

*Full Length Research Paper*

# Does debts foster economic growth? The experience of Malaysia

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**The study examines the effect of different types of debts on the economic growth in Malaysia during the sample period 1970 - 2006. Using cointegration test, the findings suggest that all components of debts have a negative effect on long-run economic growth. In addition, the Granger causality test reveals the existence of a short-run causality linkage between all debt measures and economic growth in the short-run. The policy conclusion is that an increase in foreign debt level adversely influences economic performance, whereas the decline in the rate of economic growth weakens the ability of the country to service its debt.**

**Key words:** Debts, economic growth, debt overhang, cointegration, causality.

## INTRODUCTION

An important economic issue facing policymakers during the last two decades of the twentieth century has been the effects of national debt on economic growth. There are at least two reasons why a rising burden of debt may cause concern. Firstly, if there is no debt neutrality or Ricardian equivalence<sup>1</sup>, the substitution of (government) debts and future taxation of labour income for current taxation of labour income will result in redistributions of lifetime resources among heterogeneous consumers that increase aggregate consumption. This may lead either to the displacement of private investment or to a raise in the

deficit on the current account of the balance of payment. This situation is defined as financial crowding out (Diamond, 1965; Barro, 1989; Elmendorf and Mankiw, 1998).

Another reason concerns with deficits stems from the arguments that government deficits eventually are monetised and therefore lead to inflation. According to Elmendorf and Mankiw (1998), a country with a large debt is likely to face high interest rates and the monetary authority may be pressured to try to reduce those rates through expansionary policy. This strategy is believed to be able to reduce interest rates in the short run, but in the long run will leave real interest rates roughly unchanged and inflation and nominal interest rates higher<sup>2</sup>.

There have been explorations of the role of various specific debts in the development process. Yet an empirical literature reveals few recent analytical insights about alternative debt financing, which includes external debt, long-term debt, multilateral debt, private non-

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<sup>1</sup> The Ricardian argument is based on the insight that lower taxes and a budget deficit require higher taxes in the future. Thus, the issuing of government debt to finance a tax cut represents not a reduction in the tax burden but a postponement of it. However, government debt might irrelevant to this Ricardian equivalence as it represents a redistribution of resources across different generations of taxpayers. When the government cuts taxes and issues government debt today, the government budget constraint requires a tax increase in the future, but the tax increase might fall on taxpayers who are not yet living.

<sup>2</sup> However, Lin (2000) argued that an increase in government debt may not increase the real interest rate with the real interest rate being greater than the growth. In addition, an introduction of government debt will increase the growth rate per capita output if the growth rate is greater than the real interest rate. Conversely, it will decrease the growth rate if the growth rate is less than the real interest rate.

guaranteed debt, public and publicly guaranteed debt (PPG), public and publicly guaranteed debt service, short-term debt and total debt service nonrecourse lending to private borrowers. To our best knowledge, the existing studies offer little solid guidance for distinguishing between these types of financing modes with respect to host country's economic performance, for identifying the optimal financing modes for international firms investing in developing countries, which are the countries where the potential impact of debts is greatest. It is important for a study to look at the role of different components of debts on the economic growth as each debt contributes to different effects on the economic growth. The debates over the effects of different debts to economic growth are fascinating as many studies provide different outcomes. It is not obvious whether a country is developing incentives and establishing safeguards that are most effective in attracting alternative forms of debts. Moreover, examining different types of debts is crucial to capture the risk or uncertainty lenders face about the borrowers' preferences. The present paper therefore, aims to examine the impact of different types of debts on the economic growth in Malaysia during the sample period 1970 - 2006.

Over the years, Malaysia has been the successful country implementing and undertaking prudent debt management strategies such as minimising risk exposure against global shocks, managing exchange rate fluctuations and against shifts in investor sentiments. These prudential strategies are aimed to encourage the diversification of external debts by the public and private sectors. In view of this, Malaysia's total foreign debt decreased to RM179.4 billion (USD50.3 billion) in 2006 (RM197.7 billion or USD51.8 billion in 2005), equivalent to 34.1% of GNP. The capacity of Malaysia to service the foreign debt has also improved and enhanced. As at end 2006, the total external debt accounted for only 26.9% of the exports of goods and services (end 2005: 32.4%). In addition to this, the country's vulnerability to a reversal in short-term foreign debt has also decreased as short-term debt now accounts for only 7.8% of gross national product (end 2005: 10%), 14.2% of reserves (end 2005: 17.7%) and 6.2% of the exports of goods and services (end 2005: 7.7%). The short-term debt accounted for 23% of total external debt (Central Bank of Malaysia, 2006: 51). The effective external debt management strategies are crucial in safeguarding financial and monetary stability. A comprehensive debt monitoring system enables early indication of possible risks resulting from the country's overall foreign debt exposure of both the public and private sectors.

In order to achieve our objectives, a broad categories of debts – long-term debt, short-term debt, external debt, multilateral debt, private non-guaranteed debt, public and publicly guaranteed debt, public and publicly guaranteed debt service and total debt service, are distinguished and included in this study. Specifically, the study is aimed to investigate the long-run relationships and short-run

causal effects between different types of debts and economic growth in Malaysia.

## **SPECIFIC TYPES OF DEBTS: BENEFITS VERSUS RISKS**

Economic theory suggests that foreign debts exert positive effect to the economic growth. First, according to Lin and Sosin (2001), the benefits that a country may have from borrowing from foreign funds (external debts) include purchasing advanced equipment and technology and investing in the essential projects private firms are unwilling to support such as infrastructures. With better technology and improved infrastructure, the debtor country can raise the efficiency of the production process and perhaps reach self-sustainable economic growth.

Second, foreign debts may permit an increase in a country's current capital stock and stimulate current economic growth, while debt repayment may decrease the future capital stock and reduce future economic growth (Lin and Sosin, 2001). Furthermore, the growth of external debts in the 1990s seems to have accompanied with higher incomes, stronger GDP growth, and greater openness to trade in borrowing countries (Dadush et al., 2000). Third, in the face of adverse economic shocks, countries may borrow to smooth consumption. This is possible as global financial integration have enlarged their access to international capital markets.

Nevertheless, engaging in foreign debts involved risks. The risks to specific types of foreign debts operate via, at least, three major channels. The first risk is foreign borrowing may trigger conditions that encourage residents to engage in capital flight. External borrowing can directly lead capital flight by providing the resources necessary to effect flight (Cuddington, 1987; Henry, 1996; Chipalkatti and Rishi, 2001). For example, Cuddington (1987) shows that more capital flight occurred contemporaneously with increased debt inflows in Mexico and Uruguay, hence attesting to a strong liquidity effect in these countries. Lessard (1987, p. 99) reveals that debt disbursements "signal a raise in the likelihood of a fiscal crisis" and thus lead to capital flight. Moreover, the provision of external debt to a country gives upward pressure on its exchange rate, thereby encouraging residents to dollarize their assets before an expected devaluation. Chipalkatti and Rishi (2001) show that there is a direct relationship between debt and capital flight, where the flows directly fuel one another by providing capital for each other. They find that a percent increase in real capital flight is significantly associated with a 0.06% increase in net real debt disbursements<sup>3</sup>.

<sup>3</sup> A number of studies reveal that the causality runs from capital flight to foreign borrowing. Capital outflows may lead a country into external indebtedness where foreign debt replaces the funds lost on account of capital flight. Boyce and Zarsky (1988) notes that foreign creditors may be willing to fill the vacuum incurred by capital flight if they perceive a comparative