# CHAPTER 1: INTRODUCTION

## 1.1. Recent Trends in International Capital Flows

Financial flows to developing countries surged in the 1990s, particularly private capital flows which increased to US$243.8 billion in 1996 from US$44.4 billion in 1990 (**Figure 1.1**). Private capital flows accounted for more than 80 percent of the total of US$284.6 billion in net long term flows to developing countries **(Table 1.1)**. Thus it can be seen that private investment to developing countries is fast replacing official aid flows in the 1990s. The surge in private flows toward emerging economies in the 1990s can be attributed to factors such as investors' desire for portfolio diversification and higher profits, and the need to take advantage of macroeconomic and structural reforms in developing countries.

While all categories of private flows have been on the increase, foreign direct investment (FDI) flows dominated other types of financial flows as the predominant form of investment in developing countries (**Figure 1.2**). Of the private flows, FDI appears to be the most productive, as it creates new jobs, generates exports and contributes to a nation's economic growth. It is thus not surprising that countries compete with each other to attract foreign direct investment. The United Nations Conference on Trade and Development (UNCTAD) reports that the competition for FDI has become much more intense than it was a decade ago (*Financial Times, April 13 1995*).

However, the majority of FDI inflows stayed within the developed world (Hu, 1997). This is hardly surprising as most of the world's business activity is within the developed world. Thus FDI inflow to developed countries continued to outpace FDI inflows to developing countries (**Figure 1.3**). For example, the G-7 countries (Canada, France, Germany, Italy, Japan, United Kingdom and the United States) attracted US$150.0 billion in 1996, accounting for 72 percent of

Fig. 1.1 : OFFICIAL AND PRIVATE FLOWS TO DEVELOPING COUNTRIES, 1990-1996

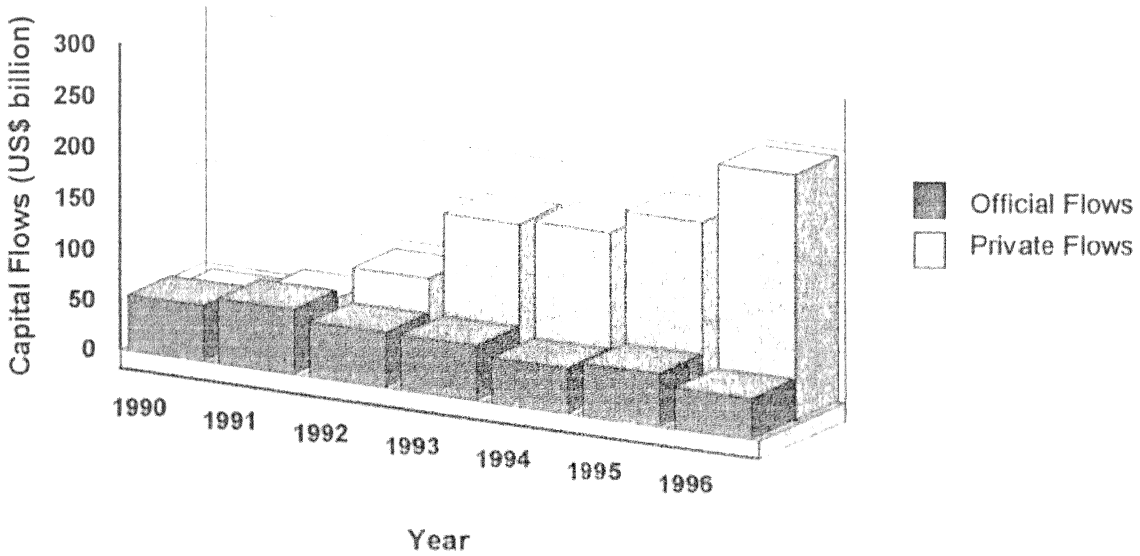


Fig. 1.2 : FOREIGN DIRECT INVESTMENT TO DEVELOPING COUNTRIES 1992-1996

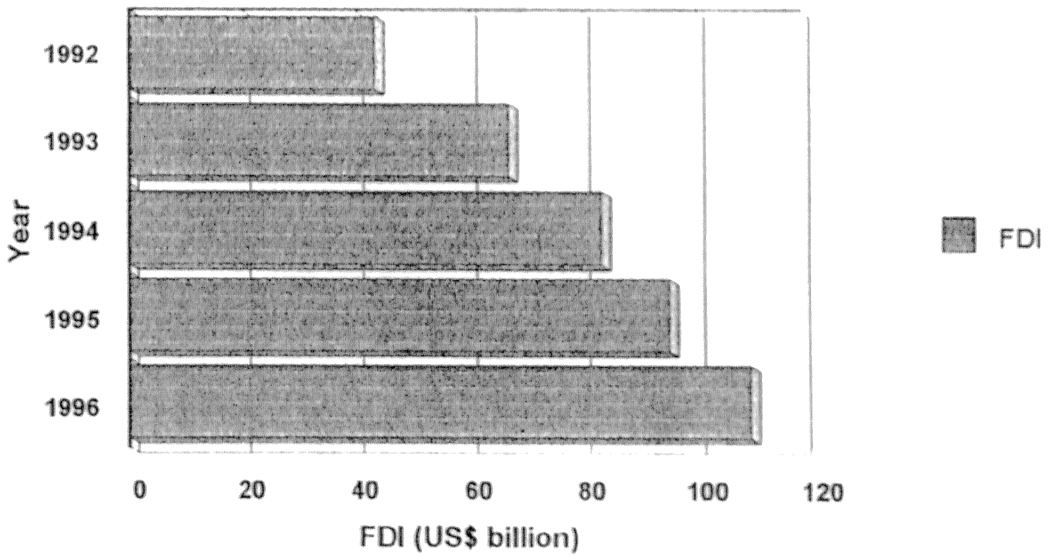

Fig. 1.3 : **FDI INFLOWS, 1991-1996 (US$ BILLION)**

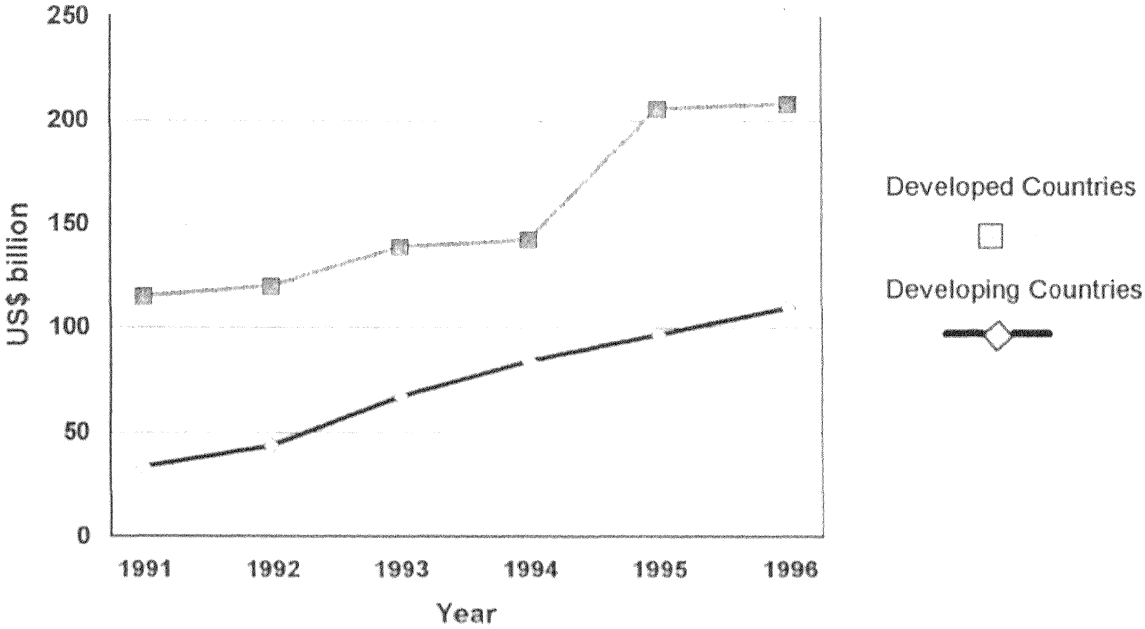


Fig. 1.4 : **FDI DISTRIBUTION IN DEVELOPING COUNTRIES, 1996**

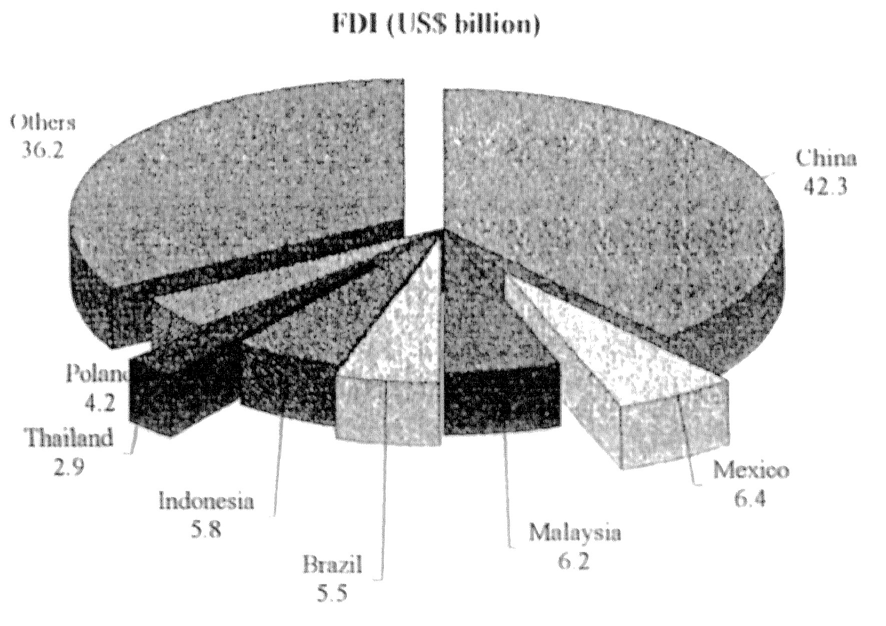

**Table 1.1: Financial Flows to Developing Countries, 1990-1996 (US$ billion)**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996* |
|---|---|---|---|---|---|---|---|
| Total flows | 100.6 | 122.5 | 146.0 | 212.0 | 207.0 | 237.2 | 284.6 |
| Official development finance | 56.3 | 65.6 | 55.4 | 55.0 | 45.7 | 53.0 | 40.8 |
| Grants | 29.2 | 37.3 | 31.6 | 29.3 | 32.4 | 32.6 | 31.3 |
| Loans | 27.1 | 28.3 | 23.9 | 25.7 | 13.2 | 20.4 | 9.5 |
| **Total private flows** | **44.4** | **56.9** | **90.6** | **157.1** | **161.3** | **184.2** | **243.8** |
| Debt flows | 16.6 | 16.2 | 35.9 | 44.9 | 44.9 | 56.6 | 88.6 |
| Commercial banks | 3.0 | 2.8 | 12.5 | -0.3 | 11.0 | 26.5 | 34.2 |
| Bonds | 2.3 | 10.1 | 9.9 | 35.9 | 29.3 | 28.5 | 46.1 |
| Others | 11.3 | 3.3 | 13.5 | 9.2 | 4.6 | 1.7 | 8.3 |
| **Foreign direct investment** | **24.5** | **33.5** | **43.6** | **67.2** | **83.7** | **95.5** | **109.5** |
| Portfolio equity flows | 3.2 | 7.2 | 11.0 | 45.0 | 32.7 | 32.1 | 45.7 |

Note: Developing countries are defined as low and middle income countries with 1995 per capita incomes of less than US$765 (low) and US$9,385 (middle)
*Preliminary
Source: World Bank, 1997. *Global Development Finance*

total FDI inflow to developed countries, and 43 percent of global FDI inflow. (**Table 1.2**).

In contrast, FDI inflow to all developing countries was US$109.5 billion in 1996. It is also observed that the pie was not equally distributed among all developing countries (**Figure 1.4**). Among the developing countries, it was observed that China, Malaysia, Mexico and Thailand continued to be important locations for FDI inflows. The United Nations Secretary General, Kofi Annan decried this lopsided distribution as FDI inflow to Africa in 1996 only amounted to US$2.6 billion against US$48 billion to Asia. In addition, only one percent of FDI goes to the 48 least developed countries (*Panafrican News Agency, August 12, 1997*).

Among developing economies, China was the leading recipient of FDI during 1990 – 1996 (**Table 1.2**). In 1996, FDI inflow to China was valued at US$42.3

billion, representing 38 percent of total FDI flows to developing economies. This was way ahead of other major recipient countries such as Mexico (US$6.4 billion), Malaysia (US$6.2 billion) and Indonesia (US$5.8 billion).

## 1.2. Background of the Problem

In the light of private capital flows, particularly FDI rapidly replacing official aid to developing countries in the 1990s, there has thus been intense competition among nations to attract FDI. It is perhaps pertinent to study and analyse why FDI chooses to flow to certain countries. The research project will attempt to find out the factors that attract FDI and why certain countries continue to remain choice locations to foreign investors.

Among the developing economies, Malaysia appears to be one of the major FDI recipients, attracting US$32.8 billion during the period 1990 – 1996 (**Table 1.2**). This represented close to 9 percent of the total of US$369.6 billion in FDI inflow to selected emerging economies. FDI has featured significantly in the country's industrialisation since the 1960s. FDI has spurred the expansion of the manufacturing sector in the country. As such, the manufacturing sector has continued to remain the engine of growth. In 1997, the manufacturing sector contributed 34.2 percent to the nation's GDP and 27.7 percent of total employment.

The country experienced buoyant economic growth in the 1990s with GDP growth averaging more than 8 percent. However, the economy took a downturn since the second half of 1997 due to the regional currency crisis. As capital took flight from the region due to the economic uncertainties, our Prime Minister, Dr. Mahathir Mohamad has stated strongly that the nation does not need hot money (portfolio investment) from foreign investors, instead we welcome productive long-term investments, which is FDI.

**Table 1.2: Net FDI Inflow to Developing Countries, 1990-1996 (US$ billion)**

| Region/Country | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996* |
|---|---|---|---|---|---|---|---|
| **All developing countries** | **24.5** | **33.5** | **43.6** | **67.2** | **83.7** | **95.5** | **109.5** |
| Sub-Saharan Africa | 0.9 | 1.6 | 0.8 | 1.6 | 3.1 | 2.2 | 2.6 |
| East Asia & the Pacific | 10.2 | 12.7 | 20.9 | 38.1 | 44.1 | 51.8 | 61.1 |
| South Asia | 0.5 | 0.5 | 0.6 | 0.8 | 1.2 | 1.8 | 2.6 |
| Europe & Central Asia | 2.1 | 4.4 | 6.3 | 8.4 | 8.1 | 17.2 | 15.0 |
| Latin America & Caribbean | 8.1 | 12.5 | 12.7 | 14.1 | 24.2 | 22.9 | 25.9 |
| Middle East & N. Africa | 2.8 | 1.8 | 2.2 | 4.2 | 3.0 | -0.3 | 2.2 |
| **Major recipient countries** | | | | | | | |
| China | 3.5 | 4.4 | 11.2 | 27.5 | 33.8 | 35.8 | 42.3 |
| Mexico | 2.5 | 4.7 | 4.4 | 4.4 | 11.0 | 7.0 | 6.4 |
| **Malaysia** | **2.3** | **4.0** | **5.2** | **5.0** | **4.3** | **5.8** | **6.2** |
| Brazil | 1.0 | 1.1 | 2.1 | 1.3 | 3.1 | 4.9 | 5.5 |
| Indonesia | 1.1 | 1.5 | 1.8 | 2.0 | 2.1 | 4.3 | 5.8 |
| Thailand | 2.4 | 2.0 | 2.1 | 1.8 | 1.4 | 2.1 | 2.9 |
| Argentina | 1.8 | 2.4 | 2.6 | 3.5 | 0.6 | 1.3 | 2.0 |
| Hungary | 0.0 | 1.5 | 1.5 | 2.4 | 1.1 | 4.5 | 1.7 |
| Poland | 0.1 | 0.3 | 0.7 | 1.7 | 1.9 | 3.7 | 4.2 |
| Chile | 0.6 | 0.5 | 0.7 | 0.8 | 1.8 | 1.7 | 2.2 |
| **Industrial countries** | **176.4** | **115.1** | **111.2** | **129.1** | **132.8** | **203.2** | **208.2** |
| **G-7** | **112.1** | **63.9** | **69.4** | **90.6** | **87.9** | **130.7** | **150.0** |

*Preliminary
Source: World Bank 1997. *Global Development Finance*

Data on industrial projects approved by the Malaysian Industrial Development Authority (MIDA) for the period 1990 – 1997 indicated a declining trend in the number of approved projects (**Table 1.3**). In 1997, the number of industrial projects approved totalled 754 (comprising 462 new projects and 292 expansion/diversification), a decline from a high of 973 projects in 1991. FDI in these projects as indicated by foreign proposed capital investment also showed a

**Table 1.3: Approved Manufacturing Projects, 1991-1997**

| Year | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|---|---|
| Number | 973 | 874 | 686 | 870 | 898 | 782 | 754 |
| Potential Employment ('000) | 179.4 | 106.0 | 94.6 | 136.5 | 117.6 | 91.9 | 71.3 |
| Proposed capital investment (RM billion) | 30.8 | 27.8 | 13.8 | 22.9 | 20.8 | 34.3 | 25.8 |
| Local | 13.8 | 10.0 | 7.5 | 11.6 | 11.7 | 17.2 | 14.5 |
| Foreign | 17.0 | 17.8 | 6.3 | 11.3 | 9.1 | 17.1 | 11.3 |

Source: MIDA

declining trend. The decline in FDI could be attributed to two factors. Firstly, there is intensified competition for FDI inflows due to the presence of new emerging economies in the region such as China, Vietnam and Cambodia. Secondly, local investment has begun to outpace FDI since 1993.

Declining FDI inflow could affect the expansion of the manufacturing sector, and subsequently impact on the nation's economic growth, unless it is augmented by local investment. It could also put a dent on the nation's aspirations to achieve developed nation status by the year 2020. This is because FDI is needed to help steer the country towards NIE (Newly Industrialising Economy) status (Ariff, 1991).

The economic crisis affecting the region could also affect FDI inflows into Malaysia due to a loss of confidence among investors regarding the recovery prospects for the region. Although Malaysia has not been as severely affected by the economic meltdown, compared to Thailand, Indonesia and South Korea, all of which have requested loans from the International Monetary Fund (IMF), it is nevertheless lumped together with these countries and perceived to be in deep waters in the eyes of the western investors. In addition, Japan which has been a major source of FDI inflows into the country since the 1980s is having its own economic woes, and may not be able to contribute much to the recovery of the region.

Based on the above discussion, it is thus necessary to examine the factors for the motivation of FDI as embodied in the various theories of FDI. It is also pertinent to discuss the factors that contribute to the nation's competitiveness in attracting FDI compared to other developing countries. An understanding of the nation's competitiveness vis-a-vis other emerging economies is useful in assessing whether the government has instituted an environment conducive to attracting FDI flows and in sustaining the nation's competitiveness in the rapidly globalised world.

## 1.3. Objectives of the Study

This study will attempt to examine the factors why FDI flows to some countries rather than others. The study will also analyse the competitiveness of the Malaysian economy in attracting FDI, compared to other developing economies. In analysing the nation's competitiveness in attracting FDI inflows, the paper will examine whether the government has instituted a conducive environment in attracting FDI inflows, and to suggest policy measures in order to sustain or further enhance the nation's competitiveness in attracting FDI inflows.

## 1.4. Significance of the Study

In the light of increasing competition for FDI due to the emergence of new competitors, particularly the lower cost producing countries (China, Vietnam and Cambodia), it is felt that this research study is timely and significant. The study will analyse the nation's international competitiveness in attracting FDI, and examine the factors contributing to the nation's ability to attract FDI vis-à-vis other developing economies.

FDI has been a significant factor in contributing to the nation's economic growth, particularly over the last decade. However of late, there has been waning confidence and investment (FDI and portfolio investment) in the region due to the financial crisis. It is thus evidently clear that the nation will have to attempt to sustain or better still to improve its competitiveness in attracting FDI inflows. In analysing Malaysia's competitiveness, the study will be able to assess whether our economy has instituted a conducive environment to attract FDI, and to suggest recommendations to improve its competitiveness in attracting FDI.

### 1.5. Scope of Study

This study will focus on factors motivating FDI inflows into the manufacturing sector of the Malaysian economy. The paper will also examine Malaysia's competitiveness in attracting FDI inflows vis-à-vis other developing economies, particularly South-East Asian countries and China. Comparison is made against China by virtue of it being the largest FDI recipient among developing countries in recent years.

The study will also attempt to establish that a nation's ranking in international competitiveness has a bearing on its ability to attract FDI. This is to say that the more favourable a nation's ranking in international competitiveness, the greater is its ability to attract FDI, and vice versa. Reference on international competitiveness will be drawn from the annual study conducted by the Geneva-based World Economic Forum (WEF) which produces the Global Competitiveness Report and the Lausanne-based International Institute for Management Development (IMD) which produces The World Competitiveness Yearbook.

## 1.6. Limitations of the Study

Both the World Competitiveness Yearbook and the Global Competitiveness Report focussed on several factors to assess the competitiveness of a nation, of which FDI inflow is only a sub-factor. However, this study will only focus on a nation's competitiveness in attracting FDI inflows, as covering all the factors as identified by IMD and WEF will be far too wide, and beyond the scope of this study.

The study will use data regarding the ranking of a nation's international competitiveness as determined by WEF and IMD. The study will also conduct a regression analysis on the factors that affect FDI inflow, using IMD data on twenty one developing countries, including Malaysia.

## 1.7. Organisation of the Study

Chapter 1 sets the background for the research project by discussing recent trends in international capital flows and the increased FDI inflow to developing countries in the 1990s. The chapter also discusses the objectives, significance, scope and limitations of the study.

Chapter 2 focuses on the literature review surrounding FDI and discusses the various theories for FDI, specifically in the Malaysian context. The chapter also discusses the concept of competitiveness by WEF and IMD.

Chapter 3 focuses on the research methodology used in this study. It also explains why secondary data is used for this paper, and examines the strengths and limitations of using certain published data.

Chapter 4 discusses the factors used in running a regression analysis on FDI inflow for twenty one developing countries, and the findings obtained. The chapter also discusses the nation's international competitiveness in attracting FDI inflows as indicated by the rankings given by WEF and IMD. The focus of comparison is with other developing economies, particularly Asean countries and China. The study also establishes some correlations, namely a nation's ranking is positively correlated with FDI inflows; economic growth rates as indicated by real GDP per capita growth are positively correlated with FDI inflows; and a nation's exports are positively correlated with FDI inflows. The chapter also examines Malaysia's ranking on the factors of FDI as per the regression analysis, vis-à-vis other developing economies.

Chapter 5 summarises the research findings, suggests additional research in this area, and concludes by indicating who might find the study useful