An Application of Vector Error Correction Model to Assess Financial Innovation Impact on Economic Growth of Bangladesh

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Abstract : Over the decade, it is observed that financial development, through financial innovation, not only accelerated development of efficient and effective financial system but also act as a catalyst in the economic development process. In this study, we try to explore insight about how financial innovation causes economic growth in Bangladesh by using Vector Error Correction Model (VECM) for the period of 1990-2014. Test of Cointegration confirms the existence of a long-run association between financial innovation and economic growth. For investigating directional causality, we apply Granger causality test and estimation explore that long-run growth will be affected by capital flow from non-bank financial institutions and inflation in the economy but changes of growth rate do not have any impact on Capital flow in the economy and level of inflation in long-run. Whereas, growth and Market capitalization, as well as market capitalization and capital flow, confirm feedback hypothesis. Variance decomposition suggests that any innovation in the financial sector can cause GDP variation fluctuation in both long run and short run. Financial innovation promotes efficiency and cost in financial transactions in the financial system, can boost economic development process. The study proposed two policy recommendations for further development. First, innovation friendly financial policy should formulate to encourage adaption and diffusion of financial innovation in the financial system. Second, operation of financial market and capital market should be regulated with implementation of rules and regulation to create conducive environment.

Keywords : financial innovation, economic growth, GDP, financial institution, VECM
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