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The bounds test approach for cointegration and causality between financial development, international trade and economic growth: the case of Cyprus

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Abstract

This study employs the bounds test for co-integration and Granger causality tests to investigate the long-run equilibrium relationship and the direction of causality between financial development, international trade and real income growth for the Cyprus economy. The results of the study reveal that financial development as measured by broad money (M2), international trade and real income growth are cointegrated; thus, a long-run equilibrium relationship can be inferred among these three variables. On the other hand, Granger causality test results suggest that in Cyprus the growth in real income stimulates the growth of international trade (both exports and imports) and the growth of money supply. Furthermore, growth in imports of goods and services also stimulates a growth in exports of goods and services of Cyprus. Although this result

contradicts our initial expectations, it indicates the importance of capital inflows in Cyprus that plays a major role in financing the investments mainly in the tourism sector. As a final point, the results of this study reveal that the supply-leading, export-led growth and import-led growth hypotheses are not confirmed by this study whereas the demand-following hypothesis can be justified for the Cypriot economy when M2 measure of money supply is under consideration.

Notes

[1] PP approach allows for the presence of unknown forms of autocorrelation with a structural break in the time series and conditional heteroscedasticity in the error term.

[2] For detailed information, please refer to Pesaran et al. (2001, pp. 295–96).

[3] Unit-root tests for trade volume was not reported in Table 1 but are available on request.

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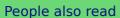Source: Journal of Development Economics
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