

CHAPTER 5

CONCLUSIONS AND POLICY INFERENCES

5.1 Conclusions

The causality relationship between financial development and economic growth is an ongoing debate in economic development. In theory, there is a two-way relationship between financial development and economic growth. It is the policy implications of this relationship which are highly relevant when formulating policy. Different causality could lead to two different policy inferences. When it is found that financial development promotes growth, there should be a role for the government in actively promoting the developmental stage of the financial system. In contrast, in a situation where financial development is derived from growth performance, policy related to financial development should be passive and policy emphasis should be shifted towards other long-term growth determinants, such as export, human capital development and/or foreign direct investment (FDI).

Against this backdrop, this thesis examines the causality relationship between financial development and economic growth, using Thailand as a case study. Thailand is an appropriate case study if we consider developing countries. First, 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. Second, over the past four decades, there has been a clear change in the nature of government policy towards financial development.

This thesis contributes to the general literature on economic development in two aspects. Firstly, there has been a growing concern about the lopsided nature of the existing empirical evidence on the financial development-growth nexus in recent years. In particular, such a relationship has predominately been examined using multi-country, cross-sectional data. The clear, fundamental limitation of such analysis is that it is based on the implicit assumption of 'homogeneity' in the observed relationship across countries. This makes cross-country comparison a rather risky

business. Hence, this thesis complements the existing literature by undertaking a country-specific study of the financial development-growth nexus. Secondly, this thesis employs a Vector Error Correction Model (VECM), which is superior to the standard cointegration approach. It is only the former which can address the possible simultaneity problem explicitly. This is of importance in examining the relationship between financial development and growth.

To illustrate the evolution of the financial sector in Thailand, a composite index of financial development is constructed in this thesis. The newly constructed index is administered with and without adjusting the degree of government supervision (*RULE*). The key finding is that the Thai financial sector gained maturity over a period of time. During the period 1966-89, the indices with and without *RULE* showed a similar trend. Interestingly, they began deviating from each other between 1990 and 1996 (the period of financial liberalization) when the Thai financial sector was being integrated into the global market. The index with *RULE* indicates a noticeably lower stage of development than the latter. This finding is consistent with the situation which was suggested in the literature of the 1997/98 financial crisis in East Asia. In particular, poor supervision of commercial banks and financial companies led to the boom in private domestic credit and made Thailand become vulnerable to the crisis (Athukorala and Warr, 2002).

Our econometric analysis suggests that the relationship between financial development and growth is bi-directional in both the short and long run. It should be noted that the relationship stipulating that financial development promotes growth is rather weak because it is found only in the case where the index of financial development with *RULE* is used. In contrast, the growth-leading-finance relationship is found in both with and without *RULE*. It is of note that this study realizes the potential benefit of a well-developed financial sector in encouraging the growth-enhancing process. In view of the arbitrariness in measuring *RULE*, the policy inference of the finance-led growth findings must be done with caution.

5.2 Policy Inferences

Three policy inferences can be drawn from this study:

1. Fostering the development of the financial sector must be done with caution. They must go hand in hand with the overall developmental stage of the economy. Any policy attempts to accelerate the development of the financial sector regardless of overall economic development are unlikely to allow a country to achieve long-term, sustainable growth.

2. Measuring financial sector development must take into consideration the size and quality of the financial sector. Quantitative measures of the index of financial sector development alone are not sufficient to indicate the growth-enhancing effect of a well-developed financial sector.

3. Our results point to the vital role of country-specific factors in influencing the relationship between financial development and growth. Ignoring them could result in misleading policy inferences.

5.3 Suggestions for Further Study

There are two major suggestions for further study. The first is related to the measurement of rules and regulations. Firstly, it is clear that the measurement of rules and regulations in this study is involved largely with discretion. While the important role of rules and regulations in measuring the developmental stage of the financial sector is realized in this study, constructing a better measure of rules and regulations requires a considerable amount of time and resources that are far beyond the scope of the current study. In fact, it *per se* could be a valuable research topic that is left for further study.

Secondly, examining the relationship between financial development and economic growth should be extended to include the role of the equity and bond markets when longer series of data become available. While the banking system remains dominant in Thailand, its role is declining. In contrast, the role of the equity and bond markets is growing and becoming the key element in the financial sector.