Financial Sector and Economic Growth in Malaysia: Sectoral Shock Analysis

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Abstract. Findings from the generalized impulse response functions (IRFs) reveal that innovations in the stock market, real estate market and banking sector have significant impacts on economic growth. Further analysis on the variance decompositions (VDC) confirms that variance in economic growth is explained most by innovation in the stock market and the real estate market. This finding suggests that the banking sector is not the major source of output variability.

Keywords: Real Sector, Financial Sector, Impulse Response Function, Variance Decompositions.

1. Introduction

Studies have shown that the financial sector plays an important role in a country’s economic growth. It generates spillover effects on other sectors of the economy (UNDP, 2009: p.60). The recent global financial crisis has major impacts on the financial sector and hence on economic growth. For Malaysia, the crisis has driven the economy into a recession. As a highly open economy, Malaysia is not insulated from global economic downturn. Deterioration in the global economy had decreased the economic growth from 6.3 per cent in 2007 to 4.8 per cent in 2008 and -1.5 per cent in 2009. Several measures taken by the government via fiscal stimulus and easing monetary policy had brought about a strong recovery in 2010.

This study analyzes the effects of the financial sector on the real sector. Specifically, it examines the effects of the financial sub-sectors, namely stock market, banks and real estate on the level of real output. Given that some sectors are more vulnerable to financial crises than others, assessing the relationship from sectoral data may give more accurate assessment of the effects of financial sector on the level of real output. This also implies that real output may be more sensitive to certain financial sub-sectors. It can be used to benchmark how far real output is affected by the financial crises as claimed by others (Stiglitz, 1999; Kutan et al., 2012). This study raises two questions. First, do financial sector shocks affect the real sector in Malaysia? Second, is the real sector hit by variable-specific shocks or system-wide shocks? This study attempts to shed some lights on the dynamic relationship of the sectors and thus contributes new knowledge.

2. Literature Review

Understanding the channels that exist between the real and financial sectors in the economy is especially important when assessing financial stability and determining economic performance (Johnston and Pazarbasioglu, 1995). Since the emergence of endogenous growth theory, the importance of financial development has been widely studied (King and Levine, 1993; Denizer et al., 2002). Motivated by the work of King and Levine (1993), Johnston and Pazarbasioglu (1995) tried to examine the importance of the financial sector in determining economic performance. Their studies demonstrate that reforms in financial sector have important structural implications in the way financial sector variables affect the real economy. Although some researchers attempt to examine the causality between the financial and real sectors (Denizer et al., 2002; Ang and McKibbin, 2007; Jaafar and Ismail, 2009; Nidhiprabha, 2011), there is no clear consensus regarding the effects of the financial sector on the real sector or vice versa.

A growing body of literature has developed studying the feedback between the real economy and the financial sector in times of economic shocks. Dovern et al. (2010) noted that the well being of the banking sector can be affected by macroeconomic shocks, but bank lending plays no role in transmitting financial shock to the real sector (Mansor, 2006). In the context of the global financial crisis, Nidhiprabha (2011)