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# Macroeconomic Determinants of Capital Flight: An Empirical Study in Malaysia

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**Abstract:** This study aimed to examine empirically the macroeconomic determinants of capital flight in Malaysia, namely the Foreign Direct Investment (FDI), external debt, stock market and political risk. To perform the empirical research, the Augmented Dickey-Fuller (ADF) and Phillips-Peron (PP) unit root tests as well as the Kwiatkowski-Phillips-Schmidt-Shin (KPSS) stationary test were conducted to examine the order of integration of the variables. Bounds test for cointegration and the Autoregressive-Distributed Lag (ARDL) approach were utilized to determine the factors affecting capital flight in Malaysia by employing the measure of World Bank (1985). Empirical results indicated that there is a long-run relationship among the variables under study. The findings denoted that political risk and financial crisis are positively related to capital flight in Malaysia, whereas FDI, external debt and stock market have negative impact on capital flight. In addition, the results also indicated that there is a short-run causal impact running from specific determinants towards capital flight. This study suggests that the government should implement appropriate economic policies to reduce capital flight in Malaysia. This is because the management of capital flight and macroeconomic policies has become increasingly important in an ever more integrated global economy.

**Key words:** Capital flight, Foreign Direct Investment (FDI), political risk, bounds test, Autoregressive Distributed Lag (ARDL)

## INTRODUCTION

Since the late 1990s, private capital flows have become an increasingly important source of investment for many developing countries. This has become an essential step in facilitating economic integration and promoting a wider division of labor within the region. Consequently, strong economic growth, healthy corporate and household sectors and continue global search for yields have led to huge capital inflows into Asia region. As such, it has brought about an impressive achievement on Foreign capital flow that has eventually exposed East Asia to international economics activities (Urata, 2001). However, private capital flow tends to be volatile in which financial upshots can cause a sudden reversal of capital flows as well as deep declines in inflows. For example, the Asian financial crisis in 1997-1998 has raised arguments on the region's overdependence on foreign capital flow, most often taken as one of the development strategies (Stiglitz, 2001).

It is assumed that Foreign Direct Investment (FDI) is more stable as compared to portfolio investment in which it is less prone to volatility and brings significant development benefits to the country. Therefore, many developing countries came out with incentive packages which can trigger foreign capital inflow. According to Ghose, many economists believe that the surge in cross-border capital flows since, the early 1990s has generated unprecedented chances for developing countries, which in turn will speed up the country's economic growth.

However, such inflows of capital can also lead to rapid expansion that will sooner or later cause inflation. Thus, if a country depends heavily on foreign capital, it may, in the worst case scenario, cause the collapse in currency and stock market in which the economic activities are destroyed by a sudden and there will be huge withdrawal of capital. This happened during the 1997-1998 Asian economic crisis when many countries panicked due to sudden and large outflows of investment that worsen their already fragile macroeconomic conditions. It also sparked a chain reaction where it had caused political instability within the nation that further fuelled capital flights.

Capital flight is the shift of one's investment from one market to another in search of greater prospect or increased returns. This is sometimes stimulated by a nation's unfavourable conditions. For example, the

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