HOW IMPORTANT IS MALAYSIA FOREIGN DIRECT INVESTMENT? EVIDENCE FROM 1992 THROUGH 2019

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ABSTRACT:

This study aims at examining Malaysia's investment policy in attracting foreign direct investment (FDI) for the past 28 yearswith a specific focus on investigating strength of relationship betweennet FDI and three key economic indicators – real Gross Domestic Product (GDP), exchange rates and long-term interest rates. Within the framework of Keynesian Income Theory and Theory of Optimal Capital Accumulation by Jorgenson, this paper deploysboth Ordinary Least Squares (OLS) regression and Engle-Granger Cointegration testas estimation tools to model the yearly secondary data from 1992 through 2019. The empirical results from the study show that Malaysia net FDIdo have some influence onreal GDP, exchange rates and long-term interest rates. From Pearson correlation coefficient, we observe a strong positive correlation between net FDI and real GDP. It is now evident that net positive FDI plays an important role not only in sustaining growth in GDP but also in strengthening the value of RM against USD. Malaysia needs a good investment policy which could attract quality FDI into the country allowing its economy to reach full employment and to optimize scarce resources in the best possible manner.

INTRODUCTION

Foreign direct investment (FDI) has been one of the key enablers that helps stimulate Malaysia economic growth since early 1960s. By definition, FDI involves foreign entities investing in local economies and they bring with them foreign capital. FDI is a specific type of inward investment over a long haul ranging from mergers and acquisitions to establishing new operations for existing businesses. In view of long-term benefits of FDI, Malaysia government has embarked an economic transformation program since mid-1960s with a specialfocus on streamlining economic resources from low value-added activities to higher productivity-based economic sectors. As such, there has been a structural change in Malaysian economic landscape since then from agrarian-based economy to manufacturing and services sectors. Since late 1980s, Malaysia has been enjoying robust economic growth of more than 9% per annum for nine consecutive years. The all-time record high was of 10% in 1996.

Today, Malaysia is a major supplier of natural gas and a key producer of palm oil and rubber-related products. Being an industrialized developing country that promotes quality FDI and efficient work force, Malaysia has been able to enjoy transfer of technologies from its foreign investors in many strategic sectors such as crude oil exploration, petrochemical engineering, natural gas and other high value-added economic sectors. In the light of intense global competition, Malaysia has taken a pragmatic approach by putting an emphasis on export-oriented manufacturing to sustain its economic growth. By the virtue of its inexpensive but highly-skilled workforce, well-developed infrastructure and stable domestic currency, Malaysia has now become an attractive investment destinationluring hefty foreign direct investment particularly from China, Japan and Taiwan(Leinbach, 2020).

Looking at the current business environment in Asia, there are a lot of opportunities for foreign investors to explore. For instance, Malaysia is one of the Asian countries that is very focused on

accelerating its digital economy growth. By this virtue, foreign investors can tap into Malaysia's digital economy as its e-commerce segment alone is developing so rapidly for the past five years. A part of digital economy, foreign investors are also considering countries which are committed towards embracing Industry-Revolution 4.0 and green technology. In this respect, Malaysia has started offering attractive tax policies and investment incentives to both local and foreign firms so as to ensure their competitive agility in the global marketplace. In short, FDI is expected to grow well into the future and Malaysia will evidently become one of the most preferred investment hubs in Asia.

This study is driven by the motivation to examinethe impact of Malaysia inward FDI on strengthening the macroeconomic fundamentals, namely real GDP, exchange rates and long-term interest rates.As mentioned earlier, FDI is an economic wealth but its value is subject to some degree of uncertainty. Suffice to say that all trading countries around the world are competing for this economic wealth. Real GDP or national income is a yard stick that measures the level of economic prosperity of any country. A sustainable growth in national income is a reflection of sound economic policies and well-functioning market activities. Both exchange rates and long-term interest rates exert significant influence on the level of a country's competitiveness and it is therefore important to see how inward FDI helps in stabilizing these two important economic indicators. All in all, the real challenge for any government is to promote price stability and to support continued economic growth which in turn will help improve living standard of the people and maximize public welfare. More importantly, government and business community must recognize the significance of FDI in harnessinga country'slong-term competitive advantage.

LITERATURE REVIEW

Harping on the traditional view on foreign aid, Rosenstein-Rodan(1961) postulate that the purpose of an international aid program to underdeveloped countries is to accelerate their economic development and to sustain their economic growth. According to Chenery and Strout (1966), the inflow of foreign aid will increase domestic savings leading towards self-sustained national growth. All capital inflows constitute net additions to a country's total output. This model work on the basis that net amount of foreign aid will be required to achieve a target growth rate. In addition to that, the model also suggests that foreign grants, public loans or private capital are needed to meet any deficiency in domestic productive capacity and resources, domestic savings and shortage of foreign reserve. Therefore, the need for foreign capital inflows is of paramount importance in order to pay for the developing country's import commitment as well as contributing to its economic growth.

MacDougall (1960) analyses the effect of direct foreign investment by utilizing a simple aggregate neoclassical production function approach, where output in the recipient country is a function of labour and capital. Foreign investment will bring a marginal increase in the domestic reserve of capital. The changes in the wage rate and return on capital contribute to changes in income of domestic labour and capital, but the net effect is zero, since the gain to labour is at the expense of capital.

A modified view by Hymer(1960) asserts that foreign direct investment (FDI) is a not a pure transfer of capital, but rather the transfer is a "package" that includes capital, management and new technology. The main addition here is the transfer of management and technology, which is not initially available in the developing countries. This view of transfer of technology is supported by Findlay (1978) and Wang (1990).

Findlay (1978) suggests that there is a relationship between transfer of technology and amount of foreign capital flowing into a developing country. Increase in technological advances in home

country will lead to a corresponding increase in technological changes in the recipient country. The net long-term effect of the technology transfer will see the income gap between the less developed countries and the developed countries beginning to narrow or even converges at some point in the future. There is even a possibility that the developing countries can catch-up completely. Wang (1990) improvises Findlay's hypothesis to examine further the relationship between economic growth and technological changes together with international capital movements. His study focuses on technological transfer through international capital movements. Under a free capital movement regime, the rate of growth of developing countries will increase because their long-run level of income and consumption are higher under free capital movements. As foreign investment expands, it will accelerate the pace of development for firms in recipient country or host country in term of human capital utilization and efficiency in technological adoption. Brecher and Diaz (1977) explain that most of the foreign investors would bring in capital-intensive technologies into the developing countries, which indirectly influence the development of the workforce. Correspondingly, there are a number ofdeveloping countries that still impose some restrictions on foreign capital so as to prevent capital flight. Miyagawa (1993) argues that transfer of inappropriate technology may be harmful only in the short run or under restrictive policies. The host country may encourage inward FDI by encouraging implementation of liberal policies that promotes healthy competition among the foreign firms.

In the context of entrepreneurship, Scaperlanda(1994) argues that growth in FDI will improvethe economic welfare of the host country in the short-run through lower prices offered by foreign entrepreneurs, particularly from their multinational companies. In the long run, however, some undesirable results might surface. First, the host countries will be entrenched with

welfare mentality because of the economic benefits directly derived from these foreign companies. Secondly, these multinational companies are likely to monopolize and reap extraordinary monopoly profit at the disadvantage of the recipient country's business environment. Hence, strategic policies that canbenefit both foreign and local investors must be devised.

Chao and Yu (1994) examine the effects of foreign capital inflows on resource allocation and welfare within a general equilibrium model. The recipient country is characterized by imperfect competition and low economies of scale. As such, the market by nature is oligopolistic. This will only exacerbate further market imperfections and contribute more serious problem for developing countries. Although the welfare effect of foreign capital in the short run is indeterminate, the inflows of foreign capital always improve welfare in the long- run.

Ruffin (1995) looks at foreign direct investment from a different perspective. He supports the concepts of utility of new knowledge and entrepreneurial skills. New knowledge is one of the most important benefits of the international exchange of goods and services. Research and development (R&D) are conducted to make profits from introduction of a new product into the local market. As experience gained from the production of each new products, it only adds to the pool of human knowledge. Consequently, this will drive down costs of invention and innovation. Based upon endogenous growth model, Romer (1990) points out that technological know-how grows exponentially against accumulated level of human knowledge. Countries with relatively large educated population coupled with conducive economic environment would promote not only fair competition but also encourage accumulation of human knowledge. The key assumption of this endogenous growth model centres around the technological spill-over effects. It works on the idea that the cost of invention decreases as human knowledge accumulates. The larger the number of people being able to carry out R&D, the higher

the rate of economic growth. Innovative ideas are the foundation to this theory and international trade via FDI complements the entire process. Ruffin(1995)firmly believes that foreign direct investment can lower fixed costs of developing new products, and therefore increasing the rate of growth of the country.

Rivera-Batiz and Revira-Batiz(1990) examine the external effects generated by foreign capital inflows in the context of a small open economy. Foreign capital that moves into the industrial sector of the recipient countries has the ability to increase the extent of the local markets and also inducing greater specialization among service firms within the supply chain. This will enhance their overall productivity. The service sector in this study consists of firms that produce intermediate inputs for the industrial sector needs, such as advertising, transportationand financial services. It also provides the linkage between the foreign-owned firms and the host economy.

A study by Bhagwati (1978) links trade strategy, FDI, and economic growth of a country. He hypothesizes that the volume and efficacy of an incoming FDI vary according to a host country's trade policies. It can be either be export promotion (EP) or the import substitution (IS) strategy. An EP strategy is said to be trade neutral or bias free. In contrast, IS policy is where the effective exchange rate on imports exceeds the effective exchange rate on exports and biased in favour of import substitution activities. Given other factors, an EP strategy is more likely to attract a higher volume of FDI and promote more efficiency in the utilization of resources than IS strategy.

There are basically two different significant effects of FDI on the domestic economy as suggested by Stoneman (1975). The first is the direct effect on the economic activities and on the balance of payments. Consequently, quality FDI will lead to changes in the national income, the level of investment, consumption and the value of net exports. Meanwhile, the indirect effect is on the structure of the economy. Structural changes in the economy with respect to market structure,

workforce and public welfare can happen with the presence of this FDI over long haul.

DATA & METHODOLOGY

An econometric modelling is used to analyse yearly macroeconomic data from 1992 through 2019. All data on net foreign direct investment (Net FDI), long-term interest rates, real gross domestic product (Real GDP) and exchange rates (RM/USD) are obtained from Bank Negara Malaysia (BNM) Statistical Bulletin.This 28-year period is chosen because the secondary data on long-term interest rate series is only available in 1992. The net FDI is sum difference between FDI inflows and outflows, while the long-term interest rate is proxied by 20-year Treasury Bond rate. Real GDP is preferred because it is an adjusted-inflation measure that reflects the true value of the economy. Lastly, RM-USD exchange rate is considered as this American greenback is the most widely accepted currency in international trade.Ordinary Least Square (OLS) Regression and Engle-Granger 2 steps cointegration procedure (EG Cointegration test)are deployed to investigate the relationship between net FDI and these three macroeconomic variables. The OLS regression acts as the baseline estimation method, whilst cointegration test is the main tool in this contemporary time series analysis. It is important to note that time series data normally have trends – either in stochastic manner or in deterministic fashion. As such, the deployment EG cointegration test is deemed appropriate in modelling non-stationary time series data.

3.1 Dependent and Independent Variables

Foreign direct investment (FDI) is an economic catalyst that has been supporting Malaysia's economic growth since 1960s.For this reason, it is critical to look at how inward FDI in the past has helped stabilize and promote stronger Malaysia's economic fundamentals –growth in gross domestic product, stable exchange rate and low long-term interest rate. As part of the modelling process, the dependent and independent variables must be specified. Net FDI is designated as the

controlled variable (or independent variable) that influences Malaysia's real GDP, exchange rate and long-term interest rates.

3.2   Estimation Methods

Based upon the Keynesian Income theory (Keynes, 1936), we deploy OLS linear regression function as well as Engle-Granger Cointegration test. The use of Engle-Granger methodology is warranted as some of these variables might have a stochastic trend in time series. This study is an attempt to measure the strength of relationship between net FDI and the three individual key economic indicators. Here, we hypothesize that real GDP is a function of net FDI and the same goes to exchange rates and long-term interest rate respectively. Due to Asian Debt Crisis 1997-1998, Malaysia government has implemented capital control policy on RM-USD exchange rates from 1998 till 2004. As such, this 7-year capital control period is removed from our FDI-exchange rate dataset. Specifically, thereare three estimated models in this study and they aremathematically expressed as follows:

Real GDP$_t$= α + Net FDI$_t$+ ε$_t$(t=1,2,…N=T) …………..(1)

Exchange Rate$_t$= α + Net FDI$_t$+ ε$_t$ (t=1,2,…N=T) …………..(2)

Long-Term Interest Rate$_t$= α + Net FDI$_t$+ ε$_t$ (t=1,2,…N=T) …………..(3)

Where:
α =Intercept of the regression model
Net FDI$_t$ = Net FDI at time t
Real GDP$_t$= Real GDP at time t
Exchange Rate$_t$ = Exchange Rate at time t
Long-Term Interest Rate$_t$= Long-Term Interest Rate at time t
ε$_t$= Error term(assumed to be normally distributed)

EMPIRICAL RESULTS

This study employs econometric time series analysis involving 28-year observation from 1992 till 2019. This section provides detailed explanations on the empirical findings from both OLS regression analysis and EG Cointegration test. The diagnostics tests are also presented and elaborated in this section.

4.1   Descriptive Statistics and Pearson Correlation Analysis

Figure 1 below shows the movements of both net FDI and real GDP over a 28-year period from 1992 through 2019. It is clear that both variables are not moving in tandem and have been detrimentally affected by the global financial crisis of 2007-2008. The economic activities started picking up in 2010 and a sign of strong economic recovery was observed from 2012 till 2016. Looking at these two line charts, we can see how volatile and vulnerable the net FDI has been for the past 28 years. Any dramatic changes in international business environment would most definitely affect the degree of competitiveness among the trading nations like Malaysia in particular.
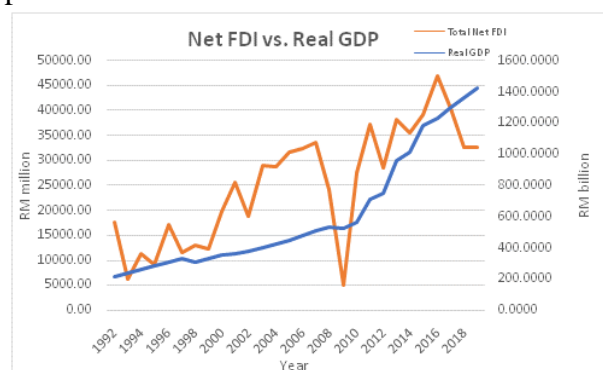

Figure 1. Movements of Net FDI and Real GDP over a 28-year period

Figure 2 provides a comparative analysis involving movements of net FDI versus RM-USD exchange rates from 1992 till 2019. Similar to net FDI, the exchange rates seem volatile after the removal of capital control measure in 2005. For the first 8 years after the removal, RM appeared stronger against the USD but this Malaysian currency began to show a sign of weakening in 2013 and this unfavourable trend continues until 2019.
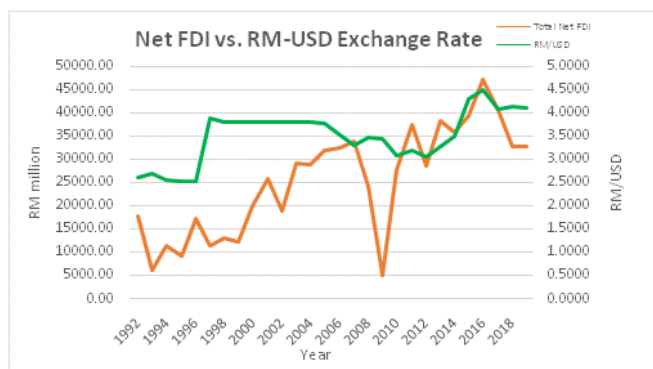
Figure 2. Percentage Change in Government Revenue vs. Government Debt

From Table 1 below, we find that the mean net FDI stands at RM25.2 billion vis-à-vis the mean of real GDP at RM612 billion. Real GDP continues to grow steadily and the highest mark was RM1,420 billion in 2019. Looking at the RM exchange rate, the mean settles at very much strong rate of RM3.4045 as compared to 2019's year-end rate. As mentioned earlier, the weakening of RM could be attributed to sharp decline in net FDI from 2017 onwards. The strongest exchange rate ever recorded was at RM2.5279 in 1996. Lastly, the long-term interest rates depict somewhat an interesting characteristic. The mean long-term interest rate over the entire observed period is 5.6161% and this rate is relatively low in relation to other benchmark rates among ASEAN countries. During the booming economy from 1992 till 1996, the long-term interest rates fell within the range of 7.25% to 8.50%. It is worthy to note that there was a drastic change in Malaysia fiscal and monetary policies subsequent to the Asian Debt Crisis of 1997-1998. As soon as the government introduced capital controls measure in September 1998, the Malaysian stock market (previously known as Kuala Lumpur Stock Exchange) was the first to take the hardest hit. Later on, the central bank of Malaysia loosened up its interest rate regime and reduced statutory reserve requirement on all financial institutions. The objective was to flush the economy with liquidity and to stabilize the financial system.

Variable	Mean	Std. Deviation	Max	Min
Net FDI (RM mill)	25,262	11,495	47,025	5,040
Real GDP (RM billion)	612.28	380.49	1420.49	214.32
Exchange Rates (RM/USD)	3.4045	0.6110	4.486	2.5279
Long-Term Interest Rates (%)	5.6161	1.4832	8.500	3.7330

Table 1. Descriptive Statistics of Net FDI, Real GDP, Exchange Rate and Long-Term Interest Rate

Looking at thePearson correlation coefficients in Table 2 below, we find that there is a significant positive correlation between net FDI and real GDP. Also, there is a positive significant association between net FDI and exchange rate. On contrary, the long-term interest rate is negatively correlated with net FDI but their degree of association is statistically significant.

Table 2. Pearson Correlation Coefficients (N=28) Ho: Rho = 0.00 (p-value)

Variable	Net FDI
Net FDI	1.00
Real GDP	0.7436 (<0.0001)
Exchange Rate	0.6489 (<0.0015)
Long-Term Interest Rate	-0.7254 (<0.0001)

4.2 OLS Regression Analysis

The OLS regression is a preliminary test which examines the validity of the three estimated modelsand their goodness of fit. Table 3 presents

the empirical results from the first model and the significant t value implies that the model is statistically credible. Furthermore, the coefficient of determination or the adjusted R-squared is above 50% level suggestinga fairly acceptable goodness-of-fitfor this first model.By looking at the p-value, the anticipated positive relationship between FDI and real GDP has been proven valid as there is a presence of statistical significance between them.

Variable	DF	Parameter Estimate	Standard Error	t value	Pr > t
Intercept	1	-9.773	120.11	-0.08	0.9358
Net FDI	1	24.623	4.341	5.67*	<0.0001
R-Squared	0.553	Adj R-Square	0.535		

Table 3. Model 1 Parameter Estimates Dependent Variable: Real GDP

*significant at 5% level

From this 28-year period of observation, we do see the significant influence of FDI on the exchange rate. Positive net FDI signifies increase in demand for RM which makes RM becoming stronger. From the p-value of 0.0015, this model 2 has statistically proven that net FDI exerts

significant impact on RM-USD exchange rate over long-haul. However, the adjusted R-squared is rather low at 39% and it is most definite that the statistical properties in Model 2 need to be examined further. Due to this limitation, the use of Engle-Granger Cointegration test is warranted.

Variable	DF	Parameter Estimate	Standard Error	t value	Pr > t
Intercept	1	2.5571	0.2505	10.21	<0.0001
Net FDI	1	0.00003	0.000008	3.72*	0.0015
R-Squared	0.421	Adj R-Square	0.390		

Table 4. Model 2 Parameter Estimates Dependent Variable: Exchange Rate

*significant at 5% level

There is no doubt that stable growth in net FDI will increase demand for RM, which ultimately increase the supply of money in the money market. The net result is a decline in the level of market interest rate. Using 20-year Treasury Bond as the benchmark for long-term interest rate,

model 3 reveals that a significant negative relationship between net FDI and long-term borrowing rate. Suffice it to say that Model 3 is fairly credible and acceptable as its adjusted R-squared is approximately 51% specifying that about 51% of total variations in long-term interest rate is being explained by the net FDI.

Variable	DF	Parameter Estimate	Standard Error	t value	Pr > t
Intercept	1	7.9794	0.4817	16.57	<0.0001
Net FDI	1	-0.00009	0.00001	-5.37*	<0.0001
R-Squared	0.526	Adj R-Square	0.508		

Table 5. Model 3 Parameter Estimates Dependent Variable: Long-Term Interest Rate

*significant at 5% level

From the results of White test in Table 6, all three estimated modelsdo not have any heteroscedasticity issues. One of the main assumptions for the OLS regression is the constant variance of the residuals and this requirement

must be fully met. If the model is well-fitted, then there would be no pattern to the residual plotted against the predicted or fitted values. Looking at the column of p-value in Table 6, all of them are larger than α of 5% and therefore we cannot reject the null hypothesis that the variance of the residuals is homogeneous.

Table 6. Test of First and Second Moment Specification (White test)

Estimated Model	DF	Chi-Square	Prob>ChiSq
Model 1	2	2.27	0.321
Model 2	2	1.29	0.523
Model 3	2	2.61	0.271

While the White test turns out favourable to all the three models, the autocorrelation test proves otherwise. The coefficients of first-order autocorrelation are positive for all the three

models suggesting the presence of positive autocorrelation. As a result, our model's estimators are still consistent but they are not statistically efficient.

Table7. Autocorrelation Test

Estimated Model	No. Observation	Durbin-Watson D	1st Order Autocorrelation
Model 1	28	0.626	0.563
Model 2	21	1.362	0.260
Model 3	28	0.770	0.518

4.3　Engle-Granger Cointegration Test

The results from OLS regression highlight some fundamental flaws in Model 2. Hence, Engle-Granger two stepsprocedure is deployed to look into this issue. All the basic requirements for this cointegration test must be fulfilled before we move further. First, all data series from Model 2 must undergo Augmented Dickey-Fuller test (or unit root test) and they are found to be integrated at first difference or I(1). The same test is applied to the residuals ofthe long-run regression at level and the test results show they have no unit root. Next, a cointegrating regression analysis is employed to estimate the RM-USD exchange rate. The detailed results are presented in Table 8.

Variable	DF	Parameter Estimate	Standard Error	t value	Pr > t
Intercept	1	0.0491	0.0875	0.56	0.5825
ldFDI	1	-0.000004	0.000008	-0.46	0.6523
lr	1	-0.6279	0.2440	-2.57	0.0212*
ldER	1	0.3472	0.2542	1.37	0.1922
R-Squared	0.317	Adj R-Square	0.181		

Table 8. Parameter Estimates Dependent Variable: Exchange Rate (ER)

*significant at 5%

There are some interesting findings unleased in this cointegration test. Firstly, the study reveals a significant long-run relationship between net FDI and exchange rate but there is an absence of short-run dynamic between them. The lag-one residual (denoted by lr) represents the long-run causality of this model and its low p-value supports the equilibrium relationship between net FDI and exchange rate. The coefficient of lag-one residual also signifies the model's speed of adjustment towards equilibrium and its value of 62.79% is considered moderately fast and credible. This model 2 is also a unidirectional modeland there is a negative relationship between net FDI and

exchange rate. Any increase in net FDI over a given time period will subsequently strengthen RM-USD exchange rate.

Table 9. Test of First and Second Moment Specification (White test)

DF	Chi-Square	Prob >ChiSq
9	5.26	0.8109

From diagnostic perspective, there is no issue of heteroscedasticity and autocorrelation at all. The high p-value from White test in Table 9 above strongly supports our null hypothesis of homoscedasticity. Likewise, the diagnostic results from Durbin-Watson tests in Table 10 also points towards the acceptance of our null hypothesis on absence of serial correlation between the residuals.

Table 10. Autocorrelation Test

Durbin-Watson D	2.112
Pr< DW	0.5414
Pr>DW	0.4586
No. Observations	19
1st Order Autocorrelation	-0.087

CONCLUSION

The primary focus of this study is on investigating the impact of net FDI upon real GDP, exchange rate and long-term interest rate over the 28-year period.There are three important findings that can

be construed from this study. First, the study reveals a strong positive correlation and significant relationship between net FDI and real GDP. In explaining this empirical evidence, one must understand that an increase in net FDI indicates an increase in private investment, which at the later process translated into growth in national income. Our findings are consistent with the work of earlier researchers (Stoneman, 1975; Sandalcilar&Altiner, 2012). Secondly, the error-correction model has shown us that there is an equilibrium relationship between net FDI and exchange rate, plus these two variables move in opposite direction in the short-run. However, this short-run dynamic is not statistically significant. Lastly, we discover that there is a negative significant relationship between net FDI and long-term interest rate. One possible explanation on this is the fact that net positive FDI will increase demand for RM which automatically increase money supply in the money market. If this positive trend of net FDI continues overtime (assuming money supply is not perfectly inelastic), it would put downward pressure on the prevailing market interest rate. Ultimately, business communitywould benefit from the lower borrowing rates making them becoming more competitive in the global market.

As a whole, this study has shed some lightin that a good investment policy is needed in attracting quality FDIand ultimately rejuvenating economic growth. For an industrializeddeveloping country like Malaysia, a sustainable economic growth which is driven by a steady increase in positive net FDI would reflect investor confidence and best practices. It is government's primary duty in overseeing and luring quality investment into our productive economic sectors, particularly in manufacturing and services industries. As such, government must hold a very clear objective of optimizing economic resourcesand promoting operational efficiencies at all levels.

In view of intense competitionsamong Asian countries in attracting quality FDI, a new dynamic methodological approach is deemed desirable in

terms of enlarging the sample size and employing a more robust technique in model estimation. Expanding the country-specifics and combining this variable of interest with other relevant macroeconomic variables will not only improve the existing model but also help contribute towards better understanding anddevelopment of new knowledge in international business.It is hoped that future studies will into this suggestion so that a new perspective or a new approach can be established and deliberated to policy makers and international investors.

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