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The Structure of External Financing in
Malaysia
- The Policy Framework for Foreign Direct
Investment and Debt Inflows -

by

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The Kiel Institute of World Economics

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I. Debt versus Foreign Direct Investment*

Developing countries are generally faced with several options to raise foreign capital in order to supplement domestic savings and investment funds. Basically, these options reduce to a choice between foreign debt and equity finance. Especially fairly advanced developing countries such as Malaysia, for which development aid from industrialized countries is no longer available to a significant degree, are left with the alternative to borrow abroad or to attract foreign direct and portfolio investments. In the 1970s and early 1980s, most of the developing countries opted for external borrowing in the first place. The share of foreign direct investment (fdi) in the Third World's total resource receipts decreased from 19 per cent in 1970 to 8 per cent in 1983. Over the same period, the role of commercial bank lending increased from 15 per cent to 36 per cent [World Bank, 1985, p. 21].

Sometimes it is argued that the structural shift of external financing towards borrowing contributed to the subsequent debt crises in many developing countries. Debt inflows are assumed to involve higher risks for the recipient country than fdi-inflows. Debt-service schedules are fixed ex ante and, typically, are not related to the country's ability to pay. Especially in the case of flexible-interest loans, the risk of adverse world-market developments is shifted from the creditor to the borrower. In contrary, the payment of dividends in the case of fdi is closely related to the host country's economic performance. The servicing of non-debt creating capital inflows is more flexible because fdi provides for risk sharing between the host country and foreign investors. Moreover, fdi is designed for specific projects; whereas, in the case of debt, general balance-of-payments finan-

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cing figures prominently, which may be more susceptible to an unproductive use of foreign capital. Finally, fdi is considered superior to debt because it provides managerial skills and technological knowledge in addition to foreign finance. Fdi may thus help to overcome the relative scarcity of human capital in developing countries.

According to this reasoning, developing countries would be well advised to change the external financial structure towards more equity participation as a means to prevent or solve foreign debt problems¹. This re-orientation may include debt-equity swaps, the establishment of mutual funds to attract portfolio investments, the development and liberalization of domestic stock markets, as well as the issue of "quasi-equities" such as commodity-linked bonds [see e.g. World Bank, 1985]. Malaysia provides an interesting example in this respect. In contrast to many overindebted economies, fdi played a major role in the external financing of this country. Consequently, the well-known argument that a significant restructuring of foreign resource inflows is not possible, due to the sheer amount of accumulated debt, does not apply to Malaysia. Actually, this country attempted to restructure external financing along the proposed lines recently. The rapid growth of external debt which averaged 30 per cent per annum in the 1980-1986 period was reversed subsequently. Simultaneously, the fdi-legislation was liberalized. As a consequence, approved fdi jumped from an average of M\$ 300 million (US\$ 126 million) in 1983-1985 to M\$ 750 million (US\$ 291 million) in 1986 and M\$ 614 million (US\$ 239 million) in January-May 1988.

It is the principal aim of this paper to discuss whether or not Malaysian policies towards capital inflows helped to achieve an

¹ Once the country has borrowed and gotten into trouble, the restructuring of external financing is, of course, no panacea to solve debt problems but has to be supplemented by economic policy reforms.

optimal external financial structure¹. The shift from debt to fdi may prevent payment crises particularly in countries which have engaged in cooperative financial relations with foreign lenders and investors. On the other hand, the choice between equity and debt may involve a risk-return trade-off between income stability and expected growth under non-cooperative conditions. This hypothesis refers to a choice-theoretic model which analyses the international transfer of capital on the basis of the agent-principal approach [Lächler, 1985]. The model is summarized in Section II, where it is also assessed whether or not the agent-principal relationship can be characterized as cooperative in the case of Malaysia. Subsequently, government regulations affecting external financing have to be evaluated in order to decide what constitutes the optimal debt-equity structure. The model predictions on the effects of debt and fdi-inflows on overall investment and economic growth in the capital recipient country are based on the assumption that different capital inflows are perfectly fungible. Actually, however, government regulations not only determine the structure of capital inflows; they are also likely to affect the efficiency of different types of capital inflows. In Section III, the regulatory framework governing debt and fdi in Malaysia is analysed. This discussion results in hypotheses on the economic performance effects of debt and fdi, which will be tested empirically in ongoing research. Consequently, only tentative conclusions are presented in Section IV as far as current policies of the Malaysian government towards capital imports are concerned.

¹ External debt and fdi are assessed with respect to their effects on economic performance exclusively. The focus is on the effects on the investment ratio, the efficiency of investments, and economic growth. The relative merits and shortcomings of debt and fdi with respect to other factors which may enter the country's welfare function are largely neglected in the following. For example, many developing countries are restrictive in allowing fdi due to concerns about foreign control over national resources.

II. Agent-Principal Relations: The Case of Malaysia

Various proposals recommending measures that would change the external financial structure of developing countries in favour of foreign equity participation basically refer to fdi as a risk-sharing device. Recently it was shown, however, that this strategy may involve costs in terms of lower economic growth for the capital recipient country [Lächler, 1985; Lächler, Nunnenkamp, 1987]. Transfer negotiations between foreign lenders or investors (principals) and capital recipients (agents) are typically subject to moral-hazard problems. Once the capital is transferred, the agent is free to decide on how to allocate the available funds between consumption and investment purposes. In the case of foreign equity participation, the agent may reduce complementary domestic investments and thus invest a smaller share of domestic absorption as compared to a situation where foreign resources would be available as gifts. Since the foreign investor is entitled to a predetermined share of the agent's future output, the agent may improve his own welfare position by shifting domestic absorption to current consumption. Under such conditions, the effects of fdi on overall investment and economic growth can be supposed to be less favourable than in the case of debt finance¹.

The risk-return trade-off of fdi-inflows may be overcome if the agent is able to precommit himself credibly to a certain investment behaviour before transfers are effected. Moral-hazard problems are ruled out under such cooperative agent-principal relations. In this case, the investment response of a transfer involving future repayment obligations is always greater than for foreign gifts, irrespective of whether the transfer takes the

¹ Moral-hazard problems arise in the case of debt finance as well. Since the principal is entitled to a fixed sum of debt-service payments, the agent may improve his own welfare position by switching to higher-risk projects [see also Jensen, Meckling, 1976]. However, it was shown by Lächler [1985] that more external debt always leads to more investment; whereas the change in overall investment may be negative after increased fdi-inflows.

form of debt or fdi. It is thus important to get an idea on the regime under which transfers are negotiated, in order to decide whether it is favourable for developing countries such as Malaysia to substitute fdi for debt.

It depends on the principal's perception of the agent's investment behaviour whether or not a cooperative equilibrium is achieved in the transfer negotiations. The agent may indicate that he is prepared to engage in cooperative relations. Especially high investment ratios and successful mobilization of domestic savings may provide such signals. However, it is the principal who decides on the terms under which debt and fdi is transferred. The terms of capital transfers in turn determine the type of equilibrium¹. Information on the transfer terms is easily available for debt finance. Interest-rate spreads above LIBOR clearly point to cooperative financial relations in the case of Malaysia. The spreads paid by Malaysia averaged 0.42 per cent in the 1978-1984 period [Nunnenkamp, Junge, 1985, p. 57]. This was less than half the figure of 1.0 per cent calculated for the average of the 21 most important Third-World borrowers². Malaysia was even granted substantially better credit terms than the group of borrowers without major debt-servicing difficulties (0.82 per cent).

Similarly straightforward information on transfer terms is not

¹ Moral-hazard problems in transfer negotiations threaten to reduce the expected gains of the principal. Rational principals would modify the terms under which transfers are made if they anticipate a non-cooperative behaviour of agents. Given harder (i.e., non-cooperative) transfer conditions, the agents are then forced to a non-cooperative investment behaviour. For example, higher interest rates render low-risk projects unprofitable for the agent in the case of debt finance. The hardening of credit terms will induce the agent to shift to higher-risk projects.

² The calculation is based on data on interest-rate spreads for syndicated bank loans, as presented by the Euromoney Syndication Guide. The comparison is thus not affected by the relatively high share of credits from official sources in Malaysia's overall external debt.

available for fdi-inflows¹. However, indirect evidence points to cooperative relations in the case of fdi as well. Malaysia's investment ratio amounted to 29.4 per cent in the 1975-1986 period [IMF, 1987]. This was about 4 percentage points higher than the average figure for all Third-World economies as well as developing countries in Asia. The extraordinarily high investment ratio indicated that Malaysia was prepared to engage in cooperative financial relations with foreign principals². The investment ratio peaked in 1980-1984 (about 34.5 per cent), i.e., when realized fdi-inflows were extraordinarily high as well³. Hence, principals could be confident that Malaysia did not abstain from undertaking complementary investments in order to reduce future dividend payments to foreign investors. This is underlined by the fact that, in 1980-1984, the domestic savings rate of Malaysia was only 1 percentage point below the average of the 1977-1986 period and remained substantially above the average savings rate for middle-income developing countries. Apparently, foreign capi-

¹ Balance-of-payments data, collected from different sources by Steven Wong, show that repatriated dividend payments exceeded the interest payments on external debt throughout the 1979-1984 period. However, the relative terms of fdi and debt inflows cannot be derived from such data. The aggregate figure of interest payments is strongly affected by subsidized credits from official sources. Moreover, a significant part of profit repatriation was undertaken by only two multinational companies operating in the petroleum and gas sector.

² Arguably, the nationalization of foreign-based plantation and mining companies, following the implementation of the New Economic Policy (see also pp. 17f.), points to non-cooperative agent-principal relations. Apparently, however, "the NEP had little effect on foreign investors" [Imran, Fadil, 1986, p. 180]. This may be due to several reasons. First of all, the nationalization was selective rather than unspecific [for an analysis of the different effects of selective versus unspecific expropriation, see Picht, Stüven, 1988]. Secondly, "buying-back" foreign companies is likely to have less detrimental effects on agent-principal relations than outright expropriation without adequate compensation. Thirdly, the negative effects of the NEP on the (micro-economic) profitability of investments might have been considerably smaller than its effects on macro-economic performance of Malaysia.

³ According to the World Bank [1987], Malaysia's fdi-inflows developed as follows (period averages in US\$ million): 1975-1979: 442; 1980-1984: 1131; 1985-1986: 612.

tal inflows were largely used to finance additional investments rather than to compensate for lower domestic savings.

From the discussion in the preceding paragraphs, it appears that Malaysia succeeded to engage in cooperative relations with foreign creditors and investors. According to the underlying agent-principal model, a risk-return trade-off is thus unlikely to exist. Under such conditions, the optimal debt-equity ratio turns out to be "0" in the model; i.e., risk-averse agents always prefer equity finance over debt finance¹. Actually, however, Malaysia experienced significant debt inflows as well, particularly in the first half of the 1980s. This points to the relevance of welfare considerations of the agent which are neglected in the model's utility function, e.g. the government's motivation to prevent specific industries from being controlled by foreigners.

III. Government Policies and Capital Inflows

1. The Relevance of the Regulatory Framework

Traditionally, Malaysia referred to fdi as a major source of external financing. According to balance-of-payments data, fdi accounted for 47 per cent of total resource inflows over the 1967-1986 period; the share of debt inflows amounted to only 21 per cent (Table 1)². This was in sharp contrast to the external financing structure of countries such as Chile, Mexico, Indonesia and South Korea, all of which strongly preferred debt over fdi-inflows³. The exceptional structure of external financing in Malaysia is likely to be due to government regulations in the

¹ This follows from the maximization of the agent's expected utility function [for details, see Lächler, 1985].

² Portfolio investment (mainly public sector bonds) accounted for the rest, i.e., 32 per cent of resource inflows.

³ In the 1970s and 1980s, the share of fdi in total resource inflows amounted to about 5, 8 and 14 per cent in Korea, Chile, and Mexico and Indonesia respectively [for details, see Corsepius, 1988a; 1988b; Schweickert, 1988].

Table 1 - The Structure of External Financing in Malaysia 1967-1986

	Foreign direct investment		Public sector bonds		Long-term debt		Short-term debt		Total resource inflows
	US\$ million	per cent	US\$ million	per cent	US\$ million	per cent	US\$ million	per cent	US\$ million
1967	43	n.a.	n.a.	n.a.	10	n.a.	-83	n.a.	-30
1968	30	34.1	n.a.	n.a.	22	25.0	36	40.9	88
1969	80	81.6	28	28.6	29	29.6	-39	-39.8	98
1970	94	104.4	-28	-31.1	30	33.3	-6	-6.7	90
1971	100	39.2	87	34.1	45	17.6	23	9.0	256
1972	114	39.9	67	23.6	115	40.3	-11	-3.8	286
1973	172	50.5	-11	-3.2	72	21.1	107	31.6	340
1974	571	70.0	11	1.3	85	10.5	149	18.3	817
1975	351	53.2	267	40.5	104	15.8	-63	-9.6	659
1976	381	74.2	50	9.7	174	33.9	-91	-17.8	514
1977	406	156.8	65	25.2	183	70.7	-396	-152.7	259
1978	500	79.3	79	12.5	110	17.5	-59	-9.3	630
1979	574	298.0	194	100.7	158	81.9	-733	-380.5	193
1980	934	65.3	-10	-0.7	98	6.8	410	28.6	1 432
1981	1 265	48.4	1 131	43.2	178	6.8	42	1.6	2 617
1982	1 398	37.3	1 804	48.2	404	10.8	137	3.7	3 743
1983	1 260	32.7	1 410	36.6	1 296	33.6	-111	-2.9	3 855
1984	797	26.3	1 002	33.1	1 344	44.4	-117	-3.9	3 027
1985	694	36.0	335	17.4	552	28.6	347	18.0	1 929
1986	530	41.9	598	47.3	99	7.8	39	3.1	1 266
1967-1986 ^a	10 294	46.6	7 079	32.1	5 108	23.1	-419	-1.9	22 069

^aPer-cent figures are weighted averages.

Source: IMF, Balance of Payments Statistics, various issues.

first place. Moreover, changes in the government's attitude towards debt and fdi may be responsible for variations in the relative importance of various resource inflows.

Government regulations influencing the structure of capital imports can also be expected to affect the efficiency of different types of resource inflows. The effects of fdi and debt on economic growth may differ even if the investment response was the same for all capital imports. This is because foreign capital inflows are typically not perfectly fungible, as was assumed in the agent-principal model.

The government's leverage on the use and, hence, the efficiency of capital inflows is likely to differ between the various types of external finance. The government agent can freely dispose of resources directly transferred to official agencies; he immediately determines the efficiency of foreign aid and public debt for example. The government's control is less strict for other types of capital inflows. Nevertheless the efficiency of private debt and fdi can be influenced indirectly by the government. Public regulations may modify the incentives of the recipients of foreign capital as to how to use the transferred resources. The ranking of the growth effects of different types of external financing is thus likely to depend on the degree and nature of public interventions concerning the transfer of foreign resources. It is mainly with respect to efficiency that the regulatory framework for debt and fdi-inflows in Malaysia is discussed in the following paragraphs.

2. The Case of Foreign Debt

As concerns Malaysia's policies towards external debt, three sub-periods can be differentiated:

- Until 1980, foreign debt policies remained fairly conservative.
- In the first half of the 1980s, counter-cyclical borrowing abroad represented an important instrument to finance the promotion of heavy industries.

- Recently, further debt inflows were discouraged due to concerns about the sustainability of debt accumulation.

Traditionally, Malaysia's recourse to external borrowing was insignificant. The high growth rate of outstanding debt in the 1970s (nearly 25 per cent per annum) was largely to be attributed to the extremely low debt figure at the beginning of this period (Table 2)¹. External borrowing was regarded as a residual. Bank Negara (i.e., the Central Bank) was restrictive to allow for foreign debt inflows since domestic finance was easily available, which was due to the booming economy and favourable commodity prices. Government budget deficits were largely financed through "captive" domestic savings, e.g. from the Employees Provident Fund. In 1971-1980, external borrowing accounted for only about a quarter of the government's development expenditures.

Project loans granted by multilateral agencies such as the World Bank and the Asian Development Bank as well as bilateral donors accounted for a significant share of total debt inflows throughout the 1970s. These funds were mainly used to finance infrastructure projects such as highways, bridges and hydroelectric dam projects, the promotion of which was considered to be an important input for private sector activities. Due to long gestation periods, positive growth effects were not to be expected in the short run. Moreover, the loan-financed projects did not generate foreign exchange by their own. Nevertheless debt-servicing difficulties were unlikely to result from public project loans. Typically, the official creditors granted soft loan conditions, i.e., lower than market rates of interest and long grace periods. Consequently, the debt-service ratio (interest and amortization payments relative to exports) remained still below 5 per cent in 1980.

¹ Total debt outstanding of M\$ 1.2 billion in 1970 equalled US\$ 390 million at the then prevailing exchange rate of M\$ 3.1 per US\$. The Ringgit appreciated over the 1970s reaching M\$ 2.2 per US\$ in 1980; subsequently it depreciated to M\$ 2.6 in 1986.

Table 2 - Malaysia's External Debt Outstanding 1970-1987

		1970	1980	1983	1985	1986	1987
Federal government	M\$ billion	0.7	4.9	17.7	23.1	28.3	27.6
	per cent	58.3	44.5	53.3	50.7	53.6	54.8
thereof ^a :							
Market loans		53.6	45.0	69.2	70.7	71.7	68.5
Project loans		46.4	55.0	21.8	24.7	24.7	27.9
Suppliers' credits		-	-	4.3	3.5	3.6	3.6
IMF facilities		-	-	4.7	1.1	-	-
Government guaranteed ^b	M\$ billion	0.4	2.4	7.7	11.9	14.6	16.8
	per cent	33.3	21.8	23.2	26.1	27.7	33.3
Private sector	M\$ billion	0.2	2.7	6.3	7.2	7.5	6.0
	per cent	16.7	24.5	19.0	15.8	14.2	11.9
Total medium and long-term debt	M\$ billion	1.3	10.0	31.7	42.2	50.4	50.4
Net commercial bank liabilities	M\$ billion	-0.1	1.0	1.5	3.4	2.4	-
	per cent	-8.3	9.1	4.5	7.5	4.5	-
Total debt	M\$ billion	1.2	11.0	33.2	45.6	52.8	50.4
	per cent	100.0	100.0	100.0	100.0	100.0	100.0
Memo item:							
Debt-service ratio (per cent)		2.6	4.3	9.8	15.8	18.7	16.0
^a In per cent of federal government debt. - ^b Non-financial public enterprises (NFPEs).							

Source: Bank Negara Malaysia

The policy stance towards foreign borrowing changed remarkably in the early 1980s. Total debt outstanding increased by 30 per cent annually in the 1980-1986 period. Private sector debt nearly tripled; nevertheless its share in total debt outstanding decreased to less than 15 per cent. The government did not intervene into the allocation of private debt. Public guarantees were not issued for this debt category. Hence, the incentives of private borrowers to use external funds efficiently were not distorted. On the other hand, capital market segmentation may have hindered the external financing of relatively small but highly

productive private investments. Many companies had not yet established a credit standing in international financial markets. Especially small manufacturing firms were not able to borrow abroad without public guarantees. The increase in private debt in the early 1980s was mainly to be attributed to external borrowing by non-resident controlled companies (NRCCs) engaged in oil and gas related activities, the financial restructuring of other NRCCs, and real property development by some private companies. The required approval of Bank Negara for private external borrowing exceeding the equivalent of M\$ 100 000 (since 1987: M\$ 1 million) was not difficult to get in this sub-period. However, tight controls were introduced since 1983 [Bank Negara, various issues].

In 1980-1983, the accumulation of external debt was largely due to the government's attempt to sustain economic growth via expansionary fiscal policies in the face of global recession. The federal government's budget deficits soared from M\$ 3.7 billion in 1979 to an average of M\$ 10.5 billion in 1981-1983 [Imran, Fadil, 1986, p. 51]. To a significant extent, the government raised loans in international financial markets to cover high deficits (Table 2). The structure of public external debt changed drastically towards private creditors¹. This in turn caused the debt-service ratio to rise to 10 and 19 per cent in 1983 and 1986 respectively; although rather low by international standards, the latter figure was more than four times as high as the 1980-figure. More importantly, it remains open to question whether counter-cyclical public borrowing was used productively.

Concerns about the sustainability of public debt accumulation induced the government to curb public spending. Comparing 1982 and 1985, budget deficits were reduced by 40 per cent. Nevertheless they remained high by international standards (according to

¹ The share of official creditors in Malaysia's public external debt decreased from 50 per cent (1975) and 44 per cent (1980) to less than one quarter in the mid-1980s (data from Bank Negara Malaysia).

IMF-data, nearly 8 per cent of GNP in 1985). Moreover, external borrowing by non-financial public enterprises (NFPEs) was not yet controlled strictly. The government continued to issue guarantees for NFPE-loans. Such loans represented the fastest growing type of debt during 1983-1986 (24 per cent per annum). NFPE-loans were largely used to finance investment projects. However, the provision of public guarantees is likely to have weakened the incentives to carefully assess the productivity of investments.

External borrowing by NFPEs in the 1980s represented a major element in the government's strategy to broaden the industrial base of the country via promotion of heavy industries. This included the development of a national automobile industry; ship-building and the production of steel and cement figured prominent as well. In contrast to earlier announcements that the private sector was to be assigned a greater role in economic development, the government continued to play the central role. Both theoretical arguments and historical experience suggest that policy-induced distortions in the allocation of economic resources typically give rise to inefficiencies and thus affect economic growth negatively¹. In the case of Malaysia, the external financing of NFPE-investments may have avoided the crowding out of private investors which largely relied on domestic credit sources. However, the concentration on heavy industries was probably in conflict with Malaysia's comparative advantages². This applied especially to human-capital intensive industries such as automobile production. In the longer run, mis-specialization is bound to negatively affect the growth effects of investments. Costs in

¹ This hypothesis will be tested empirically in ongoing research on the effects of different capital inflows on economic performance in Malaysia.

² According to calculations provided by Steven Wong, the incremental capital-output ratio (ICOR) increased dramatically from an average of 3.0 in 1976-1980 to 5.4 in 1981-1985. This increase represented the most important factor in explaining the drastic decline in the critical interest rate, i.e. the maximum interest rate to be paid without further increasing external debt. During the first half of the 1980s, the actual interest rate was twice as high as the critical interest rate.

terms of reduced economic growth may also result from government policies which aim at an improved income distribution and favour the equity participation of specific population segments¹. In the case of Malaysia, continued "attempts to expedite Bumiputra participation in commerce and industry through direct government involvement" [Imran, Fadil, 1986, p. 49] figure prominently in this respect².

Actually, a significant portion of public and publicly guaranteed debt has been utilized in projects which were unlikely to generate sufficient resources to service debt through their own operations [ibid, pp. 54ff.]. The performance of many NFPEs did not live up with high expectations [see also Imran, 1988, pp. 29ff.]³. Favourable effects of heavy industrialization on the development of ancillary industries and on export performance did not materialize in the short run. Many NFPEs asked the government to convert non-performing loans into equity, i.e., to shift debt-servicing problems to the federal government. The intensified drain on the federal budget added to concerns about the sustainability of debt-intensive heavy industrialization. This led to the government's recent resolution to slow down the rate of debt accumulation by reducing the twin deficits in the public budget and the balance of payments.

Presently, further external borrowing is strongly discouraged by the government. A maximum of 20 per cent was imposed for the debt-service ratio. The decision on loan applications by private enterprises may be delayed, the amount of loans applied for may be reduced by means of moral suasion, or approval may be outright refused. As far as NFPEs are concerned, the strategy of heavy

1 Arguably, such equity considerations are necessary in order to sustain political stability. Nevertheless it is worthwhile to assess the economic costs which might be involved.

2 Bumiputra refers to the indigenous population of Malaysia.

3 Several factors which were beyond their control contributed to the failure of NFPEs, particularly the appreciation of the Yen and other major currencies against the Ringgit, as well as the recession in foreign and domestic markets in the mid-1980s.

industrialization is not completely abandoned. However, a major restructuring is aimed at, encompassing a stronger impetus on small and medium-sized companies as well as resource-based industries, the privatization of selected NFPEs, comprehensive monitoring of the financial management of NFPEs, improvements in operational efficiency, the cancellation and postponement of projects, and the shift towards domestic financing. Direct government borrowing is to be reduced by assigning the private sector a greater role in economic development. Additional measures include: diversification and lengthening of the maturity profile of debt, in order to avoid any bunching of repayments; refinancing and prepayment of high-interest bearing market loans; continuous monitoring of international financial market conditions and an improved tuning in foreign borrowing.

The favourable current account position of Malaysia in 1987 and ample liquidity in the domestic financial market set the stage for the selective prepayment of external debt and its domestic refinancing. This exercise is expected to continue. Basically, the re-orientation in industrialization and debt policies seems well-suited to improve the efficiency of investments and to prevent major debt-servicing difficulties. Several problems remain to be solved however. Domestic investors seem still reluctant to trust in the government's resolution to reduce its own role in manufacturing and to foster private initiative¹. Uncertainties about the government's course in promoting the role of Bumiputras in economic development may add to the wait-and-see attitude. Moreover, the publicly enforced shift to domestic financing involves considerable risks. Presently, commercial banks in Malaysia are urged by the government and Bank Negara to reduce lending rates so that domestic borrowing is relatively cheap.

¹ Officials in Malaysia frequently argue that the privatization drive of the government may lose impetus because of the sluggish responsiveness of private investors and mounting unemployment problems. However, exactly the remaining uncertainties about the government's determination in assigning a greater role to the private sector are likely to add to the reluctance of private investors.

However, interest rate margins are typically fairly high in Malaysia and financial deepening is relatively poor by international standards¹. Consequently, the increased demand for domestic funds by NFPEs may result in the crowding-out of more productive private investments and thus impair future growth prospects.

3. The Case of Foreign Direct Investment

In contrast to the traditionally conservative Malaysian attitude towards external debt, the country has been a significant recipient of fdi since the early 1960s. Foreigners owned more than 60 per cent of the share capital in the Malaysian economy in 1970 [Imran, Fadil, 1986, pp. 162f.]. However, important changes in the government's attitude towards fdi took place over the last two decades. They are likely to have affected both the amount and efficiency of fdi.

Initially, fdi was mainly attracted in agriculture and mining. The policy focus shifted towards the promotion of manufacturing in the late 1960s. The introduction of a new tariff schedule and subsequent tariff increases raised the effective rate of protection in manufacturing to an average of about 40 per cent [Hoffmann, Tan, 1980]. This encouraged fdi in import-substituting activities. The Industrial Incentives Act (IIA) of 1968 reflected the government's intention to promote viable export-oriented industries as well [Tan, Kulasingam, 1984, p. 110]. The IIA provided various investment incentives such as income-tax exemptions

¹ Inefficiencies in financial intermediation in Malaysia are due to several factors. Most importantly, competition among financial intermediaries is artificially reduced. The operations of foreign banks are principally restricted to one branch. Moreover, the activities in which commercial banks and merchant banks may engage are strictly separated. It is argued that the protection of domestic banks is necessary since they would not survive intensified competition. However, this is mainly due to inefficiencies created by government interference in credit policies. The high share of non-performing loans, for example, can be attributed at least partly to credit quotas which have to be extended to priority sectors at preferential interest rates.

and special export incentives. Fdi-inflows were largely unregulated in this period. Malaysia did not introduce strict foreign exchange controls so that foreign capital and dividends could be transferred back easily: "The free movement of capital is guaranteed to foreign investors since Malaysia is a signatory of Investment Guarantee Agreements, which also insure against non-commercial risks such as expropriation and nationalization of capital" [ibid, p. 112].

The liberal treatment of fdi which was well-suited to generate favourable growth effects was subject to important changes in the early 1970s. Growing nationalistic sentiments and internal imbalances in equity ownership caused pressure to reduce the dominance of foreign control in the economy. In line with the objectives of the New Economic Policy (NEP), Malaysia's attitude towards fdi became more regulated and selective. Foreign participation in agriculture and mining projects was strongly discouraged, and the process of take-overs of plantation and mining companies was speeded up [Imran, Fadil, 1986, p. 168]. The Petroleum Development Act, in its original form of 1974, had detrimental effects on foreign owned oil companies. The Malaysian owned PETRONAS was empowered with the exclusive right to exploit petroleum resources. The NEP ensured that fdi in manufacturing had to be in the form of joint ventures mainly. The Industrial Coordination Act (ICA) of 1975 provided a major instrument to achieve a more equitable distribution of wealth and income. The new guidelines required all manufacturing projects of more than M\$ 250 000 in capitalization and full-time staff of 25 and above to be licensed under NEP-conditions. In many industries, direct foreign participation was restricted to a maximum of 30 per cent. This referred to domestic-market oriented industries and projects utilizing non-renewable resources in the first place¹. In addition to Malaysians owning the majority of shares, the equity participation of Bumiputras was required to be at least 30 per cent.

¹ Regulations on domestic equity participation were more flexible for export-oriented projects. Wholly foreign owned companies were operating in free trade zones particularly.

The powerful Foreign Investment Committee (FIC) was established to promote Bumiputra participation [Tan, Kulasingam, 1984, p. 112]. The selective treatment of fdi and restrictions on equity participation continued into the 1980s. During 1980-1985 (i.e., before the fdi-legislation was liberalized), joint ventures with Malaysian majority accounted for two thirds of total fdi-projects (Table A1).

The foreign investors' reaction to the NEP and ICA differed between multinationals from different home countries. US companies were more reluctant than Japanese companies to engage in joint ventures, for example [ibid, p. 115]. However, overall fdi-inflows increased continuously in the early 1970s. The set-back in 1975 (from fairly high inflows in the previous year) may be due to uncertainties arising from the implementation of the ICA. But fdi-inflows recovered quickly and increased steadily until 1982. From this it has been concluded that "the NEP had little effect on foreign investors" [Imran, Fadil, 1986, p. 180].

This judgement is based on the development of total fdi-inflows. The impact of the NEP on the structure of fdi and its effects on overall investment and economic growth in Malaysia are less clear. Several factors are noteworthy. Firstly, government agencies and government backed corporations were frequently involved in joint ventures with foreign investors by providing public funding and holding shares in trust for later divestments to Bumiputras [ibid, pp. 184f.; Imran, 1988, p. 29]. The significant public contributions to joint ventures absorbed domestic savings and external debt inflows to a considerable extent. They can thus be expected to have crowded out private sector investments.

Secondly, the policy focus on heavy industries may have influenced the structure of fdi in a way which did not conform to

Malaysia's comparative advantages¹. The evidence on the sectoral distribution of fdi presented in Table 3 is mixed in this re-

Table 3 - Foreign Direct Investment in Manufacturing Industries of Malaysia in 1980-1987 (approved)

	M\$ million	per cent
Electrical and electronic products	569	16.7
Chemical products	528	15.5
Food products	383	11.2
Basic metals	245	7.2
Petroleum and coal	240	7.0
Transport equipment	210	6.2
Rubber products	173	5.1
Machinery	172	5.0
Textiles and textile products	118	3.4
Paper printing and publishing	113	3.3
Others	663	19.4
Total manufacturing	3 414	100.0

Source: MIDA.

¹ The interpretation is based on the assumption that Malaysia can still be considered a country where capital is relatively scarce. This refers to human capital in the first place. Consequently, production should be concentrated on relatively labour-intensive or standardized (i.e., less human-capital intensive) manufacturing, in order to reap the full benefits from the international division of labour and thus improve the productivity of investments. It would be interesting to compare the sectoral distribution of fdi-applications and the corresponding structure of approvals, in order to decide whether or not the approval procedures involved a bias towards heavy industries. However, data on industry-specific applications was not available.

spect¹. The production of electrical and electronic items, representing the most important area for fdi, can be considered as fairly labour-intensive². On the other hand, about 30 per cent of fdi was approved in sectors which were clearly human-capital intensive (chemicals, basic metals, and transport equipment). This may negatively affect the export potential and economic growth effects of fdi in the longer run³.

Thirdly, the publicly enforced majority participation of Malaysian investors in joint ventures may have hindered the transfer of technologies and managerial skills. The "reluctance of foreign investors to pass on to locally-controlled firms their latest technology" [Tan, Kulasingam, 1984, p. 116] rendered it difficult for Malaysia to take full advantage of the generally assumed superiority of fdi over debt in improving the human-capital endowment of developing countries.

Only recently, the Malaysian government relaxed fdi-restrictions and granted additional incentives in order to improve the investment climate⁴. Most importantly, equity participation rules were liberalized. Since late 1986, companies selling at least 50 per cent of output to world markets or Malaysian free trade zones may be wholly owned by foreign multinationals. The same applies to companies employing at least 350 full-time Malaysian workers. Work permittances and visa requirements for expatriate staff

¹ It is noteworthy that the development and structure of overall fdi were strongly influenced by the fluctuation of fdi in the petroleum sector. While petroleum and coal accounted for only 7 per cent of approved fdi in 1980-1987, the share of this sector in total fixed assets of foreign investors in Malaysia amounted to 17 per cent (December 1986).

² For the classification of industries according to factor intensities, see Spinanger [1987].

³ Strongly export-oriented fdi accounted for about 40 per cent of approved projects in 1980-1987 (Table A2).

⁴ The government's attempt to encourage further fdi was part of a broader re-orientation in development strategies [Fifth Malaysia Plan 1986-1990]; for the various measures introduced in 1985-1986, see MIDA [1987].

members were liberalized as well¹. Moreover, it was announced that the new rules were to be applied in a flexible way. The joint solution of remaining problems is aimed at by improving the dialogue between foreign investors and the Malaysian government. Bureaucratic procedures and delays should be kept to the minimum, the Malaysian Industrial Development Authority (MIDA) acting as a one-stop agency for foreign investors.

As a result of the liberalization measures,

- fdi increased by 30 per cent in 1987 (January-October)²;
- fdi-projects wholly owned by foreign multinationals gained in importance (Table A1);
- a shift towards export-oriented fdi-projects was observed (Table A2).

All in all, the liberalization of fdi-regulations seems well-suited to attract more foreign investments and to improve their productivity. However, remaining uncertainties about the future course of fdi-legislation in Malaysia may still act as a hindrance to fully exploit the economic growth potential of fdi [see also Imran, Fadil, 1986, pp. 191ff.]. The required Bumiputra participation of 30 per cent may severely limit the choices of foreign investors to select local partners, especially in foreign majority fdi-projects. Moreover, the more liberal treatment of fdi is presently restricted to project applications up to 1990³.

¹ Other measures included: relaxation of the Industrial Coordination Act of 1975; waiver of FIC-approval for corporate share transactions below M\$ 5 million; replacement of the administratively cumbersome Investment Incentives Act of 1968 by the Promotion of Investment Act which provided a range of tax and import duty exemptions; introduction of the New Investment Fund Scheme; reform of the Kuala Lumpur Stock Exchange; review of labour laws.

² Other factors responsible for this increase were the improvement in overall economic prospects of Malaysia and the relocation of investments from countries such as Japan, South Korea and Taiwan, whose currencies appreciated against the M\$.

³ This refers to Section C.1.b. of the Investor's Guide [presented in Imran, 1988, Appendix 4; see also MIDA, 1987, pp. 5 f.],
continued on page 22

No final decision has been taken on the treatment of new fdi-projects in the 1990s¹. Finally, the revised fdi-legislation continues to discriminate against relatively small projects although various tax incentives have been extended in the 1989-budget. Most importantly, the relaxation of equity participation rules does not apply to mainly domestic-market oriented companies with less than 350 employees.

IV. Some Tentative Conclusions

In contrast to the external financial structure of most Third-World economies, Malaysia preferred fdi over foreign debt during much of the 1968-1987 period. Recent policy measures clearly reflected this preference. Further debt accumulation was strongly discouraged, whereas the fdi-legislation was liberalized. As a result of the changes in the regulatory framework introduced in the mid-1980s,

- the overall inflow of external finance was reduced considerably, and
- the structure of resource inflows shifted towards fdi.

Principally, the reduction of capital imports is not an end in itself. Restrictions on resource inflows are likely to impair future growth prospects provided that the country offers profitable investment opportunities which cannot be financed out of domestic savings exclusively. Nevertheless the restrictive Ma-

i.e., fdi-projects which meet the following conditions: (i) the foreign investor exports at least 50 per cent of his production or employs at least 350 full-time Malaysian workers, and (ii) the company's products do not compete with locally manufactured products for the domestic market.

¹ The Consultative Economic Council, recently set up by the Malaysian government and consisting of representatives of various interest groups, is going to submit new recommendations concerning the policies to be followed after 1990. The common view is that the government will continue to encourage fdi-inflows.

Malaysian attitude towards external debt may be justified. It was mainly the government which was responsible for the significant debt accumulation in the first half of the 1980s. Probably, external borrowing was used for unproductive purposes to some extent. Moreover, government guaranteed borrowing by non-financial public enterprises was largely absorbed by heavy industrialization projects. The productivity of such investments can be supposed to be relatively low. Arguably, the concentration on heavy industrialization did not conform to Malaysia's comparative advantages. In subsequent research, this hypothesis will be tested empirically by comparing the growth effects of different types of debt and fdi-inflows.

Imposing overall restrictions on further debt inflows may help to reduce the policy bias towards heavy industries. However, this second-best solution is likely to affect the external financing of private sector investments as well. The problems arising from the mis-allocation of resources should be tackled in a more direct way, i.e., by revising the industrialization strategy. As was recently announced by Malaysian authorities, the government should rely more strongly on private initiative in identifying and realizing the most productive investment opportunities. The government's role in manufacturing should be reduced. Public debt accumulation would then be controlled even though non-interventionist debt policies were maintained. In this way, the external financing of productive private investments would not be obstructed.

As far as the fdi-legislation is concerned, some problems remain to be solved as well, in order to achieve an optimal external financial structure. According to the agent-principal model outlined in Section II, Malaysia is well advised to strengthen the country's attractiveness for foreign investors. Definite conclusions on whether or not fdi-finance involves a trade-off between economic growth and income stability (i.e., risk sharing with foreign investors) can only be reached in ongoing empirical research. However, the evidence presented above indicates that

the country succeeded to engage in cooperative financial relations with foreign principals. The conceivable trade-off is unlikely to exist in the case of Malaysia.

It is thus in the country's best interest to maintain and further strengthen the liberal treatment of fdi¹. Remaining uncertainties about the future course of fdi-legislation must be removed. As far as equity participation rules are concerned,

- foreign investors must be allowed to keep the majority of shares so that Malaysia can reap the full benefits from the transfer of technologies and managerial skills;
- the choice of foreign investors to select local partners in joint ventures should not be unduly limited by imposing detailed minimum standards with respect to the participation of specific segments of the Malaysian population²;
- remaining discriminations against relatively small fdi-projects should be abolished.

Moreover, the efficiency of fdi-inflows was probably impaired by the government's involvement in joint ventures in heavy industries in the past. As in the case of debt finance, improvements in the efficiency and productivity of fdi are to be expected if fdi-projects were no longer intertwined with the government's attempts to foster heavy industrialization and a more equitable distribution of income and wealth.

¹ Sometimes domestic investors complain about a bias in incentives against them and in favour of foreign investors. It is thus important to note that the proposed liberal treatment of fdi must not involve any privileges at the expense of domestic investors; the latter should rather be given the same liberal treatment.

² In order to achieve a more equitable distribution of income and wealth, policies should be adopted which do not interfere with the allocation of economic resources and which minimize adverse effects on the country's attractiveness for foreign capital.

Table A1 - Equity Ownership Pattern of Foreign Direct Investment in Malaysia 1980-1987 (number of projects)

	Joint ventures			Wholly foreign owned	Total
	Malaysian majority	foreign majority	50/50		
1980	183	71	4	40	298
1981	207	111	8	29	355
1982	155	52	6	17	230
1983	199	52	5	27	283
1984	315	81	10	25	431
1985	248	60	13	34	355
1986	175	78	15	34	302
1987	87	49	10	81	195
1980-1987	1 570	554	71	287	2 482

Source: MIDA.

Table A2 - Breakdown of Fdi-Projects According to Domestic-Market and Export Orientation 1980-1987 (number)

	Export oriented ^a	Domestic-market oriented	Total
1980	147	151	298
1981	146	209	355
1982	86	144	230
1983	109	174	283
1984	152	279	431
1985	123	232	355
1986	126	176	302
1987 ^b	117	78	195
1980-1987	1 006	1 443	2 449

^a50 per cent and more of production devoted to exports. -

^bJanuary-October.

Source: MIDA.

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