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Article

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The Link between Foreign Direct Investment and Stock Exchange Value

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Abstract: Foreign direct investment is said to play a vital role in local economic growth, but research about its effect on stock market is uncommon. Objective: The objective of this paper is to analyze the link between foreign direct investment and the Malaysian stock index value. Prior Work: The paper relies on the capital market theory and eclectic theory of foreign direct investment. Approach: the paper used a case of Malaysian stock market and captured secondary data from the Malaysian stock market archives. The paper applied a quantitative analysis and used the Augmented Dickey Fuller test and Granger causality tests in data analysis. Results: Findings from the statistical analysis showed that the stock market performance (measured by all share index) Granger cause FDI, but FDI did not prove to Granger cause all share index. Implications: The findings of this paper holds some economic policy implication for developing countries; policy makers should strengthen economic policies that favor the growth and positive performance of local stock exchange market as their performance would serve as a catalyst for attracting foreign direct investments. Value: the paper provides first empirical analysis to apply the Granger Causality tests to show that local stock market performance is key to foreign direct investment growth with a focus on Malaysian stock market; the paper recommends that future research should replicate this study in other emerging markets with more time series data with the inclusion of country differences.

Keywords: foreign direct investment; all share index; economic growth; stock market; monetary policy

JEL Classification: G1; G15; 04; E22; F21

1. Introduction

Discussions regarding factors that spur a country's economic growth and development would hardly bypass key variables such as foreign direct investment (FDI) and stock market performance. However, research attention seems to focus more on how these variables and their relative strength impact growth and development. As local economic and monetary policies bourgeon, focus is gradually shifting to how these key variables (FDI and stock market) influence each other, this is needed to inform a stronger economic and monetary policy of developing nations to improve the pace of growth. Since both of them constitute crucial catalyst of growth, it becomes pertinent to devise strategies and policies that would strengthen the causal alternative. Whilst existing research concerning the movement of these two variables have largely dwelt on linear relationship, this paper contributes a nuance by examining their causal positioning.

Zekarias (2016) describes Foreign Direct Investment (FDI) as an investment made by a foreign firm into another firm abroad whereby the foreign firm takes direct or indirect control in the host country

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firm by having at least 10% voting rights in the company. Masron and Hassan (2016) categorize FDI as either Greenfield investments or mergers and acquisitions. As indicated by Magombeyi and Odhiambo (2017), Greenfield FDI takes the form of new business creations in the host country. It is imperative to understand the motive behind FDI inflows from the owners of capital's perspective (Makoni, 2015). The stock market is an organised market that combines various markets and exchanges where publicly listed companies buy and sale shares.

This paper focuses attention to answering the question on whether foreign direct investment is related to stock exchange values in the Malaysian stock exchange. The choice of Malaysia is that it is one the key Eastern Asian countries whose economic development 'miracle' have attract the name "Asian Tigers" given the speed with which East Asia experience an unprecedented economic development (Chia et al. 2007). Hence the paper unravels whether stock market performance is contributory to the attraction of foreign direct investment into Malaysia.

1.1. Problem Statement

Growing unemployment around the world and mostly in developing economies necessitates policies that can contribute to employment creation and economic growth. The performance of a country's stock market is an important factor (amongst others) in measuring general economic and financial health of the country. Accordingly, the stock market performance provides an overall indicator of the value of shares over a given time period (Onyinyechi & Ekwe, 2017). This means that stock market plays a critical role in any country's financial development (Ali, 2014). Despite bourgeoning research on the importance of foreign direct investment (FDI) and stock market performance, there is a lack of consensus about their relationship; importantly, their causative relationship has not been researched in a country like Malaysia. Hence, the problem of this paper is boosted by the fact that whilst pervious researchers have largely focused on economic growth and FDI, the causal relationship between FDI and stock market performance have not been studied in a Malaysia; therefore, this paper makes contribution by focusing on the relationship between stock market value and FDI in Malaysia. This approach is important because investors are looking for new investment destinations where the stock markets have stability and enhanced value (Harris & Ravenscraft, 1991).

1.2. Objective of the Paper

Therefore, the objective of this paper is to explore the causal relationship between foreign direct investment and all share index of Malaysian stock exchange. Hence in addition to exploring the correlation between the two variables, the paper will also identify which of the variables that drive the other to provide additional decision information for economic policy. The paper thus suggests policy implication that would enhance the attraction of foreign direct investment in developing economies.

2. Theoretical Framework

This paper is inclined on two important theories in finance and economics, namely the capital market theory and the eclectic theory. The capital market theory endeavors to explain why some countries end up moving their capital to foreign countries. The theory as propounded by Aliber (1970) asserts that the differences in the purchasing power of currencies makes countries with a stronger currency to see it gainful to invest in foreign countries with weaker purchasing power currencies. According to Nayak and Choudhury (2014), countries with a weaker currency are in the best position to attract more FDI. Makoni (2015) notes that foreign firms with a stronger currency benefit from host countries' low interest rate on borrowing. This creates a win-win transactional relationship between these two parties. This theory is robust enough to explain FDI inflows from first world into third world countries. However, some studies argue that this theory is weak as it cannot justify how in some cases FDI flows from developing countries with weaker currencies into developed countries (Nayak & Choudhury, 2014). Nevertheless, a study by Idenyi, Ifeyinwa, Obinna and Promise (2016) as well as Onyinyechi and Ekwe (2017) believe that this theory is still relevant to explain FDI inflows into developing countries.

In addition to the above discussed capital market, theory, the eclectic theory is the second important theory that supports this paper. Developed by Dunning (1979), the Eclectic theory tries to explain the determinants of FDI inflows from mother countries to foreign nations. Dunning (1979) believes that investors are willing to invest in foreign countries only if there are opportunities to be had which far much outweighs the decision to continue operating in their mother countries. The advantages which may attract investors are categorised as ownership, location and internationalisation advantages. The ownership advantages explain the extent to which the foreign firm will have preferential access to natural resources and other intangible resources. FDI becomes feasible in the event that the foreign firm has unmatched advantage over other firms in form of patent benefits, exclusive rights to distribute a certain product and an upper hand to access certain raw materials crucial for production in relation other firms. Location advantages explain the extent to which the institutional framework and the business environment is inclined towards FDI inflows. FDI favours only destinations where the investments and returns are protected by the local legal framework. Relaxed tax policies, interest rates and favourable labour laws tend to attract more FDI. The internationalisation advantages refer to the ease of doing business in a foreign land compared to the home country. After all the above advantages are perceived as sufficient enough, it becomes feasible for the foreign firm to invest in other countries over the decision to produce in the home country. In support Kumari and Sharma (2017) assert that FDI emanates from internationalisation. According to Makoni (2015), for an investor to finally decide to move their capital, these advantages should greatly outweigh the costs associated with the FDI inflows. On that note, Adegboye, Ojo and Ogunrinola (2016) are of the view that policy makers in host countries should reduce red tapes associated with exorbitant taxes, stringent labour laws and procurement laws among others if they are to succeed in attracting FDI in their countries. The Eclectic Theory as discussed above sets a fertile ground to understand the reasons why foreign firms engage in FDI. However, the theory is not without its own shortcomings. Nayak and Choudhury (2014) argue that due to the fact that theory used so many variables, as well as trying to incorporate a number of theories in one model, this reduces its effectiveness in explaining the FDI inflow phenomenon. Still, the theory is robust enough to explain this phenomenon as indicated by studies by Makoni (2015) and Adegboye et al. (2016) which allude that the Eclectic theory has been used widely in extant literature to understand the motive behind FDI inflows.

3. Literature Review

FDI inflows into emerging economies have proliferated over the past decade (Khalikov, 2016; Alzaidy, Ahmad & Lacheheb, 2017). Countries such the US, China and Netherlands are documented as top contributors of FDI in Malaysia for the past 5 years. China contributed immensely in the manufacturing sector while the US and Japan dominated in the services sector (United Nations Conference on Trade and Development (UNCTAD), World Investment Report, 2017). Masron and Hassan (2016) identify the US as the major and stable source of FDI inflows in Malaysia. Malaysia has been dubbed among the best investment destinations in South East Asia (Fadhil & Almsafir, 2015). UNCTAD (World Investment Report) (2016) concurs and assert that Malaysia is among the top countries in Asia receiving large volumes of FDI inflows. Handley (2017) notes that FDI constitutes a huge percentage of all inflows in Malyasia. However, there was a decline in FDI from a USD 11.1 billion in 2015 to USD 9.9 billion in 2016 (UNCTAD, World Investment Report, 2017).. It is within the scope of this study to investigate whether, this growth has been propelled by FDI or some other micro or macro-economic factors.

Malaysian economy has been growing steadily and its global competitiveness has improved significantly. Malaysia's competitiveness rating stood at 23rd position when compared with other global players in the past years (Global Competitiveness Report, 2017). According to the Malaysia Department of Statistics (2015), the manufacturing sector grew at an increasing rate by mid-2014 as the country was transitioning from mining and agricultural sectors. The manufacturing sector has performed extremely well and contributed immensely towards gross domestic product (GDP) in the country in 2014. It was noted in the literature that it is sub sectors such as electric and electronics which performed above the norm when compared to other sub sectors. This study is of the view that FDI can be among the key drivers behind the increase in industrial performance in Malaysia for the past 3 years. However, some studies argue that, regardless o

Idenyi et al. (2016) allude that FDI enhances local industry performance given that FDI investors tend to have long term vested interest in the host countries. The study further elucidate that FDI brings stability in the local industry because FDI investors cannot opt out easily given the high cost of relocation, establishing a new market and having to deal with a completely new legal framework in a different country. Ali (2014) is of the view that FDI broadens the capital base of the host country which is good for production. Adegboye et al. (2016) studied the nexus between FDI and industrial performance of firms in Africa. The study used value added as an indicator of industrial performance. Employing a pooled method to analyse data from 1996 to 2015, the study established that FDI is positively linked to local industry performance. Furthermore, Adegboye et al. (2016) assert that FDI increases competition within the local industry which spurs efficiency in the whole industry.

Conversely, Masron and Hassan (2016) argue that a high FDI does not automatically translate into a well performing local industry. Masron and Hassan (2016) further assert that FDI inflows are usually high in poor functioning markets as investors see it rewarding to exploit such weaknesses. Other studies maintain that FDI can result in big Multinational Companies (MNCs) enjoying monopolistic advantages over local firms. This in most cases worsens the performance of the local industry as local firms are driven out of the market by big well established MNCs with huge marketing budgets and sophisticated technology. Alege and Ogundipe (2013) agrees and remark that MNCs can become so strong that they end up overshadowing local young firms. A study by Adegboye et al. (2016) is of the view that for FDI to improve local industry performance, it has to be channeled to the rightful sectors. Existing studies by Adejumo (2013) and as well as Agu and Okoli (2015) found out that FDI had a negative relationship with industrial value added on firms in Nigeria. The two studies attribute this negative relationship to the issue of imports flocking into the country as opposed to the foreign firms acquiring the resources locally.

According to Azam and Ibrahim (2014), the stock exchange is open for both local and international investors. The stock market is dominated by the equity and bond market. Onyinyechi and Ekwe (2017) define stock market performance as an overall indicator of the value of shares over a given time period. Ali (2014) is of the view that a stock market plays a critical role in any country's financial development. A stock market can enable growth oriented listed firms to raise more capital through issuing shares to potential investors (Hoque & Yakob, 2017). Idenyi at al. (2016) remark that FDI is somewhat linked to the stock market performance of shares because all investors operate mostly via financial markets. Makoni (2016) agrees and point out that FDI increases the liquidity of home country stock market as foreign investors purchase shares in incumbent listed firms. Kunal and Phani (2017) indicate that a consortium of strategies should be put in place to improve stock market performance as it occupies the heart of any country's economy. Khalikov (2016) shares the same sentiments and asserts that, a well-functioning stock market is crucial for the overall economic performance. Arčabić, Globan and Raguž (2013) allude that FDI inflows makes policy makers in host countries to revise and relax institutional policy which improves the stock market performance of shares as a number of players come in to invest in local firms. Khalikov (2016) further remarks that there is evidence in the existing literature that FDI inflows improves the stock market performance of shares of listed firms. FDI affects stock market performance by boosting economic growth (Shahbaz, Hooi & Kalim, 2013). The study argues that economic growth becomes a catalyst which then will improve the value shares of listed firms.

Studies such as Doytch (2013), Soumaré and Tchana (2015), Ali (2014) and Acheampong and Wiafe (2013) established that FDI is positively related to stock market performance of shares. In another research, Azam and Ibrahim (2014) found a positive relationship between FDI and stock market performance and argued that FDI appear to have a stabilizing impact on the stock market of the host country. However other researchers such as Onyinyechi and Ekwe (2016) found an insignificant relationship between FDI and the stock market performance of shares. Also, Sulaiman and Ibrahim (2014) established that FDI had a positive but insignificant relationship with the stock market performance. Soumaré and Tchana (2015) argues that FDI enhances the performance of the stock market in that most MNCs usually operate by listing their companies on the host country stock exchange. This further development in the stock market then attracts more FDI in the longrun as the value of shares on the stock market increases. The study recommends that developing countries should endeavor to liberalise their institutional policies investor friendly to attract more FDI as the gains are tangible.

4. Methodology

In an empirical research, where data is sourced from the secondary data through the time series data availability, the number of time series of data available represents the population whilst the number of years covered in the study is the sample. In this study therefore, the population from where the secondary data was sought comprised the entire data on Malaysia FDI from, however the paper use only a total of 27 years as the sample. The sample method applied was the non-probability sample method (specifically the purposive sample). The authors chose the 27 years FDI and all share index data, which began in 1991 based on authors' judgement or purpose, which is that the year 1991 was remarkable as a year within which the Malaysian FDI witnessed an outstanding boost.

In statistical analysis, the unit root test is useful to determine whether a time series data contains elements of non-stationarity and thus has a unit root. Accordingly, the null hypothesis is usually stated in the form that the data possesses a unit root (non-stationary), whilst the alternative hypothesis means that the data is stationary. In mathematics and statistics, stationary connotes a situation where the joint probability of two events do not alter with the passage of time. This thus implies that the mean and variance of such events or variables tend to remain the same without significant change even with the passage of time (see example Bhargava, 1986). This situation bestows some confidence on the user of such data. It is for this reason that this paper applied a test of unit root before the OLS regression test.

In this research, the empirical model used were the Augmented Dickey-Fuller test and the Granger Causality Wald test.

The general form for testing of unit root existence is represented by:

$Y_t = D_t + Z_t + e_t$

Where:

Y_t = the time series being tested over time

D_t = the seasonal or trend component (which is the deterministic element)

Z_t= the stochastic element (the test checks whether this element contains unit root)

e_t = the error which is stationary

5. Analysis and Results

The analysis and results are shown in Tables 1 to Table 3. The paper applied the empirical tests of Augmented Dickey-Fuller test for stationarity, the Granger causality test and the cointegration tests. Table 3 results from the cointegration test show that the two variables are highly correlated at a P value of less than 0.001. Furthermore, the results from Table 1 present the stationary test, following which the paper proceeded to test for causality using the Granger causality test in Table 2. Tested at a P value of 0.05, the causality results (Table 2) show that, within the sample size studied, the strength of all share index is found to Granger-cause foreign direct investment (FDI); but foreign direct investment does not Granger cause all share index. This result contrasts some previous empirical research findings, which indicated that FDI may influence stock market performance (Khalikov, 2016; Idenyi at al. (2016); on the other hand, the findings of this paper is related to the findings of some other researcher such as (Onyinyechi and Ekwe, 2016). These findings therefore provide an answer to the objective of this paper, which sought to evaluate the causal link between FDI and stock market value. These findings have therefore proven that a well-functioning stock market will attract foreign investors' interest in the local market.

Table 1. Testing for a Unit Root in Allshareindex and in Valuefdi

Augmented Dickey-Fuller test for AllShareIndex	
sample size	25
unit-root null hypothesis:	a = 1
test statistic: tau_c(1)	-0.753211
asymptotic p-value	0.8314
Augmented Dickey-Fuller test for ValueFDI	
sample size	25
unit-root null hypothesis:	a = 1
test statistic: tau_c(1)	-2.14924
asymptotic p-value	0.2254

Table 2. Granger Causality Wald Tests

Equation	Excluded	F	df	Df_r	Prob>f
valuefdi	Allshareindex	10.119	2	20	0.0009
valuefdi	All	10.119	2	20	0.0009
Allshareindex	valuefdi	2.2705	2	20	0.1292
Allshareindex	All	2.2705	2	20	0.1292

Table 3. Co-integrating Regression

Cointegrating regression - OLS, using observations 1991-2017 (T = 27) Dependent variable: AllShareIndex				
	coefficient	std. error	t-ratio	p-value
const	-87.0654	182.304	-0.4776	0.6371
ValueFDI	1.41808e-07	2.46906e-08	5.743	5.52e-06 ***

Mean dependent var	817.2963	S.D. dependent var	712.9335
Sum squared resid	5697493	S.E. of regression	477.3884
R-squared	0.568866	Adjusted R-squared	0.551620
Log-likelihood -	203.8173	Akaike criterion	411.6346
Schwarz criterion	414.2263	Hannan-Quinn	412.4052
rho	0.458039	Durbin-Watson	1.062147

5.1. Implication

The findings of this paper holds some economic policy implication for developing countries; for instance, since the preceding analysis show that the stock exchange performance has the propensity to attract FDI, policy makers should therefore strengthen economic policies that favors the growth and performance of local stock exchanges as their performance would serve as a catalyst for attracting foreign investors. Monetary policies such as interest rate controls should be carefully managed to avoid unnecessary fluctuations that would affect the price of shares in the stock market. Similarly, politicians should avoid political decisions that reverberates on the stock market negatively as this is an indirect approach of scaring foreign investors. Rather policy makers should strive to promote the performance of their stock exchanges by pronouncing positive money and economic policy decisions and using foreign policy and/or economic diplomatic that promotes the national stock market positively. In addition to the aforesaid policy implication, this paper provides a new case from an emerging market perspective for the academia for academic case study of foreign direct investment and stock market.

5.2. Value

This paper contributes a new application of empirical analysis, which a combination of Augmented Dickey Fuller test and Granger causality test in studying the relationship between foreign direct investment and stock market value using the Malaysian stock market. This approach is lacking in the previous literature and hence the value of this paper.

6. Conclusions and Future Work

This paper set out to explore the causal relationship between foreign direct investment and stock market value by using the Malaysian stock exchange data as Malaysia is one of the renowned East Asian "economic tigers" (Chia, et al. 2007). From the review of the literature, none of the previous literature have explored this important relationship, which is needed to provide further information for economic policy makers in developing countries. Hence this paper has bridged existing gap in the literature. Using a combination of ADF and Granger Causality models, the paper provides a novel finding to show that a country may attract foreign direct investment through the function of its stock market. This therefore implies that economic institutions and policy makers should strengthen the functioning and value of their stock markets, and avoid local policies that may cause negative fluctuations in the stock market. One of the limitations of this paper is that it focused only on twenty-seven (27) year time series data and studied only one emerging economy. Therefore, the paper provides an agenda for future research to employ many years of time series data beyond the 27 years used in this research and to including other regional and other emerging economies' data in the analysis to explore the possibility of different findings from such future research to provide additional information for other emerging economies in strengthening their economic policies around foreign direct investment and stock market.

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