

FINANCIAL STABILITY, BUSINESS CYCLE AND CREDIT EXPANSION IN MALAYSIA

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Objective: This study constructs a financial stability index to measure the stability of Malaysian financial system. The index is then relates with business cycle (economic growth) and the degree of synchronization between business and household credits.

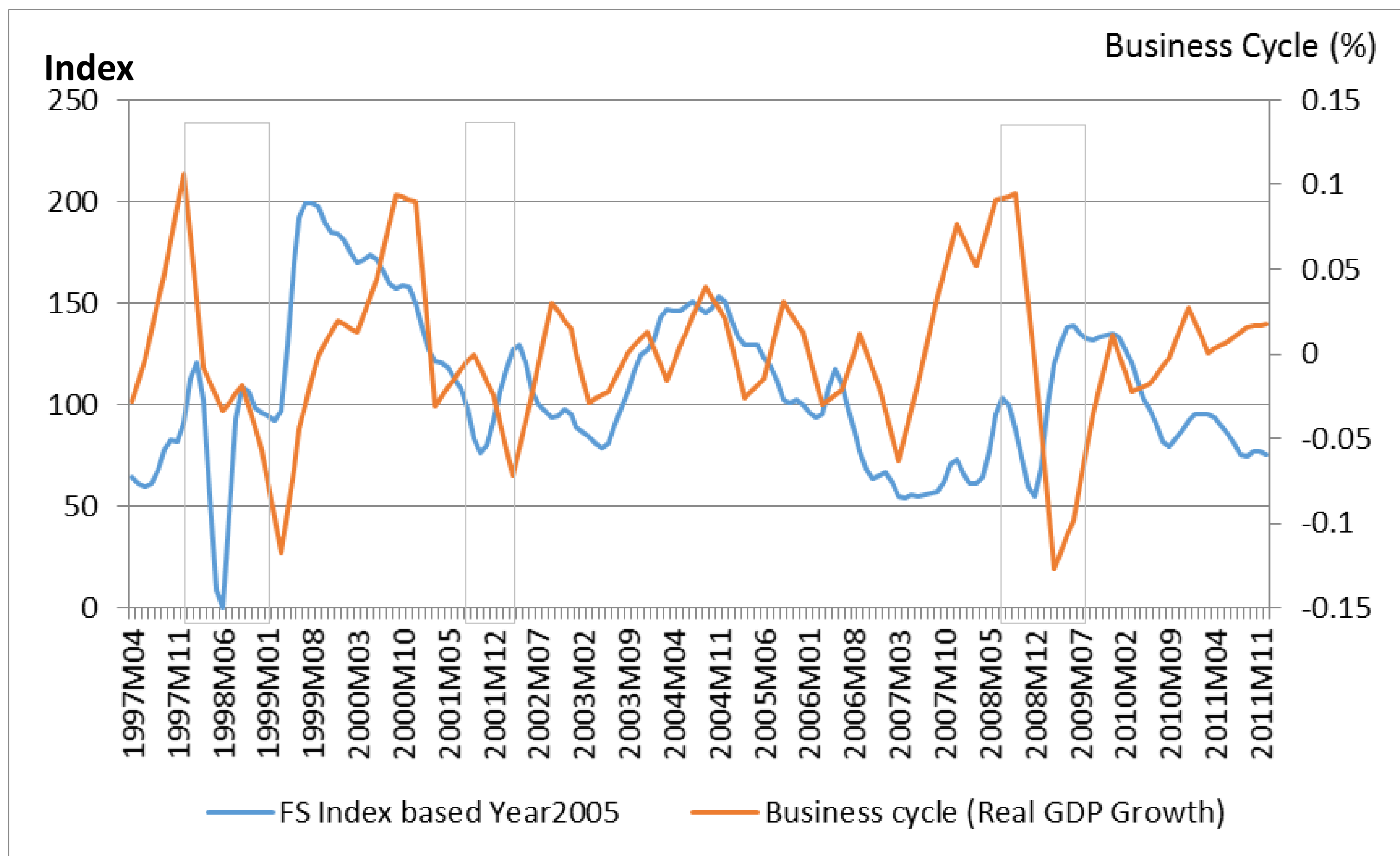


Figure 1: Financial Stability Index and Business Cycle (Real GDP Growth)

NEED

- To act as an early warning system of financial condition in Malaysia
- To predict economic growth using a broad range of macro-financial variables
- To guide policy-makers who face difficulties in designing financial development policies
- To evaluate the role of credit in influencing financial stability in a high credit expansion emerging market (Malaysia is ranked top 3)

APPROACH

- The dynamic factor model and a broad range of macro-financial and market based variables (15 indicators) are used to construct a financial stability index
- Formal predictive tests to investigate the ability of a financial stability index to forecast the business cycle.
- The non-parametric method is subsequently employed to gauge the degree of synchronization between credit and financial stability.

FINDINGS/BENEFITS

- The index appears to be predictive power for Malaysian business cycle (economic growth) based on forecast rationality (3 months or one quarter)
- Financial stability plays an essential role in driving economic growth
- An expansion in business credit would lead to financial instability, household credit has no negative influence on financial stability
- Policy-makers need to consider expansionary credit policy actions for the purposes of financial development
- Provides benefit to usage of credit in an economy and future generation needs to plan their personal finance and business firms should allocate the external finance (credit) to productive economic activities

Publications: Thomson Web of Science / SSCI

1) Koong, S. S., Law, S. H. and Ibrahim, M. H. (2017) Credit expansion and financial stability in Malaysia. *Economic Modelling* (Q2), 61,339-350.

2) Law, S. H., Kutan, A. and Naseem, N. A. M. (2017). The role of institutions in finance curse: Evidence from international data. *Journal of Comparative Economics* (Q2), in press.



Project Leader : Assoc. Prof. Dr. Law Siong Hook
 Co-Researchers : Dr. Koong Seow Shin, Prof. Dr. Mansor H. Ibrahim
 Faculty : Economics and Management
 Email : lawsh@upm.edu.my
 Tel : +603-89467768
 Expertise : Financial Economics, Applied Economics, Panel Data and Time Series Analysis

Table 1: Results of dynamic factor model estimation

Financial variables	Coefficients (λ)	p-value
Non-performing loans (NPL)	0.0898**	0.000
Risk-weighted capital ratio (RWCR)	0.0303*	0.072
Money supply (MS)	0.0029	0.859
Stock market index (SMI)	0.0400**	0.019
Money market rate (MMR)	-0.0907**	0.000
1 year MGS/3-month T-bills spread (Spread1)	0.0583**	0.002
10 years MGS/3-month T-bills spread (Spread2)	0.2130**	0.000
MMR/3-month T-bill spread (Spread3)	-0.0348**	0.037
MMR/U.S. federal fund rate spread (Spread4)	-0.0944**	0.000
Domestic credit to private sector (DC)	-0.0361**	0.034
Real effective exchange rate (REER)	0.0142	0.388
Net international reserves (NIR)	0.0099	0.545
House price index (HPI)	0.0342**	0.044
Crude oil price (COP)	0.0622**	0.001
Private capital fund (PCF)	0.0129	0.430
Z_{t-1}	1.8280**	0.000
Z_{t-2}	-1.3127**	0.000
Z_{t-3}	0.4401**	0.000
Wald Chi-square	4180.28**	0.000

Note: ** and * represent 5% and 10% significance level, respectively.

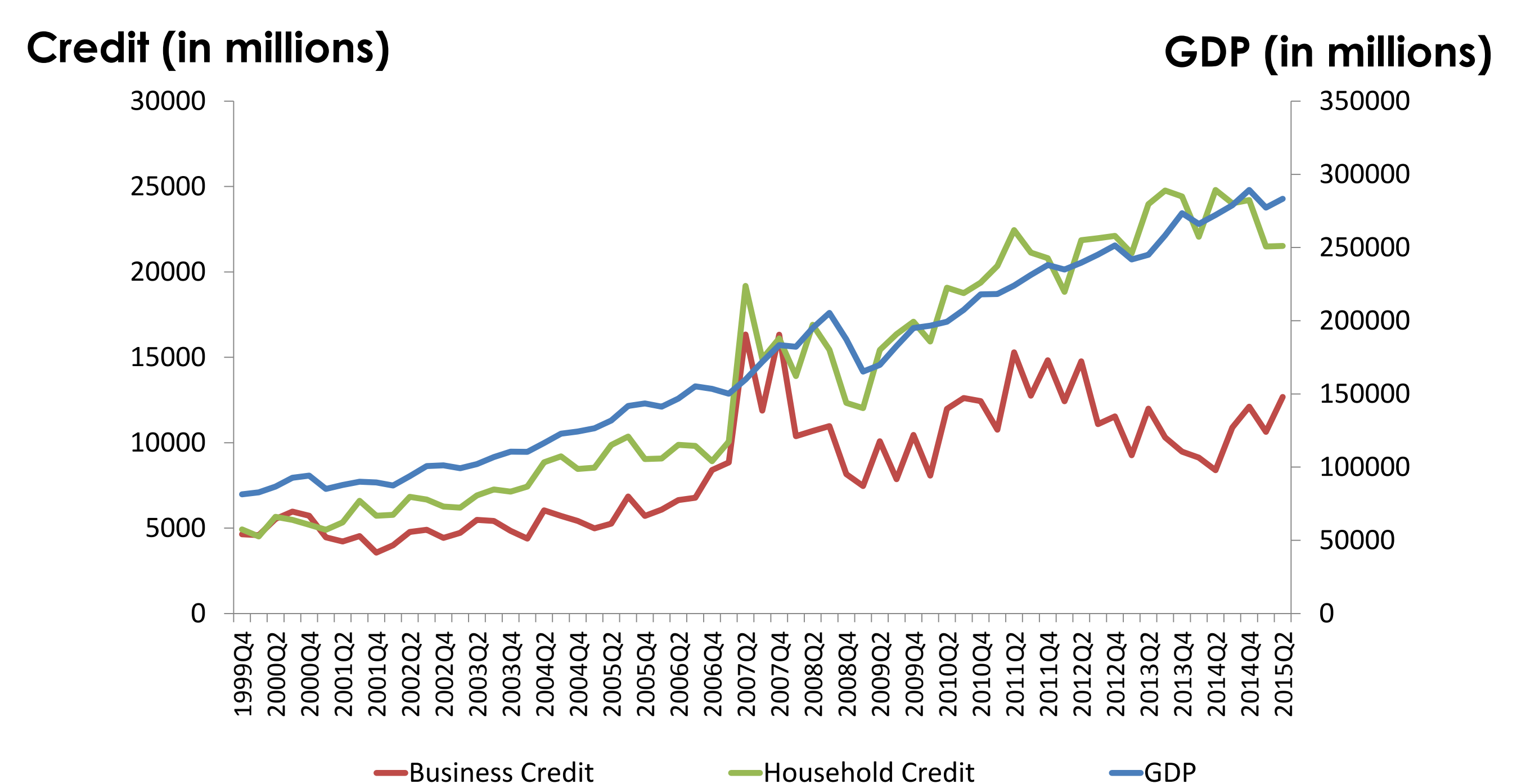
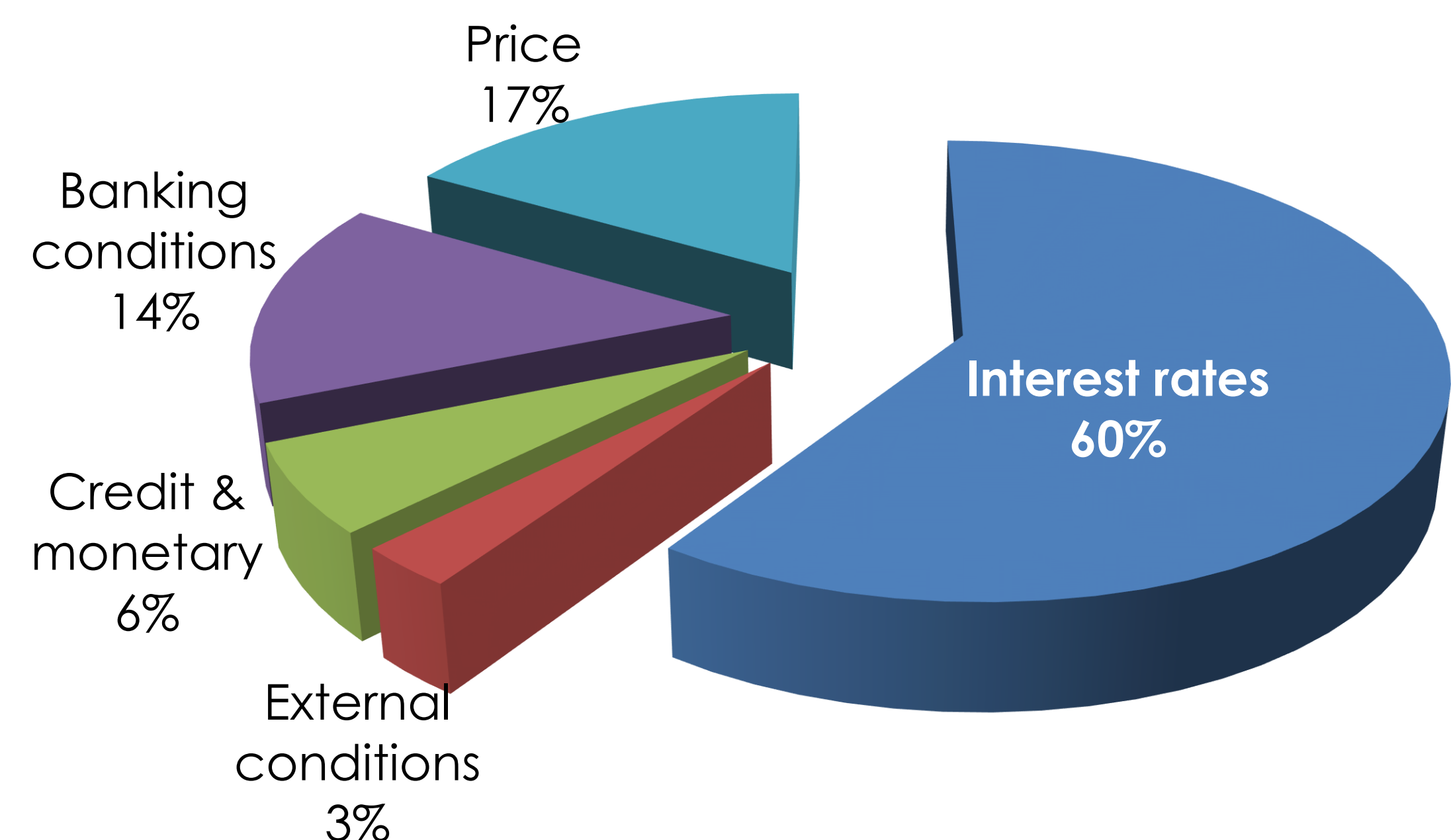


Figure 3: Time Plots of Business Credit, Household Credit and GDP of Malaysia

MARKET POTENTIAL

- The index provides a source to monitor financial stability and predict economic growth in Malaysia
- The index is needed by policy makers and financial markets & institutions for observing Malaysian financial stability behavior