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Foreign capital flows and economic growth in East Asian countries

Ahmad Zubaidi BAHARUMSHAH *, Marwan Abdul-Malik THANOON

*Department of Economics, Faculty of Economics and Management, Universiti Putra Malaysia,
43400 UPM Serdang, Selangor, Malaysia*

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Abstract

This paper provides a quantitative assessment of the effect of various types of capital flow on the growth process of the East Asian countries, including China. The empirical analysis was based on dynamic panel data and we found; first, that domestic savings contribute positively to long-term economic growth. Second, we confirmed that FDI is growth enhancing and that its impact is felt both in the short and long run. Additionally, FDI influence on growth is much higher than domestic savings. Third, short-term capital inflow has adverse effect on the long-term as well as short-term growth prospects and it appears to be sensitive to long-term capital inflows. Fourth, long-term debt has positive effect on growth but its effect does somewhat disappear in the long-term. By and large, the observed positive contribution of FDI in the growth process of East Asian economies is a robust finding. From policy perspective, the evidence convincingly suggests that countries that are successful in attracting FDI can finance more investments and grow faster than those that deter FDI.

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1. Introduction

The degree of integration in the global financial markets has increased dramatically in recent years. Net capital flows to developing countries have reached the highest level since the 1980s debt crisis. The composition of international capital flows to developing economies has also

* Corresponding author.

E-mail address: zubaidi@putra.upm.edu.my (A.Z. BAHARUMSHAH).

become more diverse in the last decade or so. The international balance of payments statistics divide international capital flows into four categories: short-term investment, long-term investment, portfolio investment and direct investment (see also Chuhan, Perez-Quiros, & Popper, 1996; Gruben & Mcleod, 1998). There has been a shift from long-term loans, mainly to governments, to short-term loans to private sector, and from bank to non-bank sources such as direct investment flows and portfolio investments. From the macroeconomic perspective, this indicates that private capital flows are increasingly becoming a major source of financing of large current account imbalances in the developing economies. Indeed, the share of private borrowing increased from less than 25% in the 1980s to more than 50% in the 1990s. In other words, current account deficits in the 1990s were largely due to private saving–investment decisions. A major factor that has contributed to this phenomenon is the liberalization policies on foreign capital adopted by the developing countries.

The surge of foreign capital also carries an inherent risk. It exposes the recipient country to external shocks. Some authors view the increase in capital mobility as a mixed blessing for developing nations. They have taken the view that short-term capital flows can increase the fragility of the financial system and destabilize the economy. The financial crises in the 1990s are a point in case—they not only pose a threat to the financial system but also undermine the economic progress of the developing nations. The financial turmoil was mainly triggered by capital reversal leading to the collapse of exchange rates and the fall of asset prices to unprecedented levels.¹ This in turn had an adverse impact on external debt obligations and undermined the stability of the financial system of the crisis-affected countries. Perhaps, an important lesson learned from the Asian (1997–1998), Mexican (1994–1995) and Brazilian (1999) crises is that foreign capital, especially short-term capital, can exit as easily as it enters in an open economy.² Additionally, it is more volatile than other categories of capital flows and its sudden reversal tends to have destabilizing effects on the host country.

Meanwhile, there are other authors who have argued that foreign direct investment (FDI) represents a more stable flow of capital. It is generally known that current account sustainability is enhanced when the external deficit is largely financed by FDI, relatively to the deficit financed by short-term flows that may reverse if market conditions and sentiments change. In contrast to short-term capital inflows, FDI is less volatile. It is usually seen as a safer form of financing investment since it involves long-term commitments to a country. The present study analyzed the complexities relating to the interaction between foreign and domestic sources of investments in the growth process of the East Asian countries. Many studies have focused on the role of FDI in the growth process of emerging markets. In this paper, we make a distinction between the types of capital movement (FDI, short-term and long-term debts). Specifically, we test for the interdependence of domestic savings and foreign savings on economic growth. Do different types of foreign capital have different impacts on economic growth?

We relied on a sample of eight Asian countries (China, South Korea, Fiji and five countries in ASEAN). Why these countries? Asian countries provide an interesting case to study the effect of foreign capital inflows since they received large capital inflows in the 1990s. Before the 1997 Asian financial crisis, these countries had been admired for their economic achievements: fast growth, low inflation, strong fiscal position, high savings rates, open economies and strong

¹ Capital flight is generally taught as the cause of the collapse of exchange rate system in the 1990s. For more detailed accounts of the 1997 Asian financial crisis, see Corsetti, Pesenti, and Roubini (1999).

² We note that a number of authors have argued that this view has yet to be supported by persuasive empirical evidence (see for example, Chowdhry & Goyal, 2000).

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