Chapter 3
Factors Affecting Economic Growth in Malaysia:
Evidence from a Dynamic ARDL

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ABSTRACT

This chapter aims to meticulously investigate the key elements of economic growth in Malaysia, focusing on the intertwined interplay of several crucial financial and external sector variables. Specifically, the study delves into the roles of financial development (FD), domestic credit to the private sector (DCPS), foreign direct investment (FDI), and remittances from 1986 to 2023. The chapter employs the Dynamic ARDL model to automatically generate, estimate, and depict graphs of both positive and negative variations in the factors, as well as their short- and long-term trends. The outcome of the bound test verifies a long-term association among variables. The empirical findings from the dynamic ARDL model indicate an absence of a significant link between FD and EG. Conversely, the analysis reveals a statistically significant, albeit negative, nexus between DCPS and EG. Besides, the outcome unfolds a robust positive link between FDI and EG. These findings offer valuable guidance for government and policymakers in formulating effective strategies.

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INTRODUCTION

The association of financial development (FD) and economic growth (EG) has become a prominent topic in development economics. Its concept has evolved from the 6th century BC to the 15th century AD and continues to the present day. This evolution encompasses various phases and terminological refinements, transitioning from elements of the financial market to contemporary interpretations based on working and outcomes. The nexus between the financial market and EG was initially addressed nearly 150 years ago by the classical school of thought. (Čižo et al., 2020).

FD pertains to the instructions, procedures, and plans that focus on improving access to finance, enhancing the depth, and boosting the effective functioning of financial institutions and markets. A progressive financial system improves economic efficiency by directing limited resources to their best use, which then fosters sustained growth (Tariq et al., 2020). There are two core macroeconomic ways through which FD is thought to influence EG. First, it determines savings. Second, it guarantees that intermediation is effective in offering the best chances for return on investment. Hence, the function of financial growth is too important to be ignored for an economy to have a strong and viable structure (Wen et al., 2022).

The evolution of Malaysia into a middle-income economy has been intricately linked to the progress and diversity of its financial sector. Following the industrial revolution of the 1970s and 1980s, the economy grew rapidly. Malaysia has been one of the developing world's leading nations in recent times (Ang, 2008). Malaysia has a rich past of fixing its financial sector. From the 1970s, numerous financial restructuring initiatives have been started with the purpose of strengthening the financial system. Nevertheless, there is a shortage of empirical data that can tell policymakers whether these reforms have affected the financial system in any way. Interestingly, Malaysia's economy has witnessed substantial growth in terms of financial depth over the past ten years. By 2023, the financial system's share of GDP had grown to 119%, from about 51 times GDP in 2013 (Wong et al., 2025). Through its Financial Markets Committee (FMC) and close industry interaction, the Central Bank of Malaysia has persisted in promoting financial market development initiatives (Wong et al., 2025).

FDI has long been acknowledged by Malaysia as a key component of its industrialization plan. Rapid expansion in the 1980s and 1990s, driven by manufacturing and electronics, has been witnessed in Malaysia's FDI history. With regulatory changes in the 2000s, it recovered from its downturn after the 1997 Asian Financial Crisis (Shah et al., 2022). Following a brief decline amid the global crisis of 2008, foreign direct investment switched to high-tech and service sectors. Despite complications caused by COVID-19, Malaysia continued to be desirable. The nation's developed financial infrastructure, favorable geographic location, and liberal investment reg-

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