CHAPTER ONE

INTRODUCTION

1.1 Introduction

In development economics, growth is thought to be a function of investment and other factors. The conventional belief is that foreign capital inflows 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 development is an issue that has provoked continuous debate. Foreign capital augments the total resource availability of a country, but its impact on investment and economic development is controversial. If judiciously used, it could have favorable effects on economic growth through higher investment and other positive effects. But it is equally possible that FCI might not yield any beneficial effects to the host country.

Since independence in 1957, Malaysia has adopted liberal policies towards the inflows of foreign capital. Malaysia has been rated favourably in terms of overall competitiveness as well as attracting foreign capital. Malaysia's attributes have included the ability to sustain a high economic growth rate over long periods with price stability, reflecting policies to attract foreign investment inflows and provide an environment conducive for business activities. Although domestic capital formation is mainly financed by domestic savings, FCI has also played an important role FCI into Malaysia are mainly in the form of 'aid' or grants, loans and foreign direct investment

Malaysia was a receiver of aid in the 1950s and 1960s, and at the same time encouraged FDI In the 1970s, it participated actively in the Eurocurrency market while continuing to receive 'aid' on increasingly 'harder' terms In the early 1980s, the prolonged world recession increased the current account deficit in Malaysia, with a resulting accumulation of external debt Since then, the Malaysian government has turned to greater emphasis on 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 to only RM2 2 billion in 1980 Of this total, RM0 75 billion was the net inflow of official capital and RM12.8 billion consisted of private long-term capital

1.2. Objective and Methodology

This paper attempts to assess the role of FCI in Malaysian economic development between 1966 and 1996 by empirically evaluating its impact on the growth of output The evaluation will take into account both 'direct' and 'indirect' positive effects emphasized by orthodox theory and the critical literature on FCI The inflows will be treated in aggregate as well as disaggregated into two components, i e debt and FDI, so that their impact in the aggregate as well as differences in their individual effects can be estimated.

The methodology used in the study is regression analysis using the ordinary least squares (OLS) method. FCI's direct effects on growth and their indirect effects on the savings rate are tested by inserting FCI as an additional explanatory variable in the growth and savings equations. The size, sign and the significance of the FCI variable indicate the strength and direction of its effects on these two variables.

The data used in the study were mainly obtained from secondary sources which include BNM Annual Reports, Treasury Economic Reports, Ministry of International Trade and Industry Reports, Malaysia plan documents and other sources.

1.3 Organization of Chapters

Chapter 2 reviews the positive contribution of FCI to growth using the orthodox analysis and examines FCI's direct contributions to Malaysian growth in the context of a production function type equation.

More detailed analysis is carried out in Chapter 3 by dividing FCI into two components, i.e. debt and FDI, to assess their effects on the Malaysian economic growth rate.

Chapter 4 examines the negative influences of FCI by evaluating their effects on the savings rate and the balance of payments. The discussion covers both FCI as an aggregate variable as well as the disaggregated debt and FDI variables.

Finally, Chapter 5 concludes the analysis by highlighting the key findings and implications of the study