

# AIA, AFTA and Domestic Private Investment: Evidence from Malaysia

(AIA, AFTA dan Pelaburan Domestik Sektor Swasta: Bukti dari Malaysia)

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## ABSTRACT

*The ASEAN Free Trade Area (AFTA) was proposed in 1992 and followed by the introduction of the ASEAN Investment Area (AIA) in 1998. Both are meant to promote regional economic prosperity through improvements in regional trade and investment. Unfortunately, to date, there is no clear sign that either AFTA or the AIA can really trigger regional economic activity and, therefore, spur regional economic development. The main point often neglected in literature concerning the implications of AFTA and AIA on regional economic development is the role and development of domestic private investment (DPI). In other words, AFTA and AIA will only result in positive and sustainable economic impacts on regional economic development if such developments followed or supported by the development of domestic private investment in each ASEAN member country. Hence, this study aims to investigate the implication of AFTA and AIA on Malaysian DPI.*

*Keywords: AFTA; AIA; Domestic Private Investment*

## ABSTRAK

*Kawasan Perdagangan Bebas ASEAN (AFTA) telah dicadangkan pada 1992 dan lanjutan dari AFTA, Kawasan Pelaburan ASEAN (AIA) telah diperkenalkan pada 1998. Kedua-duanya bertujuan untuk mempromosi kemakmuran ekonomi serantau melalui perkembangan perdagangan dan pelaburan serantau. Malangnya, sehingga ke hari ini, tiada petunjuk yang jelas sama ada AFTA atau AIA mampu melonjakkan aktiviti ekonomi serantau dan seterusnya menggalakkan pembangunan ekonomi serantau. Perkara utama yang selalu tercicir dalam perbincangan apabila sesiapa membincangkan implikasi AFTA dan AIA ialah peranan dan perkembangan pelaburan domestik sektor swasta (DPI). Dalam lain perkataan, AFTA dan AIA hanya akan menghasilkan kesan ekonomi yang positif dan lestari ke atas pembangunan ekonomi serantau sekiranya ianya disokong oleh pembangunan pelaburan domestik sektor swasta di setiap negara ASEAN. Oleh itu, kajian ini bertujuan untuk mengkaji implikasi AFTA dan AIA ke atas DPI di Malaysia.*

*Kata kunci: AFTA; AIA; Pelaburan Domestik Sektor Swasta*

## INTRODUCTION

According to growth theories, investment is the most important factor in the growth process because it determines the rate at which physical capital is accumulated. Thus, investment plays an essential role in the expansion of an economy's production capacity. Investment can also be part of the business fluctuating factor. The neoclassical growth theory emphasizes investment as one of the important elements in the production process with the simplest expression being that the main sources of growth are the autonomous factor (A) and the growth of capital per labour (K/L). The effect of the rate of physical capital accumulation depends on whether there are externalities to capital accumulation. Arrow (1962) and Romer (1986) suggest that while private returns to scale might experience a diminishing trend, social returns may be constant or even increasing,

reflecting spillovers of knowledge or other externalities. For example, if the introduction of new capital leads to better organization, it will then help in more efficient production techniques.

The year 2011 marked the implementation of two key initiatives – the Economic Transformation Programme (ETP) and the 10th Malaysia Plan (10MP) – by the Government, thereby laying the foundation for the country's transformation into a high income economy as envisioned in the New Economic Model (NEM). As part of the possible implications of these initiatives, and in the midst of world economic uncertainty, Malaysia successfully generated positive economic growth in 2010. As shown in Table 1, the performance of Malaysia's economic growth is impressive, but volatile. Starting from remarkable economic performance prior to the 1997 economic crisis, quick recovery from the severe consequence of the 1997 crisis allowed Malaysia to



TABLE 1. Growth, Gross Fixed Capital Formation (% of GDP) &amp; FDI (% of GDP)

	1980	1985	1990	1995	2000	2005	2010
GROWTH		-1.12	9.01	9.83	8.86	5.33	7.19
GFCF	29.95	28.71	33.04	43.59	25.29	20.52	20.31
FDI	3.75	2.19	5.30	4.70	4.04	2.88	3.86

Source: World Development Indicators (World Bank 2012).

record a slightly low level of growth rate of 8.8 per cent in 2000. High dependence on the external sector, particularly exports, and high sensitivity to economic conditions of the USA and several European countries is reflected by the slow economic growth in mid 2000 during the numerous crises that struck the West. Nonetheless, witnessed Malaysian success in 2010 in relation to the preservation of its vision to be a high-income country by 2020.

Literature often cites that openness policies, either those related to foreign capital or international trade, play an important source of growth. In particular, FDI, which has been credited by many as growth-enhancing (see Mirza and Giroud 2003), is typically a focus or target in order to further boost economic growth. However, over reliance on FDI may not be a wise long-term strategy for two principal reasons. First, Malaysia no longer sufficiently attracts FDI because FDI inflows are typically the result of motives that include market-seeking, resource-seeking and efficiency-seeking. The small size of Malaysia's economy relative to China and India, diminishing natural resources and increasing labor costs have resulted in Malaysia gradually losing its position among the top recipients of FDI in the world. Second, the expected positive spillover effect from FDI is also being questioned by many studies, such as Mirza and Giroud (2003). According to Mirza and Giroud (2003), there is less evidence of the spillover effect. Masron, Zulkaffli and Haslindar (2012) provide mixed results concerning the impact of FDI on the Malaysian manufacturing sector. Even though Masron et al. (2012) observe some positive spillover effects due to FDI inflows, the existence of several negative consequences and low positive effects overshadow the growth-enhancing prospect of FDI inflows. In conclusion, Masron et al. (2012) argue that the role of FDI is likely to have been exaggerated in the past. Taking into account the two weaknesses of FDI mentioned above, Table 1 also illustrates that view. Malaysia most probably reached its maximum reliance on FDI and it is therefore time to shift its focus to domestic resources. Due to the small ratio of FDI to total gross fixed capital formation (GFCF) since 1980, combined with the emergence of China and India as attractive locations for global FDI, one could reasonably conclude that focusing on the promotion of domestic private investment could potentially provide a remedy for the situation resulting from the slowdown of FDI inflows in recent years. More

importantly, in order to achieve the vision of becoming a developed nation by 2020, Malaysia is required to have 60 percent of domestic private investment out of total investment domestically. However, 2009 figures indicate that domestic private investment was only about 32 percent (Siti Sakinah 2010).

At the national level, several policies seem to promote domestic private investment (DPI) to champion the economic development in Malaysia. Nevertheless, the increasing competitiveness of DPI cannot be fully supported by the small economic size of Malaysia. In addition, to ensure that the development of DPI can benefit Malaysia, its efficiency in production can be confirmed through its ability to participate in the world market. In short, DPI can only be beneficial in the sense that it produces goods and services at the lowest cost possible domestically, which are later sold to domestic consumers at affordable price. Hence the creation of the AFTA in 1992, followed by the proposal of the AIA in 1998, can lead to the ASEAN region emerging as the first international arena through which DPI is encouraged to be more active via regional competition. Therefore, it is of interest to many to understand the implications of the AIA and AFTA, especially when the revision of the AIA policies does not discriminate against foreign investors as potential beneficiaries in favor of regional investors. With this objective in mind, this study attempts to investigate the effect of AIA and AFTA on Malaysian DPI.

The organization of this study is as follows: The next section offers a brief discussion on the relative share of DPI against FDI in the Malaysian economy in recent years. Section three will provide several possible determinants of DPI based on several studies in the past. Section four is devoted to the methodology employed in this study and section five reveals and discusses the findings of this study. Finally, section six concludes.

## BACKGROUND

### INVESTMENT IN MALAYSIA

As shown in Figure 1, investment in Malaysia reached RM148.6 billion in 2011. Out of this total, investment in services is the largest with a value of RM64.4 billion, followed by the manufacturing sector (RM56.1 billion) and primary sector (RM28.1 billion). The service sector

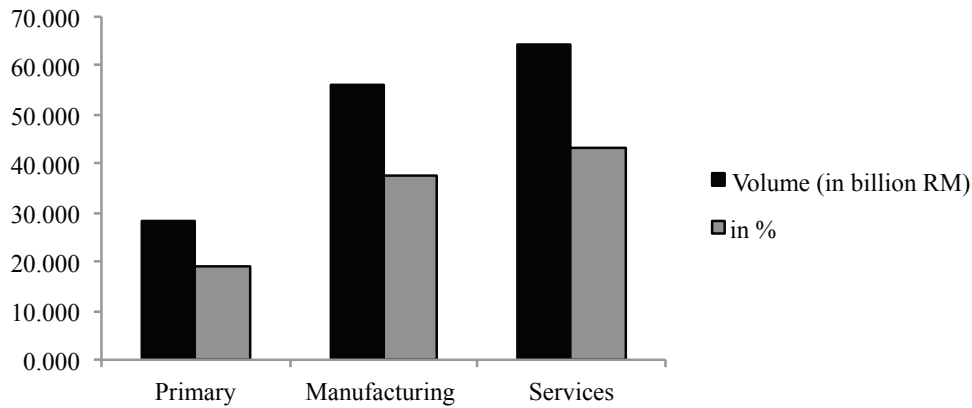


FIGURE 1. Total investment approved by sectors in 2011 (in billion RM)

Source: Malaysian Industrial Development Authority (2012).

has continuously been the leading sector, particularly since the recent liberalization of the sector, and is expected to increase further in 2012 (MIDA 2012). Interestingly, DPI constituted 78.4 per cent or 48.3 per cent of overall investment activities during 2011, implying the growing importance of the role played by DPI in Malaysia's economic development. DPI in the manufacturing sector for 2011 represents only 39 per cent of the total, but this figure was in increasing mode relative to the performance in 2010. In 2010, the value of DPI was about RM18.1 billion and improved to RM21.9 billion in 2011, an increase of about 21 per cent.

#### AFTA AND AIA

The progression of AFTA towards full implementation can be observed through the concept of common effective preferential tariffs (CEPT). As shown in Table 2 below, there is a promising progression towards AFTA. Singapore is, by nature, an open economy with no restriction of entrance being imposed. Other ASEAN members are also in the process of relaxing the restrictions that prevail in the economy, particularly core ASEAN members such as Malaysia, Thailand and Indonesia.

The low restriction of entry among ASEAN members can be manipulated by ASEAN investors to gradually move abroad to engage in regional competition. This will, to a certain degree, signify the gradual improvement of competitiveness among ASEAN investors to eventually compete in the international or global market.

In addition, as part of the efforts to promote regional investments, ASEAN governments have agreed to introduce the AIA to encourage more active investment activities to take place in the region. In general, the benefits that can be derived through the initiatives under the AIA can be summarized as follows:

1. By opening up all industries, investors could enjoy more investment access to economic sectors and industries if they qualify as ASEAN investors;
2. If investors qualify as ASEAN investors, they will be awarded national treatment;
3. Investors could expect more investment opportunities, greater transparency, ease of access to information and awareness for investments in the region;
4. More competitive investment regimes that are more liberal; and
5. Cost of transactions that are lower for business activities across the region.

TABLE 2. CEPT in the selected ASEAN

	Brunei	Cambodia	Indonesia	Malaysia	Philippines	Singapore	Thailand	Vietnam
1998	1.58	12.29	7.06	3.46	7.22	0	10.24	3.95
2000	1.26	10.39	4.76	3.32	5.18	0	6.12	7.25
2002	0.96	8.89	3.69	2.62	4.13	0	4.97	6.92
2004	0.89	6.99	1.86	1.67	3.27	0	3.97	5.51
2006	0.65	5.09	1.37	1.23	2.41	0	2.92	4.05
2009	0.41	2.24	0.86	0.77	1.51	0	1.84	2.55

Source: ASEAN Secretariat (2011).

With all the advantages offered, the AIA is anticipated to boost regional investment provided that each ASEAN member's domestic firms can gradually develop their strength in line with the progression of the AIA.

#### LITERATURE REVIEW

Rodrik (1999) argues that investment (as well as other macroeconomic policies) remains the key to economic growth. However, this conclusion is challenged by Bhagwati and Srinivasan (1999) who state that it is dangerous to rely exclusively on Rodrik's remark. Two events could reverse this view. Firstly, the experience of Soviet bloc countries, which experienced macroeconomic stability and substantial investment before their collapse, and, secondly, India's poor economic growth records in the 1980s, despite macroeconomic stability and rising investment. Both events tell us something different. Sun and Parikh (2001) examine the underlying theoretical model of Feder (1982) with data for the 29 Chinese provinces for the period of 1985 to 1995 and found that investment, as a ratio of GDP, has a positive impact on economic growth. Nair-Reichert and Weinhold (2001), whose study examines 24 developing countries, conclude that a significant causal relationship exists between domestic investment and economic growth, as well as finding that the relationship is not generally a strong determinant of future growth. Another interesting result regarding the role of domestic investment is that economic growth returns of extra domestic investment decline with increases in trade (openness) based on the coefficient of interacted variable of domestic investment with the level of trade (openness). Khan and Reinhart (1990) develop a simple growth model that allows private investment and public investment to exert differential impacts on output growth and find that private investment and public investment do have different effects on the long-run rate of economic growth. In other words, the marginal productivities of private and public investment differ in developing countries, with private investment playing a more important role in the growth process than public investment.

Grossman and Helpman (1991) indicate that protection could increase long-run growth if government intervention in trade encourages domestic investment along the lines of comparative advantage. Otherwise, it is anticipated that domestic investment will be discouraged by increasing competition resulting from the liberalization of capital accounts and inflows of FDI. Batra and Slottje (1993) draw the same conclusion, arguing that trade will only lead to economic downturns through a reduction in the competitiveness of domestic manufacturing goods due to lower tariffs and non-tariff barriers. Nam and Kim (2000) investigate systematic links between domestic investment and trade reforms in light of the South Korean experience beginning in the early 1960s when trade

policy shifted from an inward to outward orientation. The evidence from this study suggests that the long-lasting investment boom experienced by South Korea between 1960 and 1995 was initiated and maintained to a significant degree by the trade reforms of the 1990s and thereafter. Levine and Renelt (1992), and Wacziarg (2001) suggest that openness and growth relations may be established through investment and that increasing openness may raise long-run growth only insofar as openness provides greater access to investment goods. Wacziarg (2001) decomposes the growth factors and, by using his newly developed trade liberalization index, investigates the impact of trade liberalization on growth channels. This study finds that trade liberalization and growth relation may occur through investment and that increasing openness may raise long run growth insofar as openness provides greater access to investment goods.

#### METHODOLOGY

Several theoretical frameworks can be combined to support our empirical work below. According to Jorgenson (1963), and in line with the 'accelerator' hypothesis, the value of the desired capital stock for a typical firm depends positively on the demand level. Acosta and Loza (2005) argue that the most commonly used proxy for demand is GDP. Meanwhile, Loungani and Rush (1995) propose the role of bank credit on private investment, particularly when small and medium enterprises (SMEs) are concerned. The inability to directly attract funding from the public due to low credit-worthiness and long-term prospects has made the further development of banking systems an important option. Additionally, Balasubramanyam, Salisu and Sappford (1996) and Serven (2002) postulate that liberalization, either trade or capital, can have an effect on investments, especially through the channel of productivity and competitiveness. According to Serven (2002), an abrupt increase in competition may leave the sector less attractive for any investment. More importantly, the issue of crowding out domestic investment, potentially by foreign capital, can emerge.

Combining the above basic model of investment, the present study employs a similar model to Ndikumana (2000), who specifies the investment model by stating that investment is a function of financial development and that several macroeconomic variables play a role as control variables. In this study, in addition to domestic financial development, FDI is added as another important push or pull factor of DPI. Given the limited observation, GDP is chosen as the only macroeconomic control variable in the present study. In addition, investment-related initiatives are introduced as the focal variable, which is later proxied by AIA and AFTA. In short, the model is demonstrated as follows:

$$DPI_t = \alpha_0 + \alpha_1 DFD + \alpha_2 FDI_t + \alpha_3 GDP_t + \alpha_4 INI_t + \varepsilon_t \quad (1)$$

Where *DPI* stands for domestic private investment as a percentage of GDP, *DFD* represents domestic financial development, *FDI* denotes foreign direct investment, *GDP* represents gross domestic investment, and *INI* represents investment-related policies. All variables are entered in logarithmic form. On the measurement of each variable, *DFD* will be represented by lending rate, and *FDI* will be proxied by net inflows of FDI as a percentage of GDP. For *INI*, AIA and AFTA will be the proxy. For AIA and AFTA, a dummy is introduced as the first proxy for both. In addition, to reflect the gradual progression of AFTA, *CEPT* is utilized as another proxy for AFTA. A more robust conclusion is hoped to be attained in the analysis as a result of this approach.

In order to estimate model (1), the fully modified ordinary least squares (FMOLS) method is employed. The primary reason for employing this approach is because of the inability for the vector error correction model to deal with a dummy variable. The period of study is from 1984 to 2010. Data on *DPI* are obtained from the Department of Statistics Malaysia (the data were gathered upon special request to the Department of Statistics, Malaysia); *FDI* and *GDP* are obtained from the World Development Indicators (World Bank 2012); and the *CEPT* information is obtained from the ASEAN Secretariat (2011).

## RESULTS AND DISCUSSION

Table 3 presents the correlation among the variables under study. The negative association between *DPI*-*GDP* is rather surprising. The negative link between *DPI*-*GOV* is understandable as many big private companies in Malaysia have, to a certain degree, association with the government, normally referred to as government-linked companies (GLCs). The positive correlation between *DPI*-*FDI* could signify the benefit of FDI inflows on *DPI*. It might also imply that although the new investment-related measures may attract and benefit FDI inflows, and the FDI inflows, in turn, are able to generate a positive spillover

effect on *DPI*. Overall, we observe that high correlation exists between several variables, such as *CEPT*-*DFD* and *CEPT*-*GDP*. Hence, the use of ordinary least squares (OLS) may create bias, and, thus, the estimated results are no longer reliable.

In order to avoid the endogeneity problem, the model is estimated by using FMOLS. The results are presented in Table 4. In addition, a new proxy is constructed for *CEPT*, which is free from the influence of *DFD* and *GDP*. Regression is performed on *DFD* and *GDP* in relation to *CEPT*, utilizing the residual as an instrumental variable for *CEPT* and treating it as demonstrated in Model 4. As shown in Table 4, the impact of *FDI* is in line with many studies, such as Mirza and Giroud (2003), as FDI exerts a positive and significant impact on *DPI*. The insignificant implication of *GDP* could imply that the domestic market currently plays a minor role in explaining the development of domestic private entrepreneurs. If *GDP* is translated as a combination of various incentives or *DPI*-promoting strategies, the insignificant effect means there is a lot more room for improvement either in the types of strategy chosen or the amount of incentives to spur the development. Domestic financial development, which is proxied for by the domestic lending rate, also demonstrates the expected results, which are insignificant for Model 1 and Model 4. The negative effect clearly demonstrates that the higher the lending rate, the lower the amount that would be demanded by the local entrepreneurs to start up a new business or expand the existing business. This finding is consistent with the recent finding by Acosta and Loza (2005) that debt has a negative and significant impact on private investment in Argentina.

Finally, on the implication of *AIA* and *AFTA*, all proxies are observed to contribute highly to the promotion of *DPI*. More importantly, the dummy variables (*DAIA* and *DAFTA*) are found to exert a stronger impact. This could imply that the maximum benefits of *AIA* and *AFTA* can only be enjoyed by Malaysia provided that they are fully implemented. Although the *CEPT* demonstrates a positive

TABLE 3. Correlation Analysis

	lnDPI	lnDFD	lnFDI	lnGDP
lnDFD	-0.4486** (-2.6082)	1		
lnFDI	0.3519* (1.9537)	-0.0769 (-0.4006)	1	
lnGDP	-0.5088*** (-3.0710)	0.6890*** (3.7478)	-0.1054 (-0.5509)	1
lnCEPT	0.6291*** (4.2056)	-0.9080*** (-11.2646)	0.2601 (1.3994)	-0.9469*** (-15.2991)

Note: Asterisks \*\* and \*\*\* denote significant at 5% and 1% critical level, respectively. Figure in ( ) stands for t-value.



TABLE 4. Regression results [DV =  $\ln DPI$ ]

	Model 1	Model 2	Model 3	Model 4
Constant	0.8902 (0.1674)	26.5856*** (4.9355)	-3.1439 (-0.4717)	8.7314* (1.7337)
$\ln GDP$	0.1383 (0.6999)	-0.9107 (-0.4200)	0.3032 (1.1230)	-0.2343 (-1.2922)
$\ln DFD$	-0.4362 (-1.2780)	-0.5476** (-2.2821)	-1.2699* (-2.6527)	0.0807 (0.2538)
$\ln FDI$	0.0497 (0.6314)	0.0938* (1.7533)	0.1586** (2.3328)	0.1549* (1.9948)
DAIA	0.3889*** (4.3272)	-	-	
DAFTA	-	0.4622*** (3.2532)	-	
$\ln CEPT$	-	-	0.0088*** (2.9799)	
$\ln MODCEPT$	-	-	-	0.0083** (2.5529)
Adjusted-R <sup>2</sup>	0.5999	0.4022	0.3679	0.4453
S.E. of Reg.	0.1685	0.2060	0.2118	0.2205

Note: Asterisk \*, \*\* and \*\*\* denote significant at 10%, 5% and 1% critical value, respectively. Figure in ( ) denotes t-value.

impact, it is smaller in size due to the smaller value of its coefficient. In summary, the results in Table 4 reveal the potential benefits of AIA and AFTA if they can be fully realized. The result of Model 4 for the modified CEPT does not appear to significantly alter the result, thereby confirming the result of Model 3.

### CONCLUSION

The introduction of the AIA in particular, as well as the AFTA, is expected to boost regional investment and trade. The AIA objective to promote regional investors to be more active combined with the recently revised AIA framework, which does not discriminate in regards to the source of the contribution stemming from either ASEAN investors or non-ASEAN investors, raises the serious issue of whether the AIA will provide a real incentive for regional investors to develop, vice versa. With this as the baseline, the present study attempts to gauge the implications of AFTA and AIA in boosting regional investment. Regional investment, however, is the outcome of DPI being activated in each ASEAN country. In short, this study examines the effect of AFTA and AIA on DPI in Malaysia for the period between 1981 and 2009.

Our results show that all proxies of AIA and AFTA demonstrate a promising impact on DPI. With the positive impact of FDI on DPI, the full realization of AIA and AFTA is expected to accelerate the DPI. AIA and AFTA allow for Malaysian DPI to extend their operation abroad and FDI inflows, which are also partly due to AIA and AFTA,

elevating the performance of DPI. In short, AIA and AFTA are anticipated to produce a positive effect on DPI and the effort to accelerate the implementation must be intensified.

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