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Original Articles

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

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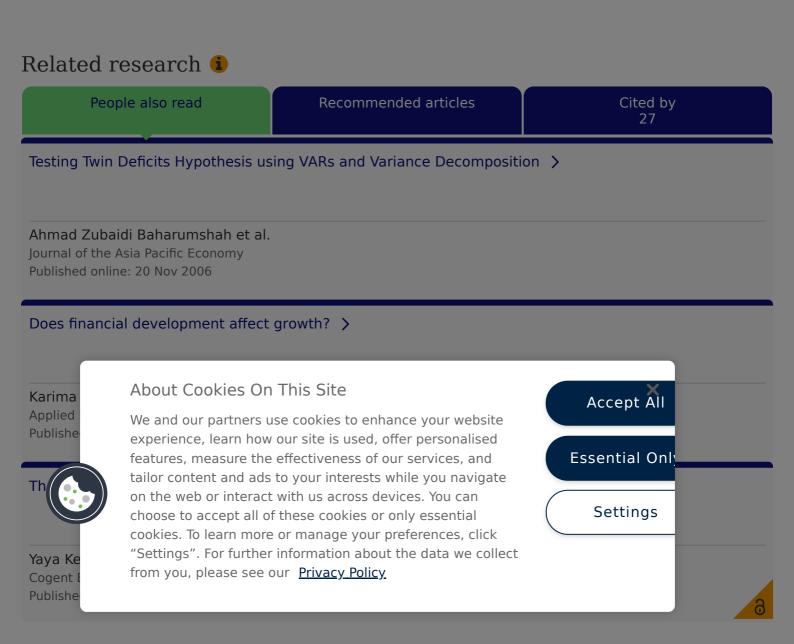
eoretical in issue with the functions ares

(CUSUMSQ) and Chow Test (CHOW) tests. Our findings, based on the above mentioned

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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