Applied Economics ›
Volume 37, 2005 - Issue 12

Original Articles

Financial development and economic growth: the case of Taiwan

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Pages 1329-1335 | Published online: 16 Aug 2006

Cite this article https://doi.org/10.1080/00036840420003387O2

Abstract

This paper examines the relationship between financial development and economic growth in Taiwan from 1962 to 1998. Using a four-variable VAR model, the competing hypotheses of demand-following versus supply-leading are empirically tested. The results from Granger causality tests based on vector error-correction models (VECM) suggest unidirectional causality running from financial development (measured as the ratio of M2 to GDP) to economic growth. This result supports the supply-leading hypothesis for Taiwan. This finding highlights the importance of financial development in Taiwan's recent growth.

Notes

An alternative measure calculated as the ratio of liquid liability to GDP was also used in this study. Results are similar to those reported here and are available upon request from the authors.

The sample period for the data, 1962–1998, covered two oil-price shocks and the economic liberalization in Taiwan, so structural breaks are expected for the data series studied.

Regarding the KPSS test, Lee et al. (1997) also show that the test suffers from a size distortion problem if a structural break exists but is ignored. The problem parallels the power loss problem of unit root tests when an existing break is ignored.

When the coefficients of both dummy variables are not significantly different from zero, Model C reduces to the standard ADF equation.

Using Monte Carlo simulations, Cheung and Lai (1993) showed that for autoregressive processes, standard selection criteria, like the SIC and Akaike Information Criterion (AIC), can be useful for selecting the correct lag structure for the Johansen's cointegration test. They found that the SIC performs slightly better than the AIC.

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