

**THE RELATIONSHIP BETWEEN FOREIGN DIRECT INVESTMENT (FDI)  
AND ECONOMIC GROWTH IN MALAYSIA**

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## SUPERVISOR VALIDATION

I hereby declare that I have read this thesis and in my opinion this project is sufficient in terms of scope and quality for the award of Bachelor of Technopreneurship with Honors'

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## DECLARATION

I hereby declare that the report has been prepared by my own self except the summaries and citation that I have been clarify the resources.

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## ABSTRACT

Malaysia is one of the developing countries that is in the process of keeping up with the latest technology by other developed country globally. In order to sustain in the global market, a lot of aspect have to be assessed properly. One of the important aspect is the economic financial. Gross Domestic Product (GDP) is one of the economic growth measurement. In this increasingly globalized world economy, Foreign Direct Investment (FDI) is considered as the main source of the external finance. FDI is a cross-border investment where home country, which is the country that invested into a foreign country that was also known as host country. FDI benefited to both countries, home and host country respectively as each of the country receives different favours. On top of that, Malaysia is one of the countries that actively participate in the FDI because it known to exerts a positive effect on GDP. There are five main sectors of FDI that contribute to economic growth of Malaysia which is agriculture, forestry and fishing sector, mining and quarrying sector, manufacturing sector, construction sector and service sector. Thus, this research will determine the relationship between FDI and economic growth between sectors to find the sector that contributed the most towards Malaysia's economic growth.

## ABSTRAK

Malaysia adalah sebuah negara yang sedang membangun dan juga sedang di dalam proses untuk mengadaptasikan teknologi baru secara global. Justeru itu, dalam usaha untuk melestarikan pembangunan di pasaran global, terdapat pelbagai aspek yang perlu dikenalpasti dan dititikberatkan. Antara aspek yang perlu dititikberatkan ialah kewangan ekonomi negara. Keluaran Dalam Negara Kasar(KDNK) adalah merupakan satu pengukur pertumbuhan ekonomi negara. Di dalam ekonomi global yang sedang pesat membangun ini, pelaburan langsung asing adalah dianggap sebagai sumber kewangan luar utama. Pelaburan langsung asing merupakan pelaburan yang dilakukan secara rentas sempadan di mana negara asal, yang merupakan negara yang melabur di luar negara yang juga dikenali sebagai negara tuan rumah. Pelaburan langsung asing mendatangkan faedah untuk kedua-dua buah negara iaitu negara asal dan juga negara tuan rumah kerana kedua-duanya juga menerima faedah yang tersendiri. Tambahan lagi, Malaysia adalah merupakan negara yang mengambil bahagian secara aktif dalam aktiviti pelaburan langsung asing kerana aktiviti pelaburan langsung ini didapati dapat memberi kesan positif kepada KDNK negara. Terdapat lima sektor utama pelaburan langsung asing yang menyumbang kepada pertumbuhan ekonomi Malaysia iaitu sektor pertanian, perhutanan dan perikanan, sektor perlombongan dan pengkuarian, sektor pembuatan, sektor pembinaan dan sektor servis. Oleh itu, kajian ini akan mengenal pasti hubungan antara pelaburan langsung asing dan pertumbuhan ekonomi Malaysia antara sektor untuk mengenal pasti sektor yang paling banyak menyumbang kepada pertumbuhan negara Malaysia.

## TABLE OF CONTENTS

CHAPTER PAGE	TITLE
ii	SUPERVISOR VALIDATION
iii	DECLARATION
iv	ACKNOWLEDGEMENT
v	ABSTRAK
vi	ABSTRACT
vii	TABLE OF CONTENTS
x	LIST OF FIGURES
xi	LIST OF TABLES
CHAPTER 1	INTRODUCTION
1	1.1 Background of Study
3	1.2 Problem Statement
4	1.3 Research Questions
5	1.4 Research Objectives

6	1.5	Significance of the Research
7	1.6	Scope of the Research
7	1.7	Limitation of the Research
8	1.8	Summary
<b>CHAPTER 2 LITERATURE REVIEW</b>		
9	2.1	Introduction
10	2.2	Foreign Direct Investment
13	2.3	Gross Domestic Product
	2.4	Malaysia's Economic Industry
15	2.4.1	Agriculture, Forestry and Fishing Sector
16	2.4.2	Mining and Quarrying Sector
17	2.4.3	Manufacturing Sector
18	2.4.4	Construction Sector
19	2.4.5	Service Sector
19	2.5	Factors Determining Foreign Direct Investment to Gross Domestic Product
	2.6	Theory
21	2.6.1	Neoclassical Growth Theory
22	2.7	Research Framework
22	2.8	List of Hypotheses



23	2.9	Summary
<b>CHAPTER 3 RESEARCH METHODOLOGY</b>		
24	3.1	Introduction
25	3.2	Research Design
26	3.2.1	Research Philosophy
27	3.2.2	Research Approach
28	3.2.3	Methodological Choices
29	3.2.4	Research Strategy
29	3.2.5	Time Horizon
30	3.2.6	Technique and Procedure
30	3.3	Sampling Design
31	3.4	Sources of Data
32	3.5	First Stage Analysis
32	3.5.1	Descriptive Statistics
32	3.6	Second Stage Analysis
32	3.6.1	Multivariate Panel Regression Analysis
33	3.7	Summary
<b>CHAPTER 4 DATA ANALYSIS AND FINDINGS</b>		
34	4.1	Introduction
35	4.2	Descriptive Statistic

36	4.3	Multivariate Panel Regression Analysis	
	4.4	Hypotheses Verification	
37	4.4.1	Hypothesis	1
39	4.4.2	Hypothesis	2
40	4.4.3	Hypothesis	3
41	4.4.4	Hypothesis	4
42	4.4.5	Hypothesis	5
43	4.4.6	Hypothesis	6
44	4.5	Summary	
	<b>CHAPTER 5</b>	<b>CONCLUSION AND RECOMMENDATION</b>	
45	5.1	Introduction	
	5.2	Conclusion of Findings	
46	5.2.1	Discussion on Objectives	
48	5.2.2	Theory Incorporated	
49	5.3	Implication of the Research	
50	5.4	Limitation of the Research	
51	5.5	Suggestion for the Future Research	
52	<b>REFERENCES</b>		
56	<b>APPENDICES</b>		
			<b>A</b>

## LIST OF FIGURES

NO PAGE	OF	FIGURE	TITLE
1.1 2			Forecast of GDP Growth Rates, 2003-2015
2.1 14			Gross Domestic Product- Value Added and Annual Percentage Change for Malaysia
2.2 15			Percentage share to Gross Domestic Productivity at constant 2010 prices
2.3 22			Research Framework
3.1 25			Research Onion
5.1 46			FDI and GDP Performance in Malaysia for the Year 2008-2016

## LIST OF TABLES

NO PAGE	OF TABLE	TITLE
4.1 35		Descriptive Statistics on Independent Variable
4.2 36		Summary Statistics of Foreign Direct Investment from 2008 to 2016
4.3 37		Summary Statistics of Foreign Direct Investment by Sector from 2008 to 2016
4.4 38		Multivariate Panel Regression Analysis between FDI and GDP in Malaysia
4.5 39		Multivariate Panel Regression Analysis between

	FDI and GDP in Malaysia for Agriculture, Forestry and Fishing Sector	
4.6 40	Multivariate Panel Regression Analysis between	
	FDI and GDP in Malaysia for Mining and Quarrying Sector	
4.7 41	Multivariate Panel Regression Analysis between	
	FDI and GDP in Malaysia for Manufacturing Sector	
4.8 42	Multivariate Panel Regression Analysis between	
	FDI and GDP in Malaysia for Construction Sector	
4.9 43	Multivariate Panel Regression Analysis between	
	FDI and GDP in Malaysia for Service Sector	
5.1 47	Summary Statistics of Foreign Direct Investment by Sector from 2008 to 2016	

## CHAPTER 1

### INTRODUCTION

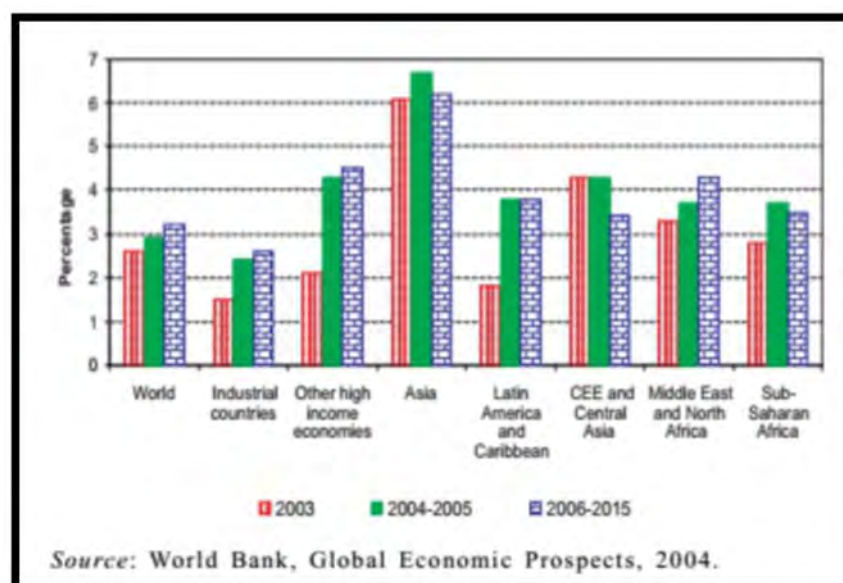
#### 1.1 Background of Study

In today's global economic environment, FDI is one of the major source of financial investment mostly for developing countries. According to Liu (2004), based on neoclassical growth model, FDI lead to increase of economic growth by increasing the value of investment and the efficiency of the FDI. In the meantime, FDI also act as the solution for economic problem in the market (Mencinger 2003). This is because the positive impact of FDI on economic growth that had been known widely made it becomes the way out of the economic problem. Ameer and Xu (2017) found that there are positive impact of long run FDI inflows and outflows towards economic growth of developing countries. The positive impact of FDI inflows and outflows on economic growth are immensely strong by implementing various econometric technique.

Over the years of 1970 until 2005 economic growth of Malaysia in GDP is homogeneous with average annual rate of 7 percent. As Malaysia is a country that practice open economy, other external sector facing the impact including oil crises on 1970s, downturn of electronic industry in the mid of 1980s, and especially during Asian financial crisis on 1997 where it still felt in early twenty first century

(Karimi & Yusop 2009). FDI plays an important role in bringing back the economic stability of Malaysia. FDI and its causal relationship with GDP can attract foreign countries. Hence, it causes foreign investor to actively search for place with a lot of natural resources while having a weak market to maximize benefits from the investment. Though, the host country also in the same position as they also receive a lot of benefits from the foreign investment including lead their growth of economy (Solomon et al. 2015).

The establishment of policies that supported FDI which known as Malaysia Industrial Development Authority (MIDA) on 1967 formally known as Financial Industrial Development Authority (FIDA) which was the first act of Malaysia government to attract FDI into Malaysia. In the year of 1968, Malaysian government develop Investment Incentive Act to promote export oriented FDI. These actions were the starter of Malaysian government acts to promotes the inflow of FDI in order to increased economic growth (Solomon et al. 2015). Supported by Duasa (2007) where she stated that Malaysia impressive economic growth since 1960s and it stability before Asian financial crisis was due to policies that promoting FDI.



**Figure 1.1: Forecast of GDP Growth Rates, 2003-2015**

In overall, FDI and GDP shows positive relationship globally as in Figure 1.1. FDI affect the availability of funds that can be invested from corporate profits or loans. This condition will then affect the domestic economic environment (United Nation, 2004). According to the report that quoted from Mohamed (2017), FDI have contribute to the success of various key sectors such as investment, trade and tourism. Plus, it also stated that Malaysia is ranked Top 10 among Asia Pacific's FDI hot spots, according to a study by US-based global information company IHS Inc. According to the data from Trading Economics, the value of FDI into Malaysia decreased to RM 8.3 billion in the second quarter of 2017 from RM17.0 billion on the previous period and compared to RM 10.6 billion in the same quarter of 2016. While Surach (2017) uncover that Chinese investment was merely represent 2% of FDI stock in Malaysia. Based on International Monetary Fund (2011), Malaysia's economy was ranked on 30th largest economy in the world which was resulted from FDI that contribute to strong growth performance.

## **1.2 Problem Statement**

Malaysia economy have shown stable increasing pace, even though increase moderately. According to The Star Online (2017), the most crucial issues about Malaysian economic condition were increasing prices, downgrading value of Ringgit Malaysia and the outflow of capital. These issues have been discussed widely among economic expert even by citizens. Therefore, there must have been ways to improving Malaysian economy, purposely through the international investment such as FDI. FDI have been source of increased economic growth. Though, not all of the foreign investment will bring benefits to its host countries. There are varies result of the effectiveness of FDI between sectors. So, this research will identify the most impactful sector that will contribute to the advantages in the economic growth.



Following Asian Financial Crisis on 1997, it gave a big impact on many countries and Malaysia was one of them. During the crisis, the whole economic have fall, luckily Malaysia manage to survive even though there was slight fall in the Ringgit Malaysia value and also a lot of foreign investor backed out from the investment. This results to downturn of Malaysia's economy. To avoid this situation again happened in the future, Malaysia need to have a better back up plan and quick action to reduce the loss. Apparently, there are opportunity for Malaysia to put action hindering foreign investor from backed out their investment such as by liberalization of policy.

Besides, this research also aims to fill the research gaps on the relationship between FDI and economic growth among five different sectors in Malaysia. Most studies have been carried out about the impact of FDI on economic growth, especially in Malaysia. Meanwhile, lack of studies had been carried out on the relationship of FDI and economic growth between sectors. Moreover, as the economics conditions are not always having a stable condition, this research are hope to contribute in helping Malaysia to keep the growth of economics.

### **1.3 Research Questions**

According to Bryman (2007), research question defined as a clear statement about an area of concern, a condition to be improve, a trouble to be eliminated or disconcerting question that exist in scholarly literature. Plus, research question also known as a derivative from the current basis of theory and empirical evidence. As there are uncertainty on the research concern, which regarding FDI and economic growth of Malaysia, the first research question that have been identified is:

**RQ 1: What is the relationship between FDI and economic growth in Malaysia?**

Next, the curiosity about the relationship of FDI and economic growth arise when there is difference in evaluating economic sector. Therefore, the second research question is about:

**RQ 2: What is the relationship between FDI and economic growth in Malaysia between sectors?**

#### **1.4 Research Objectives**

Research objectives explained about the purpose of this research and what to achieve in the end of the research. This research was conducted to confirm the relationship between FDI and economic growth by using GDP as the indicators of economic growth. This is to make sure that the inflow of FDI effected the economic growth of Malaysia. Therefore, the first objective for this research is:

**RO 1: To measure the relationship between FDI and economic growth of Malaysia**

After there have been confirmed that there is relationship between inflow of FDI and economic growth of Malaysia, this research will then determine the relationship between FDI and economic growth in Malaysia in terms five main sectors which are, agriculture, forestry and fishing sector, mining and quarrying sector, manufacturing sector, construction sector and service sector.

**RO 2: To determine the relationship between FDI and economic growth of Malaysia between main sectors.**

## 1.5 Significance of the Research

Over the past decades, Malaysia have facing many ups and down in its economic growth. Therefore, it is important to determine the possible way to improve the growth of economic. Therefore, FDI is one of it. There are many empirical studies that have been proved that FDI could increase economic growth. While there are also some that deny it. Thus, this research will reveal the relationship of FDI towards economic growth of Malaysia.

From academic perspective, the significance of this research is to find the distinct relationship between FDI and economic growth of Malaysia. Plus, this research will also confirm the relationship between FDI and economic growth of Malaysia between five main sectors which is agriculture, forestry and fishing sector, mining and quarrying sector, manufacturing sector, construction sector and service sector.

In the other hand, from the industry perspectives, the research may be significant to potential foreign investor whose main desire is to secure higher profits from their investment. The findings may be a guidance for industrial player to achieve more benefits and avoid loss from their investment by focusing on more benefited sector.

Finally, the significant of this research from government perspective to make sure Malaysian government will give more attention to the more benefited sectors that contribute most to GDP and improving other sectors. In fact, this research also affects the existing policy implication.

## **1.6 Scope of the Research**

This study will investigate the relationship between FDI and economic growth of Malaysia. Therefore, the scope of this research will be focus on the FDI and Gross Domestic Product of Malaysia for 9 years term. The data of FDI and GDP will be collected from the years of 2008 until 2016. Besides, the scope of this research will be focusing only on the inflow of FDI into Malaysia.

Moreover, this research also will analyse on different sectors of FDI and GDP in Malaysia. There are five main sectors used in analysing this research, which is agriculture, forestry and fishing sector, mining and quarrying sector, manufacturing sector, construction sector and service sector. These sectors have been identified as the main sectors in the industry (Department Statistics of Malaysia, 2016).

## **1.7 Limitations of the Research**

There are several limitations for this research:

- 1- This research will only study on the Malaysia economic growth, therefore the results may not be applicable for other countries in the world.
- 2- This research also focusing on the inflows of FDI without take account on the outflows of FDI.
- 3- This study also will only focus on FDI-led growth. This is where this research will look into prospect that FDI lead to growth of economies of host countries which in this case is Malaysia.

## 1.8 Summary

This chapter has described the overall study of this research includes research background, problem statement, research questions, research objectives, hypotheses, significance of the study, scope of the study and limitation of the study. The next chapter will discuss on the previous study to support this research and also to encourage more understanding about this research.

## CHAPTER 2

### LITERATURE REVIEW

#### 2.1 Introduction

FDI is one of the mode of technology transfer. It helps widened the market of country and exposed them with foreign market. According to Froot (1993) in recent years, FDI has become the main structure of transfer global technology as its grows rapidly. FDI could either increased the economic growth or vice versa. This situation was due to the characteristics of the host country. Adaption of FDI in host country is crucial to ensure the positive spill overs from the investment. Therefore, host country has to make sure to improve their technology adoption capabilities in order to gain the benefits that been offered through the foreign investment. Malaysia have been giving support to FDI inflows in view of the potentials that FDI increased economic growth. Therefore, Malaysian government have taken several measures to encourages FDI includes establishment of policies that favourable for foreign investment and exemption of tax to gain attention of foreign investor.

In this chapter, we will discuss about the empirical studies of this topic by reviewing the previous research of related topic. It will give general idea on the relationship between FDI and GDP of country. Plus, researcher will explain more about this topic through the conceptual framework.

## 2.2 Foreign Direct Investment (FDI)

FDI is define as foreign investment in which a resident in one economy acquire lasting interest in an enterprise in other economy. The lasting interest includes establishment in manufacturing facilities, bank premises, warehouses and other long-term organizations abroad. Direct investment was established when the direct investor gained 10 percent or more of the shares on the enterprise abroad (CMCG Working Group, 2003). FDI is one of the crucial indicator to boost economic growth of Malaysia. It was known as a medium to gain skills, knowledge, technology, a key to expand business internationally and reduce debt (Tanggapan et. al, 2011). Sustained global economy is among the thing that every company looking for. For developing countries, one of the way for them to survive in global market is by allowing FDI inflow in their country. FDI is the leading factor for international unification of economic policies between different state. In these past decade, FDI market have develop gradually all over the world (OECD Benchmark Definition of FDI 2008). Thus, it helps to enhance country's economic growth and expand the international connections within countries. FDI encourage growth of economic of host country by boosting technological progress instead of expanding total capital accretion (Borensztein et. al 1998).

There are many large international company that have been leading in the foreign investment market. In the meantime, small medium enterprises also taking their chances to expand their company globally. There are several criterions that is needed to make sure the quality and efficiency of FDI which is in line with national standard, reduce inconsistency between countries, achieve the standard within time, punctual and allow data exchange between partner country (OECD Benchmark Definition of FDI 2008). Recent research (Kok and Ersoy 2009) explained that problem faced by most developing country regarding FDI was developing country cannot undertake technology transfer and minimize the gap between developing and developed country because of technology competence deficiency. In the other hand, according to other empirical studies (Borensztein et al. 1998), developing countries

have greater capability in FDI due to the prior management skills and more advance technology is transferred.

FDI flows to Association of Southeast Asian Nations (ASEAN) countries ascend for third consecutive years from \$177.7 billion in 2013 to \$136.2 billion in 2014. This level overreach inflows to China for the first time since 1993, that makes ASEAN the biggest FDI recipient among the developing country. Apparently, this success was caused by various factors including strong regional economic fundamental and increased of intra-regional investment and strong flows of FDI from majority of ASEAN partners. Plus, biggest aspect for the changes in ASEAN FDI environment is the increasing of the transfers of labour-intensive manufacturing activities (ASEAN Investment Report 2015).

Following major pioneering research in 2006 undertaken by United Nations Conference on Trade and Development (UNCTAD) it has been shown that service sector considered as the major FDI recipient, allocated for about two third of FDI inflow among worldwide. Meanwhile, by using Generalised Method of Moment Technique, the level of financial development in Malaysia will contribute to the changes of economic growth. This view has been supported by Anwar and Sun (2011). In the other hand, Choong and Lam (2010) reviewed that manufacturing sector was the major sector in FDI. This is because manufacturing sector was likely to develop positive spill overs and also have high value-added in the same time. Data from this research was collected in Malaysia for the period of 1970 until 2006.

Based on previous research from other studies, (Baig et al. 2016) there were several factors that can increase FDI which is marketing skills, capital that develop new job opportunities, effect of competent market, inflow of technology and increased in managerial know-how. This research was conducted at South Asian countries and the data was collected from the year of 1991 until 2012.