile, the economic growth (GDP) is proxied by the growth rate of real Gross Domestic Product (GDP). Since price stability is believed to have a great impact on the Malaysian economy, thus the inflation rate is included in the study as another ancillary variable to avoid the simultaneity bias (Gujarati, 1995). In this study, inflation (INF) is measured by the changes in Consumer Price Index (CPI).

3.1. Autoregressive Distributed Lag (ARDL) Bound Testing Approach

In this study, the short- and long-run dynamic relationships between economic growth and financial depth are estimated by using the newly proposed ARDL bound testing approach which was initially introduced by Pesaran et al. (1996). The ARDL has numerous advantages. Firstly, unlike the most widely method used for testing cointegration, the ARDL approach can be applied regardless of the stationary properties of the variables in the samples and allows for inferences on long-run estimates, which is not possible under the alternative cointegration procedures. In other words, this procedure can be applied irrespective of whether the series are $I(0)$, $I(1)$, or fractionally integrated (Pesaran and Pesaran 1997; and Bahmani-Oskooee and Ng, 2002), thus avoids problems resulting from non-stationary time series data (Laurenceson and Chai, 2003). Secondly, the ARDL model takes sufficient numbers of lags to capture the data generating process in a general-to-specific modelling framework (Laurenceson and Chai, 2003). It estimates $(p+1)^k$ number of regressions in order to obtain optimal lag-length for each variable, where p is the maximum lag to be used, k is the number of variables in the equation. Finally, the ARDL approach provides robust results for a smaller sample size of cointegration analysis. Since the sample size of

[4] The chosen of the study period, the post-1997 financial crisis is based on the availability of data.

our study is 36, this provides more motivation for the study to adopt this model.

The ARDL model used in this study can be written as follow:

$$GDP_t = \alpha_0 + \alpha_1 FD_t + \alpha_2 SI_t + \alpha_3 INF_t + e_t \qquad (1)$$

Where GDP_t is growth rate of real output at time t as a measure of economic growth, FD_t is a measure of financial depth, SI_t is the share of investment, INF_t is inflation, and e_t is an error term.

The error correction version of ARDL framework pertaining to the variables in the Equations (1) can be reproduced as follows:

$$\Delta GDP_t = \delta_0 + \sum_{i=1}^{p} \varepsilon_i \Delta GDP_{t-i} + \sum_{i=0}^{p} \phi_i \Delta FD_{t-i} + \sum_{i=0}^{p} \varphi_i \Delta SI_{t-i} + \sum \gamma_i \Delta INF_{t-i}$$
$$+ \lambda_1 GDP_{t-1} + \lambda_2 FD_{t-1} + \lambda_3 SI_{t-1} + \lambda_4 INF_{t-1} + u_{1t} \qquad (2)$$

The terms with the summation signs in the Equation (2) represent the error correction dynamic while the second part (term with λs) correspond to the long run relationship. The null of no cointegration in the long run relationship is defined by H_0: $\lambda_1 = \lambda_2 = \lambda_3 = \lambda_4 = 0$ is tested against the alternative of H_0: $\lambda_1 \neq \lambda_2 \neq \lambda_3 \neq \lambda_4 \neq 0$, by the means of familiar F-test. However, the asymptotic distribution of this F-statistic is non-standard irrespective of whether the variables are $I(0)$ or $I(1)$. For a small sample size study ranging from 30 to 80 observations, Narayan (2004) has tabulated two sets of appropriate critical values. One set assumes all variables are $I(1)$ and another assumes that they are all $I(0)$.

This provides a bound covering all possible classifications of the variables into $I(1)$ and $I(0)$ or even fractionally integrated. If the F-statistic lies exceeds upper bound level, the null hypothesis is rejected, which indicates the existence of cointegration. On the other hand, if the F-statistic falls below the bound level, the null hypothesis cannot be rejected, which supporting no cointegration exist. If, however, it falls within the band, the result is inconclusive.

Finally, in order to determine the optimal lag-length incorporated into the model and select the ARDL model to be estimated, the study employs the Akaike Information Criteria (AIC). Since our study utilizes

quarterly data with only 36 numbers of observations, the possible optimal lag-length to be considered is only 4.

3.2. Vector Error Correction Model (VECM) Framework

To examine the multivariate causality relationship among the variables, the study employs the vector error correction model (VECM) framework. The VECM regresses the changes in the both dependent and independent variables on lagged deviations. The multivariate causality test based on VECM can therefore be formulated as follows:

$$\Delta Z_t = \delta + \Gamma_i \Delta Z_{t-1} + \ldots\ldots + \Gamma_k \Delta Z_{t-k} + \Pi Z_{t-k} + \varepsilon_t \qquad (3)$$

where Z_t is an *n x 1* vector of variables and δ is an *n x 1* vector of constant, respectively. In our case, Z_t = *(GDP, FD, SI, INF).* Γ is an *n x n* matrix (coefficients of the short run dynamics), $\Pi = \alpha\beta'$ where α is an *n x 1* column vector (the matrix of loadings) represents the speed of short run adjustment to disequilibrium and β' is an *1 x n* cointegrating row vector (the matrix of cointegrating vectors) indicates the matrix of long run coefficients such that Y_t converge in their long run equilibrium. Finally, ε_t is an *n x 1* vector of white noise error term and *k* is the order of autoregression.

A test statistic is calculated by taking the sum of the squared F-statistics of Γ and t-statistics of Π. The multivariate causality test is implemented by calculating the F-statistics (Wald-test) based on the null-hypothesis that the set of coefficients (Γ) on the lagged values of independent variables are not statically different from zero. If the null-hypothesis is not rejected, then it can be concluded that the independent variables do not cause the dependent variable. On the other hand, if Π is significant (that is different from zero) based on the t-statistics, then both the independent and dependent variables have a stable relationship in the long-run.

From the Equations (3), two channels of causation may be observed. The first channel is the standard Granger tests, examining the joint significance of the coefficients of the lagged independent variables. Whereas, the second channel of causation is the adjustment of the dependent variable to the lagged deviations from the long run

equilibrium path, represented by the error correction term (ECT). If the ECT is found to be significant, it substantiates the presence of cointegration as established in the system earlier and at the same time; it tells us that the dependent variable adjusts towards its long run level. From these tests, we can reveal four patterns of causal interactions among pairs of the variables, i.e., (i) a unidirectional causality from a variable, say *x*, to another variable, say *y*; (ii) a unidirectional causality from *y* to *x*; (iii) bidirectional causality; and (iv) independent causality between *x* and *y*.

3.3. Variance Decompositions (VDCs) and Impulse-Response Functions (IRFs)

Apart from the above battery of time series techniques, the study also generates variance decompositions (VDCs) and impulse-response functions (IRFs) to further delve into the dynamics interaction among the variables. The VDCs enable us to examine the out-of sample causality among the variables in the VAR system. It measures the percentage of the forecast error of variable that is explained by another variable. Precisely, it indicates the relative impact that one variable has on another variable. At the same time, it provides information on how a variable of interest responds to shocks or innovations in other variables. Thus, in our context, it allows us to explore the relative importance of financial development in accounting for variations in economic growth. To interpret economic implications from VDCs findings, the Sim's (1980) innovation accounting procedure is employed. This procedure involves the decomposition of forecast error variance of each variable into components attributable to its own innovations and to shocks of other variables in the system.

On the other hand, the IRFs (also known as innovation accounting in the literature) allow us to trace temporal responses of variables to its own shocks and shocks in other variables. In our context, from the IRFs we can assess the direction, magnitude and persistent of economic growth responses to innovations in the financial development and inflation.

4. EMPIRICAL RESULTS

Before estimating the short- and long-run relationships between financial development and economic growth for the Malaysian

economy, we have to decide about the lag-length on the first-differenced variables. Bahmani-Oskooee and Bohl (2000) have shown that the results of this first step are usually sensitive to the lag-length. To verify this, we incorporate lag-length equal to 1 to 4 on the first-differenced variables.

Table 1: F-statistics for Testing the Existence of a Long-run Growth Equation

Lag-Length	F-Statistics
1	1.7958
2	2.5761*
3	4.1525**
4	0.25502

Note: The relevant critical value bounds are taken from Narayan (2004) [Case II with a restricted intercept and no trend and number of regressors = 3 from]. They are 4.480 – 5.700 at the 99%; 3.170– 4.160 at the 95%; and 2.618 – 3.502 at the 90% significance levels respectively. *, **, and *** denotes that F-Statistics falls above the 90%, 95% and 99% upper bound, respectively.

The computed F-statistics for each lag-length is reported in Table 1 along with the critical values at the bottom of the table. As reported, the test outcome of the significance levels varies with the choice of lag-length. Only the lag-length = 2 and 3 are found to be significant at 90% and 95% levels respectively, while the lag-length = 1 and 4 are not. The results seem to provide evidence for existence of a long-run relationship between economic growth, financial depth, share of investment and inflation in Malaysia. In other words, these variables are found to have a long-run equilibrium in which the variable has a tendency to move together in the long-run. This results should be considered preliminary and indicate that in estimating Equation (1) we must retain the lagged level of variables.

In the second stage, we retain the lagged level of variables and estimates Equation (2) using the Akaike Information Criterion (AIC) lag-length selection criteria. Based on the F-statistic values, the maximum lag-length is set at 3. The long-run ARDL model estimates selected based on the AIC criteria are reported in Table 2.Based on ARDL [2, 1, 2, 1], we find that except the share of investment, all other variables are found significantly in promoting economic growth in Malaysia. In a nutshell,

the common sources of economic progress/regress in Malaysia were price stability and financial development.

Our findings of the positive finance-growth relationships is compatible with many earlier studies such as by Christopoulos and Tsionas (2004) for Thailand during period 1970-2000, Habibullah and Eng (2006), Choong et al. (2003) and Vaithilingam et al. (2005) for Malaysia during different periods, spanning from 1976 to 2000. Furthermore, the relatively lower rate of inflation in the country during the study period as compared to some other ASEAN economies has intensified the economic growth.[5] Earlier empirical studies documented that for countries with low inflation rate below 10 percent annually, their economic growth will be accelerated (Bekaert et al., 2005; and Hung, 2003), while countries with high inflation about 10 – 20 percent a year could detriment the long-run economic growth (Gylfason et al., 2001; and Andrés et al., 2004). This particular finding implies that in order to promote growth in the country, the government have to maintain a lower rate of inflation below two digits.

Table 2: The Long Run ARDL Model Estimates

Regressor	ARDL [2,1,2,1]
C	7.7892*** (5.2776)
FD	1.7481** (2.2325)
SI	-3.9361 (-1.1143)
INF	2.3031*** (8.4321)
	Adj-R^2 =.95195 D-W = 2.3216

Note: *, ** and *** denotes significantly at 10%, 5% and 1% level of significance, respectively. Figures in the parentheses and squared parentheses are the *t*-statistics values and the selected ARDL model. D-W denotes Durbin-Watson test for autocorrelation.

[5] See, for example, the IMF report for the year 2005. The average rate of inflation for Malaysia was 2.96%. With the exception of inflation rates in Singapopre (0.47%) and Brunei Darussalam (1.22%), the rates of inflation in the rest ASEAN countries were higher than that of Malaysia (i.e., Thailand (4.54%), Cambodia (5.56%), Laos PDR (7.17%), the Phillipines (7.64%), Vietnam (8.25%), Myanmar (9.37%), and Indonesia (10.45%).

Our findings on the finance-growth nexus seem to indicate that in the aftermath of the 1997 financial crisis, the Malaysian government has successfully enhanced their financial sector and controlled price stability in speeding up the economic growth of the country. This indicates that maintaining and even enhancing the current practices of banking sector and stock market should be given priority by the Malaysian policy makers in order to further promote the economic growth.

After exploring the long run association between economic growth and measures of financial development, we now proceed to multivariate Granger causality test based on VECM. At this juncture, it is important to note that the documented cointegration among the variables suggests only their long run association and, while it implies causality, does not reveal the directions of causation among them. Table 3 reports the multivariate causalities among the economic growth (GDP), financial depth (FD) and two other ancillary variables, i.e., share of investment (SI) and inflation (INF).

Table 3: Multivariate 'VECM' Causality

Dependent Variable	Independent Variables				
	ΔGDP	**ΔFD**	**ΔSI**	**ΔINF**	**ECT_{t-1}**
ΔGDP	-	0.8378** (0.0460)	5.0694*** (0.0081)	0.751915 (0.4832)	-0.1969** (-2.6202)
ΔFD	0.9655 (0.4266)	-	0.5776 (0.6358)	1.5509 (0.2344)	0.1010 (1.5771)
ΔSI	6.7934*** (0.0021)	1.7017 (0.2055)	-	1.3949 (0.2689)	0.1021 (1.2543)
ΔINF	5.6664*** (0.0049)	1.4828 (0.2488)	0.7050 (0.5594)	-	-1.2379 (-0.9070)

Note: ***, ** and * represent significance at the 1%, 5% and 10% levels, respectively. ECT_{t-1} is derived by normalizing the cointegrating vectors on the GDP as proxy for economic growth, producing residual *r*. By imposing restriction on the coefficients of each variable and conducting Wald test, we obtain *F*-statistics for each coefficient in all equations. Figures in the parentheses and squared parentheses represent *t*-statistics and probabilities for *F*-statistics, respectively.

It is interesting to note that both error correction terms (ECTs) and short run channels of Granger causality were temporarily active for our main models (i.e., when GDP is considered as dependent variable) for Malaysia. The significance of ECTs at least for our main models,

confirms the existence of long-run relationship among the variables as documented in earlier ARDL models, i.e., ARDL [2, 1, 2, 1]. Specifically, this implies that any deviations from the long-run equilibrium relationships in the Malaysian economy are mainly caused by the changes in GDP. In other words, the GDP bears the brunt of short run adjustment to the long run equilibrium.

We also note that there are only two short-run dynamic interactions among the variables for the Malaysian equation. We find a bidirectional causation between GDP and SI. This indicates that in short run, the development of the Malaysian economy hinges crucially on the performance of the investment. Accordingly, while we do not find the long run causality between GDP and SI in Malaysia (see Table 2); there exist short-run interactions between them (see Table 3). Finally, we also find a unidirectional causation running from GDP to INF for Malaysia. At this jucture, it is interestingly to note that the economic growth leads to increase price in the Malaysian economy. This type of inflation is categorised under the demand pull inflation. The higher income leads to the higher purchasing power of the citizens thereby they will demand more for goods and services.

The finding of the short-run causality stemming from financial development to economic growth is in favour of "the finance-growth led hypothesis" or "the supply-leading view". This implies that the financial institutions can be viewed as an effective leading sector in channelling and transferring the financial resources between surplus and deficit units in the Malaysian economy. This particular result echoes the findings of Choong et al. (2003) and Habibullah and Eng (2006) on the Malaysian economy during the periods 1978-2000 and 1990-1998, respectively.

Table 4: Variance Decompositions

Horizon (Quarterly)	Explained by shocks in:			
	GDP	FD	SI	INF
1	100.00	0.00	0.00	0.00
2	93.15	2.33	2.46	2.06
4	91.50	3.58	2.84	2.08
8	85.09	11.02	2.42	1.47
12	80.20	16.33	2.30	1.17

To further explore dynamic interaction between financial development and economic growth, the study proceed to test the variance decompositions (VDCs) and impulse-response functions (IRFs). The results of VDCs reported in Table 4 provide detailed information on the relative strength of the financial depth, share of investment and inflation in explaining the changes in the economic growth. From the VDCs and IRFs results, we are also able to capture the relative important of various shocks and their influences on the economic growth. The VDCs and IRFs are simulated by orthogonalizing the innovations in the vector autoregression (VAR) equations using the so-called Cholesky decomposition suggested by Sim (1980) with the orderings of the variables: GDP, FD, SI, INF.[6] Based on VDCs results for the horizon of 1 – 12 quarters, we find that the variations in the Malaysian economic growth respond more to shocks in the financial depth account for about 0 – 16 percent of economic growth forecast error variance. The variations in the economic growth in Malaysia, however, rely more on its own innovations. This finding seems to support our earlier finding of short-run dynamic causalities among the variables examined in the study.

[6] We also have tried to use different orderings of the variables such as GDP, FD, INF, SI; GDP, INF, SI, FD; and GDP, INF, FD, SI. We also have tried to employ the generalized impulses which do not depend on the VAR ordering, as described by Pesaran and Shin (1998). However, their results are very much similar.

Figure 1: Generalized Impulse-Responses Functions

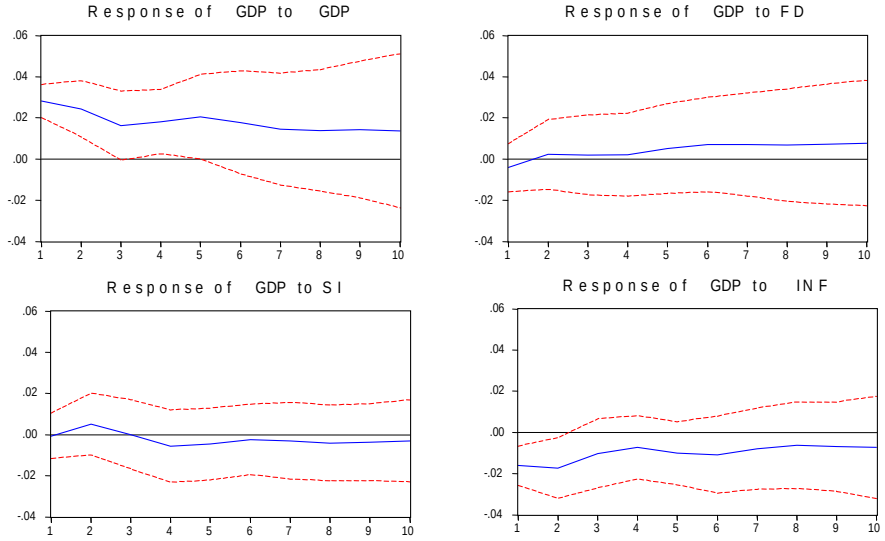
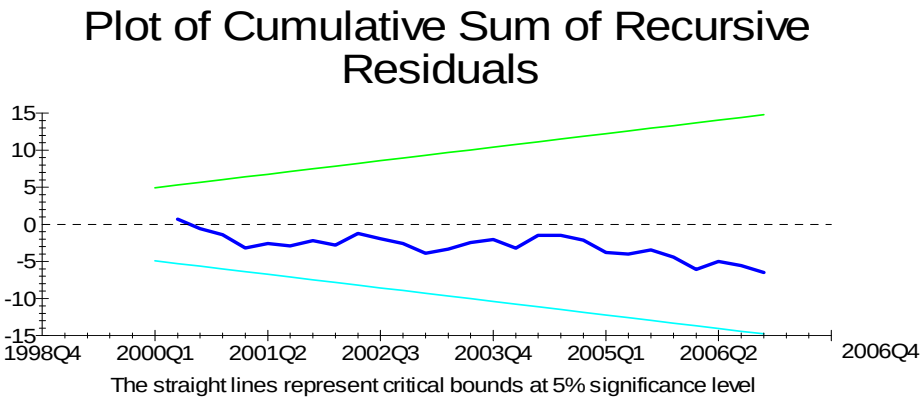
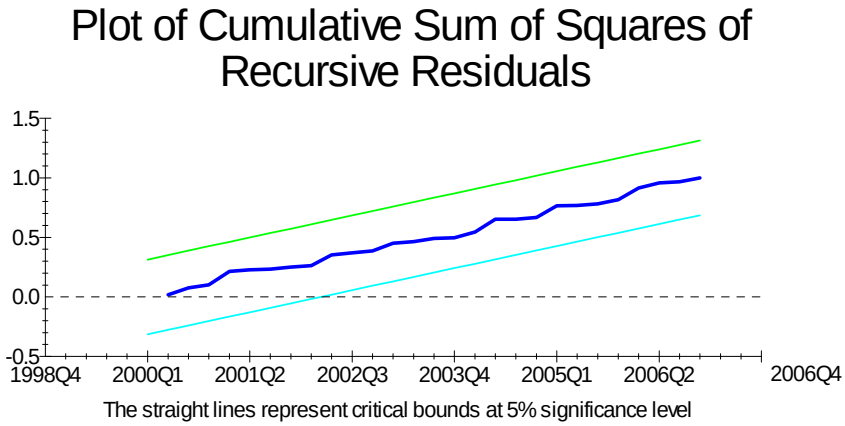


Figure 2: CUSUM and CUSUMSQ Plots



Cont.



Finally, we performed the cumulative sum of recursive residuals (CUSUM) and cumulative sum of squares of recursive residuals (CUSUMSQ) stability tests for our chosen ARDL model. Figure 2 provides the plots of the CUSUM and CUSUMSQ stability tests. From the figures, we find that the plots of CUSUM and CUSUMSQ statistics remain within the critical bounds at 5% significance level. This implies that all coefficients in the error correction model are stable over the time. These selected models adopted in the study seem to be good enough and robust in estimating the short- and long-run relationships between financial development and economic growth.

5. CONCLUSION AND SOME POLICY IMPLICATIONS

By employing a battery of statistical tests, this paper empirically explore the short- and long-run relationships between financial development and economic growth in Malaysia during the post-1997 financial crisis. It also attempts to empirically investigate the dynamic causality among the variables using vector error correction model (VECM) and re-examine the model in level form and generates variance decompositions (VDCs) and impulse-response functions (IRFs) to further assess their interactions such that robust conclusion can be made. Based on the specified ARDL model, the paper finds a long-run equilibrium between economic growth, finance depth, share of investment and inflation. Specifically, this implies that in promoting the growth of economy in the country, it is very important for the government to preserve price stability by maintaining the low rate of inflation below two digits.

In terms of the dynamic causalities among the variables, the study documents the unidirectional causality stemming from financial development to economic growth. This empirical evidence is in favour of "the finance-growth led hypothesis" or "the supply-leading view". This implies that the financial institutions can be viewed as an effective leading sector in channelling and transferring the financial resources between surplus and deficit units in the Malaysian economy. This particular result echoes the findings of Choong et al. (2003) and Habibullah and Eng (2006) on the Malaysian economy during the periods 1978-2000 and 1990-1998, respectively.

Based on VDCs and IRFs tests, we find that the variations in the economic growth respond more to shocks in financial depth, it accounts for about 0 – 16 percent of economic growth forecast error variance after 12-quarter. Economic growth seems to have immediate negative response to shocks in the price stability and share of investment, while no significant effect is found between the shocks in the financial development to the innovations in the economic growth. This further implies that any policies pertaining to the price stability, financial development and investment should at least be noted by the government in order to speed up the economic growth.

The most important implication of our findings is a policy recommendation: if policy makers want to promote growth, then attention should be focused on long run policies, for example the enhancement of the existing modern financial institutions both in the banking sector and stock market and the preservation of low rate of inflation. The government, therefore, needs to further enhance the banking sector and provide a conducive environment for investors to allocate the assets in the stock markets. Apart from maintaining the low rate of inflation, the enhancement of financial sector, banking and stock market should are among the important factors to be looked into by the government in order to speed up the economic growth.

Finally, to enhance and enrich the findings of present study, more robust analysis is needed. Further researches that are recommended in this context are in terms of comparing the analyses between the pre- and post-1997 financial turmoil periods; perhaps this could provide a clearer picture for the policy implementation. Additionally, the enrichment of the finding could also be done by including more countries into the

analysis such as by examining all ASEAN countries. A comparative study between the emerging economies such as Malaysia with the developed markets would also provide additional insight into the existing empirical evidence.

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