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Determinants of foreign direct investment in Malaysia

James B. Ang *

Monash University, Department of Economics, 900 Dandenong Road, Caulfied East, Vic. 3145, Australia

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Abstract

Using annual time series data for the period 1960–2005, this paper examines the determinants of FDI for Malaysia to inform analytical and policy debates. Consistent with the prediction of the market size hypothesis, real GDP is found to have a significant positive impact on FDI inflows. There is evidence that growth rate of GDP exerts a small positive impact on inward FDI. From a policy point of view, the results suggest that increases in the level of financial development, infrastructure development, and trade openness promote FDI. On the other hand, higher statutory corporate tax rate and appreciation of the real exchange rate appear to discourage FDI inflows. Interestingly, the results also seem to suggest that higher macroeconomic uncertainty induces more FDI inflows.

JEL classification: C22; F21; O16; O53

Keywords: Foreign direct investment; Malaysia

1. Introduction

Foreign direct investment (FDI) has been seen as a key driver underlying the strong growth performance experienced by the Malaysian economy. Policy reforms, including the introduction of the Investment Incentives Act 1968, the establishment of free trade zones in the early 1970s, and the provision of export incentives alongside the acceleration of open policy in the 1980s, led to a surge of FDI in the late 1980s. Apart from these policy factors, it is generally believed that sound macroeconomic management, sustained economic growth, and the presence of a well

* Tel.: +61 3 99034516.
E-mail address: james.ang@buseco.monash.edu.au.

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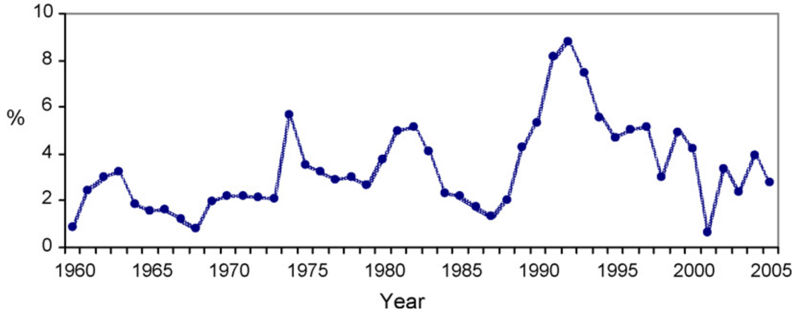

Fig. 1. Total FDI inflows in Malaysia: 1960–2005 (as a percentage of GDP).

functioning financial system have made Malaysia an attractive prospect for FDI. However, there has been a persistent decline in the ratio of FDI inflows to GDP since the early 1990s (Fig. 1). While this disappointing pattern of development has become a major concern of researchers and policy makers, there has been little attention paid to the understanding of what determines FDI in Malaysia.[1] Hence, this warrants an investigation into what are the key forces that stimulate FDI in Malaysia.

2. Variables and methodology

Based on earlier work, the empirical model is specified as follows:

$$\begin{aligned}\mathrm{FDI_t} = {} & \beta_0 + \beta_1\mathrm{FD_t} + \beta_2\mathrm{GDP_t} + \beta_3\mathrm{GRO_t} + \beta_4\mathrm{INF_t} + \beta_5\mathrm{OPE_t} \\ & + \beta_6\mathrm{RER_t} + \beta_7\mathrm{TAX_t} + \beta_8\mathrm{UNC_t} + \beta_9 D_{97-98} \qquad (1)\end{aligned}$$

where $\mathrm{FDI_t}$ refers to the inflows of foreign direct investment to Malaysia at 1987 prices. Financial development ($\mathrm{FD_t}$) is measured by the ratio of private credit to GDP. $\mathrm{GRO_t}$ is the annual growth rate of GDP. Total government spending on transport and communication is used as the proxy for infrastructure development ($\mathrm{INF_t}$). Trade openness ($\mathrm{OPE_t}$) is defined as the sum of exports and imports over GDP. $\mathrm{RER_t}$ is the real exchange rate and $\mathrm{TAX_t}$ is the statutory corporate tax rate in Malaysia. $\mathrm{UNC_t}$ refers to macroeconomic uncertainty related to output fluctuations. It is constructed based on a GARCH(1,1) specification in a simple equation in which the logarithmic real GDP follows an AR(1) process. The above specification also includes a dummy variable ($D_{97–98}$) to account for the Asian financial crisis in 1997–1998.

The specification in Eq. (1) is augmented with adequate dynamics to form an unrestricted error-correction model. Inder (1993) demonstrates that under this framework the problems of endogeneity bias are minimal and relatively unimportant in many situations. This also avoids omitted lagged variable bias. Furthermore, we follow the 2SLS approach of Bewley (1979) by using the first lags of the variables as instruments for the current differenced terms to account for the problems of endogeneity bias. The long-run model for $\mathrm{FDI_t}$ can be obtained from the reduced form solution when all dynamic terms of the regressors are set to zero.

[1] This paper is concerned with examining the determinants of FDI in Malaysia. For studies that examine the impact of FDI on other macroeconomic variables, see Morikawa (1998) and Akinlo (2004), among others.