CHAPTER 1

INTRODUCTION

1.1 Statement of Problem and Its Significance

The financial development-growth nexus is one of the key challenges facing policymakers in emerging market economies. In theory, there is a two-way relationship between financial development and economic growth. Financial development could promote economic growth as a well-developed financial market encourages the mobilization of savings, ameliorates asymmetric information, and provides greater opportunity for risk spreading and risk pooling. This would result in a higher savings rate and more efficient allocation of resource, thereby positively affecting long-term economic growth. Meanwhile economic growth could promote the development of financial market as it generates derived demand for financial services. Financial institution, financial product and service emerge as a response of growing economy, and therefore, financial development is induced by economic growth.

Understanding the causality relationship between financial development and growth is policy relevant as different causality could lead to two different policy inferences. The finding that financial development promotes growth points to the need of the government's active role in enhancing developmental stage of financial system. This is in marked contrast to the situation where financial development is derived from growth performance. Policy related to financial development would be passive and policy emphasis would be shifted toward other long-term growth determinants like export, human capital development and/or foreign direct investment (FDI).

In recent years, there has been a growing concern about the lopsided nature of the existing empirical evidence on the financial development-growth nexus. Given the nature of data availability, such a relationship has predominated been examined using multi-country cross-sectional data (e.g. King and Levine, 1993; Atje and

Jovanovic, 1993; De Gregorio and Guidotti, 1995; Levine and Zervos, 1998; Rousseau and Sylla, 2001 etc.). They found financial development supports economic growth[1]. Nevertheless, cross-country regression analysis is based on the assumption of homogeneity in the observed relationship across countries. This is a very restrictive assumption. It is common knowledge that there are considerable variations among developing countries in relation to various structural features and institution aspects, all of which would have a considerable impact on the financial development-growth relationship. Interestingly, when the country-specific factors are well taken into consideration the opposite result was reached. In particular, the recent study by Ang and McKibbin (2007), which is based on Malaysian experience, found that economic growth causes financial development in the long-run, but not vice versa.

In addition, evidence from the recent crisis casts doubt to the findings mentioned above. All crisis-affected countries which accelerated financial liberalization as a part of their financial development package in the pre-crisis era suffered from significant financial sector vulnerability (Isard, 2005). This simply points to the fact that the role of financial development in the growth enhancing process might be overstated. Financial development could result in economic growth disruption and sometimes output contraction because it could induce volatility and discourages risk-averse investor firm investment (Lucas, 1998; Singh, 1997). Likewise, Mauro (1995) concludes that the introduction of certain financial tools that allow individuals to hedge against risks may lead to a reduction in precautionary savings and, hence, lower long-term economic growth. All in all, it points to a growing need for an in-depth time-profile analysis of financial development-growth nexus. Therefore, this thesis aims to fill a gap of the existing literature by examining the causality relationship between financial development and economic growth in Thailand with a view to formulating a prudential policy encouraging sustainable economic growth.

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[1] Although most of these studies documented a positive association between financial development and economic growth which did not necessarily imply causalities, this implied that the level of financial development is a good predictor of subsequent rates of economic growth.

Thailand is suitable for considering the issues in hand for two main reasons. Firstly, to the best of our knowledge so far, there has not been a systematic analysis of the causality relationship between financial development and economic growth in Thailand. Secondly, during the past four decades, there has been a dramatic change in financial development in Thailand (e.g. the late 1980s, the early 1990s and the post-crisis period). This would allow an appropriate case study of the financial development-growth nexus.

1.2 Objectives of the Study

The objectives of the study are as follows:

1. To examine the evolution of financial development in Thailand over the past four decades.

2. To construct a freshly estimated index of financial development in Thailand

3. To examine the causality relationship between financial development and economic growth by employing the recent econometric innovation, Vector Error Correction Model (VECM).

4. To formulate prudential policy concerning the role of government in financial development.

1.3 Scope of the Study

This thesis examines the causality relationship between financial development and economic growth in Thailand during the period 1966 to 2005. The scope of financial development emphasises the money market covering banking and non-banking systems, especially financial institutions governed by the central bank (Bank of Thailand), i.e. commercial banks, finance companies and credit foncier businesses. The capital market is not included in this study for two reasons. Firstly, it is only

since the mid-1980s that the capital market has begun to play a role in Thailand's financial market (Warr and Nidhiprabha, 1996; Vines and Warr, 2003). Systematic data series related to the Stock Exchange of Thailand (SET) began in the mid-1980s, which is too short to a time-frame to undertake a systematic time series analysis. Secondly, there is a growing literature highlighting that the developmental impact of capital markets is different from that of banking systems (Fischer, 2002).

1.4 Organization of the Study

This thesis is divided into five chapters. Chapter 1 spells out the statement of the problem, the objectives, scope and organization of the study. An analytical framework of the financial development-growth nexus is discussed in Chapter 2. Chapter 3 presents the development of the financial system in Thailand over the past four decades. In this chapter, a composite index is developed to illustrate the time pattern of financial development in Thailand. In Chapter 4, the causality relationship between financial development and growth is examined. Conclusion and policy inferences are presented in the final chapter.