

# Historical background of malaysia



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Foreign direct investment (FDI) is an activity in which an investor resident in one country has a lasting interest in, and a large influence on the management of an entity resident in another country (OECD, 2003). It involves either 'greenfield investment' or merger and acquisitions (M&As). The former represents generating a wholly new enterprise and it exerts more positive effects, while the latter represents amending the ownership of existing enterprises and it has a lower positive effect or even a negative externalities. FDI can also be defined as other kinds of financial transactions among enterprises, such as reinvestment of the earnings of the FDI enterprise or other transfer of capital.

There are various forms of FDI, in which one of them is the ownership of the full penalty of the shares of the national firm or possession of the project before the acquisition of the foreign investor. Joint venture is another form of FDI, in which a company is being set up in the host country with the collaboration of local partners. Due to the partnership and the experience of the local market, this form is generally preferred. Another reason that makes it less risky is that foreign partner is not given the right to fully intervene over the operation of the project. In addition, FDI could be in the form of setting up new subsidiaries or branches of foreign parent companies, as well as marketing goods in the host country (Madura, 2006).

FDI consists of the establishment of mobile and huge equipments like aircraft and oil; construction activity, exploration or extraction of natural minerals; acquisition of real property by foreign investors; retained profits, which accelerate capital accumulation; investment property rights, which are the funded projects and the setting up of companies and factories in which

investor is a direct partner with shares atleast 10% of the total property rights (Abdel Ghaffar, 2002).

There are determinants of FDI in the recipient country, despite its benefits. First of all, the economic determinants are separated into three components: (i) the economic determinant related to investments that seek to market along with abundance and growth of per capita income and size of the market as well as the free areas. (ii) the economic determinants related to those investment that are making production efficient, and (iii) involving those investments that seek the resources and assets, having plenty of primary natural resources, infrastructure, and most of the investment involve horizontal integration in seeking investment in the market. In addition, there is also a factor called policy framework that determines FDI in the host countries. It consists of institutional framework and economic policies that have an impact on investment in the host country's political stability, law and legislation, exchange rate and others. Another determinant is related to business facilitation, i. e. the particular facilities to assist management of investors, the promotion of investment, building reputation, investment incentives, administrative and bureaucratic practices, as well as the provision of social services (Chung et al, 1999).

According to Choong and Lim (2009), the choice of models for economic development determines the channels through which FDI influence economic growth. For example, a great impact of FDI on economic growth which can be observed via the production function is theorized by the endogenous growth models. In particular, foreign capital inflows (FCIs) have a significant impact on domestic capital formation or accumulation, in which it either has

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a crowding-out or a crowding-in effect on local investment. If foreign capital complements domestic capital, FDI will have greater influence on output growth. On the other hand, if FDI expand the variety of intermediate and capital goods, then the productivity level of the recipient country can be enhanced. Moreover, FDI reduces unemployment by creating job opportunities (Borensztein et al., 1998).

FDI is important in the sense that it provides investible funds and foreign exchange (forex) earnings, in which forex can be used to import raw materials (Wong & Jomo, 2005). Both elements enlarge the resource availability of a country, thus enhance savings and investment, and in turn promote economic growth. Therefore, it will help developing countries to eventually achieve self-sustained growth. This is because higher investment and growth rate with foreign capital supplement, are in turn also increase the domestic saving rate. Most developing countries do not have enough capital goods to meet the desired investment level and required inputs have to be imported by using forex. FDI makes up for any forex shortage by bringing in forex to pay for the necessary imports of capital and intermediate goods. Besides, it brings in new technology, technical assistance and expertise, scarce managerial skill, international marketing connection, marketing know-how etc.

Foreign direct investment played a crucial role in Malaysian economy since last few decades. Through both micro and macro levels, FDI can affect a recipient country (Choong & Lim, 2009). In micro level, via labor training, technological transfer, and positive spillover effects, multinational corporations (MNCs) can bring in technical and management efficiency to

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local firms. While for the latter case, FDI may affect both the 'financial' variables (like balance of payment (BOP), inflation, interest rate, and foreign exchange rate) and 'real' variables such as import, export, employment, economic growth and domestic investment (Levine, 1997).

According to Choong and Lim (2009), it cannot be denied that the significance of FDI is greater in diffusing or transferring technology know-how embodied in human capital such as organizational arrangements, new management practices, skill acquisition, and training. All of these will promote greater economic growth through higher level of efficiency and productivity in labor. On the other hand, by raising the technological level in the recipient country, FDI can bring technological change equally to both labor and capital. In this case, via a learning-by-doing process, economic performance can be influenced by FDI. In particular, expertise in fully occupied factor endowments of the recipient country, new managerial and organizational techniques, international marketing connections, product design and production methods can be diffused by FDI (Dunning, 1995). Imitation is therefore important. FDI is also favorable to the productivity of local research and development (R&D) activities.

In contrast, FDI may have a negative impact on domestic economy. First of all, FDI may have a substitutive effect on domestic savings. Any negative effect of FDI on the domestic saving rate will have negative side effects on the investment rate. In addition, liberal regulations on income repatriation, which is often considered necessary as an investment incentive, may also adversely affect the balance of payment (BOP). Investment income, which consists mostly of interest profits and dividends, may contribute significantly

to a country's services account deficits. If the private capital inflows are not large enough to fully offset net dividend outflows, meaning that the net financial contribution of FDI will be negative. The huge outflows of interest payments also will contribute significantly to the service account deficits, which will in turn have negative implications for macroeconomic stability. The danger of high import content may also deteriorate the domestic economy. Specifically, large influx of FDI into a country may lead to huge imports of investment and intermediate goods, which will in turn contribute significantly to growing import bill, declining merchandise account surplus and large current account deficit. High import content also implies low domestic value-added and limited domestic linkages. In short, FDI may cause import propensities to increase. Furthermore, FDI may also in increased industry concentration, which is equivalent to high degree of market power for a few large firms, resulting in high barriers to entry for other small firms. To the extent that large firm is MNCs, a crowding out of local firms can be assumed to have taken place (Wong & Jomo, 2005).

FDI is also conventionally seen as a critical source of capital accumulation of a country from the perspectives of standard neoclassical growth models (Solow-type) (Choong and Lim (2009). Specifically, there is no disparity between oversea and local capital in stimulating output growth. It is also suggested that FDI significantly affect growth only in the short term, but not in the medium or long term, given the assumption of diminishing return to capital (Barro & Sala-i-Martin, 1992).

In short, there are various forms of FDI and it (FDI) consists of the establishment of mobile and huge equipments. FDI is beneficial to a country's

economic performance as well as welfare. However, there are also disadvantages that bring harm to a nation's economy.

## **1. 2) Historical Background of Malaysia**

According to World Bank (1993), Malaysia was designated as one of the 'East Asian Miracles' due to the rapid growth of its economy during the period of 1960-1990. The steady growth rate (long lasting) attained drew a lot of attention around the world.

In the 1960s, the economy grew annually in an average of 6%, followed by 7.3% per annum in the first half of the 1970s, which indicated an improvement in the growth rate. After that, it performed better by achieving higher growth rate (GDP) at 8.6% per annum until 1980. However, in 1981-1985, the growth rate slowed down to 5.1% annually, followed by a picked up again to 6.7% annually in 1986-1990. From 1996 to 2000, the economy grew at a slower rate of 4.6% per annum, following a relatively faster growth of 8.7% annually in 1991-1995 (Jajri, 2009).

Based on the report, it was shown that FDI generally plays a critical role in the economy of Malaysia (Wong, 2006). FDI has been carrying a heavy weightage in Malaysia's GDP. For example, it carried 23.7% in 1985, 24.1% in 1990, and even 65.3% in 1999. Over time, there was also a rise in the stock of FDI. For instance, it was 7.4 billion U. S dollar(\$) in 1985, raised to \$10.3 billion in 1990, and even increased by \$44 billion from 1990 to 2000. Furthermore, in terms of gross fixed capital formation, FDI has been carrying a high portion, that is, it carried 15.1% in 1997, 13.9% in 1998, and even 20.1% in 1999.

Since manufacturing industry has been attracting the largest amount of FDI in Malaysia compared to other industries, we will specifically concentrate on it. According to Yusop and Ghaffar (1994), in the development of manufacturing industry in Malaysia, FDI plays an important role. By enhancing product quality, the competitiveness of the manufacturing export (Malaysian) has been improving globally. In addition, business experiences and technology know-how has been spilled over to Malaysia when various multinational corporations (MNCs) invest directly in the manufacturing sector in Malaysia.

One of the major strategies of the policy makers is to open foreign investment projects which can enlarge the country's resource availability and potential, diversify investments or activities and promote economic development through contribution of capital, skilled jobs creation, and technological transfer (Jajri, 2009). Attracting FDI was one of the Malaysian government's key approaches to stimulate growth. The country always favored a 'welcome' policy on investment and trade since the 1980s. Obviously, FDI has a crucial role in the formation of capital and thus, the economic development. In the 1980s and 1990s, Malaysia was very participative in deregulating its investment regime in the manufacturing sector compared to other countries under the Association of South East Asian Nations (ASEAN). We can observe a significant progress when Mahathir Mohamad, our former prime minister, launched the new joint venture projects (especially with Korea and Japan) with the state-owned enterprise (SOEs). For instance, Malaysia received large inflows of FDI accompanied by better expertise and technology due to the promotion of the Investment Act



in 1986. In particular, various incentives like the establishment of Free Trade Zones (FTZs), export promotion by having tax deduction, tax allowances for projects expansion, investment expansion, tax holidays, pioneer status and other kinds of incentives to attract FDI were being provided.

In the late 1980s, Malaysia continued to pursue trade liberalization by deregulating the barriers over capital ownership of MNCs, which in turn raised its FDI inflows. Over the years, the rates of tariff in Malaysia have gradually decline because FDI is needed to take entrepreneurial risks in order to make profits, at the same time to enhance the host country's productivity. Despite the importance of other determinants, the strategic location of Malaysia is the main factor that attracted foreign investors to invest in the domestic markets (Jajri, 2009).

As a result, Malaysia has been receiving vast amount of FDI during 1980s and 1990s. However, since the early 1990s, total foreign investments had been slowed down in several periods, though it has generally been increasing over the years. Specifically, a decrease in investments from Taiwan and Japan, the major source of investments led to a substantial decrease in FDI in 1993. The drop in investment can be attributed to the lacking of competitiveness in terms of labor cost as compared to other South East Asian countries like Indonesia and Vietnam. On the other hand, investments that are not much affected by the rising labor cost (relatively) in the manufacturing sector such as investments in petroleum and petroleum related products sector by US were relatively stable.

Asian Financial Crisis in 1997-1998 which affected most of the South East Asian countries is another key reason to the decrease in investment to Malaysia. Nonetheless, the substantial depreciation in ringgit Malaysia (RM) against US dollar led to an increase in the value of investments by General Electric, Boeing and other US-based huge MNCs. Therefore, local consumers were benefited from a positive effect of the influx of the US investors in terms of after-sales service and follow-up services, which are highly valued by Malaysians (Jajri, 2009).

In short, due to the successfulness in the adoption of economic policies, programs and strategies, Malaysia's economic performance has been spectacular from the late 1980s (Karim & Ahmad, 2009). Nevertheless, its distribution gap of economic growth among states has to be filled. As a consequence, the government continues to prioritize the distributional affairs in its national development plans. In order to decrease the imbalances of social welfare between states (less and more developed), a poverty alleviation program was adopted in its regional development plan. During the Third Outline Perspective Plan (OPP3) period (2001-2010) which was under the National Vision Policy, agricultural, services, and manufacturing sectors are being determined to facilitate a more rapid economic growth under the program. Specifically, in the manufacturing sector, foreign and domestic firms were given incentives to diversify their activities across all states. In this case, liberal equity policies, tax incentives, and different types of investment options were provided in order to attract FDI inflows into Malaysia.

Figure 1: Malaysia's foreign direct investment (FDI), net inflows from 1970 to 2008.

Source: World Bank.

Figure 1 illustrates the trend of Malaysia FDI inflows from 1970 to 2008, where the X-axis represents time period in year while the Y-axis measures FDI net inflows in thousand of US dollar. From the period of 1970 to 1982, although Malaysia's FDI inflows shown an increasing trend (gradual), it was quite inactive due to the lack of knowledge, unpopularity in this area, as well as restrictive government policies which in turn will result in less mobility of capital between countries. In 1982 to 1987, there was a slight decrease in Malaysia's FDI inflows before it raised dramatically in 1987 from approximately US\$0.5 million to about US\$5 million in 1992. This was due to the Japan's currency appreciation, Japan's and Asian newly industrialized economies' (NIEs) trade friction with the US and European Union (EU) countries, as well as Japan's and NIEs' rising wage rates in the mid-1980s (Wong, 2006).

In addition, the equipped necessary infrastructures for investment need and incentives (monetary and fiscal) provided by the government led to the increment of Malaysia's FDI inflows. Another reason that causes the increase of Malaysia's FDI inflows is the pool of disciplined and well-trained workers with relatively low wage.

To further encourage investment activities in manufacturing industries, the Investment Act 1986 was introduced. The introduction of this act reflected Malaysian government's active efforts in stimulating private sector

investment since the mid-eighties, that was when the country facing its worst recession. As a result, there were more foreign investors, especially from China switching their capital (investing) into the country. After that, the trend of FDI inflows was decreasing from 1992 to 2001, followed by an increasing trend from 2001 to 2007, before it decreased in 2008. In conclusion, Malaysia FDI inflows were fluctuated from 1970 to 2008.

### **1. 3) Problem Statement**

Although Malaysia received FDI from China, it has to contend with China (one of the emerging economies) for oversea funds and facing domestic constraints and structural weaknesses simultaneously. Specifically, these limitations include high cost of doing business, inappropriate public delivery system and lack of skilled labors. In addition, Malaysia was relatively low in terms of competitiveness compared to other countries, and Malaysia's capital outflows trend has generated a few issues. One of them is the chances that deteriorating FDI will lower the country's potential output, given falling private investment. Another concern is about a loss in domestic investors' confidence in the country which is resulted from capital outflows. In short, Malaysia is still lag behind in " ease of doing business".

For a developing country like Malaysia, the issue of job creation is very important. According to Abor and Harvey (2008), although FDI is related to technological unemployment, it does play a critical role in job creation. FDI inflows from China are associated with large-scale and mass production and thus there is a need for large amount of domestic labor force to maintain the high production. In short, China's FDI serves as an alternative engine of growth to Malaysia. Besides increasing domestic investments, it improves

the ability of foreign technology absorption, contributing to technology transfers and helping in innovation, promotes international trade integration, and thus brings our country to a competitive situation (Ghosh & Wang, 2009).

Figure 2: China's FDI outflows to Malaysia from 1987 to 2009

Figure 2 depicts the trend of FDI outflows from China into Malaysia over 1987-2009 through annual flows and its share in total China's FDI outflows to Malaysia in ringgit Malaysia (RM). Since the late 1980s, it shows a small fluctuation in trend of Malaysia's inward FDI from China with a relatively stable and low amount (amount not deviate too much). During the 1990s, and early 2000s, the stable trend showed that China has opened up its economy to international trade and this in turn lead the amount of Malaysia's FDI receipts from China increased. In 2006, we can see that there is a dramatical increase in trend due to China's heavy investment in Malaysia's big steel project in Terengganu in producing flat irons, slabs, billets, hot rolled coils, and the former also involved in the mega project of Penang's second bridge. However, after the peak in 2007, there was a sharp decline in amount of Chinese investment which was mainly attributed to 2007/08 global financial crisis.

China played a major role in the expansion of intra-regional trade and vertical specialization which become more important. According to Zebregs (2004), China carried out 32 % proportion of Asian's total export growth. The rising intra-regional trade among the Asian high-performing countries was significantly affected by spectacular outward-oriented growth performance of

the Chinese economy. The vertical specialization in the case means China imports goods from Malaysia and to produce final products which will be exported back to Malaysia. In recent years, China's trade has become more vertically specialized and China's exports contain a large proportion of imported goods from other Asian countries including Malaysia (Rumbaugh and Blancher, 2004).

Besides that, China is guaranteed to be continuously affect the growth trends of Malaysian economy due to the former's rapid economic growth, openness and economy size. China became an example of autonomous liberalization as it became the biggest liberalizer of the local economy. China and other Asian high performing countries pursued free trade among themselves to the World trade organization.

Furthermore, an increasing number of Malaysia's capital goods and investment, components and sub-assemblies, parts, as well as primary products have been absorbed by China. In this short time period, a wholly new investment and trade pattern has occurred. Malaysian economy has been influenced both directly and indirectly by China's investment and trade, in which the indirect influences came from the method in which China's investment and trade manipulate Malaysia's economic condition; while the direct effects came from China's bilateral trade and investment relationships with Malaysia. In short, it is clear that a major economic change in Malaysia has been caused by China.

In addition, China also becomes increasingly crucial to Malaysia because of upgrading technology base reasons. According to Das (2008), China

managed to absorb a wide range of industrial technologies, and was proved to be superior to other emerging market economies in doing so over the previous two decades, which were also the period when China was gradually becoming the world's number 1 manufacturer of high-volumed industrial products. The trend was due to its extra focus on science and technology education, the admittance of the private sector into the provision of tertiary education, wide-based education adjustments, and the low-wage, but acceptable skilled and flexible workers. Because of huge and increasing investment, the life span of equipment and plant was reduced to seven years (Das, 2008).

In a nutshell, since China's outwards FDI is extremely important to our nation's economy (and even important to the rest of the world), it is worthwhile and beneficial for us to study its impact on our country's economic growth. Furthermore, the factors that determine China's FDI are crucial in the field of economics, and thus this motivates us to shed some light on them.

#### **1. 4) General Objective of the Study**

The research question and problem statement give us an insight and motivation to analyze the relationship between China's FDI and Malaysia's economic growth, in which China's outwards FDI and Malaysia's GDP serve as the respective proxies. Our research will be able to serve as a significant contributor to the efforts in stimulating Malaysia's economic growth as well as the field of development economics.

## **1. 5) Specific Objectives of the Study**

To examine the effect of China's FDI on Malaysia's economic growth from 1987-2009.

To examine the determinants of China's FDI outflows in Malaysia.

To investigate the short-run dynamic linkage between FDI outflows (China) and economic growth (Malaysia).

## **1. 6) Significance of the Study**

Most of the empirical literatures in examining the relationship between FDI and economic growth were too general. The rapidly emerging economies in China who is able to provide huge investment funds, provided the recipient country is fundamentally strong in terms of macroeconomics and financial system have not been studied specifically. Thus, through our research, we may able to solve the problem by filling the gap resulted from past researchers. It is a very important study as it may suggest the rationality and suitability of further employing FDI (especially from China) as an engine of growth for Malaysia. As such, it might prevent waste of resources as the government can certainly allocate funds to appropriate areas for economic development and economic growth.

In addition, the study on the determinants of China's FDI (outward) might suggests some appropriate factors in attracting China's outward FDI, which will in turn enhance the efficiency and effectiveness in the efforts or process of attracting China's FDI into Malaysia. Therefore, the study may assists policy makers in their decisions to enlarge or enhance certain promising



areas, for example market size and human capital development in order to attract China's FDI into Malaysia, and thus stimulate economic growth.

In short, by conducting this study, we will be able to provide more robust results on the impact of Malaysia's trade openness, financial development, and most significantly China's FDI on Malaysia's economic growth. The relationship was seldom being analyzed by previous researchers. Note that FDI is important to stimulate private investment as well as to create job opportunities. In addition, after the study, we can clarify the determinants of China's FDI outflows, specifically the relationship between Malaysia's market size, exchange rate, human capital development (all are independent variables), and China's FDI outflows (the dependent variable). Lastly, the causal relationship between China's FDI and Malaysia's economic growth can also be justified after the study. All three aspects being mentioned above are crucial in assisting policy makers to implement sound and wise policies, strategies as well as programs. Therefore, we hope that our research could contribute to the society as well as the nation as a whole in the expansion and development of our country in order to achieve 2020 Vision and become a developed nation.

## **1. 7) Organization of the Paper**

The following sections are organized as the followings: section 2 represents literature review, followed by section 3 which illustrates the data description and methodology being employed. Our empirical results and interpretation are in section 4 before we conclude in section 5.