



**UNIVERSITI PUTRA MALAYSIA**

***THE RELATIONSHIP BETWEEN FOREIGN DIRECT INVESTMENT IN  
MANUFACTURING SECTOR AND THE INTEREST RATE, INFLATION  
RATE AND INVESTMENT INCENTIVES***

***MOHD ELFEE BIN AB RASHID***

**FEP 2004 12**

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Project Paper submitted in Partial Fulfillment of the Requirement for the degree  
of Master of Economics in the Faculty of Economics and Management  
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## ACKNOWLEDGEMENT

Alhamdulillah to Allah S.W.T, finally this project paper has been completed within the period given. First of all, I would like to express my gratitude to my advisor Dr. Huson Joher for his guidance and advice in the preparation of this project paper.

I also would like to thank Cik Habibah Enok, from Information Management and Statistic Division MIDA. Despite her tight and busy schedule, she managed to spend her precious time to provide all the information that I needed regarding the Foreign Direct Investment. Without her assistant, this project paper could not be completed.

Special appreciation to all my family members especially my mother for her continuous support, encouragement and understanding. Not forgetting my friends, Abu Zaril, Azmirul Ariff, Mohd Faizal Jewari, Zainuddin and Ida Weduri for their ideas, comments and moral support while preparing this project.

Last but not least, my special thanks to everyone who has directly or indirectly contributed his or her time and effort towards the completion of this paper.

*"MAY GOD GIVE HIS BLESSING TO ALL OF US"*

## **ABSTRACT**

This study attempt to examine the relationship between the Foreign Direct Investment in manufacturing sector and interest rate, inflation rate and investment incentives. The data for this study is taken on yearly basis, which covers the period of twenty years (from 1983-2002).

By using the regression and correlation analysis, two alternate hypothesis were developed. First hypothesis mentioned that interest rate, inflation rate and investment incentives are significant explanatory variable for foreign investment inflow. Second, foreign direct investment is dependent on interest rate, inflation rate and investment incentives. Besides, coefficient of determination and coefficient of correlation were used to quantify the relationship between the dependent variable and independent variables.

Consistent to the hypothesized, empirical evidences from this study revealed that there is significant relationship between foreign direct investment and interest rate, inflation rate and investment incentives.

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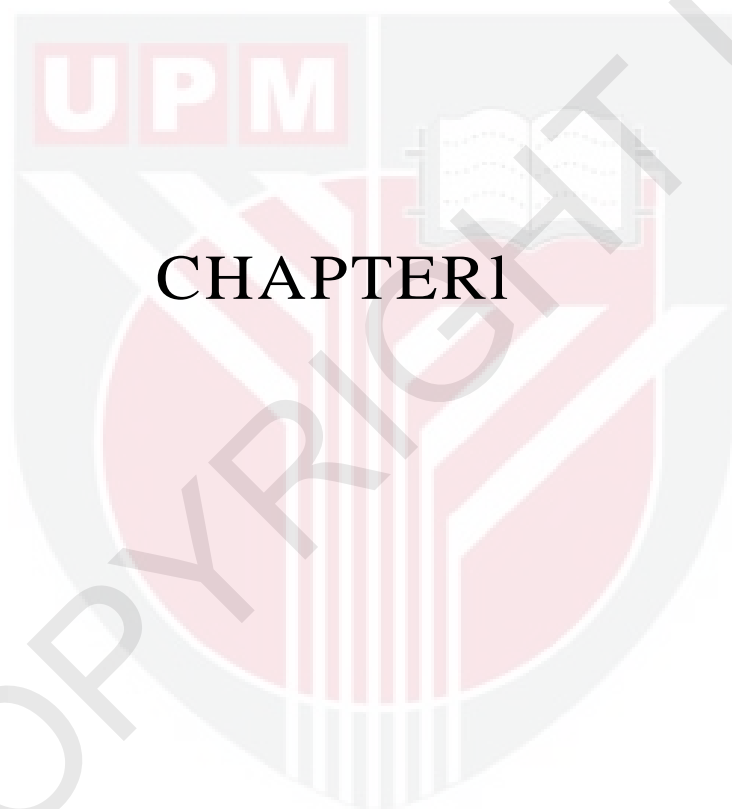
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# CHAPTER 1

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## **CHAPTER I**

### **INTRODUCTION**

#### **1.1 INTRODUCTION**

Foreign investment has contributed significantly to the economic development of the country not only in term of GDP growth but also in term of structural changes that have transformed Malaysia from basically a primary producer to a rapidly industrializing economy. Foreign investment has provided capital, technology, market channels and managerial inputs, which constitute the necessary ingredients for rapid industrialization.

In the last ten years, FDI and national savings have generally been more the sufficient to finance total investment including foreign and reverse investment. However, in 1991 and from 1994, gross investment including reverse investment, exceeded the total amount of national savings and the inflow of FDI.

Malaysian government has encouraged foreign investment activity as an important means of economic growth. It also as an important means of promoting industrial growth technology transfer, skill development and employment creation. In order to achieve this objective, private sector played a key role in implementation of these program and part of it play by the government. A variety of incentives are offered to foreign investors in order to attract them to invest to our country.

Currently, in our country, the strategy to move to the next stage of industrial development is to place greater emphasis on higher technology and capital-intensive industries. The second Industrial Master Plan (IMP2), which outlines the strategy for the development of industrial sector, focuses on a cluster-based approach, which emphasizes strong interlinkages of industries with supporting business services, requisite infrastructure and institutions. An important aspect of the implementation of this plan is the availability of funds to finance the industries. It has been estimated that the total investment required for the sector over the period 1996-2005 would amount to RM250 billion, with RM110 billion for the first five years and RM140 billion for the subsequent period. It can be said that the manufacturing sector is likely to require on average more than RM25 billion per annum to achieve the vision of the IMP2. While the significant increase in investment approved in 1996 as well as the increase in the foreign share of the investment approved portends well for our country's ability to attract enough foreign investment to

meet the need of the IMP2, implications on the balance of payments have to be closely monitored and safeguard investor confidence.

The outlook for the international environment remains favourable as the global economy is expected to grow by 4.1 % and world trade is envisaged to expand by 7.2% in 1997. According to the World Investment Report 1996, global FDI inflow reached new heights, amounting to US \$314.9 billion in 1995, with increasing inflows into the developing countries. Among the ASEAN countries, Malaysia has been an important destination for FDI. In fact there was an encouraging trend of increasing FDI inflows over the last six years. Whereby the value increase from US \$2.3 billion in 1990 to US \$5.8 billion in 1995. With the bright prediction both for world economic growth and trade, Malaysia could continue to receive healthy investment flows. In another hand, a tight monetary policy and fiscal restraint had contributed to the lower inflation rate (below 4%) and high saving rate. These are the part of the attraction for foreign investment inflow to our country. In addition the prospects for investments inflows could be further enhanced through the progressive realization of the ASEAN Free Trade Area (AFTA) and the ASEAN Investment Area (AIA).

As stated above that the foreign investment is one of the importance sources of financing for the development of this country. So, it is an interesting to do a research on the performance of the foreign investment inflow. In this study,

I will examine and look at any correlation between foreign inflow with interest rate and inflation rate.

I will look how significant the interest rate and inflation rate affect the inflow of foreign investment. In addition, I also will look at the performance of foreign investment inflow according to the investment incentives.



## 1.2 PROBLEM STATEMENT

Malaysia has depended to a large extent on foreign financing. Net FDI as a percentage of gross domestic investment averaged over 25 percent between 1991 and 1994. Net FDI as a percentage of GDP averaged almost 9 percent. FDI also has been a source of foreign exchange revenue, averaging 9.7 percent as a percentage of exports revenue between 1991 and 1995. Foreign financing has played a major role in Malaysia's economic growth by supplementing domestic investment and a minor role as a source of foreign exchange. Because of those facts, the purpose of this study is to examine and analyse the inflows of FDI specifically in manufacturing sector in Malaysia and whether it has any significant relationship with the interest rate, inflation rate and investment incentives.



### 1.3 OBJECTIVE OF THE STUDY

This project paper is aimed at achieving several objectives as stated below.

#### Primary Objective

1. To study the impact of FDI inflow in the manufacturing sector to the fluctuation of the interest rate and inflation rate in the given period of 1983 to 2002.
2. To study the effectivity of Investment Incentive to the performance of FDI in the manufacturing sector in the period of 1983 - 2002.

#### Secondary Objective

1. To study the foreign investor reaction in term of their direct investment in the manufacturing sector towards the changes of the interest rate and inflation rate during the study period.
2. To identify any relationship between FDI inflows in the manufacturing to the interest **rate**, inflation rate and investment incentives.

3. To identify the effectiveness of the investment incentives that implement under the Promotion of Investment Act, 1986 in term of attracting the FDI.
4. To identify which factors that the most significant in affecting the inflow of FDI.



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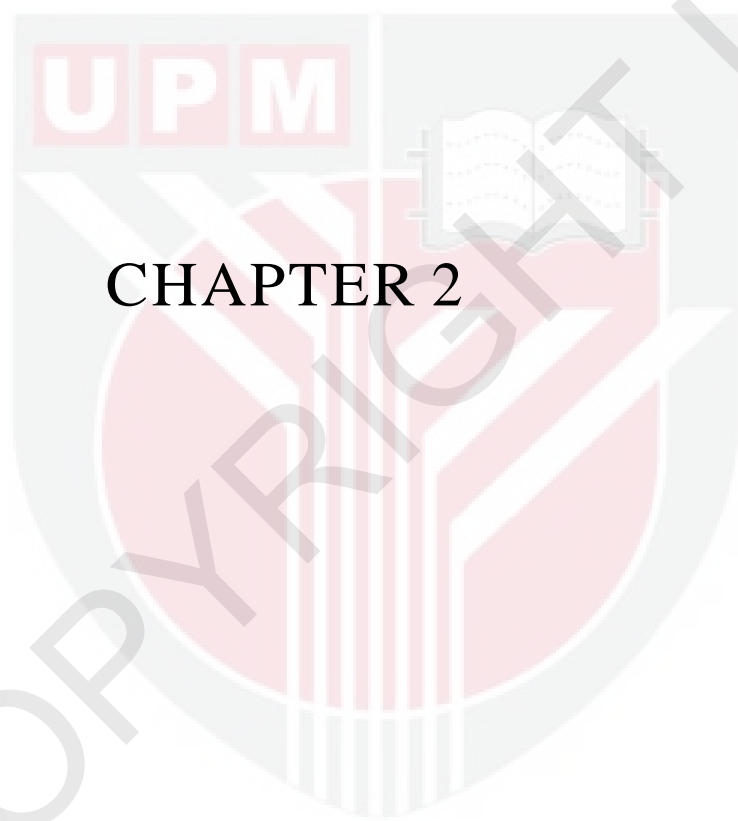
## **1.4 SCOPE AND LIMITATION**

### **SCOPE**

- a. The area of this study is base on the economic factors. For the purpose of this study, two economic factors are considered as a sample to determine the impact of the FDI inflow. The two economic factors are as follow:
  1. Interest rate
  - ii. Inflation rate
- b. This study also uses the investment incentives as a factor to determine the impact of FDI inflow.
- c. This study is only focus in the manufacturing sector.

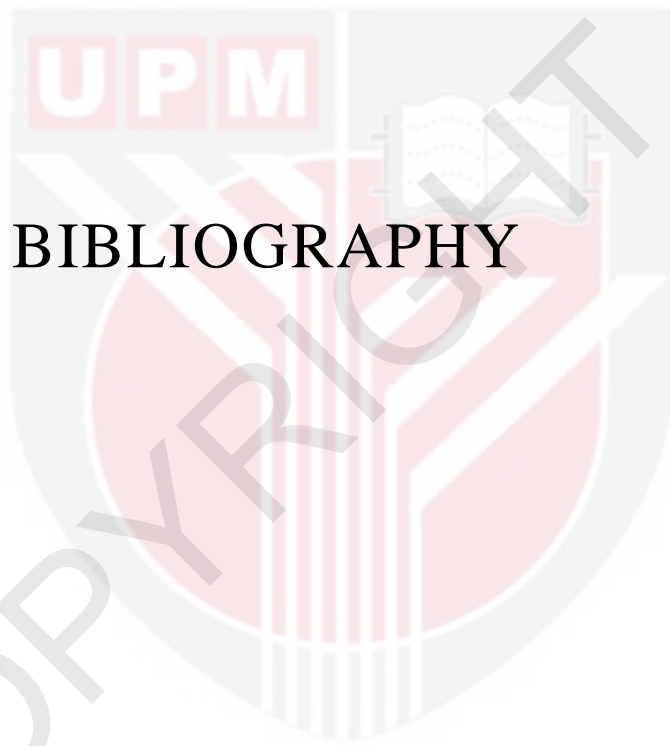
## **LIMITATION**

- a. This study does not consider other factors besides the interest rate, inflation rate and investment incentives that will also affect the inflow of FDI.
- b. In order to evaluate the effectiveness of the investment incentives, the number of manufacturing project that approved for foreign equity is use as a measurement to the effectiveness of the incentives. It assumed that the increase of the number of manufacturing project means that the incentives are effective.
- c. This study only looks for the financial data for 20 years, from 1983 until 2002.
- d. This study is based on the secondary data.



## CHAPTER 2

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