



UNIVERSITI PUTRA MALAYSIA

**THE ROLE OF PRIVATE CAPITAL FLOWS ON GROSS DOMESTIC
PRODUCT OF LOW, MIDDLE AND HIGH INCOME GROUP COUNTRIES**

CHOONG CHEE KEONG

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DOCTOR OF PHILOSOPHY
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2007



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By

CHOONG CHEE KEONG

**Thesis Submitted to the School of Graduate Studies, Universiti Putra
Malaysia, in Fulfilment of the Requirement for the Degree of Doctor of
Philosophy**

September 2007



DEDICATION

**This thesis is specially dedicated to my parents, my lovely wife, daughter and
son,
for their love, courage
and
endless devotion**



Abstract of thesis presented to the Senate of Universiti Putra Malaysia in fulfilment
of the requirement for the degree of Doctor of Philosophy

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September 2007

Chairman: Associate Professor Zulkornain Yusop, PhD

Faculty: Economics and Management

There were many critics saying that private capital flows created financial volatility in the local financial market leading to volatile economic activity. Developing countries, therefore, face the challenge of designing economic policies and institutions to an increasingly integrated financial environment that secure the most benefits from capital inflows while reducing their vulnerability to sudden reversals. This dissertation addresses the role of different types of private capital, namely foreign direct investment (FDI), total foreign debt and portfolio investment in the global economy with particular reference to their effects on economic development in developing countries. The dissertation also aims to investigate to what extent the effectiveness of these private capital flows depends on the quality of financial system in the host countries. In addition, the path (or shock) of these capital flows in developing countries is also examined to provide meaningful



policy implications. For example, if the private capital flows are characterized by a stationary (non-stationary, or contain a unit root), then it implies that shocks to private capital flows are temporary (permanent). To achieve these objectives, both panel unit root tests and generalised method of moments (GMM) panel data analysis are applied, covering 71 developed and developing countries over the period of 1988-2002.

The empirical results indicate that: First, using three types of panel unit root tests, this study concludes that shocks to portfolio investment and foreign direct investment are temporary while total debt series is permanent in developing countries from year 1988 to 2002. Furthermore, the shock of East Asian financial crisis had significant impact in influencing the time path of these private capital flows.

Second, while FDI and portfolio investment has positive and significant impact on economic growth in the countries under study depending on the stage of economic development, foreign debt have negative and significant impact in all countries under study. These findings are consistent and confirmed by using different types of financial development and stock market indicators. It seems that unfettered capital flows do not necessarily promote growth. In fact, some data suggest that foreign debt is deleterious to expansion under certain conditions.

Third, the findings are in line with previous studies in the literature on private capital flows, quality of institutions and economic growth, which suggest that the

consideration of institutional and financial absorptive capacity produces most of the significant results. The dissertation, therefore, suggests that for countries to benefit more from all types private capital flows, they have to achieve certain development level of domestic financial and banking sector, favouring the hypothesis that well-functioning domestic financial institutions in a recipient country is able to benefit more from private capital flows.



Abstrak tesis yang dikemukakan kepada Senat Universiti Putra Malaysia sebagai memenuhi keperluan untuk ijazah Doktor Falsafah

**PERANAN ALIRAN MODAL SWASTA TERHADAP KELUARAN
DALAM NEGARA KASAR DI NEGARA-NEGARA BERPENDAPATAN
RENDAH, SEDERHANA DAN TINGGI**

Oleh

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Ramai pengkritik-pengkritik telah mengatakan bahawa aliran modal swasta telah menimbulkan ketidakstabilan di pasaran kewangan tempatan and seterusnya menyebabkan ekonomi aktiviti yang sentiasa bergolak. Oleh itu, negara-negara sedang membangun menghadapi cabaran dalam merekabentuk institusi dan polisi ekonomi di dalam alam sekitar kewangan yang semakin bersepadu supaya berkeupayaan untuk mendapatkan manfaat daripada aliran modal swasta sementara mengurangkan risikonya. Tesis ini mengutarakan peranan yang dimainkan oleh pelbagai aliran modal swasta, iaitu pelaburan langsung asing, hutang asing dan pelaburan portfolio di arena global terutamanya kesan-kesannya terhadap pembangunan ekonomi di negara-negara sedang membangun. Tesis ini juga meninjau sejauh mana keberkesanan pelbagai aliran modal swasta ini bergantung kepada kualiti sistem kewangan di negara-negara tersebut. Selain

daripada itu, kejutan (shock) bagi pelbagai aliran modal swasta di negara-negara sedang membangun juga ditentukan supaya dapat memberi cadangan polisi yang bermakna. Untuk mencapai objektif-objektif ini, kedua-dua analisis data berpanel iaitu ujian akar unit berpanel (panel unit root test) dan kaedah generalisasi masa (generalised method of moments) telah digunakan yang melibatkan 71 negara-negara membangun and sedang membangun mencangkupi jangka masa 1988-2002.

Keputusan empirikal menunjukkan: Pertama, dengan menggunakan tiga jenis ujian akar unit berpanel, kajian ini menyimpulkan kejutan bagi pelaburan portfolio dan pelaburan langsung asing adalah sementara manakala hutang asing adalah tetap di negara-negara sedang membangun. Tambahan pula, kejutan bagi krisis kewangan Asia Timur mempunyai kesan yang penting dalam mempengaruhi lintasan bagi pelbagai aliran modal swasta.

Kedua, sementara pelaburan langsung asing dan pelaburan portfolio mempunyai kesan positif yang penting terhadap pertumbuhan ekonomi di kesemua negara-negara yang dikaji, hutang luar pula mempunyai kesan negatif terhadap pertumbuhan ekonomi. Keputusan ini telah diyakinkan dengan menggunakan pelbagai petunjuk bagi sector-sektor kewangan dan pasaran. Ini bermakna aliran modal swasta yang tidak terkawal tidak semestinya mendatangkan faedah. Sebaliknya, pelaburan-pelaburan tersebut telah melembapkan proses perkembangan ekonomi di bawah keadaan-keadaan tertentu.

Ketiga, keputusan kajian ini selaras dengan keputusan kajian sebelumnya, iaitu

pertimbangan kapasitas serapan institusi kewangan dalam kajian telah menyumbangkan kepada keputusan yang penting. Oleh itu, kajian tesis ini mencadangkan bahawa negara-negara yang ingin mendapat manfaat maksima daripada pelbagai aliran modal swasta, kemajuan sistem perbankan dan kewangan mereka adalah penting.

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I certify that an Examination Committee has met on 7th September 2007 to conduct the final examination of Choong Chee Keong on his PhD in Financial Economics thesis entitled “The Role of Private Capital Flows on GDP of Low, Middle and High Income Group Countries” in accordance with Universiti Pertanian Malaysia (Higher Degree) Act 1980 and Universiti Pertanian Malaysia (Higher Degree) Regulations 1981. The Committee recommends that the candidate be awarded the relevant degree. Members of the Examination Committee are as follows:

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DECLARATION

I hereby declare that the thesis is based on my original work except for quotations and citations which have been duly acknowledged. I also declare that it has not been previously or concurrently submitted for any other degree at UPM or other institutions.

CHOONG CHEE KEONG

Date: 8 October 2007



TABLE OF CONTENTS

	Page
DEDICATION	ii
ABSTRACT	iii
ABSTRAK	vi
ACKNOWLEDGEMENTS	ix
APPROVAL	xi
DECLARATION	xiii
LIST OF TABLES	xviii
LIST OF FIGURES	xxi

CHAPTER

1	PRIVATE CAPITAL FLOWS TO DEVELOPING COUNTRIES: SOME RECENT ISSUES	
	1.0 Introduction	1.1
	1.1 Problem Statement	1.11
	1.2 Objectives of the Study	1.14
	1.3 Significance of the Study	1.15
	1.4 Organization of the Study	1.17
2	LITERATURE REVIEW	
	2.1 Introduction: Private Capital Flows and Economic Growth	2.1
	2.1.1 Private Capital Flows to Developing Countries: Push versus Pull Factors	2.1
	2.1.2 Types of Private Capital Flows: Benefits and Risks	2.5
	2.1.3 Private Capital Flows: Are Shocks Permanent or Temporary?	2.12
	2.1.4 The Channels of FDI on Economic Growth	2.16
	2.1.4.1 Multinational Corporation (MNC), Technology Diffusion and Productivity	2.17
	2.1.4.2 FDI and Trade Policy	2.22
	2.1.4.3 FDI and Macroeconomic Variables	2.25
	2.1.5 Private Capital Flows, Economic Growth and Financial Development	2.36
	2.2 Introduction: Financial Development and Economic Growth	3.44
	2.2.1 The linkages of Financial Development and	



	Economic Growth	3.44
2.2.2	A Selection of Financial Development Indicators	3.48
2.2.3	Finance-led Growth, Growth-led Finance or Feedback Causality	3.55
2.2.4	Empirical Approaches to the Finance-Growth Hypothesis	3.62
2.2.5	Finance and Sources of Growth	3.69
3	FINANCIAL INTERMEDIARY DEVELOPMENT AND INCOME GROUPS	
3.0	Introduction	3.1
3.1	Financial Development and Economic Performance in Different Income Groups	3.4
4	THEORETICAL FRAMEWORK AND METHODOLOGY	
4.1	The Relationship between Private Capital Flows and Financial Development: A Theoretical Model	4.1
4.2	Foreign Capital, Economic Growth and Financial Development: An Empirical Framework	4.6
4.3	Panel Unit Root Tests: A Review	4.9
4.4	Panel Unit Root Tests: Testing Approaches	4.15
4.4.1	Panel Unit Root Test (Im, Pesaran and Shin, 1997, 2003)	4.17
4.4.2	Fisher-Type Using ADF Tests (Maddala and Wu, 1999; and Choi, 2001)	4.19
4.5	Generalized Method of Moments (GMM) Panel Data Analysis: A Review	4.20
4.5.1	Generalized Method of Moment (GMM): Arellano and Bond (1991)	4.22
4.5.2	Advantages of GMM	4.26
4.6	The Selection of Dependent and Explanatory Variables	4.28
4.6.1	The ratio of gross domestic saving to gross domestic product (GDP)	4.28
4.6.2	Capital and Labour Variables	4.29
4.6.3	Inflation	4.30
4.6.4	Private Capital Flows	4.31
4.6.5	Financial Development Indicators	4.32
4.6.6	Stock Market Indicators	4.33
4.7	Data Sources	4.33



5	PRIVATE CAPITAL FLOWS IN DEVELOPING COUNTRIES: VOLATILITY AND THE LEVEL OF REVERSIBILITY	
	5.0 Introduction	5.1
	5.1 Methodology and Hypothesis	5.3
	5.2 Results and Interpretation	5.7
	5.2 Conclusion and Policy Implications	5.17
6	THE ROLE OF PRIVATE CAPITAL FLOWS ON ECONOMIC GROWTH IN DIFFERENT INCOME GROUPS	
	6.0 Introduction	6.1
	6.1 Testing the Order of Integration	6.2
	6.2 The impact of Different Private Capital Flows on Economic Growth in Developing Countries (1988-2002): The role of Domestic Financial Sector	6.8
	6.3 Foreign Direct Investment (FDI), Financial Development and Economic Growth in Different Income Groups	6.17
	6.4 Foreign Debt, Financial Development and Economic Growth in Different Income Groups	6.21
	6.5 Portfolio Investment, Financial Development and Economic Growth in Different Income Groups	6.23
	6.6 Further Analysis of the Relationship between Private Capital Flows, Financial Development and Income Groups	6.27
	6.7 Conclusions and Discussions	6.40
7	PRIVATE CAPITAL FLOWS, STOCK MARKET AND ECONOMIC GROWTH IN DEVELOPED AND DEVELOPING COUNTRIES	
	7.0 Introduction	7.1
	7.1 Private Capital Flows, Stock Market Indicators and Economic Growth in Developed Countries, 1988-2002	7.3
	7.2 Private Capital Flows, Stock Market Indicators and Economic Growth in Developing Countries, 1988-2002	7.10
	7.3 Discussions and Policy Implications	7.17

8	SUMMARY, CONCLUSIONS AND POLICY IMPLICATIONS	
8.0	Introduction	8.1
8.1	Summary and Conclusions	8.1
8.2	Policy Recommendations	8.11
8.3	Limitations	8.13
8.4	Direction for Future Research	8.14
	REFERENCES	R.1
	APPENDIX	A.1
	BIODATA OF THE AUTHOR	B.1
	LIST OF PUBLICATIONS	P.1



LIST OF TABLES

Table	Page
1.1 Net Private Capital Flows to Developing Countries, 1970-2003 (US\$ Billion)	1.5
1.2 Net FDI Inflows to Developing Countries, 1970-2003 (US\$ Billion)	1.6
1.3 Net Inward Portfolio Equity Flows to Developing Countries, 1970-2003 (US\$ Billion)	1.6
1.4 Total External Debt to Developing Countries by Region, 1970-2003 (US\$ Billion)	1.7
1.5 Medium and Long Term External Debt to Developing Countries by Region: 1970-2003 (US\$ Billion)	1.7
1.6 Short Term External Debt to Developing Countries by Region: 1970-2003 (US\$ Billion)	1.8
1.7 Net Inward Portfolio Bond Flows to Developing Countries by Region, 1970-2001 (US\$ Billion)	1.8
2.1 International Private Capital Flows and Economic Growth	2.29
2.2 International Capital Flows, Financial Development and Economic Growth	2.42
2.3 Summary of the Relationship between Financial Development and Economic Growth through Different Channels	2.74
3.1 Country Groupings	3.6
3.2 Financial Intermediary Development and Economic Growth Across Countries	3.10
4.1 Data Sources and Definitions	4.35
4.2 World Bank's Income Group Classifications 2005	4.38
5.1 The shock of Private Capital Flows in a Panel of 89 Countries, 1988-2002	5.9
5.2 Countries Used	5.12



5.3	The shock of Debt Flow, by Income Groups	5.14
5.4	The shock of Portfolio Investment Flow, by Income Groups	5.15
5.5	The shock of FDI Flow, by Income Groups	5.16
6.1	The Results of Various Panel Unit Root Tests in Developing Countries: Whole Period (1988-2002)	6.5
6.2	The Results of Various Panel Unit Root Tests in Developing Countries: Pre-Crisis Period (1988-1996)	6.6
6.3	The Results of Various Panel Unit Root Tests in Developing Countries: Post-Crisis Period (1997-2002)	6.7
6.4	Private Capital Flows, Financial Development and Economic Growth in Developing Countries, 1988-2002.	6.10
6.5	FDI, Financial Development and the Income Groups, 1988-2002	6.19
6.6	Debt, Financial Development and the Income Groups, 1988-2002	6.22
6.7	Portfolio Investment, Financial Development and the Income Groups, 1988-2002	6.24
6.8	Private Capital Flows, Financial Development (PCGDP) and the Economic Growth in Developing Countries, 1988-2002	6.28
6.9	Private Capital Flows, Financial Development (DBAGDP) and the Economic Growth in Developing Countries, 1988-2002	6.30
6.10	FDI, Financial Development (PCGDP) and the Income Groups, 1988-2002	6.34
6.11	FDI, Financial Development (DBAGDP) and the Income Groups, 1988-2002	6.35
6.12	Debt, Financial Development (PCGDP) and the Income Groups, 1988-2002	6.37
6.13	Debt, Financial Development (DBAGDP) and the Income Groups, 1988-2002	6.38
6.14	Portfolio Investment, Financial Development (PCGDP) and the Income Groups, 1988-2002	6.40



6.15	Portfolio Investment, Financial Development (DBAGDP) and the Income Groups, 1988-2002	6.41
7.1	Countries Used	7.3
7.2	Private Capital Flows, Stock Market Indicator (STKCAP) and Economic Growth in Developed Countries, 1988-2002	7.5
7.3	Private Capital Flows, Stock Market Indicator (STKTRADED) and Economic Growth in Developed Countries, 1988-2002	7.8
7.4	Private Capital Flows, Stock Market Indicator (STKCAP) and Economic Growth in Developing Countries, 1988-2002	7.12
7.5	Private Capital Flows, Stock Market Indicator (STKTRADED) and Economic Growth in Developing Countries, 1988-2002	7.14



LIST OF FIGURES

Figure		Page
1.1	Foreign Aids to Developing Countries by Region, 1969-2001	1.3
1.2	Net Private Capital Flows to Developing Countries by Region, 1970-2003	1.3
1.3	Net Inward Portfolio Equity Flows to Developing Countries by Region, 1985-2003 (US\$ Billion)	1.9
3.1	Central Bank Assets to GDP Ratio (CBAGDP) Across Income Groups, 1988-2002	3.7
3.2	Deposit Money Bank Assets to GDP Ratio (DBAGDP) Across Income Groups, 1988-2002	3.7
3.3	Private Credit by Deposit Money Banks to GDP Ratio (DBAGDP) Across Income Groups, 1988-2002	3.8
3.4	Economic Growth and Financial Intermediary Development, 1988-2002	3.12



CHAPTER 1

PRIVATE CAPITAL FLOWS TO DEVELOPING COUNTRIES: SOME RECENT ISSUES

1.0 Introduction

The change in the nature of competition and the increasing pressure of financial liberalization and globalization make private capital flow as one of the most critical determinants of competitive advantage in developing countries. Until the early 1990s, most developing countries were not able to attract enough private capital flows from the international private capital markets. These countries instead heavily dependent on official capital flows, which are mostly consists of foreign development aids. In Figure 1.1, it is found that there is an increasing trend of foreign aid in East Asia and Pacific (EAP), Europe and Central Asia (ECA), Latin America and Caribbean (LAC), Middle East and North Africa (MNA), South Asia (SAS) and Sub-Saharan Africa (SSA) until early 1990s. The phenomenon, however, was changed substantially as the inflow started to decrease after early 1990s.

As the Figure 1.2 illustrates, there has been a strong upward trend in capital flows since the 1970s, especially after early 1990s in all the regions. The dollar value of inflows increased substantially between the early 1980s and early 1990s. As the largest region in absorbing the private capital flows, Latin America and Caribbean achieved its peak at close to \$130 billion, followed by East Asia and Pacific,



Europe and Central Asia, Sub-Saharan Africa, Middle East and North America and South Asia. At the same time, the figure shows that capital inflows in these regions are distinctly cyclical: A boom in private capital flows to developing countries in these regions in the 1970s was followed by a sharp reversal in the 1980s. Another much larger boom and reversal occurred in the 1990s, especially after 1997.

In the early 1990s, private capital flows undersized the foreign aids (official development flows) in terms of relative importance. They are now four to six times the size of official flows (Figure 1.1 and Figure 1.2). This recent trend in private capital flows to developing countries is mainly driven by the perception that private capital flows are increasingly an important source of financing of large current account imbalances, significantly dwarfing official development flows in terms of relative importance. Moreover, this situation is also caused by a huge increase in bank loan to developing countries in these regions resulting from the recycling of the balance of payment surpluses of oil-exporting countries (Lensink and White, 1998). In his study, Bruno (1993) shows that almost half of all aggregate external financing of developing countries came from private sources and went to private destinations in the early 1990s. Moreover, World Bank (1997, pp. 9) estimates that private capital flows are five times the size of official development flows.

