Impact of Malaysia's Capital Market and Determinants on Economic Growth

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Abstract

This study investigates the impact of Malaysia's capital market and other key determinants on Economic Growth from the period of 1988 to 2012. The key determinants studied are foreign direct investment and real interest rate. This study also examines the long run and short run relationship between the economic growth and capital market, foreign direct investment, and real interest rate by using bound testing cointegration of Autoregressive Distributed Lag (ARDL) and Error Correction Model (ECM) version of ARDL model. The empirical results of the study suggest that there is long- run cointegration among the capital market, foreign direct investment, real Interest rate and economic growth. The result also suggests that capital market and real interest rate have positive impact on economic growth in the short run and long run. Foreign direct investment does not show positive impact on economic growth in the short run but it does in the long run.

Keywords: Economic Growth, Determinants Factors, Cointegration, Malaysia.

JEL Classification Codes: E6, E00, G1.

1. Introduction

Over the decades, capital market has been researched on extensively due to its significant correlation with countries economic development. It is mainly stressed on the issue whether capital market has an impact on economic growth or otherwise. Some say that financial development paves the way for economic development while others argue that economic development brings the financial development. Some even argue that there is no relationship between them at all. According to Oke and So (2012) capital market is considered the major engine of economic development of a nation because it provides the initial seed for organizing the factors of production to maintain the sustainable economic development and growth. In addition, capital market acts as an intermediary of financial institution in mobilizing the funds from surplus units to the deficit units. Beside, Al-Faki (2006) stated that capital market helps to bring suppliers and demander of funds to increase the long-term investment in socio-economic developmental projects.

However, Malaysia's capital market plays a significance role accelerating its economic growth and capable enough to attract both local and foreign investors. As well, it offers an effective means to raise capital for investment and widen the scope for economic development. Seeing that Mun, Lin, & Man (2008) conclude based on their study that stock market of Malaysia's causes economic growth. They also emphasize that government should promote stock market by implementing new policy and rules as stock market could be one of the leading indicator of economic growth. In the same context, Choong et al. (2003) stated that there is long run conintegration between stock market development and economic growth in Malaysia.

However, it is evident that there are so many key determinants which contribute to the economic development of a particular country. Therefore, in case of Malaysia, the authors have chosen foreign direct investment (FDI) and real interest rate (RINTR) among other key determinants to examine their contribution toward economic development. It would appear that among others key determinants which are contributed to economic growth of a country; foreign direct investment (FDI) is regard as one of the imperative determinants for accelerating economic growth of host country. As we are living in globalization and integration world, the effect of FDI to world economy especially to economic growth is relatively debatable issue from one study to another. Still, foreign direct investment is considered one of the significance tools of contributing to economic growth in the case of developing countries and some economists even argue that countries which are focusing on outward development stragey have greater chance to foster higher economic growth compare with countries whose focus on internally (Sethi & Sucharita, 2009). According to De Mello (1999) the enormous effect of FDI on economic growth is probably contributed by the capital

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accumulation, transfer of new technology to the recipient countries and augmented stock of knowledge of the recipient countries. On the other hand, Interest rate is considered one of the major drivers of the economy. It has crucial impact on country's economic growth. For instance, interest rate has direct effect on the credit market. If the interest rate is high then it makes borrowing costly which in effects hurt the consumer. By contrast, if the interest is low then borrowing becomes cheaper. It increases the consumer spending and in turn stimulates the country economic growth. Udoka & Roland (2012) argued that the inverse relationship exists between the economic development and interest rate in Nigeria. It means when interest rate increase, it decreases the Nigerian GDP growth and vies-versa.

Therefore, the main purpose of this study is to provide an empirical evidence of the impact of Malaysia's capital market, foreign direct investment and real interest rate on economic growth. Moreover, the rest of this paper is organized as follows: the next section discusses the literature review of capital market, foreign direct investment, and real interest rate on economic growth. Section 3 presents the methodology and model specification of the study. Section 4 is the finding of the study and Section 5 concludes.

2. Literature Review

2.1. Capital Market and Economic Growth

There are significant numbers of literatures on the impact of capital market on economic growth. Kolapo & Adaramola (2012) stated that there is causal relation between capital market and economic development. The authors further argued that capital market activities have a propensity to impact positively on economic growth. On the other hand, Mishra et al. (2010) found based on their study on capital market efficiency in India that the capital market of India has the potentiality towards economic development of the country. They also highlighted that economic growth of modern economy depends on the efficient financial environment which pools the domestic savings and mobilize the foreign investment into a productive investment. Similarly, inefficient capital market hinders the long run productivity of the economy by increasing transaction cost or unfair stock price.

As a result, Fama (1965) came out with efficient market hypothesis theory (EMH) because if the capital market is efficient it will create positive impact on public and investor. Therefore, there will be large number of investment on securities by investor in order to get higher return in future. For that reason, an efficient capital market is necessary for long run economic growth (Osaze, 2000). Christopoulos and Tsionas (2004) stated long run causal relationships exist between financial development and economic growth, and there is no bi-directional causality between them. Further, Rajan and Zingales (2001) said that the service which are provided by financial sector like allocation of capital and risk sharing has significant affected on economic growth. In the same way, Caporale, Howells, & Soliman (2004)

based on their study on seven countries conclude that stock market can accelerate economic growth in the long run by accumulation of capital and efficient resource allocation. Ewah, Esang, & Bassey (2009) argued that capital market consider one of the powerful tool to influence the economic growth of a country.

However, Ang & McKibbin (2007) investigated the effect of financial growth on economic development in Malaysia. Their empirical results by using times series data from 1960 to 2011 suggested in case of Malaysia that economic development causes financial growth. The authors also admitted that the findings which they have got from this study are not satisfactory. Majid (2008) concluded based on his study related to economic growth and financial development in Malaysia by using ARDL model that the long run relationship exist between economic growth and financial development in Malaysia. The author also concluded from the findings that there is unidirectional granger causality between the economic growth and financial development. Lastly, the author argued that the long term policy of financial development should be undertaken by government to promote long term economic growth in Malaysia.

2.2. FDI and Economic Growth

The essence of foreign direct investment has been increasing in all reasons, countries and all over the world due to its positive effect on economic growth. With the help of globalization process foreign direct investment has increased dramatically since 1980. Due to the globalization, most of the countries became liberal to foreign inward capital flow and entrance of capital became easy. Ali Riza & Ali (2012) did a study on Economic Cooperation Organization (ECO) countries to examine the theoretical argument of FDI whether it has a positive effect on economic growth of host country or not. The authors use ten ECO countries data from 1995 to 2011 for causality test. The result of causality test shows that there is causal relationship between economic growth and foreign direct investment. The authors also highlighted that theoretical expectation of foreign direct investment and economic growth is proven.

In the same context, Usha & Diana (2001) did a study on 24 developing countries for the phase of 1971 to 1995 by using panel data estimated method. They test causality relation between economic growth and foreign direct investment. The test result demonstrates that the effect of FDI on economic growth varies among the developing countries. The authors further suggest, though the impact of foreign direct investment on economic growth differ across emerging countries but the effect is large when the countries in more open. Hence, Iqbal, Shaikh, & Shar (2010) tried to examine the relation among the FDI, trade and economic growth in Pakistan. They use quarterly data from 1998 to 2009 in order to examine the relation among the variables. The results suggest that the long run relation exists among the variables. The VECM test result shows that there are bidirectional relations among the FDI trade and economic growth. However, the authors further argue that foreign direct investment has strong impact on trade

enlargement in Pakistan.

On the other hand, Antwi & Zhao (2013) conducted a study on Ghana to investigate the causal relation between economic growth and foreign direct investment from the period of 1980 to 2010. They used cointegration approach to trace the long and short run relation between FDI and economic growth. The cointegration result suggests that the long run causal relation exist between the foreign direct investment and economic growth in Ghana. The authors further argue that the short run relationship between economic growth and foreign direct investment are nearly imaginary. However, one of the significant problem of developing and least developing countries is that they do not have sufficient capital to finance their domestic investment. Therefore, they mostly depend on the foreign capital flows or aid in order to precede the domestic investment. In the beginning, they used to borrow from the commercial bank. During 1980 so many commercial bank got bankruptcy due to the debt crisis, and this financial crack down forced so many countries to reform their investment policy.

As a results, the new investment polices attract more stable form of foreign invest and foreign direct investment without taking any linkage to the debt. The Asian development bank (ADB) outlook (2004) in Asian state that the foreign direct investment has increased tremendously in recent years due to so many factors like technological progress, rapid increase of global marketing networks and integrated production, bilateral investment treaties and lastly positive support from the developing countries to open the door for FDI.

Karimi & Yusop (2009) did a study on Malaysia to scrutinize the impact of foreign direct investment on Malaysia's economic growth. They use the Toda-Yamamoto causality test on time series data from 1970 to 2005. The econometric test result shows that there is no long run relation and bi-directional causality between the economic growth and foreign direct investment. Their result further shows that FDI has negative impact on economic development of Malaysia. However, a study by Kogid et al. (2011) shows by using Johanson and VECM approach that the long run relation exists between foreign direct investment and economic growth in Malaysia. Therefore, their study suggest that FDI is significant factor for accelerating the economic growth of country and FDI could be taken as one of the importance stimulate factor for a country future economic development policy.

Lean (2008) conducted study in Malaysia to examine the relationship between the FDI and GDP growth rate of manufacturing sector from 1980 to 2005. The empirical findings of the study show that long run relationship does not exist between FDI and economic growth of Malaysian manufacturing sector. The findings of this study further suggest that the correlation between FDI and GDP growth in manufacturing sectors are autonomous. The author also argues that FDI will bring economic growth if the host country has sufficient skill labor force and government should play significant role to develop the human capital in order to bring growth in manufacturing sectors. Lean & Tan (2011) did a study to investigate the linkage among domestic investment, foreign

direct investment and economic growth in Malaysia. The empirical result advocates that FDI, domestic investment and economic growth are co-integrated in the long run.

The empirical finding of the study shows that FDI has positive effect on economic development while domestic investment effects the economic development negatively in long run. The empirical result further suggests that FDI inflow will bring positive effect on domestic investment. Mun and Lin (2009) conducted study on Malaysia to investigate the relation between foreign direct investment and economic growth by using OLS method from the period of 1970 -2005 time series data. Their empirical result suggests that the long run relationship exists between economic development and inward FDI. Therefore, Malaysia government should come out with more effective FDI policy and policies that attract more FDI inflow in order to faster the Malaysia economic growth in future.

2.3. Interest Rate and Economic Growth

Harvey (1988) said that real interest rate predict the future consumption .However, Udoka & Roland (2012) did a study on Nigeria to investigate the effect of interest rate fluctuation on economic development. The empirical result of the study reveals that the inverse relationship exists between the economic development and interest rate in Nigeria. It means when interest rate increase, it decreases the Nigerian GDP growth. Hence, D'adda & Scorcu (1997) did a study on the 20 industrialized countries to scrutinize relationship between real interest rate and economic development from 1965 to 1994.

The empirical result of the last 30 years data shows that if the real interest rate is increase by 1% then economic growth decrease by 1/5 rate. The authors further argue that long term increase in the real interest rate effects become more severe in economic growth in recent years and the study result also shows that positive relation exists between the economic development and capital accumulation, and negative relationship exists between the real interest rate and economic growth. In the same context, Saymeh & Orabi (2013) carried out a study on Jordan to examine the impact of interest rate and inflation on real economic growth from the period of 2000 to 2010. Their empirical result shows that interest rate has influence on the economic growth.

However, Anaripour (2011) did a study on Iran to explore the relation between the interest rate and economic growth from the period of 2004 to 2010. The empirical result of the study shows that there is negative relationship between interest rate and economic growth. The study result indicates that causal relation which exit between interest rate and economic growth is unilateral. Therefore, it does not matter whether interest rate increase or decrease to the economic growth. In the same context, Hansen & Seshadri (2013) did a study to investigate the relation between productivity growth and interest rate. Their study found that there is inverse relation between the interest rate and productivity growth. Because, when interest rate is low in the long run it shows that productivity growth is high. Besides, when the interest rate is high in the long run, the

productivity growth rate is low. There is vice-versa relation between productivity growth and interest rate. Therefore, interest rate is said to be one of the significant determinants of economic development for a country. It is also regard as vital variables of policy makers in macroeconomics. This is because, change in the interest rate not only affect the economic agent but also overall country economic growth. Most of the economists believe that there is positive relation between economic growth and capital accumulation and negative relation between capital accumulation and capital cost.

However, Chang & Huang (2010) did a study on Japan to investigate the weather real interest rate has impact on the Japanese economy and finance or not. The empirical result of the study showed that lower interest rate has impact on the banking industry to contribute to the Japanese economic growth. Hence, Nakaota (2005) did a study on Japan to scrutinize the effect of term structure of interest rate on future economic activity. He also examines whether the nature of this relationship change with the time or not. The empirical results of this study found that there is break point among the interest rate and economic growth. Firstly, result shows that the relation among the future economic movement and yields spreads change over time. Secondly, yields spreads has more information regarding future economic activity compare with the other variables.

3. Methodology

3.1. Data Specification

This study is conducted based on the secondary data. The source of data is from World Bank development indicator website and United Nations conference on trade and development (UNCTAD). This study uses annual times series data cover the period from 1988 to 2012 in Malaysia on Real Gross Domestic product, Market Capitalization, Foreign Direct Investment and Real Interest Rate. RGDP is used as a proxy for economic growth.

However, Market capitalization is used to measure the role of Malaysian capital market on economic growth. Besides, this study is also used foreign direct investment, real interest rate as proxy to examine the other determinants impact on Malaysia's economic growth. All data on Real Gross Domestic product, Market Capitalization, foreign direct investment except interest rate is converted in natural logarithm before any econometrics teat performed.

3.2. ARDL Bound Test of Cointegration

The Autoregressive Distributed Lag (ARDL) model is developed by Pesaran and Shin in 1999 and the model was further expanded in 2001 by Pesaran, Shin, and Smith. One of the important causes of using ARDL cointegration method in this study is because of small sample size. This study is using only 26 years of times series data due to unavailable of data

for some of the variables and this is most proficient method to be applied for small data series. According to Dritsakis (2011) that the ARDL method has a significant compare with the other econometric method in the case of relationship analysis because it allows cointegration test regardless of stationary at (I0) or (I1). However, Unrestricted Error Correction Model (UECM) version of ARDL model has been used in this study to check for further long and short run relation between the variables. Since, this study uses annual time series data, the maximum lag of 1 has been chosen by lag selection criterion. The derived of UECM version of ARDL model in this study is presented below.

$$\triangle In(RGDP) = \beta_1 \sum_{i=1}^{\phi} In(RGDP)_{t-i} + \beta_2 \sum_{i=1}^{\phi} \triangle In(MCAP)_{t-1}$$
$$\beta_3 \sum_{i=1}^{\phi} \triangle In(FDI)_{t-1} - \beta_4 \sum_{i=1}^{\phi} \triangle(RINTR)_{t-1}$$
$$\beta_5 \; In(RGDP)_{t-1} \; + \beta_6 \; In(MCAP)_{t-1}$$
$$\beta_7 \; In(FDI)_{t-1} - \beta_8 (RINTR)_{t-1} + \mu_t$$

Where ln(RGDP), ln(MCAP), ln(FDI) and (RINTR) are logarithm of Real Gross domestic product, logarithm of Market Capitalization, logarithm of Foreign Direct Investment and Real Interest Rate (RINTR) respectively. The sign φ denotes for optimal lag selection. Moreover, Wald coefficient test is used for examining the cointegration among the variables. When the test is done, the F-statistic value is compared with critical value in order to decide whether accept or reject the null hypothesis.

4. Results

The table 1is highlighting the lag selection criteria of cointegration test of ARDL and UECM model. Basically, there are different types of criterion for selecting the lag which we can see from below table. From the table 1, it also shows that maximum criterion have chosen to take maximum lag of 1 for all variables. Therefore, the optimum lag of 1 would be better for cointegration test of ARDL and UECM model. In addition to that maximum lag of 1 or 2 is better for yearly base time series data. Since, this study is using annual time series data then it would be better to take maximum lag of 1. However, Akaike information criterion (AIC) will be used by this study to select the lag.

<Table 1> Results of Lag Selection Criteria of ARDL and UECM model

Lag	LogL	LR	FPE	AIC	SC	HQ
0	38.533	NA*	0.002	-3.453	-3.254*	-3.414
1	39.754	1.832	0.002*	-3.475*	-3.226	-3.426*
2	40.365	0.854	0.002	-3.436	-3.137	-3.378

* indicates lag order selected by the criterion.
LR : sequential modified LR test statistic (each test at 5% level),
FPE : Final prediction error,
AIC : Akaike information criterion
SC : Schwarz information criterion,
HQ : Hannan-Quinn information criterion.

4.1. Co-integration Test

To test the short run and long run relation among all the variables, ARDL cointegration test is being applied. The rational for using ARDL cointegration test in this study that the researcher has got mixture of stationary of variables at (I0) and (I1). Besides, the sample size of this study is small consists of only 26 years. This research uses maximum lag of 1 for all the variables as it has been suggested by the lag selection criterion. The table below is presenting the results of ARDL cointregation test. From there it can be decided whether all variables are cointegrated in the short run and long run or not.

<Table 2> ARDL Co-integration Test Result

Variables	Coefficient	Std. Error	t-Statistic	Probability
C	2.298	0.709	3.239	0.005
D(LNRGDP(-1))	-0.246	0.163	-1.509	0.153
D(LNMCAP(-1))	0.049	0.016	2.998	0.009
D(LNFDI(-1))	0.011	0.007	1.534	0.147
D(RINTR(-1))	0.004	0.002	2.298	0.037
LNRGDP(-1)	-0.121	0.038	-3.112	0.007
LNMCAP(-1)	0.044	0.019	2.343	0.034
LNFDI(-1)	-0.012	0.009	-1.276	0.222
RINTR(-1)	-0.006	0.002	-2.282	0.038

The above table 2 shows the output of the ARDL co-integration test. However, to see the long run or short run co-integration exist among all the variables, Wald coefficient test needed to be run

<Table 3> F-Statistics for Testing the Existence of Long-Run Relationship

Computed F-Statistic	2.803
Dependent Variable is LNRGDP:	
Bound Testing Critical Values at 5%	2.365 (lower) 3.553 (upper)

It shows from the above table 3, the F-statistic value is 2.8039 which are not significant at 5% level. The F-statistics value is lower than upper bound critical value of Pesaran (table: 3, 2001) 3.553 of the bound test. According to Pesaran et al. (2001), if the F-statistics value is less than the upper bound value, then null hypothesis is accepted. Therefore, this result suggests that there is no long run relationship between the dependent and explanatory variables.

<Table 4> F-Statistics for Testing the Existence of Short-Run Relationship.

Computed F-Statistic	11.649
Bound Testing Critical Values at 5%	2.365 (lower) 3.553 (upper)

It shows from the above table 4, the F-statistic value is 11.6497 which are significant at 1% level. The F-statistics value is higher than upper bound critical value of Pesaran (table: 3, 2001) 3.553 of the bound test. According to Pesaran et al. (2001), if the F-statistics value is greater than the upper bound value, then null hypothesis is rejected. Therefore, this result suggests that there is short run relationship between the dependent and independent variables.

<Table 5> Error Correction model

Dependent Variable is ΔLNRGDP:				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.060	0.010	5.800	0.000
ΔLNRGDP$_{t-1}$	-0.169	0.154	-1.095	0.288
ΔLNMCAP$_{t-1}$	0.049	0.016	3.045	0.007***
ΔLNFDI$_{t-1}$	0.009	0.006	1.422	0.173
ΔRINTR$_{t-1}$	0.003	0.001	2.171	0.044**
ECM (-1)	-0.103	0.037	-2.758	0.013**

Note: * 10 % Significant level, **5% Significant level,
*** 1% Significant level

To examine further long run co-integration between the dependent variable and explanatory variables, Error Correction Model (ECM) has been presented in the table 5. The main rational of ECM model is to identify the speed of adjustment towards equilibrium in the long run where dependent variable is adjusted to the changes in explanatory variables and shift towards converge in the long run equilibrium level. From the table 5 shows that the coefficient value (-0.103) of ECM (-1) is negative and the probability value of ECM (-1) is 0.013 which is significant at 5% level.

This result indicates that the long run co-integration exist between the dependent and independent variables. This result is similar with the study done by Hondroyiannis et al. (2005), Calderón & Liu (2003), Minier (2003), Hooi & Wah (2010), Karimi & Yusop (2009), Kogid et al. (2011), Sethi and Sucharita (2009), Mun et al. (2009), Anaripour (2011), D'adda & Scorcu (1997), Udoka & Roland (2012). This also means that all variables have long run association and they move together. However, the estimated coefficient of ECM (-1) indicates that the speed of adjustment towards long run equilibrium is 10.396%. This means that 10.396% disequilibrium in the previous year is closed by adjustment in the current year.

5. Conclusion

The main objective of this study is to investigate the impact of Malaysia's capital market and other key determinants on economic growth. Because, capital market provides long term capital financing such as bonds, securities and selling of shares play a major role to bring country economic and financial development. Besides, capital market acts as an intermediary of financial institution in mobilizing the funds from surplus units to the deficit units. Therefore, the significance of well-established capital market in order to faster country economic development is unavoidable and if a country has higher capital accumulation, the faster would be the country economic development. However, the authors have chosen foreign direct investment (FDI) and real interest rate (RINR) among other key determinants to examine their impact toward economic development in case of Malaysia.

However, ARDL version of ECM model result shows that there is long run cointegration among the economic growth and market capitalization, foreign direct investment and real interest rate. It means that market capitalization, foreign direct investment and real interest rate have significant impact on economic growth in the long run. Therefore, it is demonstrated that Malaysia's capital market has significant impact on economic growth in the long run. The finding of this study gives further support to the "Finance-led Growth Hypothesis" which is supported Schumpeter (1912), Goldsmith (1969), & Mc Kinnon (1974). Besides, Wald test of coefficient indicates that there is short run relationship between economic growth and market capitalization, real interest rate except for foreign direct investment (FDI). Based on the finding, this study suggests that the government should come out with the appropriate macroeconomic plan and policy to draw more inward foreign direct investment in order to faster the economic growth in future. As finding of this study shows that foreign direct investment does not have significant impact on economic growth in Malaysia in the short run.

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