Masters of Science (Banking)

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WBB 6013: SEMINAR IN BANKING

FDI Inflow, Current Account Balance, Inflation And Interest Rate: How Do They Impact The Malaysian Economy?

By

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Abstract

This article seeks to find which of the macroeconomic variables among FDI inflow, current account balance, inflation and interest rate play a significant role in economic growth in Malaysia using the SPSS Regression method for a time period of 14 years from 1995 to 2008 (Oct). The results of the research indicated that FDI and inflation are not significantly related to economic growth in Malaysia during the period of study. However, CA balance and BLR are significant determinants of economic growth of Malaysia during the period of study. Inflation was noted to have a negative relationship while FDI, CA Balance and BLR were all positively related to economic growth in Malaysia.

JEL Classification: F41, C35

Keywords: FDI, Current Account, Inflation, Interest Rate

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1.0 INTRODUCTION

1.1 Background

Malaysia achieved sustained economic growth over the three decades from 1970 to 2000 with an average annual growth of about 7 per cent. However, there were several temporary economic downturns when growth was significantly below the average. There was the first oil crisis in 1973–4; the second oil crisis in 1978–9; the global downturn in the demand for electronics and primary commodities in 1985–6, and the Asian financial crisis in 1997. Standards of living of the majority of the population were transformed over the 30-year period, with levels of real gross domestic product (GDP) per capita in 2000 being about four times the levels reached in 1970.

On the whole, Malaysia's economy accelerated to 6.4% in 2007 from 5.8% in 2006. Following the strong performance in 2007, growth is projected to ease slightly in 2008-2009, due to the less supportive global economy. The worse-than-expected US economy, due to the fallout from the sub-prime turmoil, could negatively affect Malaysia's exports, as the US market absorbs 20% of the country's exports. It is expected that the external balance will continue to make a negative contribution to the real GDP growth.

In view of the weakening global economic outlook, Malaysia's real exports are envisaged to contract by 5.0% in 2009, compared with +4.9% estimated for 2008. Nevertheless, with inflation threat easing considerably in most countries, central banks around the globe have been able to deliver sweeping interest rate cuts, which coupled with aggressive economic stimulus packages will likely prevent the global economy from falling into a protracted downturn. Indeed, with Europe's interest rates falling to 2.0-2.5% (there is room for it to fall further) and the US and Japan's key interest rates at low levels of 1.0% and 0.3%, respectively, the global economy will likely be

flushed with cheap liquidity in 2009. This, together with the stimulus packages, will gradually restore consumer and business confidence and set a stage for the global economy to gradually turn around and recover towards the end of 2009 or early 2010.

Malaysia's impressive economic growth since the 1960's can be traced back to policies promoting foreign investment. In fact, FDI is said to be the most important contributing factor for Malaysia's economic performance. The early beginnings of luring foreign investors to Malaysian soil started with the introduction of the Investment Incentives Act 1968, and followed by the establishment of the Free Trade Zones (FTZs) during the Second Malaysia Plan (1971-75). Since then, Malaysia has attracted a large portion of the investment dollar that flowed into Asia. In 1995, for example, Malaysia was the second largest FDI recipient among Asian economies at US$ 5.8 billion.

Malaysia recorded inward FDI of USD 7.3 billion and USD 6.3 billion in 1996 and 1997 respectively. The lower figures in 1997 may be attributed to the lack of confidence as a result of the Asian financial crisis but by 1998, figures indicate that investor confidence had improved. Malaysia's highest FDI inflow was recorded in 2007 when the amount surged to USD 8.4 billion from USD 6.0 billion in 2006.

FDIs are private-sector investments that are made by a company into a foreign country. Foreign direct investments create a strong demand for a local currency and help boost the economy. With money coming into a country, strong foreign direct investment is one way governments can finance current account deficits. However, just as funds flow in, they also can flow out, creating economic turmoil.

Levels of foreign direct investment are closely watched to determine how attractive a country is to investors. If foreign direct investment levels drop,

then other investors may become cautious about investing in that country. As a result, others may limit their foreign direct investment activities and also limit their purchases of stock or bonds issued by the country's corporations.

Malaysia has registered consistent and large current account surpluses. The trade surplus is the main driver. For the first eleven months of 2007, the total trade surplus was USD 2.7 billion, decreasing by 5.8% compared with the same period in 2006. Total exports rose by 2.7%, while imports expanded by 4.6%. Electronic products account for more than 40% of total exports. Palm oil and crude oil are the second and third largest exports earners. On the import front, intermediate, capital and consumption goods grew 6.2%, 6.9% and 4.1%, respectively. In 2008, exports will remain weak, as the electronic cycle just started to recover, suggesting a modest growth of the exports of electronic goods. Moreover, the slowdown of the US economy had tempered the demand of Malaysia's exports.

However, export revenues will continue to be supported by high commodity prices. Import growth will continue to outpace that in exports. Although demand for intermediate goods (70% of total imports) will also slow in response to the weaker global economy, growth will be fuelled by strong demand for consumer and investment goods. As a result, the trade surplus is forecasted to narrow to below 20% of GDP, down from the peak of 24% of GDP in 2005. The services balances used to register a small deficit, but there was a turnaround in 2007, as it registered a small surplus in the first three quarters of 2007, due to lower payment on transportation and higher surplus on tourism. We expect a balanced services account in 2008. The income and transfers balance deficits will remain broadly stable, and we expect this trend to continue. On the whole, the current account surplus is projected to decline, but will remain substantial at an estimated 14% of GDP in 2008 and 12% of GDP in 2009.

In the light of strong external position, the government has eliminated many capital account restrictions, not only to attract more foreign direct investment, but also to facilitate domestic companies to operate overseas. This has led to growing financial account outflows. In the first three of quarters of 2007, the financial account registered a net outflow of USD 6 billion, down slightly from a net outflow of about USD 6.5 billion in the same period of 2006. This was attributed to lower portfolio outflows. The overall surplus is expected to remain large in the coming years, but to decline gradually due to declining current account surpluses.

In addition to FDI-growth and CA Balance-growth relationships, economists particularly, have long reason to wonder whether inflation is generally conducive or detrimental to the economic growth. There are still substantial disagreement among the empirical researchers, however, about how quantitatively important are the growth depressing effects of inflation and at what levels of inflation these effects begin to appear. Some economists have been concerned by rates of inflation of three or four percent while others have been unconcerned by rates of twenty or thirty percent.

The headline inflation rate, as measured by the change in the Consumer Price Index (CPI), increased to 8.4% in the third quarter (2Q 08: 4.8%). The higher inflation during the quarter reflected the higher retail prices for petrol and diesel following the subsidy restructuring on 4 June 2008; higher electricity tariffs from 1 July 2008; as well as higher food prices. Indicators suggest that inflation has peaked in the third quarter. Going forward, the decline in global food and commodity prices, as well as moderating growth, will rein in domestic price pressures. In addition, with the declining energy prices, the Government has lowered domestic fuel prices. Improved supply has also reduced rice prices.

Following three interest rate hikes during 2005-2006, the benchmark overnight policy rate (OPR) has been maintained at 3.5%, still accommodative to the country's economy. Recently, the US authorities started to loosen its monetary stance. Therefore, interest rate differentials between two countries are expected to widen, which is likely to prompt the central bank, the Bank Negara Malaysia (BNM), to cut interest rates in 2008.

The OPR was left unchanged at 3.50% throughout the third quarter of 2008. The prevailing level of the policy rate remained consistent with the outlook for slower economic growth and the expected moderation in inflation into 2009 from its current elevated level. With the OPR unchanged, interbank rates for all maturities were stable during the quarter. In terms of lending rates, the average base lending rate remained unchanged during the quarter, while the average lending rate softened to 5.96% as at end-September. Deposit rates remained relatively stable during the period.

1.2 Problem Definition

Going forward, the deterioration of the global financial environment has begun to have an adverse impact on global economic activity. Global growth is weakening substantially, with several major developed economies sliding into a recession. As a result, signs of moderation in growth have surfaced in the emerging economies. Despite the aggressive injection of liquidity into the financial markets and recapitalisation of the large financial institutions in major industrial countries, international financial markets have not normalised and continue to remain highly volatile. However, with the sharp deceleration in growth and decline in commodity prices, inflationary concerns have receded. As a highly open economy with strong financial and real economic linkages with the rest of the world, the Malaysian economy has been impacted by these external developments. The significant slowdown in global growth is expected to affect the export sector while the continued volatility across financial markets may dampen business outlook. While this more challenging

period is expected to see a moderation in growth, the economy will continue to expand.

Malaysia's better resilience lies in the established strong fundamentals that have been built-up over several years. The continued significant current account surplus, low external debt, large international reserves and well-capitalised banking system, will place the economy in a stronger position to weather this challenging period. Strategies going forward will aim at sustaining domestic demand, reducing Malaysia's external vulnerabilities and ensuring that financial intermediation to proceed uninterrupted.

In order to prepare for the global financial crisis, Malaysia's key economic indicators and drivers of economy need to be assessed to adequately identify which are the ones and how can they effectively spur the Malaysian economy and/or revive Malaysia's economy in case of need. Hence, the key economic indicators which are most commonly related to economic growth, namely, FDI inflow, current account balance, inflation and interest rate are chosen to analyse their effect on GDP as an indicator of economic growth and condition.

1.3 Objective and Justification

It has been widely argued that the pegging of the Ringgit against the USD played the key role in reviving the Malaysian economy during the 1997-1998 financial crisis. What about the other macroeconomic indicators? Hence, there is also a need to determine the other determinants that played roles in the reviving of the Malaysian economy during the 1997-98 financial crisis as well as to determine whether all those determinants are in place to counter the possible future crisis.

The objective of this study is to examine the relationship between FDI inflow, current account balance, inflation and interest rate with economic

growth[1] in Malaysia. This would enable to identify which macroeconomic variable is the most effective tool to revive the Malaysian economy during financial crisis. The study would also show the trend and behavioural pattern of the identified macroeconomic variables including the GDP during normal economic conditions and during financial crisis. With such information, one would also be able to predict whether or not the Malaysian economy will be affected by the current global financial crisis and prepare us better for the economic shock. Since the current global economic crisis was not caused by currency crisis, the exchange rate was not included as one of the variables[2].

2.0 LITERATURE REVIEW

There have been numerous cross-country studies in the literature on the determinants of economic growth**.** Mete Feridun (2005) in the study "East Asian Financial Crisis Revisited: An Economic Analysis, 1981 – 2001" had summarized the results of study to emphasize the need for careful monitoring of three key variables, namely M2 relative to gross international reserves, growth of exports[3] and foreign direct investment relative to GDP. The study on 5 East Asian countries, namely, Malaysia, Singapore, Thailand, Indonesia and Philippines showed that increasing FDI relative to GDP, decrease in growth of exports, decreasing real interest rate and increased inflation apparently accounted for financial crisis in Malaysia. However, current account balance was not a significant determinant of financial crisis in Malaysia.

The linkage between FDI and economic growth was however contradicting in the study by Dierk Herzer, Stephen Klasen and Felicitas Nowak-Lehmann D (2007). In their study "In Search Of FDI-Led Growth In Developing Countries: The Way Forward" it was deduced that in the vast majority of countries there is neither

[1] In this study GDP is used as measurement for economic growth
[2] A limitation to the study is the non-inclusion of exchange rate as one of the variables.
[3] Growth of exports also denotes current account balances

a long-term nor a short term effect; in fact there is not a single country where a positive uni-directional long-term effect from FDI to GDP was found to exist. Their results also did not indicate a clear regional pattern or influence of other factors on the FDI-growth linkage.

In contrast to the findings by Mete Feridun (2005), in the study by Roberto A. De Santis and Melanie Luhrmann (2008) entitled "On The Determinants Of Net International Portfolio Flows: A Global Perspective" among others it was noted that Current Account Balances worsen with lagged real GDP growth.

Most of the studies on FDI and economic growth indicated that no direct relationship but causal relationship where other factors were also involved. Laura Alfaro, Areendam Chanda, Sebnem Kalemli-Ozcan and Selin Sayek in their study on "FDI and Economic Growth: The Role of Local Financial Markets" concluded that FDI alone plays an ambiguous role in contributing to economic growth. However, the level of development of local financial markets is crucial for these positive effects to be realized, and this has not been shown before. They also found that the link between FDI and growth was causal, where FDI promotes growth through financial markets.

The linkage between FDI and economic growth was further strengthened by Imad A. Moosa and Buly A. Cardak (2005) and Mustapha Sadni Jallab, Monnet Benoît Patrick Gbakou and René Sandretto (2008) in their studies.

Imad A. Moosa and Buly A. Cardak (2005) in relation to FDI found that countries that are more successful in attracting FDI are developed countries with large economies, a high degree of openness and low country risk. Policy targeted at attracting inward FDI should focus on enhancing physical, political and legal infrastructure along with trade openness, thereby improving the attractiveness of a nation as a destination for FDI.

Mustapha Sadni Jallab, Monnet Benoît Patrick Gbakou and René Sandretto (2008) in their study on Middle East and North African Countries found that FDI policies implementing incentives for foreign investors (such as tax reductions, import duty exemptions, subsidies, etc.) aimed at attracting foreign capital are not sufficient to generate economic growth. A more ambitious policy aimed to change the local environment, increasing human capital endowment, facilitating skill upgrading, creating a sound macroeconomic, promoting the development of the financial market, in tandem with FDI strategy complementary with the local production is more likely to boost the GDP, than subcontracting the task of economic growth and development to foreign firms by granting them pecuniary advantages. Economic growth and development cannot be purchased abroad. It has to be built collectively, by mobilizing the full resources of the country, while learning at the same time on foreign contributions.

There were also some mixed results obtained in studies on linkage between FDI and economic growth. Dharmendra Dhakat, Saif Rahman and Kamal P. Upadhyaya (2007) in their study "Foreign Direct Investment and Economic Growth In Asia**"** showed evidence of FDI-to-growth causality in three of the nine countries, and growth-to-FDI causality in six countries. Two of the countries showed causality in both directions, while two showed no causality at all. Based on their results, it was deduced that the variation in the FDI-growth relationship indicates that causality between the two variables cannot be generalized and must be considered more carefully. FDI-to-growth causality is strengthened by the presence of greater trade openness, more limited rule of law, lower receipts of aid, and lower income level of the host country. Growth-to-FDI causality, on the other hand, is reinforced by greater political rights and more limited rule of law.

Stephan Danninger and Florence Jaumotte (2008) in their study on "Lessons From Cross-Regional Analysis" found that much of the regional differences could be explained by structural factors, including the traditional view that high growth prospects attract foreign capital and lower the current account balance. In emerging

Europe, the large current account deficits are related to the rapid liberalization of the domestic financial markets and capital accounts, which attracted large capital inflows and prompted a rapid rise of foreign bank ownership. In contrast, in emerging Asia, the impact of high growth prospects on attracting inflows was outweighed by factors such as the more limited openness of the capital accounts and financial sectors, demographics and differences in the political structure.

The investigations into the existence and nature of the link between inflation and growth have experienced a long history. Although economists now widely accept that inflation has a negative effect on economic growth, researchers did not detect this effect in data. Min Li (2005) in the study "Inflation and Economic Growth: Threshold Effects and Transmission Mechanisms" found that developed countries seem to show a different form of nonlinearity in the inflation-growth effect. That is, the magnitude of the negative effect of inflation on growth declines as the inflation rate increases. Inflation has a greater adverse effect on economic growth in developed countries than in developing countries.

Another literature by Girijasankar Mallik and Anis Chowdhury (2001) indicated long-run positive relationship between GDP growth rate and inflation for all four countries in their study. Inflation and economic growth was positively related. The sensitivity of inflation to changes in growth rates was larger than that of growth to changes in inflation rates. It was however not so in the study conducted by Vikesh Gokal and Subrina Hanif (2004) where a weak negative correlation between inflation and growth was found to exist.

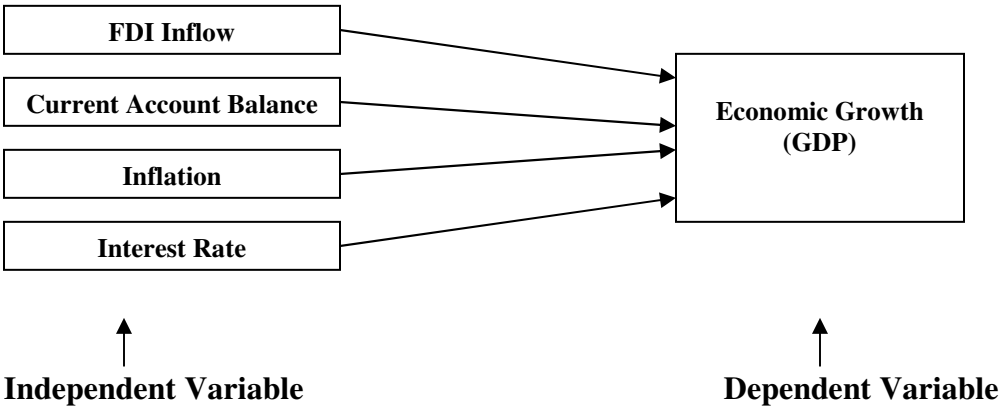
There is a conventional perception that high real interest rates are bad for economic growth. However, Shafik and Jalali (1991) showed that close examination of the experience over the last 40 years undermines the existence of such relationship. For much of the 1959-70 period ex-post interest rates were less than the growth rate of income in the major economics whereas the 1980s were a

period of rapid growth in the world economy that coincided with unprecedentedly high real interest rates.

A detailed summary of the literature review is depicted in **Appendix I.**

3.0 THEREOTICAL FRAMEWORK

In this research, the independent variables are the FDI inflow, current account balance, inflation and interest rate whereas the dependent variable is the economic growth (GDP). The thereotical framework is as follows:-



The framework is based on the previous empirical study by Mete Feridun (2005) where the above-mentioned independent variables (FDI, Current Account Balance, Inflation and Interest Rate) together with other independent variables were tested against the dependent variable of GDP to find out which macroeconomic variables played a role in the East Asian financial crisis of 1997 for five countries, namely, Malaysia, Indonesia, Thailand, Singapore, and Philippines.

In this research, the following hypotheses are to be tested:-

H1: FDI inflow has significant relationship with economic growth in Malaysia.

H2: Current account balance has significant relationship with economic growth in Malaysia.

H3: Inflation has significant relationship with economic growth in Malaysia.

H4: BLR has significant relationship with economic growth in Malaysia.

4.0 METHODOLOGY

4.1 Research Design

The behavioural patterns of the independent variables with the dependent variable are analysed by conducting a trend analysis with graphs plotted from Excel worksheet whereas the hypotheses are tested through statistical analysis using the SPSS regression model where the output of mean, standard deviation, correlations, R squared and coefficient are obtained.

4.2 Data Source

For the study, a data set[4] of yearly observations covering the period from 1995 to 2008 (Oct) was used. The variables were selected on the basis of previous empirical literature and theories. The study incorporates a total of 4 macroeconomic variables[5] as indicated in Table 1. The absolute figures were transformed into percentages of changes for synchronisation and to make testing procedures valid.

[4] All data are obtained from IMF and BNM

[5] A limitation of the study is that it is based solely on quantitative variables and takes no account of any qualitative variables.

An economic growth indicator that is used frequently in the literature that has been included in this study is the percentage change in the GDP. This explanatory variable is also used as an indicator of financial crisis.

Table 1: Explanatory variables FDI, CAB, CPI, INT and GDP

Variable	Explanation[6]
Foreign Direct Investment Inflow	Foreign direct investment is the sum equity capital, reinvestment of earnings, other log-term capital and short-term capital as shown in the balance of payments. This series shows net inflow in Malaysia.
Current Account Balance	Current account balance is the sum of net exports of goods, services, net income, and net current transfers. Data are in USD converted to percentage change year-on-year.
Inflation	Inflation is measured by the consumer price index and reflects the annual percentage change in the cost of goods and services.
Interest Rate	Is the Base Lending Rate adjusted for inflation as measured by the GDP deflator.
Gross Domestic Product	Gross Domestic Product is the measurement of national income or output of the country.

[6] Explanation taken from World Bank and BNM

5.0 FINDINGS AND DISCUSSION

5.1 Descriptive Statistics

The data set obtained for the 14 years from 1995 to 2008 (Oct) are depicted in Table 2.

Table 2: Data set for 14 years from 1995 to 2008 (Oct)

Year	GDP (% Change)	FDI Inflow (% Change)	CA Balance (% Change)	CPI (% Change)	BLR (%Change)
1995	9.8	26.1	53.6	3.2	1.2
1996	10.0	25.9	-48.4	3.5	2.63
1997	7.3	-13.7	33.0	2.7	1.56
1998	-7.4	-57.1	-260.6	5.3	-2.72
1999	6.1	44.4	32.3	2.7	-1.55
2000	8.9	-2.6	32.7	1.6	0
2001	0.5	-84.2	-14.2	1.4	-1.56
2002	5.4	433.3	10.1	1.8	0
2003	5.8	-21.9	64.6	1.1	-0.3
2004	6.8	84.0	12.6	1.4	-0.02
2005	5.3	-13.0	34.4	3.1	0.22
2006	5.8	50.0	26.2	3.6	0.55
2007	6.4	40.0	2.9	2.0	0
2008 (Oct)	5.8	-26.2	-6.8	7.6	-0.25

Prior to the 1997-98 financial crisis, Malaysia was experiencing tremendous growth as evidenced by the GDP of 9.8% and 10.0% in 1995 and 1996 respectively. For the 14 years under study, Malaysia's worst-ever economic growth was in the year 1998 when the GDP registered –7.4% mainly attributed to the financial crisis. It was also during this period when there was

a huge drop in FDI inflow, CA balance and BLR, and an increase in inflation. Malaysia's FDI dropped 57.1% from the previous year. This was after recording a drop of 13.7% in the year 1997. In the case of CA Balance, there was a sharp drop of 260.6% in the year 1998 after an increase of 33.0% in the year 2007. The BLR, on the other hand, dropped an all time high of 2.72% from the previous year. Accordingly, inflation increased from 2.7% in 1997 to 5.3% in 1998.

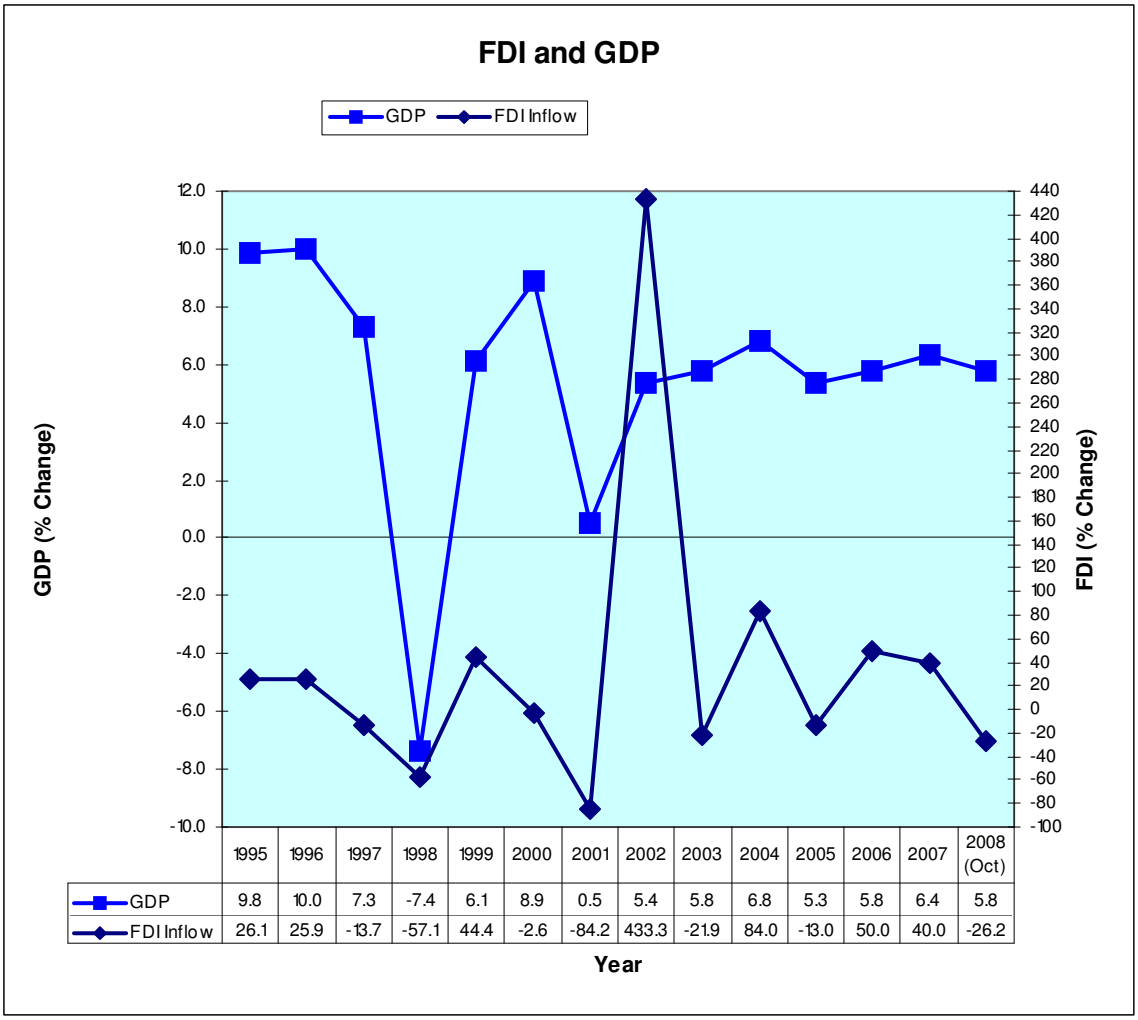
Apart from during the 1997-98 financial crisis, Malaysia's economic growth had also slowed down to 0.5% in 2001 with both FDI and CA balance registering huge declines of 84.2% and 14.2% respectively. This was mainly attributed to the recession in the USA which reduced demand for electronics, together with global over investment in new capacity in this sector resulted in another downturn in the global electronics cycle in 2001-2002. The adverse external circumstances in turn affected Malaysia's exports as it shrank from RM374 billion to RM334 billion from 2000 to 2001 while growth contracted from 8.9% to 0.5% over the same period. At the same time, the drop in global FDI flows in 2001 as well as increasing competitiveness for FDI from China, India and Vietnam, resulted in a severe drop in FDI inflows into Malaysia.

It has to be noted that the all time highest inflation during the 14 years under study was recorded in October 2008. Inflation stood at 7.6%, which was a decline from 8.4% in the third quarter of 2008. The higher inflation in the third quarter of 2008 reflected the higher retail prices for petrol and diesel following the subsidy restructuring on 4 June 2008; higher electricity tariffs from 1 July 2008; as well as higher food prices. Indicators suggest that inflation has peaked in the third quarter and had had subsequently eased a little due to lowered domestic fuel prices and reduced rice prices.

5.2 Trend Analysis

The graphical result of the trend analysis are depicted as follows:-

5.2.1 FDI and GDP



	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008 (Oct)
GDP	9.8	10.0	7.3	-7.4	6.1	8.9	0.5	5.4	5.8	6.8	5.3	5.8	6.4	5.8
FDI Inflow	26.1	25.9	-13.7	-57.1	44.4	-2.6	-84.2	433.3	-21.9	84.0	-13.0	50.0	40.0	-26.2

The comparison in the changes in FDI and GDP indicates minor relationship in the trend. Similar trend is only noted to be present prior to year 2002 after which there was a huge surge in FDI.

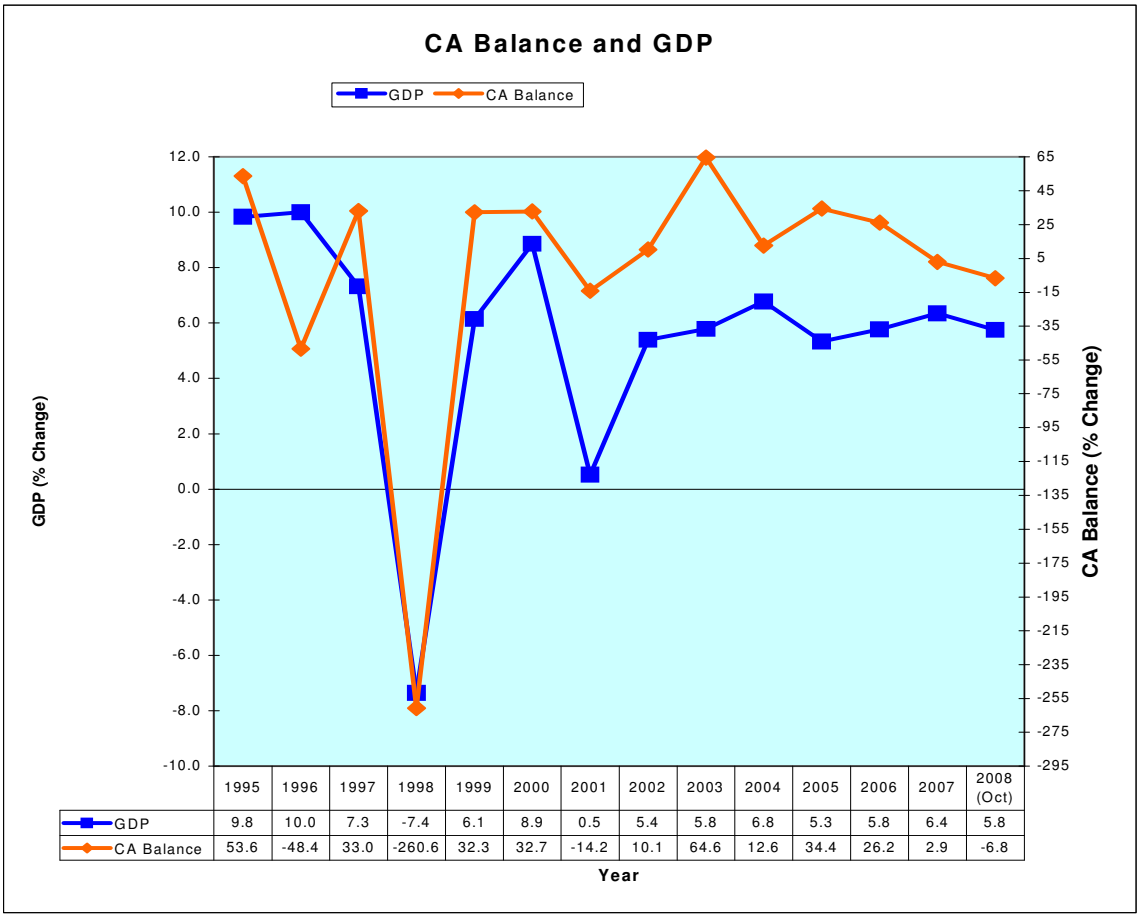
Apart from the notable 1997-98 financial crisis, there was also a decline in the Malaysia's economic growth and FDI in the year 2001, 2005 and 2008. The decline in the year 2001 was mainly due to the recession in the USA, reduced demand for electronics and global over

investment in new capacity in this sector which resulted in another downturn in the global electronics cycle in 2001-2002. The adverse external circumstances in turn affected Malaysia's exports as it shrank from RM374 billion to RM334 billion from 2000 to 2001 while growth contracted from 8.9% to 0.5% over the same period. At the same time, the drop in global FDI flows in 2001 as well as increasing competitiveness for FDI from China, India and Vietnam, resulted in a severe drop in FDI inflows into Malaysia.

Economic growth recovered in 2003 and 2004 to 5.8%and 6.8%, respectively but the global cyclical slowdown and rise in oil prices in 2005 together with the emergence of exogenous shocks such as the tsunami and the avian flu slowed the growth in 2005 to 5.3%.

The year 2008 sees another decline in the GDP and FDI attributed by the global financial crisis which emanated from the US sub-prime crisis.

5.2.2 CA Balance and GDP



	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008 (Oct)
GDP	9.8	10.0	7.3	-7.4	6.1	8.9	0.5	5.4	5.8	6.8	5.3	5.8	6.4	5.8
CA Balance	53.6	-48.4	33.0	-260.6	32.3	32.7	-14.2	10.1	64.6	12.6	34.4	26.2	2.9	-6.8

Prior to the 1997-98 financial crisis, Malaysia's current account deficits were the largest and the most persistent compared to those of the other neighboring ASEAN countries that were severely affected by the 1997-98 financial crisis. Indeed, the current account has been on deficit since 1987, a deficit which increased markedly during the early and mid 1990s. In the aftermath of the crisis, however, the current account took a sharp reversal due mainly to the fall of the ringgit against the currencies of its major trading partners.

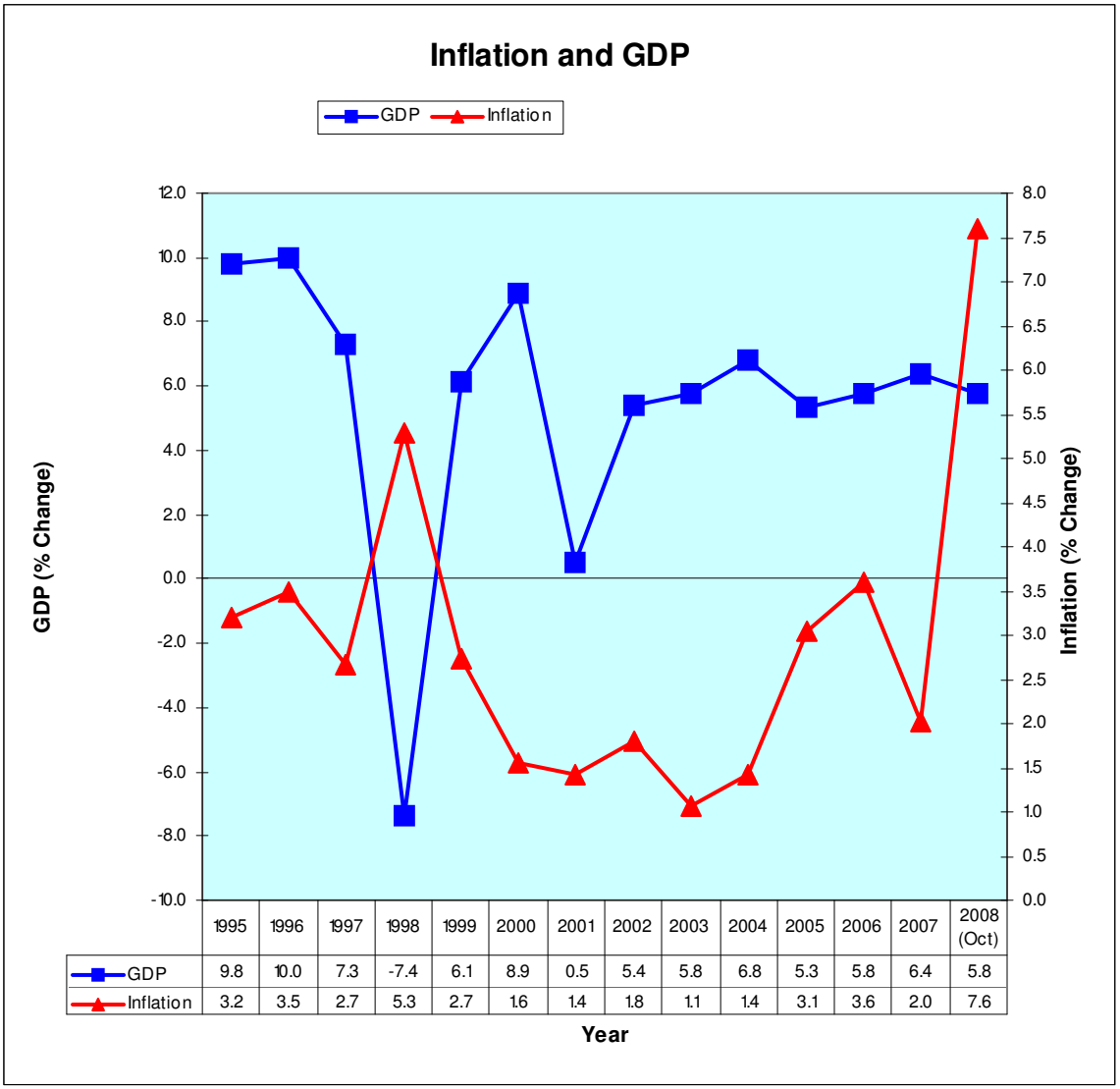
Subsequent to the 1997-98 financial crisis, Malaysia has registered consistent and large current account surpluses with the trade surplus being the main driver. Growth of CA balance remained quite strong

over much of the period, but registered a slight decrease in the 2001, as a result of the slowdown of the US stock market and its impact on Malaysian electronics exports in particular. The decline in exports was matched by a fall in imports which resulted to drop in the CA balance.

The CA balance recovered in 2003 in line with economic growth. In 2004, the stronger expansion in exports of manufactured goods, in particular electronics, and sustained growth in commodity earnings contributed to the large trade surplus. As a result, the current account balance increased further by another 12.6% from the balance in year 2003.

There is high correlation between CA balance and GDP as indicated by the Sig. (1-tailed) Correlations of 0.000 for the period under study.

5.2.3 Inflation and GDP



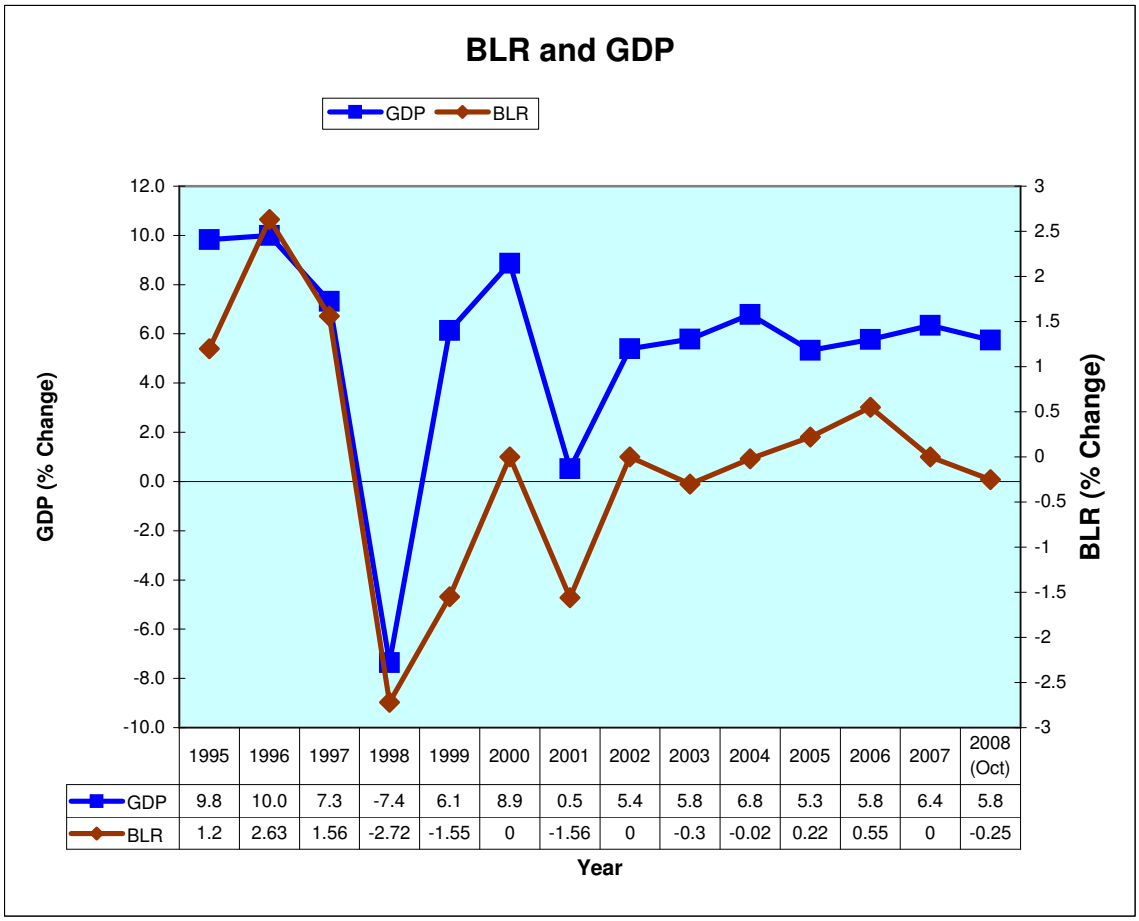
There appears to be an inverse relationship in the trend between Inflation and GDP.

During the 1997-98 financial crisis, inflation levels rose reaching a high of 6.2% in June 1998 before moderating. The inflation rate was 5.3% in 1998. The rise in inflation is one of the main channels through which the social impact of the crisis has been transmitted because it is through these channels that real household income declined. The inflation, however, showed downward trend which was first detected

in mid-1998. This has been largely due to the fixing of the Ringgit exchange rate to the U.S. dollar, which has somewhat reduced price-markups as a result of insulation from exchange rate fluctuations. Fixing the exchange rate has virtually halted imported inflation, a major problem throughout the previous year. In the first two months of 1999, inflation stood at 4.5% and finally settled at 2.7% at the end of 1999 following a rise of 5.3% in the previous year. Subsequent to the financial crisis, inflation showed a steady trend hovering between 1.1% - 1.8% from 2000 to 2004 after which there was an increase to 3.1% in the year 2005 mainly due to rise in oil prices.

It is pertinent to note that the inflation in 2008 (Oct) has hit the all time high of 7.6% for the period under study from a low rate of 2.0% in year 2007. This was attributed by the rising oil prices and the global economic crisis.

5.2.4 BLR and GDP



	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008 (Oct)
GDP	9.8	10.0	7.3	-7.4	6.1	8.9	0.5	5.4	5.8	6.8	5.3	5.8	6.4	5.8
BLR	1.2	2.63	1.56	-2.72	-1.55	0	-1.56	0	-0.3	-0.02	0.22	0.55	0	-0.25

There is a close relationship in the trend between the changes in BLR and GDP.

Theoretically, a lower interest rate, which implies a lower cost of borrowing, can help boost a country's economy by stimulating business investment and consumer demand. Businesses will find more incentives to invest when interest rates are low, while consumers will be induced to apply for loans for big-ticket purchases such as cars and houses. For the existing borrowers, on the other hand, the lower loan repayment would leave them with more disposable income to spend on other goods and services.

During the 1997-98 financial crisis, Malaysia's was to adjust the interest rates upwards to contain inflationary expectations that were likely to follow increasing demand pressures. Hence the BLR in the year 1997 rose to 12.22% from 10.66% in 1996. Additionally, policymakers were also concerned that lowering interest rates to boost the economy would cause the real exchange rate of the Ringgit to appreciate, thereby making Malaysian goods and services even more uncompetitive in the international market, in addition to many other negative repercussions on the domestic economy. Nevertheless, the impact of the interest-rate declines on the exchange rate was circumvented by the government. On September 1, 1998, Malaysia introduced selective capital control measures. The imposition of the capital controls was designed to break the link between domestic interest rates and the exchange rate so that monetary policy could be set without having the external disciplining forces of the exchange rate to reckon with. The controls further enabled the easing of interest rates without fear of negatively affecting the Ringgit, and this subsequently enabled the reflation of the economy to take place.

A significant development in 2004 was the implementation of the new interest rate framework on 26 April 2004. The new framework involved the introduction of a new policy rate and improvements to the conduct of monetary operations, as well as the removal of the ceiling on base lending rates (BLRs) and prescribed lending spreads. Banking institutions now set their BLRs based on their respective cost structures and business strategies. Hence, there were not much movements in the BLR since 2004.

The Overnight Policy Rate (OPR) was increased twice, on 22 February and 26 April 2006, by 25 basis points each time. Hence, the BLR of the commercial banks adjusted quickly to changes in the OPR.

The average BLR of all commercial banks had risen after the first OPR increase in November 2005 and continued to increase after the OPR changes in February and April and finally stabilised at 6.72% in mid-May until the end of the year 2006. On the whole, the average BLR increased by 74 basis points, slightly lower than the total increase of 80 basis points in the OPR since November 2005. Most commercial banks had adjusted their BLRs upwards in the range of 50-100 basis points over the period January to May 2006.

In the year 2007, the BLR softened due to strong competition between banks and has remained such until the reduction in 2008.

5.3 Regression Analysis

Correlations

		GDP (% Change)	CPI Average Consumer Price (% Change)	CA Balance (% Change)	FDI Inflow (% Change)	BLR (change)
Pearson Correlation	GDP (% Change)	1.000	-.323	.810	.214	.808
	CPI Average Consumer Price (% Change)	-.323	1.000	-.542	-.254	-.087
	CA Balance (% Change)	.810	-.542	1.000	.182	.482
	FDI Inflow (% Change)	.214	-.254	.182	1.000	.158
	BLR (change)	.808	-.087	.482	.158	1.000
Sig. (1-tailed)	GDP (% Change)	.	.130	.000	.231	.000
	CPI Average Consumer Price (% Change)	.130	.	.023	.191	.383
	CA Balance (% Change)	.000	.023	.	.267	.040
	FDI Inflow (% Change)	.231	.191	.267	.	.295
	BLR (change)	.000	.383	.040	.295	.
N	GDP (% Change)	14	14	14	14	14
	CPI Average Consumer Price (% Change)	14	14	14	14	14
	CA Balance (% Change)	14	14	14	14	14
	FDI Inflow (% Change)	14	14	14	14	14
	BLR (change)	14	14	14	14	14

(i) FDI and GDP

The correlation of 0.214 indicates low positive correlation between FDI and GDP. The Sig.(1-tailed) of 0.231 which is more than 0.05 indicates that the correlations between FDI inflow and GDP is not significant. So the null hypothesis: FDI inflow has significant relationship with economic growth in Malaysia is rejected and the alternative hypothesis: FDI inflow has no significant relationship with economic growth in Malaysia is accepted.

(ii) CA Balance and GDP

The correlation of 0.810 indicates a strong positive correlation between CA Balance and GDP. The Sig.(1-tailed) of 0.000 which is less than 0.05 indicates significant correlations between change in CA Balance and GDP. So the null hypothesis: CA Balance has significant relationship with economic growth in Malaysia is accepted.

(iii) Inflation and GDP

The correlation of -0.323 indicates a negative correlation between CPI and GDP. The Sig.(1-tailed) of 0.130 which is more than 0.05 indicates that the correlations between CPI and GDP is not significant. So the null hypothesis: Inflation has significant relationship with economic growth in Malaysia is rejected and the alternative hypothesis: Inflation has no significant relationship with economic growth in Malaysia is accepted.

(iv) BLR and GDP

The correlation of 0.808 indicates a strong positive correlation between BLR and GDP. The Sig.(1-tailed) of 0.000 which is less than 0.05

indicates significant correlations between BLR and GDP. So the null hypothesis: BLR has significant relationship with economic growth in Malaysia is accepted.

(v) CA Balance and CPI

The correlation of -0.542 indicates low negative correlation between CA Balance and CPI. The Sig.(1-tailed) of 0.040 which is less than 0.05 indicates significant correlations between and change in BLR and CA balance. Hence, there is also significant negative relationship between CA Balance and inflation in Malaysia.

Model Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics					Durbin-Watson
					R Square Change	F Change	df1	df2	Sig. F Change	
1	.941[a]	.885	.833	1.7780	.885	17.267	4	9	.000	1.897

a. Predictors: (Constant), BLR (change), CPI Average Consumer Price (% Change), FDI Inflow (% Change), CA Balance (% Change)

b. Dependent Variable: GDP (% Change)

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	218.341	4	54.585	17.267	.000[a]
	Residual	28.451	9	3.161		
	Total	246.792	13			

a. Predictors: (Constant), BLR (change), CPI Average Consumer Price (% Change), FDI Inflow (% Change), CA Balance (% Change)

b. Dependent Variable: GDP (% Change)

The value of regression coefficient, R which is 0.941 and its probability test of 0.000 makes the relationship between FDI, CA Balance, inflation and BLR with GDP significant. The R square of 0.885 indicates that 88.5% explained the variables.

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	95% Confidence Interval for B		Correlations		
		B	Std. Error	Beta			Lower Bound	Upper Bound	Zero-order	Partial	Part
1	(Constant)	5.162	1.309		3.943	.003	2.200	8.123			
	CPI Average Consumer Price (% Change)	.123	.423	.041	.291	.777	-.834	1.080	-.323	.097	.033
	CA Balance (% Change)	.031	.009	.569	3.612	.006	.012	.051	.810	.769	.409
	FDI Inflow (% Change)	.001	.004	.037	.312	.762	-.008	.011	.214	.104	.035
	BLR (change)	1.720	.434	.531	3.959	.003	.737	2.703	.808	.797	.448

a. Dependent Variable: GDP (% Change)

Based on the coefficient table, the regression equation is:-

$GDP = \beta + \beta_1 CPI + \beta_2 CA\ Balance + \beta_3 FDI + \beta_4 BLR$

The constant is 5.162, coefficient for CPI is 0.041, coefficient for CA Balance is 0.569, coefficient for FDI is 0.037 and coefficient for BLR is 0.531. The regression equation is therefore:-

$GDP = 5.162 + 0.041\ CPI + 0.569\ CA\ Balance + 0.037\ FDI + 0.531\ BLR$

This indicates that:-

(i) positive relationship, not significant, 0.041 point increase in CPI leads to 1 point increase in GDP;

(ii) positive relationship, significant, 0.569 point increase in CA Balance leads to 1 point increase in GDP;

(iii) positive relationship, not significant, 0.037 point increase in FDI leads to 1 point increase in GDP; and

(iv) positive relationship, significant, 0.531 point increase in BLR leads to 1 point increase in GDP.

The output of the SPSS Regression Analysis are depicted in **Appendix II**

6.0 LIMITATIONS

The research has the following limitations:-

1) No qualitative variables have been used to test the hypotheses;
2) Not all macroeconomic indicators have been tested. The research is only confined to 4 macroeconomic indicators;
3) The data for the year 2008 is only until the month of October[7];
4) The research is only confined to Malaysia;
5) The data set obtained has a limitation of only one financial crisis; and
6) The research does not take into consideration other factors such as government intervention influencing the macroeconomic indicators.

7.0 CONCLUSION

This article seeks to find which of the macroeconomic variables among FDI inflow, current account balance, inflation and interest rate play a significant role in economic growth in Malaysia for a time period of 14 years from 1995 to 2008 (Oct). The results indicated that CA balance and BLR have strong correlations with GDP and are therefore strong determinants of economic growth in Malaysia. FDI and inflation have weak correlations with GDP and are therefore weaker determinants of economic growth in Malaysia.

The study was further extended to analyse the trend between the movements in GDP against that of FDI inflow, CA balance, inflation and BLR. There were close relationships between the movement of GDP with CA Balance and BLR whereas there was an inverse trend in the movement of GDP with inflation.

The results suggest that to spur growth in the Malaysian economy or revive the economy during financial crisis, steps should be taken to promote exports or

[7] Subsequent data not available yet

alternatively reduce imports being the main components of the CA balance. Economic growth could also be spurred thru BLR adjustments. This endorses the theoretical argument that lower interest rate increases the money supply into the economy and hence spurs economic growth. FDI and inflation although are not predicted as strong determinant of Malaysian economic growth in this study, cannot be completely disregarded as studies (Imad A. Moosa, Buly A. Cardak and Min Li) have shown that FDI and inflation coupled with other factors are also strong determinants of economic growth.

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SUMMARY OF LITERATURE REVIEW

	AUTHOR (YEAR)	TOPIC	FINDINGS	CONTRIBUTION
1)	Mete Feridun (2005)	East Asian Financial Crisis Revisited: An Economic Analysis, 1981 - 2001	1) Increasing FDI relative to GDP apparently accounts for financial crisis in all of the five countries in the sample. 2) Decrease in growth of exports played a role in the crisis in all countries except Thailand where increasing growth of exports caused the crisis. 3) Deteriorating current account balance is significant in all countries except Indonesia. It has correct sign in all cases except Malaysia. 4) Real interest rate is a significant factor in the financial crisis in all countries except Indonesia reflecting distress in the finance sector before crisis. 5) Decreasing real interest rates seem to account for the crisis in Singapore and Malaysia. 6) Domestic credit relative to GDP played a role in the crisis in Philippines and Thailand only. 7) Increased inflation played a role only in Indonesia and Philippines. 8) Increasing M2 relative to gross international reserves played a role in the financial crisis in all countries except Singapore.	Results of study emphasize the need for careful monitoring of three key variables, namely M2 relative to gross international reserves, growth of exports and foreign direct investment relative to GDP.

2)	Roberto A. De Santis, Melanie Luhrmann (2008)	On The Determinants Of Net International Portfolio Flows: A Global Perspective	1) M3 to GDP ratio is associated with improvements in Current Account Balances, net inflows in equity securities and net outflows in debt instruments. 2) Rise in the short-term domestic interest rate above its trend brings about an equilibrating portfolio shift out from domestic debt instruments. 3) Current Account Balances worsen with lagged real GDP growth. 4) Net flows in debt instruments are driven by long-term interest rate differentials.	Better institutions favour net capital inflows, net outflows in debt instruments and current account deficits. Better institutions favour net capital inflows. Higher money to GDP ratio associated with lower interest rates – enhances international investments in domestic stocks to the detriment of the less attractive domestic bonds.
3)	Dierk Herzer, Stephen Klasen, Felicitas Nowak-Lehmann D (2007)	In Search Of FDI-Led Growth In Developing Countries: The Way Forward	1) FDI has no positive long-run impact on GDP in 4 countries (15%). 2) FDI has negative long-run impact on GDP in 1 country (3.6%). 3) FDI has positive short-run impact on growth in 18% of the samples. 4) FDI has negative short-run impact on GDP in 15% of the samples.	In the vast majority of countries there is neither a long-term nor a short term effect; in fact there is not a single country where a positive uni-directional long-term effect from FDI to GDP is found to exist. The results also do not indicate a clear regional pattern or influence of other factors on the FDI-growth linkage.
4)	Laura Alfaro, Areendam Chanda, Sebnem Kalemli-Ozcan, Selin Sayek (2001)	FDI and Economic Growth: The Role of Local Financial Markets	1) FDI alone plays an ambiguous role in contributing to economic growth. However, the level of development of local financial markets is crucial for these positive effects to be realized, and this has not been shown before. 2) Link between FDI and growth is causal, where FDI promotes growth through financial markets.	Countries should weigh the cost of policies aimed at attracting FDI versus those that seek to improve local conditions. These two policies need not be incompatible. Better local conditions not only attract foreign companies but also allow host economies to maximize the benefits of foreign investments.
5)	Imad A. Moosa, Buly	The determinants of	FDI can be explained in terms of GDP,	Countries that are more successful in

	A. Cardak (2005)	foreign direct investment: An extreme bounds analysis	exports as a percentage of GDP, telephone lines per 1000 of the population and country risk.	attracting FDI are developed countries with large economies, a high degree of openness and low country risk. Policy targeted at attracting inward FDI should focus on enhancing physical, political and legal infrastructure along with trade openness, thereby improving the attractiveness of a nation as a destination for FDI.
6)	Mustapha Sadni Jallab, Monnet Benoît Patrick Gbakou, René Sandretto (2008)	Foreign Direct Investment, Macroeconomic Instability And Economic Growth in Middle East and North African Countries	1) There is no significant independent impact of FDI on economic growth in MENA countries. 2) The lack of growth effect of FDI does not depend on the degree of trade openness and income per capita. 3) The most important finding of this study is undoubtedly that the positive impact of FDI on the economic depends on macroeconomic stability. More precisely, there is a threshold effect of annual percentage change of consumer prices on the link between FDI and economic growth.	FDI policies implementing incentives for foreign investors (such as tax reductions, import duty exemptions, subsidies, etc.) aimed at attracting foreign capital are not sufficient to generate economic growth. A more ambitious policy aimed to change the local environment, increasing human capital endowment, facilitating skill upgrading, creating a sound macroeconomic, promoting the development of the financial market, in tandem with FDI strategy complementary with the local production is more likely to boost the GDP, than subcontracting the task of economic growth and development to foreign firms by granting them pecuniary advantages. Economic growth and development cannot be purchased abroad. It has to be built collectively, by mobilizing the full resources of the country, while learning at the same time on foreign contributions.

7)	Dharmendra Dhakal, Saif Rahman, Kamal P. Upadhyaya (2007)	Foreign Direct Investment and Economic Growth In Asia	Evidence of FDI-to-growth causality in three of the nine countries, and growth-to-FDI causality in six countries. Two of the countries showed causality in both directions, while two showed no causality at all.	This variation in the FDI-growth relationship indicates that causality between the two variables cannot be generalized and must be considered more carefully. FDI-to-growth causality is strengthened by the presence of greater trade openness, more limited rule of law, lower receipts of aid, and lower income level of the host country. Growth-to-FDI causality, on the other hand, is reinforced by greater political rights and more limited rule of law.
8)	Stephan Danninger and Florence Jaumotte (2008)	Lessons From Cross-Regional Analysis	Much of the regional differences can be explained by structural factors, including the traditional view that high growth prospects attract foreign capital and lower the current account balance. In emerging Europe, the large current account deficits are related to the rapid liberalization of the domestic financial markets and capital accounts, which attracted large capital inflows and prompted a rapid rise of foreign bank ownership. In contrast, in emerging Asia, the impact of high growth prospects on attracting inflows was outweighed by factors such as the more limited openness of the capital accounts and financial sectors, demographics (younger populations), and differences in the political structure.	The study identifies several risk factors for abrupt endings of capital inflows and thus current accounts. These include fixed exchange rate regimes and open capital accounts, which are characteristics of several of these countries.

9)	Min Li (2005)	Inflation and Economic Growth: Threshold Effects and Transmission Mechanisms	The developed countries seem to show a different form of nonlinearity in the inflation-growth effect. That is, the magnitude of the negative effect of inflation on growth declines as the inflation rate increases. Inflation has a greater adverse effect on economic growth in developed countries than in developing countries.	The evidence strongly supports the view that the relationship between inflation and economic growth is nonlinear. Further investigation suggests that developing countries and developed countries show different forms of non-linearity in the inflation-growth relationship. For developing countries, the data suggest the presence of two thresholds in the function relating economic growth and inflation.
10)	Girijasankar Mallik and Anis Chowdhury (2001)	Inflation and Economic Growth: Evidence From Four South Asian Countries	A long-run positive relationship between GDP growth rate and inflation for all four countries.	Inflation and economic growth are positively related. The sensitivity of inflation to changes in growth rates is larger than that of growth to changes in inflation rates.
11)	Vikesh Gokal and Subrina Hanif (2004)	Relationship between inflation and economic growth	A weak negative correlation exists between inflation and growth.	The need to maintain monetary policy consistent with low inflation and inflation expectations.
12)	Nemat Shafik and Jalaleddin Jalali (1991)	Are High Real Interest Rates Bad for World Economic Growth?	For much of the 1950-79 period, ex-post real interest rates were less than the growth rate of income in the major economies. In contrast, the latter half of the 1980s were a period of relatively rapid growth in the industrial countries which coincided with high real interest rates.	High real interest rates will probably affect developing countries that are highly indebted at variable interest rates and those that need to borrow further adversely. In contrast, developing economies that are outwardly-oriented can profit from increased exports as a result of rapid growth in the industrial countries. However, the net effect on the overall growth performance of the low and middle income countries is ambiguous.

Regression

Descriptive Statistics

	Mean	Std. Deviation	N
GDP (% Change)	5.462	4.3571	14
CPI Average Consumer Price (% Change)	2.808	1.4611	14
CA Balance (% Change)	-1.970	79.8232	14
FDI Inflow (% Change)	34.643	123.1965	14
BLR (change)	-.017	1.3452	14

Correlations

		GDP (% Change)	CPI Average Consumer Price (% Change)	CA Balance (% Change)	FDI Inflow (% Change)	BLR (change)
Pearson Correlation	GDP (% Change)	1.000	-.323	.810	.214	.808
	CPI Average Consumer Price (% Change)	-.323	1.000	-.542	-.254	-.087
	CA Balance (% Change)	.810	-.542	1.000	.182	.482
	FDI Inflow (% Change)	.214	-.254	.182	1.000	.158
	BLR (change)	.808	-.087	.482	.158	1.000
Sig. (1-tailed)	GDP (% Change)	.	.130	.000	.231	.000
	CPI Average Consumer Price (% Change)	.130	.	.023	.191	.383
	CA Balance (% Change)	.000	.023	.	.267	.040
	FDI Inflow (% Change)	.231	.191	.267	.	.295
	BLR (change)	.000	.383	.040	.295	.
N	GDP (% Change)	14	14	14	14	14
	CPI Average Consumer Price (% Change)	14	14	14	14	14
	CA Balance (% Change)	14	14	14	14	14
	FDI Inflow (% Change)	14	14	14	14	14
	BLR (change)	14	14	14	14	14

Variables Entered/Removed[b]

Model	Variables Entered	Variables Removed	Method
1	BLR (change), CPI Average Consumer Price (% Change), FDI Inflow (% Change), CA Balance (% Change)[a]	.	Enter

a. All requested variables entered.

b. Dependent Variable: GDP (% Change)

Model Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics					Durbin-Watson
					R Square Change	F Change	df1	df2	Sig. F Change	
1	.941[a]	.885	.833	1.7780	.885	17.267	4	9	.000	1.897

a. Predictors: (Constant), BLR (change), CPI Average Consumer Price (% Change), FDI Inflow (% Change), CA Balance (% Change)

b. Dependent Variable: GDP (% Change)

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	218.341	4	54.585	17.267	.000[a]
	Residual	28.451	9	3.161		
	Total	246.792	13			

a. Predictors: (Constant), BLR (change), CPI Average Consumer Price (% Change), FDI Inflow (% Change), CA Balance (% Change)

b. Dependent Variable: GDP (% Change)

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	95% Confidence Interval for B		Correlations		
		B	Std. Error	Beta			Lower Bound	Upper Bound	Zero-order	Partial	Part
1	(Constant)	5.162	1.309		3.943	.003	2.200	8.123			
	CPI Average Consumer Price (% Change)	.123	.423	.041	.291	.777	-.834	1.080	-.323	.097	.033
	CA Balance (% Change)	.031	.009	.569	3.612	.006	.012	.051	.810	.769	.409
	FDI Inflow (% Change)	.001	.004	.037	.312	.762	-.008	.011	.214	.104	.035
	BLR (change)	1.720	.434	.531	3.959	.003	.737	2.703	.808	.797	.448

a. Dependent Variable: GDP (% Change)

Residuals Statistics[a]

	Minimum	Maximum	Mean	Std. Deviation	N
Predicted Value	-7.040	9.320	5.462	4.0982	14
Residual	-1.8608	2.4943	.0000	1.4794	14
Std. Predicted Value	-3.051	.941	.000	1.000	14
Std. Residual	-1.047	1.403	.000	.832	14

a. Dependent Variable: GDP (% Change)