

# Before the Storm: The Impact of Foreign Capital Inflows on the Malaysian Economy, 1966–1996

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**ABSTRACT** *Foreign capital inflows (FCI) are supposed to bring positive effects by augmenting investible funds, domestic savings and foreign exchange earnings, thus closing the savings and foreign exchange gaps. FCI may also have undesirable effects on the domestic savings rate as well as on the recipient's balance of payments position. This study examines both sets of influences on Malaysia between 1966 and 1996, i.e. before the 1997–98 crisis. Historically, Malaysia has relied heavily on foreign capital, especially foreign direct investment, rather than long-term borrowings. While FCI augmented domestic investment funds to accelerate the growth rate, they had negative influences on the savings rate as well as on the balance of payments. The findings also suggest that domestically raised funds, from savings and self-generated export earnings, are better than external funding. Hence, to sustain economic growth, greater efforts should be directed to better mobilising domestic savings, rather than relying heavily on foreign capital.*

**KEY WORDS:** Foreign capital, investment, savings, economic growth, balance of payments, Malaysia

**JEL CLASSIFICATION:** E22

## Introduction

Economic growth is thought to be a function of investment and other factors. The conventional belief is that foreign capital inflows (FCI) bring new investible funds and foreign exchange with which the recipient country can achieve higher rates of investment and therefore growth. The role of foreign capital in economic growth is an issue that has provoked continuous debate. Foreign capital augments the total resource availability in a country, but its impact on investment and economic growth is controversial. If judiciously used, it could have favourable effects on economic

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growth through higher investment and other positive effects. But it is also possible that FCI might not yield any net benefit to the host country.

Since independence in 1957, Malaysia has adopted liberal policies towards foreign capital inflows. Malaysia has been rated favourably in terms of overall competitiveness as well as attracting foreign capital, and has sustained high economic growth rates over long periods with price stability. FCI, mainly in the form of foreign direct investment (FDI), as well as 'aid' (grants and loans) played an important role before the 1990s, when short-term inflows (e.g. portfolio investments) became much more important, culminating in the crisis of 1997–98, dealt with elsewhere (Jomo, 2001).

Malaysia received significant amounts of aid in the 1950s and 1960s, and at the same time, encouraged FDI. In the 1970s, it participated actively in Eurocurrency markets while continuing to receive 'aid' on increasingly 'harder' terms. In the early 1980s, greater public sector deficits – to finance heavy industries, counter the prolonged world recession and finance the greatly increased current account deficit – involved a rapid accumulation of external debt. Since the mid-1980s, the Malaysian government has renewed emphasis on attracting private sector investment, by both domestic and foreign investors. In 1996, total net foreign capital inflows – as recorded in the long-term capital account of the balance of payments – amounted to RM13.5 billion, compared with only RM2.2 billion in 1980. Of this total, only RM0.75 billion represented net inflows of official capital (aid), while RM12.8 billion consisted of private long-term capital.

This study attempts to assess empirically the role of FCI in Malaysian economic growth between 1966 and 1996. The inflows will be treated both in aggregate terms, and disaggregated as debt and FDI, so that their differential impacts can be assessed.

The methodology used in the study is the ordinary least squares (OLS) method. The data used in the study are mainly obtained from secondary sources, including Bank Negara Malaysia (BNM) *Annual Reports*, Ministry of Finance or Treasury *Economic Reports*, Ministry of International Trade and Industry (MITI) *Reports*, Malaysia five-year plan documents and other sources.

The next section has a brief overview of FCI into Malaysia, and the section after has a brief literature review of the impact of FCI on economic growth. Empirical results and analysis are presented in the subsequent section. Possible negative impacts of FCI are then discussed. Finally, policy implications of the findings are discussed.

### **Foreign Capital Inflows into Malaysia**

Malaysia was an aid recipient in the 1950s and 1960s and, at the same time, encouraged foreign direct investment (FDI) in line with conventional faith in the benefits of such inflows. In the 1970s, domestic debt financing was a major source of investment finance in Malaysia. With considerable surplus funds deposited with commercial banks in the major international financial centres by the OPEC (Organization of Petroleum Exporting Countries) economies, real rates of interest on foreign loans were

low in the late 1970s. Many developing countries used this opportunity to increase their external debt financing in the second half of the 1970s. However, Malaysia's external borrowings increased dramatically from the early 1980s, partly in response to international recessionary pressures after the US Federal Reserve raised interest rates, tightening international liquidity and precipitating a global recession as well as sovereign debt crises in many heavily indebted economies.

During the 1960s, the government remained fiscally conservative and generally maintained balanced budgets, if not budgetary surpluses. However, due to higher expenditures in pursuit of New Economic Policy (NEP) goals, budgetary deficits, mainly financed by Employee Provident Fund (EPF) forced savings, grew in the 1970s – from 3.7 percent of GDP in 1970 to 11 percent in 1975, and remaining around 8 percent of GDP during 1976–79. Government borrowing requirements continued to rise in the 1980s, reaching a peak of around 19 percent of GDP in 1981 and 1982. Budget deficits remained around 14 percent of GDP during 1983–87.

The rising budget deficits forced the government to borrow externally. Malaysia's external debt rose from RM15.4 billion in 1981 to RM53 billion in 1986. The external debt to GNP ratio increased from 14.3 percent in 1981 to 55.6 percent in 1985 and peaked at 75.6 percent in 1986 after the ringgit devalued massively against the Japanese yen, which accounted for most government foreign borrowings to finance its new heavy industries from the early 1980s. By 1987, domestic debt was equivalent to 72 percent of Malaysia's GDP, while foreign debt had risen to 59 percent (Ghazali Atan, 1990).

Following voluntary structural adjustment policies undertaken by the government from around 1986, private investment flows became increasingly important as official flows moderated, reflecting government efforts to systematically reduce its external borrowings. In 1987 and 1988, net outflows of RM1.4 billion and RM3.2 billion were recorded as prepaid government foreign debt.

Government efforts to provide a stable medium and long-term macroeconomic environment have enabled Malaysia to attract long-term capital inflows, which has helped finance the current account deficit, due to the services account deficit. Foreign direct investment inflows have contributed significantly to surpluses in the long-term capital account since 1989, the bulk of which was concentrated in the petroleum and manufacturing sectors. Total foreign direct investment increased significantly from RM4.5 billion in 1989 to a peak of RM13.2 billion in 1992, declining slightly to RM12.8 billion in 1996.

By type of flow, equity flows have become more important, primarily due to relaxation of earlier limitations on foreign ownership in the manufacturing sector. With respect to external borrowings, active debt management by the government in the 1990s has contained the growth of external debt and debt servicing, avoiding the bunching of payments, while also reducing Malaysia's exposure to interest and exchange rate fluctuations. The external debt to GNP ratio fell to 31.7 percent by the

end of 1996 from the peak of 75.6 percent in 1986. The bulk of external loans were channelled to productive investments in the economy, while the debt service ratio remained low at 5.9 percent in 1996 (BNM, 1997, p. 45).

While long-term private capital inflows increased after the mid-1980s, short-term flows also increased in importance in the 1990s. In 1993, short-term inflows exceeded private long-term capital inflows for the first time, i.e. RM13.9 billion compared to RM12.9 billion. Large short-term capital flows were also reflected in the 'errors and omissions' item of RM7.2 billion in 1993, partly reflecting inflows not fully captured by the short-term capital account, as the size of short-term flows has been underestimated and is not fully captured in the capital account. However, with the strong interest in Malaysia from foreign investors plus the temporary government efforts to deter some short-term inflows, the net inflow of private long-term capital exceeded short-term capital inflows again from 1994. In 1996, net private long-term capital inflows amounted to RM12.8 billion compared with RM10.3 billion in net short-term capital inflows.

FDI in Malaysia has undergone major changes over the years (Athukorala & Menon, 1996). In the early 1960s, FDI was particularly significant in plantation agriculture, dredge mining and international trade. In the three decades under consideration here (1966–96), however, FDI has been most prominent in the manufacturing sector, amounting to RM1880.6 million in 1971–79, increasing to RM22,326.5 million in 1980–89 and reaching RM9.4 billion in 1996 alone. Most FDI since the 1970s has been concentrated in export-oriented industries, mainly in electronic/electric products, textiles and related products, chemicals and related products, and wood and related products.

Foreign investment proposals approved by the Ministry of International Trade and Industry (MITI), surged to RM78.7 billion during the period 1991–96, compared with RM35.9 billion during the period 1985–90. Malaysia accounted for 28.8 percent of total FDI flows to the ASEAN countries during the period 1991–96 and 6.7 percent of total flows to developing countries in the same period (BNM, 1997, p. 119).

Foreign ownership of corporate equity at par value increased by an average of 12.6 percent per annum during the Sixth Malaysia Plan period (1991–95), reaching RM49.8 billion, or 27.7 percent of total equity in 1995, compared to RM27.5 billion, or 25.4 percent, in 1990. This followed relaxation of regulations in foreign corporate ownership introduced from the mid-1980s in order to attract FDI and accompanying expertise and technology, to upgrade the skills and quality of the Malaysian labour force as well as to accelerate growth, particularly in the manufacturing sector (Government of Malaysia, 1996, p. 86).

### **Foreign Capital and Economic Growth**

As American founding father Alexander Hamilton once said: 'Foreign capital instead of being viewed as a rival ought to be considered as a most valuable auxiliary,

conducting to put in motion a greater quantity of productive labour and a greater portion of useful enterprise than could exist without it' (Rolfe & Damm, 1970, p. 121). The conventional position – for example, Rosenstein-Rodan (1961) and Chenery & Strout (1966) – sees FCI as a supplement to local capital resources. According to this view, all capital inflows constitute net additions to an LDC's productive resources, thus increasing its growth rate. The effect of FCI on growth in the well-known Harrod–Domar model can be represented as follows:

$$g = n (s + FCI/Y)$$

where  $g$  = economic growth,  
 $s = S/Y$  is the domestic savings rate,  
 $n$  = capital–output ratio,  
 $FCI/Y$  = foreign capital inflows as a proportion of output.

In the above formula, FCI augments domestic savings and increases the investment rate, which accelerates economic growth.

FCI thus supposedly helps LDCs to eventually achieve self-sustained growth. Higher investment – and growth – rates, achieved with foreign capital supplements, are, in turn, also supposed to increase the domestic savings rate. Eventually, the higher domestic savings rate is expected to provide all funds needed for investment without needing any further inflows of foreign capital. Thus, McKinnon (1964) wrote: 'Aid or private investment is likely to be offered on the assumption that a higher growth rate in the receiving country will eventually become self-sustaining, i.e. domestic savings and export capabilities will rise to the point where foreign capital transfers become unnecessary for this growth rate to be maintained.'

Most LDCs do not have enough capital goods to meet the desired investment level. In addition, there are limited substitution possibilities between imported and domestic inputs. Required inputs have to be imported with foreign exchange. Within the 'two-gap' model developed by Hollis Chenery and his associates, FCI makes up for any foreign exchange shortages by bringing in foreign exchange to pay for the necessary imports of capital and intermediate goods. Additionally, FCI, particularly foreign direct investment (FDI), may be accompanied by technical assistance and expertise, scarce managerial skills, marketing know-how, international marketing connections and new export opportunities.

This conventional position has been challenged by economists such as Griffin & Enos (1970) and Weisskoff (1972), among others, who take the view that FCI is a substitute for, and not a complement to, domestic capital resources. They argue that FCI has exercised a depressing effect on savings propensities in developing countries, reducing rates of domestic savings and capital formation, and consequently, growth rates.

*Earlier evidence*

Most of the empirical testing of the contribution of FCI to growth has been carried out with a growth equation, using a Cobb–Douglas type production function that total output is a function of resources used – namely labour, capital and technology. Earlier studies by Papanek (1973) and Stoneman (1976) – all using cross sectional data from the 1950s and the early 1960s – show that growth in developing countries is positively and significantly related to both domestic savings and foreign capital inflows. Ghazali Atan (1990) found evidence of a positive contribution of FCI to growth in his study of the direct contributions of FCI to the Malaysian economy for the period 1960 to 1986.

**FCI Contribution to Malaysian Economic Growth, 1966–96***Methodology and hypotheses to be tested*

This study, using a semi-log specification of a conventional growth equation, relates output growth to the investment rate, labour force growth rate and manufacturing growth rate as proxies for structural change in the Malaysian economy between 1966 and 1996.

The semi-log specification is as follows:

$$\ln y = a + bI/Y + c\Delta L/L + dSC$$

where:  $\ln y$  = natural log of real GDP growth,

$I/Y$  = the investment rate, i.e. gross capital formation as a proportion of GDP,

$\Delta L/L$  = growth rate of the actual numbers employed as proxies for the labour force growth rate,

$SC$  = manufacturing value added as a proportion of GDP proxies for structural change,

$a$  = rate of 'technological change',

$b$  = partial elasticity of output with respect to capital stock increments,

$c$  = partial elasticity of output with respect to the labour force growth rate,

$d$  = partial elasticity of output with respect to the manufacturing value added growth rate.

To test the contribution of foreign capital to the Malaysian economic growth rate, the investment rate variable,  $I/Y$ , was substituted by its constituents,  $S/Y$  and  $FCI/Y$ . Thus, the growth equation is as follows:

$$\ln y = a + b_1S/Y + b_2FCI/Y + c\Delta L/L + dSC$$

where:  $b_1$  = partial elasticity of output with respect to domestic savings rate,

$b_2$  = partial elasticity of output with respect to foreign capital inflows.

Again,  $b_1$  and  $b_2$  are expected to carry positive signs and should be statistically significant.

#### *Notes on data*

The statistical analysis in this study used data from 1966 to 1996. The real GDP series was created using real rates of growth. Data on the investment rate, structural change (proxied by the manufacturing value added growth rate), domestic savings rate and FCI growth were scaled against GDP to avoid the heteroscedasticity problem. However, the investment rate and FCI growth rate were lagged by one year on the assumption that investment and FCI changes would not affect growth immediately. Instead, it is assumed that an investment, whether financed by domestic funds or foreign capital, will only contribute to growth in the following year. Thus, the investment growth rate is  $I/Y = I/Y - (t - 1) I/Y$  and  $FCI/Y = FCI/Y - (t - 1) FCI/Y$ . Finally, the size of the labour force employed series was created by using the labour force growth rate.

#### *Results*

Using the ordinary least squares (OLS) method, the specification produced the following result:

$$\ln y = 1.16 + 0.023 I/Y + 0.021 \Delta L/L + 0.056 SC$$

(8.72)    (4.07)    (0.70)    (9.11)

$$R^2 = 95.6\% \quad D.W. = 1.2215$$

(figures in parentheses are  $t$ -statistics)

This regression result suggests that each 1 percent increase in the investment rate contributed to a 0.023 percent increase in the growth rate, while each 1 percent increase in the size of the labour force contributed to a 0.021 percent increase in the growth rate, and each 1 percent increase in the manufacturing sector growth rate contributed to a 0.056 percent increase in the overall growth rate.

All the explanatory variables carried the expected positive signs. At the 1 percent level, the  $t$  values for  $b$  and  $d$  were significant, although the  $c$  rate was only significant at the 50 percent level. The results thus support the hypotheses that the investment rate, labour force growth rate and manufacturing growth rate all contributed positively to Malaysian economic growth in the period covered. Interestingly, however, the manufacturing growth rate contributed much more to economic growth compared with the investment rate and the labour force growth rate. The specification was very satisfactory with  $R^2 = 0.956$ , i.e. explaining about 95.6 percent of the variation in the data, suggesting the data fit the model well.

When the investment rate variable in the equation  $I/Y$  was substituted by its constituents,  $S/Y$  and  $FCI/Y$ , we obtain the following result:

$$\ln y = 0.98 + 0.024 S/Y + 0.019 FCI/Y + 0.010 \Delta L/L + 0.056 SC$$

(6.65)    (3.76)            (2.57)            (0.36)            (9.12)

$$R^2 = 0.962 \quad D.W. = 1.8387$$

figures in parenthesis are  $t$ -statistics

This result suggests that each 1 percent increase in the domestic savings rate contributed to a 0.024 percent increase in the growth rate, while each 1 percent increase in foreign capital inflows contributed to a 0.019 percent increase in the growth rate. Relatively, the domestic savings rate contributed more significantly than foreign capital to Malaysian economic growth.

In sum, the single equation approach appears to confirm that the Malaysian economic growth rate is a function of capital, labour and structural change. Any increase of these variables should raise the growth rate. The regression analysis also supports the 'orthodox position' that FCI complement – rather than substitute for – domestic capital to finance investment and thus increase national income. However, the contribution of the domestic savings rate was found to be greater than that of FCI, both in terms of the size of the coefficient as well as statistical significance. The analysis results suggest that domestically financed investment is more productive than foreign capital.

#### *Contributions of external debt and FDI to Malaysian economic growth*

For a long time, Malaysia resorted to inflows of long-term foreign capital in the form of external debt and FDI to finance growth. The importance of each of these sources of financing has, however, varied over time, as reflected by prevailing policies. To look at the effects of foreign capital on the Malaysian economic growth rate, the following statistical analysis disaggregates foreign capital ( $FCI/Y$ ) into two components,  $DEBT/Y$  and  $FDI/Y$ . These two components then substitute for FCI in the growth equation specified in the second section. The sign, size and significance of the FCI components obtained from this analysis should indicate the strength and direction of their respective effects on the Malaysian economic growth rate. The objective of this analysis is to make an empirical assessment of the effects of external borrowings and FDI on economic growth, and of the relative importance of domestic and external funds to the Malaysian economy in the period between 1966 and 1996. Using the ordinary least squares (OLS) method, the semi-log specification of the growth equation is written below:

$$\ln y = a + b_1 S/Y + b_2 FCI/Y + c \Delta L/L + d SC$$

Disaggregating *FCI/Y* into its components, *DEBT/Y* and *FDI/Y*, the equation becomes:

$$\ln y = a + b_1 S/Y + b_3 DEBT/Y + b_4 FDI/Y + c \Delta L/L + d SC$$

The following regression results were obtained by using data for the years 1966 to 1996:

$$\ln y = 0.91 + 0.03 S/Y + 0.02 DEBT/Y + 0.01 FDI/Y + 0.006 \Delta L/L + 0.05 SC$$

(5.56)    (4.53)            (1.88)            (0.84)            (0.2)            (7.47)

$$R^2 = 96.3\% \quad D.W. = 1.538$$

figures in parenthesis are *t*-statistics

This regression result shows that each 1 percent increase in the external debt ratio contributed to an approximately 0.02 percent increase in the growth rate, and that each 1 percent increase in the FDI rate contributed to an approximately 0.01 percent increase in the growth rate. Both the disaggregated FCI variables carried the expected positive signs and were significant at the 1 percent level, although *DEBT/Y* was relatively more significant than *FDI/Y*.

The results also confirmed the greater contribution of domestic savings (*S/Y*), with a coefficient of about 0.03, suggesting that each 1 percent increase in domestic savings contributed to a 0.03 percent increase in the growth rate. The domestic savings rate contributed relatively more, and was more significant than either *DEBT/Y* or *FDI/Y* for Malaysian economic growth. The specification was very satisfactory with  $R^2 = 0.963$ , i.e. explaining about 96 percent of the variation in the data. These results corroborate the findings of Ghazali Atan (1990), i.e. that debt and FDI contributed positively – with coefficients of 0.0169 and 0.0326 respectively – to Malaysian economic growth from 1961 to 1986. He also found that domestic savings were superior to and more significant than FCI, with higher positive coefficients from the regression analysis for his sample period.

In sum, the positive coefficients for both *DEBT/Y* and *FDI/Y* suggest that both DEBT and FDI were important sources of financing for Malaysian economic growth during the period 1966–96. External debt was relatively more important as a source of external financing in the first half of the 1980s, while FDI was more important through most of the 1970s, and since the late 1980s. In terms of the size and statistical significance of the coefficients obtained, the domestic savings rate was found to be superior to both debt and FDI. This result supports the earlier conclusion that the generation of funds from domestic savings was much better for growth than external financing. Furthermore, despite an overall positive contribution to economic growth, FCI may have some adverse effects, which are investigated in the following section.

### Other Possible Effects of FCI on the Malaysian Economy

#### *Impact on domestic savings*

Despite its high savings rate, Malaysia has sought to attract foreign capital inflows to raise the investment level. A relatively large portion of national investment has been financed by foreign capital inflows, particularly borrowings and foreign investments, including both FDI and portfolio investments. The question thus arises why Malaysia has progressively become more dependent on FCI. Is it possible that FCI affected domestic savings efforts? In other words, could domestic savings have been higher in the absence of FCI or ready and easy access to external sources of financing?

In order to answer this question, we performed an OLS regression of the domestic savings rate on FCI and some other possible determinants of savings. The results are presented below:

$$S/Y = -2.59 - 0.3046 FCI/Y + 0.0084 CX + 11.167 \ln \Delta y + 0.486 \Delta L/L$$

$$\begin{array}{cccccc} (-0.47) & (-3.78) & (9.57) & (4.79) & (2.59) & \end{array}$$

$$R^2 = 86.3\% \quad D.W. = 1.882$$

where  $CX$  = change in exports as a proportion of GDP,  
(figures in parenthesis are  $t$ -statistics)

The FCI coefficient is  $-0.305$ , and is statistically significant at the 1 percent level. This result shows that each 1 percent increase in the inflow of foreign capital reduced the savings rate by 0.305 percent. The value of this coefficient ( $-0.305$ ) lies between 0 and  $-1.0$ . This means FCI only negatively affected the savings rate, but did not reduce the absolute level of savings. FCI into Malaysia appears to have had a substitutive effect on domestic savings in the study period. Any negative effect of FCI on the domestic savings rate will have negative side effects on the investment rate. Thus, the net effect of FCI on growth is less than what would have been the case had FCI positively affected domestic savings efforts.<sup>1</sup>

The analysis also disaggregated FCI into its components of  $DEBT/Y$  and  $FDI/Y$ . The result obtained is:

$$S/Y = -2.244 - 0.269 DEBT/Y - 0.249 FDI/Y + 0.02 CX + 10.8 \ln y$$

$$\begin{array}{cccccc} (-0.35) & (-3.44) & (-2.24) & (8.53) & (4.68) & \end{array}$$

$$+ 0.424 \Delta L/L$$

$$(2.43)$$

$$R^2 = 86.2\% \quad D.W. = 1.833$$

*Repatriation of investment income*

Liberal regulations on income repatriation, often considered necessary as an investment incentive, may also adversely affect the balance of payments. Investment income, which consists mostly of interest profits and dividends, has contributed significantly to the country's growing services account deficits. Total investment income outflows steadily increased from RM466 million in 1970 to about RM11.4 billion in 1996. Prior to 1991, total net dividends outflows exceeded yearly net FDI inflows. In other words, private capital inflows have not been large enough to fully offset net dividend outflows, meaning that the net financial contribution of FDI was negative. Such negative net financial contributions increased from about RM180 million in 1970 to a peak of RM2.2 billion in 1988. During 1991–94, and in 1996, FDI's net financial contributions were positive because of increased FDI inflows, which more than offset the dividends' outflows. However, the investment income outflows continued to be the largest component contributing to the services account deficit.

In addition, huge inflows of foreign capital, particularly in the form of borrowings, exposed Malaysia to external shocks, which not only threatened financial stability, but also undermined economic growth. The huge outflows of interest payments also contributed significantly to the service account deficits, which have had negative implications for macroeconomic stability.

*High import content*

The large influx of FDI into the country has resulted in huge imports of investment and intermediate goods, which have contributed significantly to the growing import bill, declining merchandise account surplus and large current account deficit. Total investment goods as a proportion of total imports increased significantly from 25.2 percent in 1970 to 40.0 percent in 1996. Likewise, the proportion of intermediate goods increased from 35.3 percent in 1970 to 45.2 percent in 1996. The high import content of Malaysian manufactures, especially electronics, also implies low domestic value-added and limited domestic linkages.

These results are corroborated by the findings of other studies. Ghazali Atan (1990) found that FDI causes import propensities to increase, where each ringgit of foreign-owned assets in the country involved around RM2.95 of additional imports. This lower average figure suggests that the import content of domestic manufacturing firms has generally been much lower than that of the foreign owned sector (Ghazali Atan, 1990).

*'Crowding-out' effects*

FDI may also have resulted in increased industry concentration. The high degree of industrial concentration in Malaysia implies a high degree of market power for a few large firms, resulting in high barriers to entry for other small firms. To the extent that

large firms have been foreign, a crowding-out of local firms can be assumed to have taken place.

#### *Destabilising effects*

In 1993, Malaysia experienced an unprecedented surge of short-term capital inflows that were largely temporary and speculative in nature. This surge put strains on the macro economy in terms of price and cost pressures, and contributed to destabilising the domestic money and foreign exchange markets. With the huge inflows of short-term capital during this period, narrow money supply increased from less than 20 percent to a peak of 48 percent in February 1994, while broader money (M3) increased by 30 percent. Nevertheless, while the inflows during this period contributed to an increase in reserve money, this was not translated into increased lending by the banking sector. This inflow created excess liquidity in the banking system, causing downward pressure on domestic interest rates. The monetary multiplier – which generally ranged from 6.5 to 7.0 – declined during this period to below 6.0. Other factors causing deceleration in loan growth included low demand for credit owing to the availability of retained profits for investment, development of the capital market and the corresponding availability of equity financing, and also relatively lower foreign interest rates (Zeti, 1994).

The short-term capital inflows also destabilised the asset price and stock markets. In 1993, inflows of foreign capital for the purchase of stock increased by RM19 billion, twice the amount of funds in the form of foreign borrowings and deposits. In addition to strong demand during the period of high growth, FDI inflows also contributed to pressure on the labour market, leading to higher costs and wages, and eventually, to a more serious cost-push inflationary problem.

In sum, the statistical analysis here has found that FCI in aggregate and its components, i.e. external debt and FDI, had significantly negative influences on the Malaysian savings rate during 1966–96. The FCI coefficient in the savings equation of between 0 and  $-1.0$  suggests that while FCI in Malaysia reduced the savings rate, it did not reduce the absolute savings level. Thus, the positive FCI contribution to economic growth – suggested by conventional wisdom – was reduced because of FCI's adverse effect on the domestic savings rate. The findings also suggest that FCI has destabilising effects, not only on the external balance, but also on macroeconomic stability, in terms of price pressures as well as via the stock market and other financial markets. Thus, the positive effects of FCI need to be balanced against the adverse effects they have had on the Malaysian economy.

#### **Concluding Remarks and Policy Implications**

The findings of this study have several policy implications for Malaysia. The most important implication is that if a country wishes to achieve rapid economic growth, efforts have to be directed towards increasing the country's internal strengths, which

include manufacturing sector productivity and human resources, and mobilising domestic resources more effectively. Measures need to be designed to improve savings propensities, including developing appropriate financial institutions, maintaining financial stability as well as ensuring an efficient tax regime. Policies and efforts to increase export capabilities include human resource development, acquisition and development of new technology, provision of more appropriate incentives and development of new areas of potential comparative advantage. In other words, the focus needs to be shifted to improving domestic economic fundamentals and enhancing the resilience of the financial system, while also addressing structural weaknesses in the economy.

Considering both the positive direct effects and the negative indirect effects of FCI on growth, efforts need to be taken to maximize the net benefits from FCI. Indiscriminate reliance on FCI will maximize net benefits. Heavy reliance on foreign capital to finance investment is not an unproblematic option that will guarantee sustainable rapid growth for the recipient country. Malaysia should, therefore, continue to draw foreign direct investment in those desired areas where domestic resources cannot provide an adequate substitute. In other words, FDI should not only be sought to augment savings, but also to develop desired capacities and capabilities in ways that complement and enhance – rather than replace – domestic resources. This underscores the need to continue to beef up domestic capital formation through increased savings.

The Malaysian government should also be careful in deciding which types of foreign investment to encourage and what economic policies to adopt in order to ensure sustainable economic development. The analysis in this study shows that both FDI and debt contributed almost equally to the growth rate as well as the domestic savings rate. The government should continue to attract FDI because FDI motives ensure enterprise profitability, thus disciplining the deployment of such investment. FDI can often bring in technology, managerial skills, international market access, marketing know-how as well as other benefits. The limited gains from other FCI, particularly portfolio investments, or for that matter, from non-‘green-field’ FDI (especially for mergers and acquisitions), underscore the need to maintain sound regulatory policies to limit problems arising from increased inflows of foreign capital.

#### **Note**

1. The estimation of net effect requires a simultaneous equation model, which is beyond the scope of this paper.

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