

CHAPTER FIVE

CONCLUSIONS

5.1 Overall Impact of FCI on the Malaysian Economy

Bringing together the findings of the previous chapters, the overall impact of FCI on the Malaysian economy can be classified as follows:

a. FCI's positive contribution to available resources (its savings augmenting function).

This refers to its use for the purchase of capital and intermediate goods.

b. FCI's positive contribution to complementary import inputs (its foreign exchange augmenting function). This refers to its use for the purchase of imported inputs.

c. FCI's indirect effect on the domestic savings rate.

d. FCI's effect on the rate of factor payment outflows, export and import propensities, terms of trade and capital flight which will all filter through the balance of payments.

The first three effects influence the direction and size of FCI's effect on the investment rate while the others effect FCI's influence on the balance of payments. FCI, by

influencing these two variables, will thus exert influence on the Malaysian growth rate. These various effects of FCI on the Malaysian economy are also shown in Figure 5.1.

5.2 Overall Findings

This paper examines the role of FCI in the economic development of Malaysia between 1966 and 1996. The high and rising investment in Malaysia during this period was mainly financed by domestic savings, but FCI also played an important role in investment financing. During 1991-96, the share of FCI in investment financing was equivalent to 6.2 per cent of GNP on average compared to 3.7 per cent of GNP during 1971-75. The main features of FCI into Malaysia during 1966-1996 can be summarized as follows:

- a. from 1966 to 1986, official long term capital flows was the dominant type, while official grants or aid moderated and private capital flows were insignificant due to various government policies and practices to reduce foreign equity ownership in the country.
- b. since 1989, long-term private capital has become the major type of inflow while the share of official long-term capital has decreased.
- c. as private capital inflows continued to increase, short-term capital inflows have also increased proportionately since 1991.

The single equation analysis using the ordinary least squares (OLS) method, carried out in the previous chapters, showed FCI's direct and indirect effects on growth. The findings, as summarized in Table 5.1, support both the positive effects of FCI stressed by orthodox theory and the undesirable side effects emphasized by the more critical literature.

The growth equation (equation 1 in Table 5.1) shows that Malaysian economic growth between 1966 and 1996 has been positively affected by the increase in the investment rate and the manufacturing sector growth rate. The labour force growth rate also contributed positively to economic growth rate, even though it was relatively less statistically significant.

Despite the high gross national savings and export earnings, Malaysia still has to depend on FCI to finance its high capital formation. The growth equation (equation 2 in Table 5.1) shows that FCI contributed positively to the Malaysian economic growth rate in the sample periods such that every one per cent increase in FCI accelerated the economic growth rate by 0.019 per cent. In terms of relative efficiency, the analysis found that the domestic savings rate and the manufacturing sector growth rate contributed more than FCI to the Malaysian economic growth rate with coefficients of 0.024 and 0.056 respectively. This means that every one per cent increase in the domestic savings rate increased the growth rate by 0.024 per cent and every one

per cent growth in manufacturing sector increased the growth rate by 0.056 per cent. The labour force growth rate contributed favorably to the output growth rate with a coefficient of 0.01, even though it was relatively less significant than FCI. These results support the self-help strategies adopted by the government since independence with efforts directed towards mobilizing domestic resources and promoting manufacturing exports goods.

A more detailed analysis was carried out in Chapter 3 by dividing FCI into two components, i.e. debt and FDI. The findings (equation 3 in Table 5.1) show that both debt and FDI contributed positively to output growth with coefficients of 0.02 and 0.01 respectively. These results support the orthodox theory emphasizing the growth-inducing effects of FCI on output growth.

An assessment of the effects of FCI on the domestic savings rate and the country's balance of payments was carried out in Chapter 4 (equation 4 and 5 in Table 5.1). The findings show that FCI had an overall negative effect on the domestic savings rate. With the coefficient bigger than minus unity in absolute terms, this indicates that FCI as an aggregate variable or disaggregated variable had a substitutive effect on domestic savings, which reduced the domestic savings rate but not the absolute levels of saving. In addition, the savings equation showed that the export and income variables had strong positive effects on the savings rate. Lastly, FCI also negatively influenced the balance of payments position, with destabilizing effects on asset and stock markets.

Taking into account both the positive direct effects and negative indirect effects of FCI, the overall impact of FCI on growth was assessed by using the simultaneous equation approach proposed by Gupta and Islam (1983) (shown in Table 5.2). The negative effects of FCI on the domestic savings rate dampened the total FCI effect on growth. Thus, we would expect the overall effect of FCI on growth to be smaller than the direct effect. This suggests the need for guarding against over-emphasizing the growth-inducing effects of such inflows.

5.3 Policy Implications

The findings of the regression analysis have several policy implications for Malaysia. The most important implication is that if the 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 the labour force, and mobilizing domestic resources. Measures need to be designed to improve savings propensities, including the development of financial institutions, maintenance of financial stability as well as establishment and maintenance of an efficient tax regime, etc. Policies and efforts to increase export capabilities include manpower development, development of new technology, provision of appropriate incentives and the development of areas of potential comparative advantage. In other words, focus needs to be shifted towards improving domestic economic fundamentals and enhancing the soundness of the banking system, while addressing structural weaknesses in the economy at the same time.

Considering both positive direct effects and negative indirect effects of FCI on growth, efforts need to be taken to balance both effects so as to derive maximum benefits from FCI. Blind and indiscriminate use of FCI will not guarantee net benefits in the long run. However, the task of setting growth targets against potential investments and selecting financing from various sources may involve difficult choices and tough policy measures. However, this finding draws the implication that heavy reliance on foreign capital to finance investment does not offer an unproblematic solution for high and rapid growth for the recipient country. Malaysia should, therefore, continue to accept foreign capital in those areas where domestic resources do not provide an adequate substitute. In other words, FCI, whether for augmenting savings or helping the development of export industries, should be used skillfully in ways which complement and enhance rather than replace these activities. This underscores the need to beef up domestic capital formation through increased savings.

The Malaysian government should also be careful in deciding which types of foreign capital to encourage and the type of trade policy to adopt. The analysis in this study shows that both FDI and debt contributed almost equally towards the growth rate as well as the domestic savings rate. The government should continue to attract FDI and to rely relatively less on official long-term capital. This is because returns from FDI require profitability of enterprises as a pre-condition and are thus believed to be 'self-correcting', especially if such investments are in the tradable sector. FDI also brings in technology, scarce managerial skills, international market linkages, marketing know-how as well as

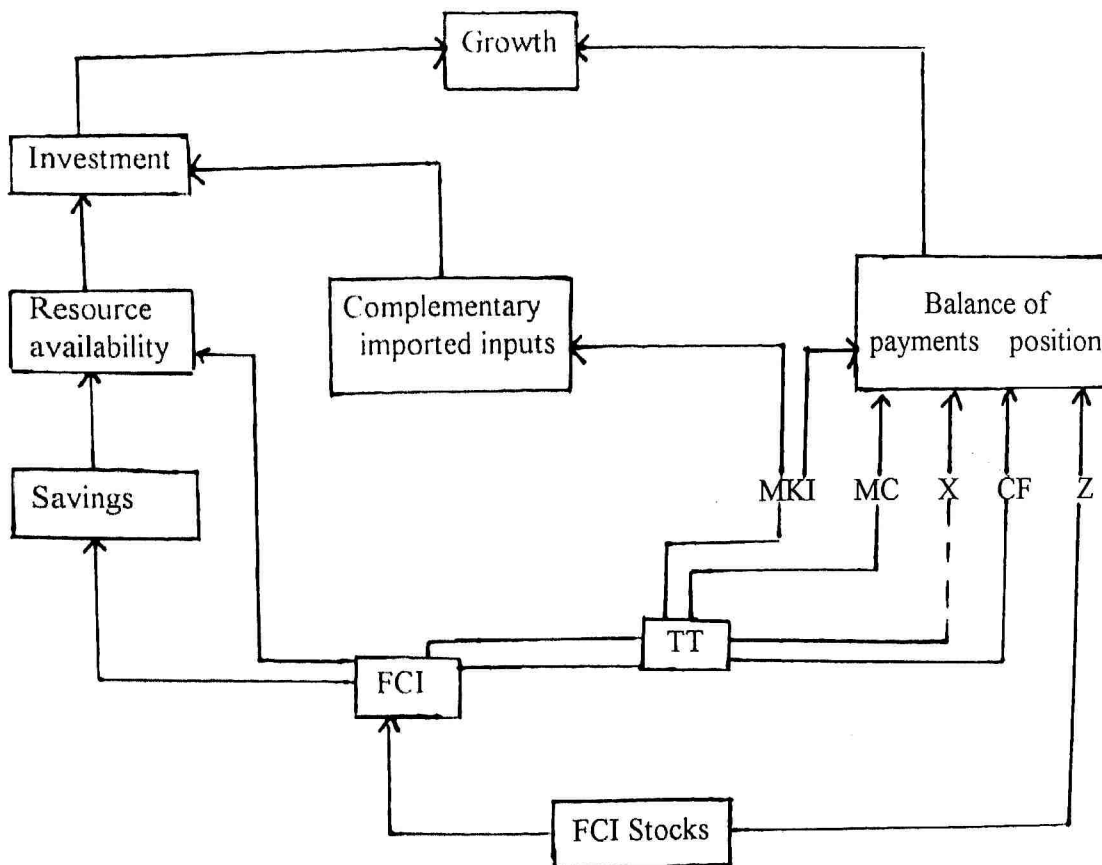
other benefits. In this context, self-help procedures based on trade liberalization and policies to attract FDI are of particular relevance.

All these experiences underscore the need for countries to maintain sound economic and regulatory policies to deal with problems that arise from increased inflows of foreign capital. In this regard, the Malaysian government has implemented various policies to introduce more competition in key domestic trading activities and to reduce investment restrictions in the financial sector as well as in other key sectors, thereby alleviating capital shortages and enhancing efficiency. To this end, the government has already raised the limits on foreign investment in the telecommunications sector to 49 per cent, the insurance sector to 51 per cent and the stock brooking industry to 49 per cent. The liberalization of investment restrictions may enhance competition and revive foreign capital inflows.

As a conclusion, the analysis in this paper evaluate the effects of FCI on the Malaysian economy between 1966 and 1996 only and does not cover the recent phenomenon.

Figure 5.1

Effects of FCI on the Malaysian Economic Growth



Notes:

- MKI = imports of capital and intermediate goods,
- X = exports,
- CF = flight of capital abroad,
- MC = consumption imports,
- Z = factor payment outflows,
- TT = terms of trade.

Table 5.1

Results of Ordinary Least Squares (OLS) Estimations Using Malaysian Data, 1966-96

$$1. \ln y = 1.16 + 0.023 I/Y + 0.021 \Delta L/L + 0.056 SC$$

$$(8.72) \quad (4.07) \quad (0.70) \quad (9.11)$$

$$R^2 = 95.6\%$$

$$D.W. = 1.2215$$

$$2. \ln y = 0.98 + 0.024 S/Y + 0.019 FCI/Y + 0.01 \Delta L/L + 0.056 SC$$

$$(6.65) \quad (3.76) \quad (2.57) \quad (0.36) \quad (9.12)$$

$$R^2 = 96.2\%$$

$$D.W. = 1.8387$$

$$3. \ln y = 0.91 + 0.03 S/Y + 0.02 DEBT/Y + 0.01 FDI/Y + 0.006 \Delta L/L + 0.05 SC$$

$$(5.56) \quad (4.53) \quad (1.88) \quad (0.84) \quad (0.2) \quad (7.47)$$

$$R^2 = 96.3\%$$

$$D.W. = 1.538$$

$$4. S/Y = -2.59 - 0.3046 FCI/Y + 0.0084 CX + 11.167 \ln y + 0.486 \Delta L/L$$

$$(-3.78) \quad (9.57) \quad (4.79) \quad (2.59)$$

$$R^2 = 86.3\%$$

$$D.W. = 1.882$$

$$5. S/Y = -2.244 - 0.269 DEBT/Y - 0.249 FDI/Y + 0.02 CX + 10.8 \ln y + 0.424 \Delta L/L$$

$$(-3.44) \quad (-2.24) \quad (8.53) \quad (4.68) \quad (2.43)$$

$$R^2 = 86.2\%$$

$$D.W. = 1.833$$

Note: Values in parentheses are for t statistics.

Notes on variable names

- I/Y = investments rate as a proportion of GDP,
S/Y = savings rate as a proportion of GDP,
SC = manufacturing sector growth rate,
 $\Delta L/L$ = labour force growth rate,
FCI/Y = foreign capital inflow as a proportion of GDP,
DEBT/Y = external debt as a proportion of GDP,
FDI/Y = foreign direct investment as a proportion of GDP,
CX = change in exports as a proportion of GDP,
 $\ln y$ = real GDP growth.

Table 5.2

Simultaneous Equation Approach: Gupta and Islam, 1983

$$\text{Growth (G)} = a_1 + b_1 S/Y + c_1 \text{FCI/Y} + d_1 \Delta L/L + e_1 \text{SC} \quad \text{Equation 1}$$

$$S/Y = a_2 + b_2 y + c_2 G - d_2 \text{FCI/Y} \quad \text{Equation 2}$$

where : G = growth rate of output,
 S/Y = savings as a proportion of GDP,
 FCI/Y = FCI as a proportion of GDP,
 y = per capita income,
 $\Delta L/L$ = labour force growth rate
 SC = manufacturing value added as a proportion of GDP.

Substituting equation (2) into equation (1), giving

$$\text{Growth} = a_1 + b_1 a_2 + b_1 b_2 y + b_1 c_2 G - b_1 d_2 \text{FCI/Y} + d_1 \Delta L/L + e_1 \text{SC} + c_1 \text{FCI/Y}$$

Collecting terms and simplifying:

$$\text{Growth} = \frac{1}{(1 - b_1 c_2)} [a_1 + b_1 a_2 + b_1 b_2 y + (c_1 - b_1 d_2) \text{FCI/Y} + d_1 \Delta L/L + e_1 \text{SC}]$$

The direct effect is given by c_1 in equation (1). The total effect of FCI on growth is given by the expression of $\frac{1}{(1 - b_1 c_2)} * [c_1 - b_1 d_2]$.

$$\frac{1}{(1 - b_1 c_2)}$$

In any event, the total effect on the growth rate, as long as foreign capital exercises a negative effect on the domestic savings rate, is going to be smaller than the direct effect.