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Causality between financial development and economic growth: an application of vector error correction and variance decomposition methods to Saudi Arabia

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Abstract

This article makes an attempt to test the possible directions of causality between financial development and economic growth, which were labelled by Patrick (1966) as the supply-leading and demand-following hypothesis. Saudi Arabia is taken as a case study. The

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rigorous techniques, tend to suggest that the direction of causation between financial development and economic growth is supply-leading (rather than demand-following), as expected at the early stage of development. These findings have clear policy implications in that a pro-active policy of growth and reform of the financial sector will help enhance economic growth in an open developing economy like Saudi Arabia.

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