IMPACT OF DOMESTIC PUBLIC DEBT ON FINANCIAL DEVELOPMENT AND ECONOMIC GROWTH IN MALAYSIA

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By

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May 2014

Abstract of thesis presented to the Senate of Universiti Putra Malaysia in fulfillment of the requirement for the degree of Master of Science

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May 2014

Chair: **Associate Professor Normaz Wana Ismail, PhD**

Faculty: Economics and Management

Government interventions through fiscal policy are important to promote growth. In a nutshell, economic growth cannot be developed without government spending. Unfortunately, government tends to borrow from internal and external sources to finance budget deficit when additional government spending is unable to meet the tax revenue. Nowadays, the issue of higher public debt in Malaysia has received an attention from policy makers and economists. Given the abundance of liquidity and ample financial funds in the banking system, Malaysian government can continue borrow and mainly rely on domestic source to close the budgetary gap. Hence, the purpose of this study is to investigate the impact of domestic public debt on financial development and economic growth in Malaysia. The sample period in this study covers the annual time series data from 1980 to 2010. By using Autoregressive Distributed Lag (ARDL) cointegration bound test, this study estimates long run and short run relationship among domestic pblic debt, financial development and economic growth in Malaysia. The empirical finding suggests that outstanding of domestic public debt does crowd out private investment and have a statistically negative impact on financial development during the occurrence of financial crisis. Meanwhile, the ARDL long run coefficient reveals that domestic public debt has an adverse impact on the level of economic growth during the estimate period. In conclusion, government needs to concern over the debt level in order to reduce the debt burden for future generations.

Abstrak tesis yang dikemukakan kepada Senat Universiti Putra Malaysia sebagai memenuhi keperluan untuk ijazah Master Sains

KESAN HUTANG DALAMAN KERAJAAN KEPADA PEMBANGUNAN KEWANGAN DAN PERTUMBUHAN EKONOMI DI MALAYSIA

Oleh

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Mei 2014

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Campur tangan kerajaan di dalam dasar fiskal secara meluas dilihat sebagai alat yang penting bagi menggalakkan pertumbuhan. Secara ringkas, pertumbuhan ekonomi tidak mungkin dibangunkan tanpa perbelanjaan kerajaan. Malangnya, kerajaan bercenderung untuk meminjam dari sumber luaran dan dalaman bagi membiayai defisit belanjawan apabila pertambahan perbelanjaan kerajaan tidak dapat ditampung oleh hasil cukai. Pada masa kini, isu hutang awam yang tinggi di Malaysia telah menarik perhatian dari para pembuat dasar dan ahli ekonomi. Memandangkan banyak kecairan dan dana kewangan yang memadai di dalam sistem perbankan, kerajaan Malaysia boleh terus meminjam dan terutamanya bergantung kepada sumber domestik bagi merapatkan jurang belanjawan. Oleh itu, tujuan kajian ini adalah untuk menyiasat kesan hutang domestik ke atas pembangunan kewangan dan pertumbuhan ekonomi di Malaysia. Tempoh sampel dalam kajian ini meliputi data siri masa dari tahun 1980 hingga 2010. Dengan menggunakan *Autoregressive Distributed Lag* (ARDL) ujian *cointegration bound*, kajian ini mengkaji hubungan jangka masa panjang dan jangka masa pendek di antara hutang domestik, pembangunan kewangan dan pertumbuhan ekonomi di Malaysia. Keputusan empirikal mencadangkan bahawa tunggakkan hutang domestic menyebabkan asakan keluar dari pelaburan swasta dan memberi kesan yang negatif kepada pembangunan kewangan semasa berlaku krisis kewangan. Sementara itu, pekali jangka masa panjang *ARDL* mendedahkan bahawa hutang domestik awam mempunyai kesan yang buruk kepada tahap pertumbuhan ekonomi semasa tempoh penganggaran. Kesimpulannya, kerajaan perlu memerhatikan tahap hutang negara supaya dapat mengurangkan beban hutang pada generasi yang akan datang.

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This thesis was submitted to the Senate of Universiti Putra Malaysia and has been accepted as fulfilment of the requirement for the degree of Master of Science. The members of the Supervisory Committee were as follows:

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CHAPTER 1

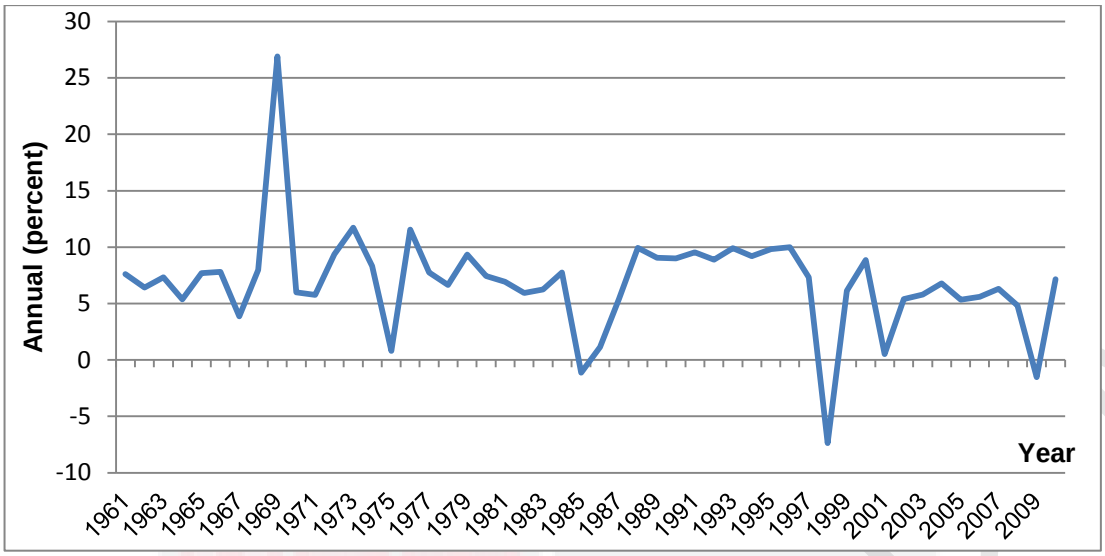
INTRODUCTION

1.1 Introduction

Budget deficit is always associated with higher public debt yet these two terms cannot be used interchangeable. A budget deficit, also known as fiscal imbalance, occurs when government revenue is insufficient to meet the countries massive expenditure. As a result, public debt occurs when the government borrows through issuance of bonds to finance the countries deficit. The recent European debt crisis has raised the attention of policy makers and academicians on how external public debt could impinge economic growth of a nation. Many developing countries that are struggling with higher fiscal deficit worry they might go bankrupt or caught in a debt crisis just like Greece, Ireland, Portugal, Spain and Italy. It is reasonable to say that external public debt always confronts more uncertainty in economic performance, yet the impact of growing domestic public debt cannot be neglected at the same time. In Malaysia, the government had triggered out the mushrooming of debt for years for development purposes. More interestingly, most of the debt in Malaysia is mainly borrowed from domestic sources (Bank Negara Malaysia, 2010). Therefore, by focusing on domestic public debt, further details of this study will be described in the following session.

1.2 Overview of Malaysia Gross Domestic Product (GDP) Growth Rate

Malaysia is an open and a small middle-income country, with its land mass being well endowed with rich natural resources and raw materials since time immemorial. Historically, Malaysia was under British rule in the mid-18th century before the formation of British-Malaya became the Federation of Malaya in 1948. Later, on 31 August 1957, the Federation was declared an independent country and had its name changed to Malaysia on 16 September 1963. During the British colonial period, the Malaysian economy was fully focused on natural resource based development such as rubber, oil palm, cocoa plantation, and tin mining. In order to meet the higher demand from industrialized firms and automobile industries, economic growth during the colonial time was well established through both the rubber plantation and tin mining sectors.



Source: World Bank, World Development Indicator (WDI) and Global Development Finance

Figure 1.1: Malaysia GDP Growth Rate from 1961 to 2010

The Malaysia GDP growth rate over the period 1961 to 2010 is presented in figure 1.1. After Malaysia achieved independence, the economic growth rate had significantly improved rapidly where the GDP growth rate had increased shaply from -0.1 percent in 1957 to 7.8 percent in 1966.[1] This conducive economic development was largely due to the dependence on the agricultural sector. However, the rapid growth rate was later severely affected by the May 13 race riots that caused the growth rate to slightly decline and reach 5 percent of the GDP in 1970. Hence, the government had implemented the New Economic Policy (NEP) in order to combat the ethnic problems and reduce poverty gaps among races in different socio-economic backgrounds.

Over time, rapid growth in development, followed by transformation from an agricultural industry to a manufacturing sector had significantly contributed to the economic performance. During the early period of the 70's, the implementation of free trade zones accompanied by export-oriented industries had led the GDP growth rate to a record 11.7 percent in 1973.[1] Nevertheless, the economic progress was moving steadily when the country was severely affected by the oil crises in 1975 and the GDP growth rate started to decline drastically to 0.8 percent. [1] Consequently, the government needed to increase excessive expenditure on public investment development in order to recover from the economic recession.

[1] Source: Compiled from World Development Indicator

Furthermore, the economic situation was falling into a global economic recession resulting from the commodity price crisis that occurred in 1980 and 1985. As a result, terms of trade in export and government revenue declined due to the collapse in commodity prices.Thereafter, private investment-led growth had become an important key that drove economic growth to sustainable development levels. For instance, private sector and foreign direct investment had contributed to the average growth rate in Malaysia that amounted to 9.6 percent over a period from 1991 to1996.[1]

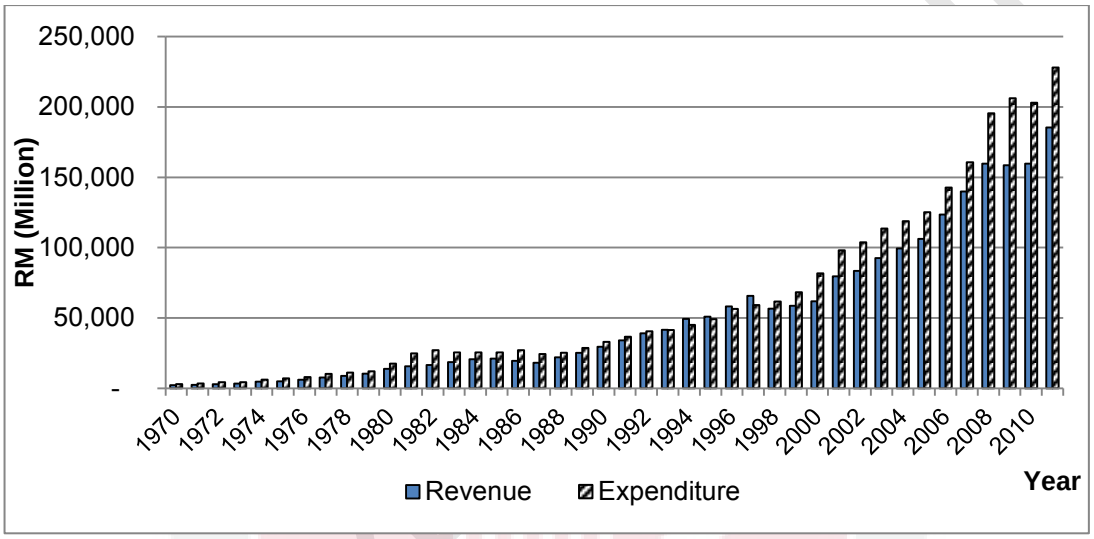
In subsequent years, the Malaysian economy was seriously affected by the 1997 Asian Financial crisis, where growth rate was sharply reduced to -7.4 percent in terms of GDP in 1998. [1] Hence, the government had imposed restrictions on currency trading and capital control in order to rejuvenate economic growth. Moreover, economic growth rate had further deteriorated by the dot-com bubble in 2001 when prices in the stock markets declined and the internet bubble existed in the technology industry. In 2008, the United States global financial crisis that followed by the bankruptcy of the Lehman Brothers had seriously caused the European zone to be trapped in a sovereign debt crisis. Consequently, many developed and developing countries had entered a global recession.

Overall, the Malaysian economic growth rate had undergone many challenges during the post-independence period. Malaysia's GDP growth rate in 2010, which was reported by the World Bank, was at a moderate level of more than 7 percent, mainly due to the contribution from the services and manufacturing sector. Despite the rest of the world experiencing a slower growth rate, Malaysia's growth rate continued to grow at a steady rate and remained at a positive level of 4.5 percent in 2011. Meanwhile, the government of Malaysia has forecast that the country could enjoy an average growth rate of 6 percent to 7 percent in the future once the Government Transformation Program (GTP) had successfully contributed to the economic growth of Malaysia.

In summary, it is well known that Malaysia is aiming to transform itself from a middle-income country to a high value-added, high-income country by 2020. According to the World Bank, Malaysia's income per capita in 2010 was US$ 8,519, which is much lower compared to other emerging economies such as Singapore (US$ 43,324), Hong Kong (US$ 31,877) and South Korea (US$ 20,757). Thus, unlike other neighbouring countries, Malaysia is struggling in a middle-income trap while on the pathway to achieve a target of high-income status, which is US$ 15,000 or RM 48,000 in its Vision 2020. Hence, the government together with economists have to spend a long journey in the development process in order to transform the Malaysian economy to a high-income nation of the future.

1.3 Malaysia Total Revenue and Expenditure

Malaysia's total revenue and expenditure has increased dramatically over the past four decades. In Table 1, government revenue can be classified into three large components, which are tax revenue, non-tax revenue and non-revenue receipts. According to a recent report from the Central Bank, total government revenue collectted in 2010 was RM 159,653 million or 28.5 percent of the GDP. This amount is expected to increase by 16.14 percent to RM 185,419 million in 2011 due to the rapid growth of the production sector in the local economy and higher demand for commodoties from abroad.



Source: Ministry of Finance, Bank Negara Malaysia

Figure 1.2: Malaysia Total Revenue and Expenditure from 1970 to 2011

As showed in Figure 1.2, tax revenue contributes the largest portion among the total revenues and becomes the main income for the government to finance its spending. For instance, tax revenue in 2010 accounted for RM 109,516 million or 67 percent of total revenue while non-tax revenue and non-revenue receipts were moderated at RM 48,867 million and RM 1270 million, respectively. In addition, the Central Bank claims that total revenue was expected to further increase due to the meticulous efforts of the government in tax administration.

Furthermore, tax revenue collection can be categorized into direct tax and indirect tax. In 2010, the federal government's tax revenue that came from direct taxes and indirect taxes were RM 79,009 million and RM 30,507 million, respectively. Basically, direct taxes received by the Inland Revenue Board (IRB) comprise company income tax, personal income tax, stamp duty and tax imposed on petroleum. Revenue collected from company income tax remains

the largest component in direct taxes, accounting to RM 36,266 million or 45.9 percent of total direct taxes.[2]

Next, the Malaysian government's indirect taxes come from duties on import and export, service taxes and sales taxes. These indirect taxes are collected by the Royal Customs and Excise Department. Moreover, the government's non-tax revenue includes fees for licensess and permits while non-revenue receipts is a repayment or compensation payment, such as refunds of overpayments made in previous years.

On the expenditure side, it can always be concluded that the government cannot generate economic growth without spending. In Malaysia, government expenditure can be divided into two major parts, which are operating expenditure and development expenditure. Operating expenditures always occur as short term expenditures, which include emoluments, pension, subsidies, debt service charges and others. At the same time, development expenditure is a long term spending strategy that includes general administration, economic services and social services that can generate returns after a few years (Table 2 and 3).

According to the Central Bank report, it is vividly noted that after the bad experience of the 1997 Asian financial crisis, total government expenditure started to increase in 1999 and reached RM 204,425 million in 2010. One of the reasons behind higher government expenditure was the implementation of the fiscal stimulation package. For instance, the government had implemented a stimulation package worth RM 7 billion in 1997-1998 and allocated RM 67 billion in late 2008-2009 to boost up the economic growth during the financial crisis. Consequently, Malaysia's economic growth had exploded to fiscal deficit in the following years after the 1997 financial crisis.

Among the total government expenditure, operating expenditure and development expenditure were allocated RM 151,633 million and RM 52,792 million, respectively. The largest component of government operating expenditure is on emoluments, which were RM 46,663 million in 2010 and was anticipated to rise to RM 50,148 million in 2011. Moreover, the two largest portions of government development expenditure were economic services and social services, which were approximately RM 26,121 and RM 20,784 in 2010, respectively. (Bank Negara Malaysia, 2010)

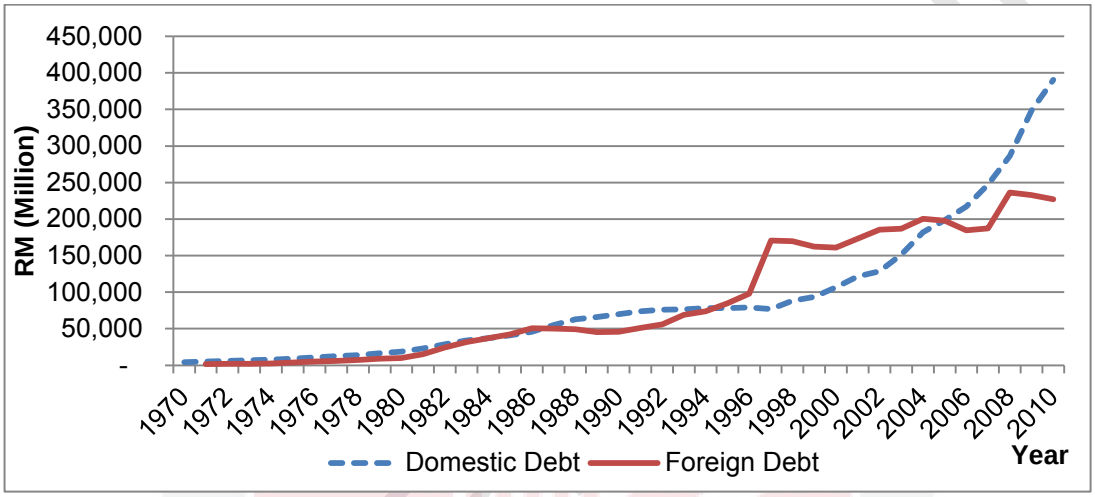
Historically, sustainable increase of government expenditure in the post-independence era shows that Malaysia had gone through fiscal imbalances for 42 years except during 1993 to 1997. It is postulated that government

[2] Source: Ministry of Finance, Bank Negara Malaysia

expenditure plays an important part in influencing the economic performance and standard of living in a country. However, this statement is under scrutiny since there is always an argument about the relationship between government spending and economic growth in existing studies.

1.4 Public Debt in Malaysia

In general, there are two types of public debts, which are domestic public debt and foreign public debt. Domestic public debt is the debt incurred when governments borrow within their own country. On the other hand, when the government borrows from foreign banks or financial bodies such as the International Monetary Fund (IMF) or World Bank, these are defined as foreign public debt. Unlike foreign public debt, domestic public debt is safer and less risk because the government can increase taxes and cut down the amount of spending to control the domestic public debt level in a country.



Source: Ministry of Finance, Central Bank of Malaysia

Figure 1.3: Public Debt in Malaysia from 1970 to 2010

Overall, the Figure 1.3 showed that the amount of domestic public debt had increased gradually and was accounted at RM 390,356 million or 63.2 percent of total public debt in 2010. Generally, government issued bonds, securities and bills to finance the deficit. Of the total, the three main domestic public debts can be classified into Malaysian Treasury Bills (MTB), Government Investment Issues (GII), and Malaysian Government Securities (MGS) which amounting to RM 4,320 million, RM 81,500 million and RM 260,994 million, respectively.[3] Government securities contributed the larger portion, which covered approximately 66 percent of total domestic public debt in 2010. The remaining RM 43,543 or 11 percent of total domestic public debt is considered as other loans, which are mainly held by the Employees Provident Fund (EPF), Cagamas Berhad and Commercial bank.

[3] Malaysia Government Securities is a long term interest bond issued by government for developing expenditure. Apart from that, Government Investment Issues is non-bearing interest bond which are issue based on Islamic principal for developing expenditure.

Furthermore, the domestic public debt holders comprise the banking sectors, non-banking financial intermediaries, public sector, foreign stakeholders and others. [4]Starting from 2009, the banking sector has substituted the role of social security institution to become the largest domestic public debt holder in Malaysia (See Appendix). However, at the end of 2010, the largest domestic public debt holder was replaced by banking sector, which own RM131, 378 million or 33.66 percent of total domestic public debt, with an increased 53.7 percent from 2008 to 2010 (2008: RM85, 471 million).

Next, foreign public debt in Malaysia can be broken down into short term, medium term and long-term debt. In 2010, total foreign public debt in Malaysia was accounted at RM 227,107 million or 36.8 percent of total public debt. Over the years, the largest stakeholder of foreign public debt in Malaysia was the private sector. As shown in the graph above, the trend of foreign public debt shows an upward and downward movement during the past four decades. Starting from 1971, the foreign public debt had slowly increased and reached a peak in 1997 with approximately RM 170,757 million. This outstanding amount was partly caused by the depreciation of the Ringgit Malaysia during the Asian financial crisis.

As suggested by Qureshi and Ali (2010), countries that accumulate both domestic and foreign public debts are always in a dangerous predicament and can impede the development of the economy. In Malaysia, the rising total public debt due to a higher deficit has become a concern issue among the policymakers and economists. According to the IMF, Malaysia's total public debt (domestic and foreign public debt) is accelerating at a dangerous rate and was at 55.47 percent of the GDP in 2012. In other words, total public debt ratio had already exceeded a debt threshold of 55 percent of the GDP. Meanwhile, IMF had projected that total public debt in Malaysia could approach RM 1 trillion by 2020 if the higher borrowing continues to increase to meet financing activities.

In summary, budget deficit can be financed through the borrowing or printing of money (Adam and Bevan, 2005). However, printing money to monetize the debt is very risky because it can result in inflation or lead to higher hyperinflation in the market (Choong et al., 2010). Given the abundance of liquidity in the banking system, the government of Malaysia can continue borrowing and mainly rely on domestic sources to close the gap of the deficit. In this way, Malaysia would focus on its domestic finance rather than foreign public debt to meet the financing requirement. Rahman (2012)

[4] Banking system comprise Central Bank of Malaysia and Banking Institution while non-banking financial intermediaries comprise Employees Provident Fund, SOCSO, Insurance companies and National Savings Bank.

1.5 Overview of Malaysian Financial Development

Financial development can be defined as the factors, policies, and institutions that lead to effective financial intermediation and markets, as well as deep and broad access to capital and financial services (Financial Development Report, 2012). More specific, financial development is the increase in the size of the financial sector which also can be defined as a process that shows the improvement in the efficiency of the financial system.

In general, financial development can be measured through a number of factors such as access, size, stability, efficiency, performance and degree of financial development. According to the Financial Development Index Report in 2012, the overall ranking of financial development in Malaysia had dropped and was ranked 18th in 2012 due to the vulnerabilities of the financial system. However, despite Malaysia's financial development ranking has fallen two spots, the score index still maintained and was marked at 4.24[5] if compared with the rest of the country.

Malaysia's financial system has gone through a significant evolution and has becomes one of the engines for enhancement of economic growth. During the pre-independence period, Malaysia's financial system performance and monetary policy was very weak and the banking system was mainly driven by foreign banks (Said and Ismail, 2008). As a result, the government of Malaysia started to restrict the participation of foreign banks to 30 percent in order to safeguard the role of domestic banks in the financial system.

Moreover, the Central Bank or *Bank Negara,* was established on 24 January 1959 to initiate and monitor monetary and financial stability, to promote financial development and overseer economic growth in Malaysia. For instance, total assets in the Malaysian financial system were recorded to be approximately RM 3,553 million at the end of 1960. This number was further expanded to RM3.5 trillion in 2011 due to the sound and safe financial system (*Bank Negara Malaysia, 2012*). Through the years of economic transformation, the objectives and role of the Central Bank has evolved and expanded in order to encounter the challenges from both the internal and external side.

The stability and competitiveness of financial development is vital to support Malaysia's transformation towards a high value-added and high-income nation (Financial Sector Blueprint, 2011). For that reason, it is not surprising that Malaysia requires a strong and sophisticated financial system to withstand the uncertainties of global challenge. Overall, the structure of the financial system in

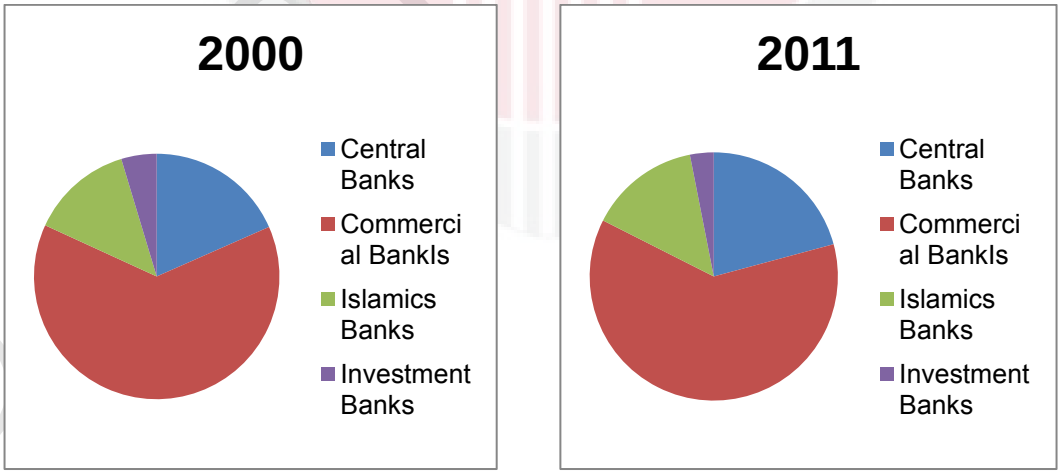
[5] The financial score index examine the financial strength which is based on seven main pillars of financial elements. These included institution environment, business environment, financial stability, banking financial services, non-banking financial services, financial market and financial access. The indexes are re-scaled from 1-7 where index rank 1 means lower growth rate while index score 7 means higher growth rate or most advantage.

Malaysia can be broadly divided into two major segments, which are financial institutions and financial markets. Financial institutions comprises the banking system and non-banking financial intermediaries, while the financial market consist of money and foreign exchange markets, capital markets, derivatives markets and offshore markets (See Appendix).

As suggested by Ang and Mckibbin (2007), the two common perspectives, which are used to measure the level of financial development are banking sector development and stock market development. For instance, the indicators for banking sector are liquid liabilities, private credit and domestic credit. In addition, the indicator for stock market development consists of three capital market development, namely stock value traded stock market turnover and number of companies listed. Since the structure of Malaysia's financial system is based on the banking sector, the proxies used to measure the financial development can be selected through the bank base system.

1.5.1 The Banking System in Malaysia

The role of the banking system in Malaysia is important because it is one of the primary sources for the government to finance economic activities. In general, banking system in Malaysia comprise Central Bank, Commercial banks, Merchant/ Investment banks and Islamic banks. The comparison of total assets in the banking system between 2000 and 2011 is shown in figure 1.4.



Source: Bank Negara Malaysia

Figure 1.4: Total Assets of Banking System in 2000 and 2011

Overall, it is clearly seen that commercial banks contribute the greatest composition of their assets in the banking system from 2000 to 2011. In 2000, total assets of commercial banks accounted to approximately 63 percent whereas investment banks only accounted for a small proportion of 5 percent. Meanwhile, Central banks and Islamic banks play a minority role with approximately 18 percent and 13 percent of assets in the banking system, respectively. In 2011, total assets in commercial banks had dropped 1 percent while total assets in the Central bank had increased to 21 percent. The remaining 14 percent and 3 percent of assets were covered by the Islamic banks and investment banks, respectively. In summary, total assets in the banking system have increased almost two-thirds from RM 0.8 million in 2000 to RM 2 million in 2011. In Malaysia, the banking system remains strong and resilient due to good regulation and effective monetary policies implemented by the Central Bank.

1.6 Problem Statement

In recent years, the sovereign debt crisis that hit European countries has become a concerned issue around the world. In general, the size of debt is driven by government spending. In one hand, it could simply be said that economic growth could not be possibly stimulated without government spending. On the other hand, sustainable increase in government spending would lead to fiscal deficit and higher public debt. Hence, the involvement of government spending has always become a controversial issue in economics (Mehrara et al., 2012).

As suggested by Feldstein (1985), a country with a fiscal deficit must be subsidized by tax revenue. Otherwise, a higher debt burden would occur if borrowing were an option to finance the budget deficit. In this case study, Malaysia has been struggling with the problem of fiscal imbalance and accumulation of public debt since the aftermath of the 1997 Asian financial crisis. Therefore, the government had triggered out the outstanding public debt for years in order to meet higher development expenditure.

However, not alike the European countries, Malaysia can mainly borrowed domestically due to the abundance of liquidity in the financial system. Indeed, the ample financial liquidity in the banking sector is a two-edged sword. On one side, the profusion of financial sources has benefited the government of Malaysia and it continues to rely on domestic resources to close the budgetary gap. On the other hand, Panizza (2008) concluded that rising domestic debt might cause the crowding out effect and be detrimental to financial stability if banks engage extremely on government debt.

From a banking perspective, the impact of public debt on financial development through the crowding out effect is an augmentative issue. According to Hauner (2009), the role of public debt in financial development can be remarked as a "safe asset" view or a "lazy bank" view. On one hand, banks will limit new lending to risky private sectors when public debt can be served as collateral and as safe assets in the banking sector (Kumhof and Tanner, 2005). On the other hand, the increasing public debt held by the banking sector might be critical to financial development when higher interest rates limit the availability of bank credit to private sectors (Ismihan and Ozkan, 2012).

Furthermore, as mentioned earlier, most of development expenditure in Malaysia is funded by domestic sources. According to Panizza (2008), the shift from external debt to domestic debt is no longer a new issue. As the consequence of the aftermath of the Euro zone crises, many developing countries have reduced their external borrowing to avoid the hazards of indebtedness. Nevertheless, Presbitero and Arnone(2007) have pointed out that domestic borrowing will only improve the sustainability of economic growth if the stability of financial and macroeconomics are sufficient. Hence, although domestic debt is less vulnerable than the external debt, the impact on economic growth of the climbing domestic debt should not be forgotten as well.

Overall, expansionary fiscal policy is one of the factors responsible for increasing public debt when additional government spending is unable to meet tax revenue. Therefore, there are questions that have emerged in this study regarding the rise of domestic public debt in Malaysia. In the following years, the government of Malaysia will continue to spend and borrow in order to rejuvenate economic growth. Hence, by focusing on private credit, the first question highlighted in this study is, "does the excessive of domestic public debt from the banking sector is large enough to cause a crowding out effect or vice versa?" Between, the second question that arises is, "does the accumulation of domestic public debt have a positive or negative relationship to the economic growth?" To answer to these questions, this study then used time series data from 1980 to 2010 to analyse several framework of models as discussed in the next section in Chapter 3.

1.7 Objective

Generally, the main objective of this study is to examine the long run relationship between domestic public debt, financial development and economic growth over the period from 1980 to 2010 in Malaysia.

More specific, this study aimed to:

1) Examine the existence of crowding out effect through the impact of domestic public debt from banking sector on financial development.

2) Investigate whether the growing domestic public debt has promoted or hinder Malaysia's economic growth.

1.8 Significance of the study

In economics, the banking sector plays an important role in improving the economic growth, yet there are limited studies carried out to explore the impact of public debt on financial development, especially country specific studies. Thus, since the aftermath of the European sovereign debt crisis, the impact of public debt on economic growth has become an important debating issue among policy makers. Previously, there have been a large number of studies that examined the relationship between public debt and economic growth. Nevertheless, most of these past studies have mainly focused on foreign public debt in panel countries while the implication of domestic public debt on economic growth was limited (Presbitero and Arnone, 2007).

As suggested by Panizza (2008), domestic public debt is no longer a new phenomenon because increasing the domestic public debt to replace foreign public debt has become a familiar scene in developing countries. Therefore, rather than just concerning itself on foreign public debt, there is room for this study to come out with a few questions regarding the increasing domestic public debt in Malaysia. In short, all of the limitations encountered have become a motive in this study to analyse how government debt, particularly domestic public debt, impinges on the performance of financial development and economic growth in Malaysia.

In addition, this study is different from past studies when it comes to analysing the relationship between public debt and growth in Malaysia case. For instance, Loganathan et al., (2010) focused on foreign debt, while Choong et al. (2010) used different components of debt and foreign debt to establish the impact of debt on economic growth in Malaysia. In recent study, Rahman (2012) covered both domestic and foreign debt, whereas Daud et al., (2013) again centred on

the role of foreign debt on Malaysia's economic growth. Therefore, by focusing on domestic public debt, the contributions from this study would add up the missing literature that has been neglected by previous researchers.

Finally yet significant, a case of Malaysia being chosen to become a specific country in this study is for several reasons. Firstly, Malaysia has a small and open economy yet has experienced an awesome history during the transformation of its financial development (Ang and Mckibbin, 2007). Meanwhile, Malaysia has gone through many unpredictable challenges during the evolution of the development process. Secondly, it would be helpful for the government if the findings in this study could become a guideline for policy makers. Lastly, due to the comprehensive and sufficient time-series data sources, the empirical results of this study can serve as a reference when researchers perform similar studies in the future.

1.9 Organization of study

The organization of this study is structured as follows. Chapter 1 describes an overview of the economic background, public debt, financial development in Malaysia, problem statement, objective, and significance of the study. Chapter 2 elaborates on some previous literature about the relationship between public debt, financial development and economic growth in both theoretical and empirical studies. Chapter 3 discusses theoretical framework, model specification, methodology and source of data in this study. Chapter 4 reports the empirical findings and discussions of the study for both objectives. Lastly, Chapter 5 presents the conclusions, limitations of the study and several policy recommendations.

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