Private Investment in Malaysia: Drivers and Sustainability

Introduction

Following Malaysia's steep decline in private investment during the 1997/98 Asian Financial Crisis, the gradual recovery of private investment had been punctuated by several episodes of global demand shocks. These included the bursting of the 'Tech Bubble' in 2001, the outbreak of the Severe Acute Respiratory Syndrome (SARS) epidemic in 2003, and more recently, the 2008/09 Global Financial Crisis (GFC). As a result, in contrast to the high average private investment of 22.9% of GDP during the 1990s, private investment had a more modest role in the economy in the period 2001-2011, averaging 11.8% of GDP.

Since the fourth quarter of 2011, however, private investment has emerged as a key contributor to growth. Following the strong growth of private investment in 2012 (22%), the share of private investment has risen to 15.5% of GDP in 2012. This strong growth momentum partly reflects the underlying shifts taking place in the Malaysian economy, particularly the strengthening of private consumption and the diversification of Malaysia's export structure. While private investment has benefited from this trend, it has also reinforced these structural shifts, contributing to the strengthening of domestic demand and further diversifying the sources of growth of the economy. Given the importance of private investment in raising the economy's productive capacity, accelerating technological progress and creating employment opportunities, this article aims to highlight the key drivers that have contributed to the rise of private investment. A broad assessment of its sustainability going forward and potential implications to growth is also explored.

Theoretical literature and empirical findings

Several frameworks that are available in the literature were used as references to determine the key drivers of private investment in Malaysia, namely: (i) The accelerator model; (ii) the expected profits model; (iii) the Jorgenson neoclassical model; and (iv) the Tobin's Q model[1]. Most of these models emphasise the importance of fundamental factors, such as demand, profitability, capacity utilisation and the cost of capital, in explaining private investment. More recent literature incorporate other determinants such as economic uncertainty and the availability of financing.

Empirical findings of the available literature show that output, profits and the level of capacity utilisation generally impact private investment positively. Furthermore, higher profitability and greater access to financing facilitate private investment through the availability of a higher level of funding. Similarly, higher interest rates and economic uncertainty can be expected to affect private investment negatively. High interest rates would also raise the cost of bank credit, and thus the cost of capital or the opportunity cost of retained earnings, while elevated levels of economic uncertainty may cause delays or even a reduction in investment.

Key determinants of private investment in Malaysia

In analysing the key determinants of private investment in Malaysia, a linear regression was estimated using a general-to-specific modelling strategy, with consideration being given to the major investment determinants that have been cited in the existing literature. Consistent with existing empirical findings, estimated results suggest that four major factors have a statistically significant impact on private investment, namely: (i) Profitability; (ii) the capacity utilisation rate[2]; (iii) the availability of financing; and (iv) the level of economic uncertainty.

[1] See Chenery (1952), Chirinko (1993), Serven and Solimano (1992), Jorgenson (1971) and Tobin (1969) for conventional models of investment and Guimaraes and Unteroberdoerster (2006) for analysis specific to the case of Malaysia.

[2] The capacity utilisation rate used was specific to the manufacturing sector.

(i) Company profitability

Existing literature suggests that operating profits, the profits earned from firms' business operations, positively affect private investment. Empirical studies also show that previous or current profits are used as an indication of expected future profits[3], as profitability is a major incentive for investment and it also contributes to the availability of internal and external financing. In the case of Malaysia, firm-level data[4] reveals that the recent increase in private investment is positively associated with the strong company profitability in recent years, particularly in the resource-based and domestic-oriented industries[5]. In the resource-based industry, particularly in the oil and gas sector, high commodity prices have contributed to the significant increase in profitability, raising the expected rate of return on investment. Meanwhile, strong private consumption activity has raised profits in the domestic-oriented sectors, particularly in the services sector, such as the wholesale and retail, transportation and telecommunication sub-sectors, and the consumer-related cluster of the manufacturing sector.

(ii) Capacity utilisation rate

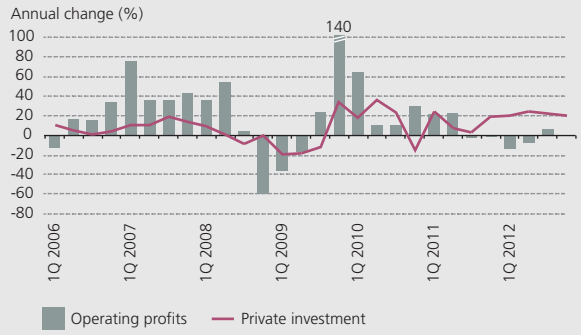
Similarly, the rate of capacity utilisation is found to exert a positive impact on private investment in Malaysia. In 2012, the capacity utilisation rate rose to 80.8% of installed capacity, higher than the average capacity utilisation rate of 76.9% in 2003-2007[6]. In line with the improvements in the capacity utilisation rate, manufacturing firms have embarked on capacity expansion to respond to the increased demand for their products (Chart 2). This was particularly evident in the domestic-oriented manufacturing sub-sectors, such as the consumer-oriented and construction-related manufacturing clusters, following the strengthening of domestic consumption and the rapid growth of construction-related activity respectively. In addition, the capacity utilisation rate has also remained high for firms in the primary-related manufacturing cluster, which has been supported by resilient regional demand.

(iii) Availability of financing

Access to financing also exerts a positive and significant influence on private investment in Malaysia, as access to bank credit[7] enables firms to obtain the required financing for investment. This is

Chart 1

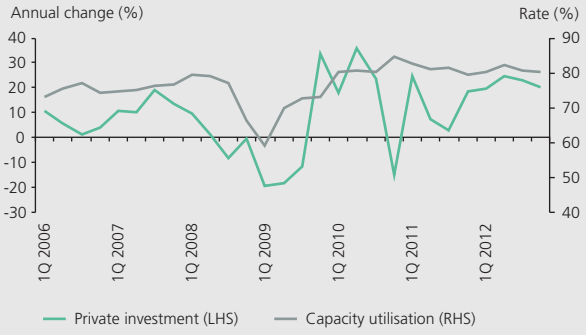
Operating Profits and Private Investment



Source: Bloomberg and Department of Statistics, Malaysia

Chart 2

Capacity Utilisation Rate and Private Investment



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

[3] See Manjappa and Niranjan (2010).

[4] Data from 250 companies listed on Bursa Malaysia and excludes firms classified as Public Enterprises in National Accounts statistics.

[5] Resource-based industry refers to the mining, agriculture and primary-related manufacturing sectors, while domestic-oriented industry refers to the services and consumer-related manufacturing sectors.

[6] 2003-2007 was used as the reference period, taking into consideration data availability and the attempt to capture information from a relatively 'normal' period.

[7] While it is acknowledged that firms, particularly large firms, also source funds from the capital markets, this study did not incorporate that data as it is highly volatile.

especially true for small and medium enterprises (SMEs), whereby bank credit is the main source of financing for their working capital and investment needs. In 2012, the financing environment remained supportive. While total credit disbursement for the year was 14.6%, credit disbursed to businesses registered a growth of 21.4% (2003-2007 average: 5.2%). Of significance, loans disbursed to SMEs expanded by 21% in 2012 (2004-2007 average: 13.1%), supported partly by various funds and programmes implemented by the authorities. The continued improvements in access to financing for businesses have also been reflected in Malaysia's favourable position in several international rankings measuring 'Ease of Access to Loans'. These include the World Bank's *Doing Business Report* (1st position for five consecutive years), and the World Economic Forum's *Global Competitiveness Report* (2012-2013: 8th position; 2010-2011: 10th position).

(iv) Economic uncertainty

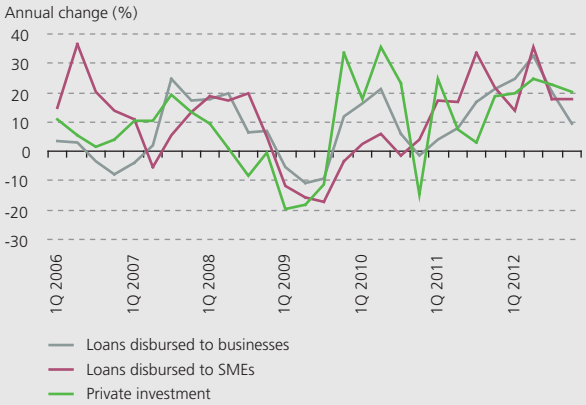
In recent quarters, private investment has also been supported by the greater economic certainty[8] prevailing in Malaysia (Chart 4). While economic uncertainty in the global economy has had an adverse impact on firms in the export sector, sustained domestic activity has generated relatively less economic uncertainty for domestic-oriented firms. Another contributing factor to greater economic certainty could be the ongoing efforts by the authorities to improve the business investment climate. In particular, various initiatives aimed at improving the ease of doing business and attracting quality investments in high value-added activity, have strengthened business sentiments and the domestic investment climate. These measures have also been reinforced by the implementation of the Economic Transformation Programme (ETP), which has provided greater policy clarity and investment opportunities for businesses.

The sustainability of private investment and its potential implications to growth

Going forward, several key underlying factors, such as favourable demand, financing conditions and the overall investment climate, are expected to continue to support private investment activity. The resilience in private consumption will also support capacity expansion in the domestic-oriented sectors, while continued efforts to enhance awareness of the access to financing and the advisory services available for SMEs will continue to facilitate investment activity by SMEs. Augmenting these favourable domestic factors, the gradual improvement in global growth prospects will also contribute towards improvements in

Chart 3

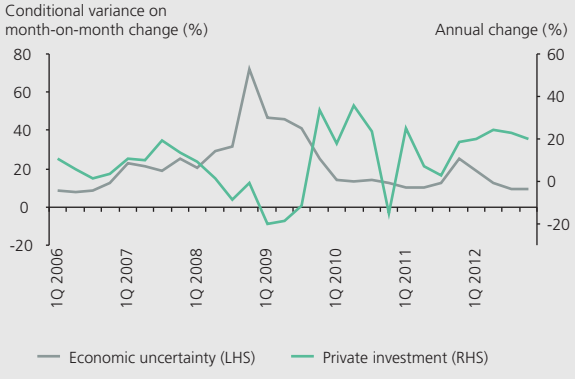
Loans Disbursed and Private Investment



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 4

Economic Uncertainty and Private Invesment



Source: FTSE Bursa Malaysia Kuala Lumpur Composite Index (FBM KLCI), Department of Statistics, Malaysia and Bank Negara Malaysia estimates

[8] Economic uncertainty was measured by a conditional variance derived from a Garch (1,1) model of monthly returns in the KLCI. The use of firm-level data such as stock returns volatility to proxy for uncertainty is common in existing literature since it captures uncertainty closely related to a firm's environment, i.e. asset returns capture the effects of relevant aspects of a firm's environment which investors deem important (see Leahy and Whited (1996)).

business confidence. The timely implementation of reforms, the catalytic projects under the ETP, and the continued provision and upgrading of infrastructure will also provide a boost to private investment.

The sustained growth in private investment is expected to benefit the Malaysian economy mainly through the acceleration in technological progress and the enhancements to the economy's productive capacity. In particular, sizeable investments in the oil and gas sector, in both the upstream exploration and development activity, and the deepening of the downstream petrochemical industry, are expected to result in technological progress which will contribute directly to raising Malaysia's growth potential. The implementation of major infrastructure projects, such as in public transportation, airports, ports and telecommunication, is also expected to indirectly enhance the productive capacity of the economy through improving connectivity, both within Malaysia and with the rest of the world. An encouraging development is the increase in research and development (R&D) spending (2011 estimate: 0.8% share to GDP; 2006: 0.6% share to GDP), which augurs well in terms of contributing towards higher value-added activities.

Conclusion

Private investment has strengthened, driven mainly by strong corporate profits, high capacity utilisation in the manufacturing sector, access to financing, and a favourable investment climate. Going forward, these fundamental factors are expected to continue, thereby providing strong support for future private investment. As the economy undergoes a transformation towards a high value-added, high-income economy, the implementation of investments that will accelerate technological progress and enhance the productive capacity of the economy will also be important in ensuring the sustainable growth of the Malaysian economy.

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