
**UNIVERSITI PUTRA MALAYSIA**

# *EFFECTS OF INSTITUTIONAL FACTORS ON MALAYSIAN OUTWARD FOREIGN DIRECT INVESTMENT, LOCATIONAL CHOICE AND EMPLOYMENT*

**CHEN JEN EEM**

**FEP 2016 26**

# EFFECTS OF INSTITUTIONAL FACTORS ON MALAYSIAN OUTWARD FOREIGN DIRECT INVESTMENT, LOCATIONAL CHOICE AND EMPLOYMENT

By

**CHEN JEN EEM**

**Thesis Submitted to the School of Graduate Studies, Universiti Putra Malaysia, in Fulfillment of the Requirements for the Degree of Doctor of Philosophy**

**December 2016**

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**DEDICATION**

*To my family*

Abstract of thesis presented to the Senate of Universiti Putra Malaysia in fulfillment of the requirement for the Degree of Doctor of Philosophy

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**December 2016**

**Chairman : Associate Professor Lee Chin, PhD**
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This study investigates the push and the pull factors of outward foreign direct investment (FDI) from Malaysia. The study also examines the effects of outward FDI on employment in Malaysia, particularly skilled and unskilled employment. In examining the push factor, or home country environment, that influences the outward investment, we focus on the role of home government institution. Given that Malaysian outward FDI increased tremendously and at the same time there are some indications that Malaysian firms experience high regulatory costs, we are uncertain if Malaysian outward FDI is driven by the institutional escapism.The results of Autoregressive Distributed Lag (ARDL) confirm that Malaysian outward FDI is driven by GDP, exchange rate, inward FDI, and corporate taxation. This portrays that internationalization strategies of firms are not only relied on home macroeconomic environment but also government institution. The significance of corporate taxation in affecting outward FDI explains that high corporate taxation is a regulatory burden to domestic firms which result in the escape response. In contrast, pull factor refers to the location advantages of host countries that attract foreign investors. Though host countries offer attractive location advantages to the investors, the business risks or uncertainties embedded in the investment cannot be neglected. These uncertainties are translated into transaction costs. The selection of host countries is important as it may bring success or failure to the investing firms. To capture the transaction costs, we employ institutional environment of host countries, common colonization, and geographical distance between home and host countries. The regression estimations reveal that the factors determine Malaysian overseas investments are GDP of host countries, low labour cost, availability of natural resources, quality of governance, geographical distance, and common colonization. Outward investment raises the public fears of job-exporting as a result of firms shifting their production plants abroad. Nevertheless, outward FDI would also stimulate the local employment following the expansion in larger foreign markets. Currently, unemployment is not a serious problem in Malaysia. Nonetheless, the retrenchment of workers in recent years deserves our attention. This leads us to

inspect the effects of outward investment on Malaysian employment, specifically skilled and unskilled employment. However, we found no empirical evidence that outward investment is statistically significant in affecting skilled and unskilled employment. Overall, the findings of this thesis give some implications to the investing firms in designing their expansion and penetration strategies such as the mode of investment, amount of investment, source of financing and the other aspects.

Abstrak tesis yang dikemukakan kepada Senat Universiti Putra Malaysia sebagai memenuhi keperluan untuk Ijazah Doktor Falsafah

**KESAN FAKTOR INSTITUSI TERHADAP PELABURAN LUAR MALAYSIA, PILIHAN LOKASI DAN GUNA TENAGA**

Oleh

**CHEN JEN EEM**

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Kajian ini menyiasat faktor-faktor tolakan dan tarikan yang mempengaruhi pelaburan luar Malaysia di negara asing. Kajian ini juga mengkaji kesan pelaburan luar Malaysia terhadap guna tenaga di Malaysia, terutamanya tenaga mahir dan tenaga tidak mahir. Dalam mengkaji faktor tolakan, atau faktor dalaman negara, yang mempengaruhi pelaburan luar Malaysia, kita bertumpu kepada peranan yang dimainkan oleh institusi negara. Memandangkan pelaburan luar Malaysia meningkat secara mendadak dan pada masa yang sama terdapat petunjuk-petunjuk yang menyatakan bahawa firma-firma Malaysia mengalami kos perundangan yang tinggi. Oleh itu, kita tidak pasti samada pelaburan luar Malaysia adalah ingin mengelak dari beban institutsi. Keputusan dari model *Autoregressive Distributed Lag (ARDL)* mengesahkan bahawa pelaburan luar Malaysia adalah didorong oleh pendapatan negara, kadar pertukaran matawang asing, pelaburan asing di Malaysia, dan percukaian korporat. Ini menunjukkan bahawa strategi pengembangan antarabangsa bukan sahaja dipengaruhi oleh faktor makroekonomi negara tetapi juga faktor institusi. Kepentingan percukaian korporat menjelaskan bahawa percukaian yang tinggi merupakan beban kepada firma-firma yang menyebabkan mereka ingin mengelak dari kekangan institusi dengan melabur di negara asing. Sebaliknya, faktor tarikan merujuk kepada kelebihan lokasi yang terdapat di negara hos yang dapat menarik pelabur asing. Walaupun negara hos menawarkan lokasi yang menarik kepada pelabur asing, namun risiko atau ketidakpastian dalam pelaburan tidak boleh diabaikan. Risiko-risiko ini diungkapkan sebagai kos urusniaga. Pilihan lokasi atau negara hos adalah penting kerana ia boleh mempengaruhi kejayaan atau kegagalan pelaburan. Untuk mengukur kos urusniaga, kami menggunakan faktor institusi negara hos, penjajahan yang sama, dan jarak geografi antara Malaysia dan negara hos. Keputusan regresi menunjukkan bahawa faktor yang menentukan pilihan lokasi ialah pendapatan negara hos, kos buruh yang murah, sumber-sumber semulajadi, kualiti institusi, jarak geografi dan juga mempunyai penjajahan yang sama. Pelaburan luar membangkitkan kerisauan orang awam tentang kehilangan pekerjaan akibat daripada pemindahan kilang-kilang ke negara lain. Walau bagaimanapun, pelaburan luar juga boleh menjanakan pekerjaan di negara asal

berikutan dari pengembangan pasaran asing yang lebih luas. Pada masa ini, pengangguran bukan masalah yang ketara di Malaysia. Namun demikian, pemberhentian kerja yang berlaku baru-baru ini perlu diberi perhatian. Dengan itu, kajian ini menganalisa kesan pelaburan luar terhadap guna tenaga tempatan di Malaysia, terutamanya tenaga mahir dan tenaga tidak mahir. Hasil kajian ini tidak menemui bukti yang menunjukkan bahawa pelaburan luar membawa kesan kepada guna tenaga tempatan. Secara keseluruhannya, penemuan kajian dalam tesis ini memberi implikasi kepada firma-firma yang melabur di negara asing, terutamanya dari segi strategi pengembangan dan kemasukan ke negara asing, seperti cara pelaburan, jumlah pelaburan, sumber pembiayaan dan lain-lain.

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This thesis was submitted to the Senate of the Universiti Putra Malaysia and has been accepted as fulfillment of the requirement for the degree of Doctor of Philosophy. The members of the Supervisory Committee were as follows:

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| | |
|---|---|
| ADF | Augmented Dickey-Fuller |
| AIC | Akaike's Information Criterion |
| ARDL | Autoregressive distributed lag |
| CUSUM | Cumulative sum of recursive residuals |
| CUSUMQ | Cumulative sum of recursive residuals of square |
| DOLS | Dynamic ordinary least square |
| FDI | Foreign direct investment |
| FE | Fixed effect |
| FMOLS | Fully modified ordinary least square |
| HT | Hausman-Taylor |
| ICRG | International Country Risk Guide |
| MNC | Multinational cooperation |
| POLS | Pooled ordinary least square |
| PP | Philip-Perrons |
| RE | Random effect |
| SBC | Schwarz-Bayesian Criterion |
| UNCTAD | United Nations Conference on Trade and Development |
| WDI | World Development Indicators |

# CHAPTER 1

# INTRODUCTION

## 1.1 Introduction

Chapter one begins with the definition of outward FDI, followed by the rise of outward FDI from developing economies. Before looking into the outward FDI, specifically from Malaysia, we go through the economic evolution of Malaysia. Next, we highlight the issues that arise and the objectives of the study as well as the significance of the study. Last but not least, scope of the study concludes the chapter.

## 1.2 Definition of outward FDI

Outward FDI is also referred to as direct investment abroad. According to the International Monetary Fund (IMF) and the United Nations Conference on Trade and Investment (UNCTAD), FDI is a direct investment, where companies which invest abroad are involved in a long-term relationship with the intention of obtaining a lasting interest. The lasting interest is reflected in the holdings of at least 10% ownership in an enterprise resident of another economy. With the provision of lasting interest, a foreign direct investor gains a significant degree of influence on the management of the enterprise. The data on direct investment abroad in accordance to the IMF and the UNCTAD definition includes investment in the form of equity, reinvested earnings, and other capital, mainly intra-company loans (Bank Negara Malaysia (BNM), 2006; UNCTAD, 2006).

Equity capital is the foreign direct investor's purchase of shares of an enterprise in a country other than its own. Reinvested earnings comprise the direct investor's share (in proportion to direct equity participation) of earnings not distributed as dividends by affiliates, or earnings not remitted to the direct investor. Such retained profits by affiliates are reinvested. Intra-company loans or intra-company debt transactions refer to short- or long-term borrowing and lending of funds between direct investors (parent enterprises) and affiliate enterprises (UNCTAD, 2006). The investors venture into investment abroad through cross-border mergers and acquisitions (M&A), joint-ventures, and greenfield projects.

## 1.3 Rise of outward FDI from developing countries

Outward FDI, from the very beginning, has been dominated by capital-rich developed countries such as United States (US), European Union, and Japan. Prior to 1990, almost 95% of global outward FDI came from developed countries (UNCTAD, FDI database). These countries set up their operation plants overseas, in particular in developing countries, to seek higher marginal returns to capital through multinational corporations (MNCs). For instance, IBM, a US based software MNC, establishes research facilities in India; Japanese MNCs, such as Toyota and Honda

automotive manufacturers, have their plants in Thailand. The MNCs of developed countries relocate their plants in developing countries with the motives to exploit the factors of production and access to a larger market in developing countries. At the same time, developing countries that serve as host countries also benefit from FDI inflows where they spur economic growth and employment, which in turn improve the standard of living and accelerate the economic development of developing countries.

Nonetheless, when it came to the mid 1990s, these giant economies, particularly the US, encountered large and persistent current account deficits as a consequence of the 1990-2000 I.T. bubble crisis. The current account deficits of developed countries were counterbalanced by current account surpluses of developing countries. This led to global imbalances where capital started to flow from developing to developed countries (Park and Estrada, 2009). Table 1.1 depicts the share of FDI outward flows of developed and developing economies from 1980 to 2010.

**Table 1.1 : Share of FDI outward flows from developed and developing economies (%), 1980-2010**

| Region | 1980 | 1985 | 1990 | 1995 | 2000 | 2005 | 2010 |
|---|---|---|---|---|---|---|---|
| Developed economies | 94 | 94 | 95 | 85 | 89 | 85 | 71 |
| Developing economies | 6 | 6 | 5 | 15 | 11 | 14 | 25 |
| South-East Europe and CIS | - | - | - | - | - | 1 | 4 |

*Source: UNCTAD, FDI database; author's calculations*

Until 1990, developed countries piloted global outward FDI flows with a share of more than 90%. However, beginning from 1995, the developing countries, which were primarily the recipients of FDI, showed a remarkable increase in the share of outward FDI from merely 5% in average to three-fold of 15%, driven by the international expansion of Asian MNCs (UNCTAD, 2006). This double-digit share remained over time and spiked to 25% in 2010. Likewise, the share of developed countries demonstrated a continuous declining rate.

Developing economies, in particular East Asian developing economies, which have traditionally been treated as host countries of FDI, are recently playing a crucial role in contributing to outward FDI. The region's rapid economic growth and development, as well as large and persistent current account surpluses since the Asian financial crisis, are the motivations behind the rising bulk of outward FDI from these economies (Park and Estrada, 2009). Prior to the Asian financial crisis, developing economies were generally having current account deficits. Nevertheless, owing to the weak currencies during the financial crisis, these economies conducted export promotion as a channel to gain current account surpluses, thus adding to the build-up of foreign exchange reserves. The reserves held by central banks exceeded the requirement for liquidity purposes that resulted in the inflation. Therefore, to ease the inflationary pressure, these countries have to release the reserves by letting

capital outflows through investment abroad. Subsequently, it led to the transformation of developing countries from net capital importer to net capital exporter (Park and Estrada, 2009). In addition, the FDI from developing countries is not only flowing to developing countries (South-South) but also to developed economies (South-North). Table 1.2 reports the share of outward FDI stocks of developing economies to the global outward FDI.

**Table 1.2 : Origin of outward FDI stock of selected developing countries,1990-2010**

| | | 1990 | | 2000 | | 2010 | |
|---|---|---|---|---|---|---|---|
| **Region** | | **$ millions** | **%** | **$ millions** | **%** | **$ millions** | **%** |
| **World** | | 2 094 169 | **100** | 7 962 170 | **100** | 2 040 8257 | **100** |
| **Developing** | | 145 525 | **6.95** | 857 354 | **10.77** | 3 131 845 | **15.35** |
| | **Asia** | 67 600 | **46.45** | 608 366 | **70.96** | 2 276 194 | **72.68** |
| | China, People's Rep. of | 4 455 | 6.59 | 27 768 | 4.56 | 297 600 | 13.07 |
| | Hong Kong, China | 11 920 | 17.63 | 388 380 | 63.84 | 948 494 | 41.67 |
| | Taiwan, China | 30 356 | 44.91 | 66 655 | 10.96 | 201 228 | 8.84 |
| | Korea, Rep. of | 2 301 | 3.40 | 21 497 | 3.53 | 138 984 | 6.11 |
| | Singapore | 7 808 | 11.55 | 56 755 | 9.33 | 300 010 | 13.18 |
| | Malaysia | 753 | 1.11 | 15 878 | 2.61 | 96 758 | 4.25 |
| | Thailand | 418 | 0.62 | 2 203 | 0.36 | 25 454 | 1.12 |
| | India | 124 | 0.18 | 1 733 | 0.28 | 92 407 | 4.06 |
| | **Latin America** | 56 014 | **38.49** | 115 170 | **13.43** | 406 071 | **17.84** |
| | Argentina | 6 057 | 10.81 | 21 141 | 18.36 | 29 841 | 7.35 |
| | Brazil | 41 044 | 73.27 | 51 946 | 45.10 | 180 949 | 44.56 |
| | Chile | 154 | 0.27 | 11 154 | 9.68 | 49 838 | 12.27 |
| | Colombia | 402 | 0.72 | 2 989 | 2.60 | 22 772 | 5.61 |
| | Mexico | 2 672 | 4.77 | 8 273 | 7.18 | 66 152 | 16.29 |

*Source: UNCTAD, FDI database; author's calculations*

From Table 1.2, a growing significance of FDI from developing economies can be observed over the period of 1990 to 2010. Furthermore, the share jumped from 7% in 1990 to more than two-fold in 2010. Within this respective share, Asian developing countries accounted for the largest portion compared to that of Latin America. In addition, while the share of Asian developing countries rose sharply, the share of Latin America, in contrast, fluctuated where the share fell from 38.5% in 1990 to 13.4% in 2000 and bounced back to 17.8% in 2010. In 1990, among the Asian developing economies, Taiwan led the way with 45%. When came to year 2000, Hong Kong overtook Taiwan with a share of 64% and remained as the leader in 2010 even though its share dropped to 42%. Surprisingly, the share of India, which was negligible in 1990 and 2000, rose noticeably to 4% in 2010, that went ahead of Thailand. Outward FDI from China fall slightly from 1990 to 2000 but surged substantially to a double digit in 2010. Korea and Malaysia documented steady and rising shares over the past two decades. Turning to Latin America, Brazil

was the major source of outward FDI despite of its declining rates over the period. On the other hand, Chile, Colombia, and Mexico were also increasingly active in investment abroad.

Table 1.3 highlights the performance of fast-growing FDI from developing economies. Among these top 10 non-financial MNCs, East Asian countries accounted for the majorities and followed by Latin America countries. Thus, it reflects that MNCs from developing and emerging countries are rapidly playing an important role as international investors. In addition to that, there is a possibility that these MNCs, particularly East Asian economies, would become the main source of FDI inflows to lower income countries such as Vietnam and Laos (Aminian et al., 2007).

**Table 1.3 : The top 10 non-financial MNCs from developing and transition economies, ranked by foreign assets, 2009**

| Foreign Assests ($ millions) | Corporation | Home Country | Industry |
|---|---|---|---|
| 72 047 | Hutchinson Whampoa Limited | Hong Kong, China | Diversified |
| 43 814 | CIITC Group | China | Diversified |
| 39 225 | Cemex S. A. B de C.V. | Mexico | Non-metallic mineral products |
| 38 848 | Vale SA | Brazil | Mining & quarrying |
| 34 795 | Samsung Electronics Co., Ltd. | Korea, Republic of | Electrical & electronics equipment |
| 33 599 | Petronas-Petroliam Nasional Bhd. | Malaysia | Petroleum exploration/refining/distribution |
| 28 092 | China Shipping Ocean (Group) Company | China | Transport and storage |
| 27 627 | Hyundai Motor Company | Korea, Republic of | Motor vehicles |
| 25 400 | LG Corp. | Korea, Republic of | Electrical & electronics equipment |
| 23 992 | Lukoil OAO | Russian Federation | Petroleum and natural gas |

*Source: The Top 100 Non-Financial MNCs from developing and transitions economies, ranked by foreign assets, 2009. UNCTAD, FDI database*

## 1.4 Background of Malaysia

Malaysia is a small open developing country. Since independence, Malaysia has recorded a rapid and rigorous economic transformation from an agricultural based to an industrial based economy. Such an achievement was associated with a few major policies that were undertaken by the government of Malaysia. Table 1.4 reports a summary of major economic policy evolutions adopted since independence in the 1957.

**Table 1.4 : Major economic policy evolutions: A summary**

| Policy | Issue focus |
|---|---|
| Post-independence,<br>1957-1970 | Laissez-faire / Export-oriented,<br>Economic and rural development |
| New Economic Policy (NEP),<br>1971-1990 | Growth with equity |
| National Development Policy (NDP),<br>1991-2000 | Balanced development |
| National Vision Policy (NVP),<br>2001-2010 | Building a resilient and competitive nation |
| Vision 2020,<br>1991-2020 | Total development |

*Source: Poon (2008)*

Back to the early days of independence from the 1950s to the 1970s, economic activities were primarily focused on the agricultural, fishery, and mining sectors as Malaysia possesses vast natural resources and agricultural commodities. At the same time, the emergence of light manufacturing was required to play a supporting role in enhancing the effectiveness of the primary sector. However, there was a time when fluctuating world prices negated the comparative advantages of the primary sector commodities, particularly the export of processed rubber and tin. Hence, Malaysia had to reduce its dependency on resources and commodities. Instead, the government strove to widen and diversify its manufacturing and industrial bases to achieve the status of an industrialized country.

In progressing towards the goal of industrialization, Malaysia introduced an import substitution industrialization strategy in the 1960s to reduce its dependency on imported components to outfit its burgeoning manufacturing industries. The rationale for the implementation of this plan was the limited scope of the agricultural sector which could only employ a limited number of Malaysia's growing population and to better diversify Malaysia's range of industrial products. This effort was further complemented by the implementation of tariff and non-tariff protection for certain products in the domestic market. With the provision of import substituting industries, raw materials and machinery were imported for the purpose of local production. In turn, the manufacturers assembled and supplied intermediate and final goods for local consumption. Nonetheless, there were several flaws in this policy. The drawbacks stemmed from the small Malaysian domestic market and the prevalent inefficient conditions and processes within the respective industries, both of which were woefully inadequate to support the minimal infrastructure requirements for an import substitution oriented industry. Thus, the import substitution industry was dropped in favour of an export-oriented strategy.

The export-oriented strategy was implemented during the development of the New Economic Policy (NEP), where the NEP spanned from 1971-1990. The NEP emphasized poverty eradication and social restructuring to produce a better-educated and healthier population. During the NEP period, Malaysia experienced remarkable economic structural change. This could be seen from the changes in sectoral

contribution to GDP, export, and employment. The secondary sector, particularly manufactured exports, surpassed the performance of the primary sector. Thus, this explained that the secondary sector was the key driver in uplifting and accelerating the development and transformation of the economy. For instance, the contribution of the secondary sector, specifically manufacturing, in GDP, increased from 19.4% in 1970 to more than 30% during the 1990s, while the exports of the secondary sector rose tremendously from 11.1% to almost 60% over the same period (Yussof, 2009). With the expansion of the manufacturing sector, employment opportunities increased thus reducing the unemployment rate and poverty. Hence, the secondary sector became the highlight of the country compared to the primary sector in eradicating poverty and making way for industrialization.

An export-oriented strategy is considered to be a better choice than an import substitution strategy as an export-oriented strategy is easier to monitor regarding its relative effectiveness of export promotion policies. Its results are also readily visible within a short time span. Thus, corrective action can be undertaken at short notice, which allows for economies of scale as well as enhancing the competitiveness of Malaysian products abroad. In contrast, an import substitution strategy discriminates against export-oriented industries as well as distorting the domestic market, while an export-oriented industry benefits both the domestic and export markets.

In response to the vigorous growth of the manufacturing sector and to further strengthen the goal of industrialization, the government has formulated several policies to boost private investment by giving investment incentives to attract foreign direct investment (FDI) in the industrial sector to complement domestic investment. One of these policies is the Investment Incentives Act 1968 to support the expansion of manufactured exports. This Act allows the Malaysian Inland Revenue Board (MIRB) to grant tax holidays and pioneer status to companies whose products, location and choice of raw materials are in accordance with the industries currently promoted by the Malaysian government. The tax exemption is based on the percentage of capital investment expenditure and additional incentives include export incentives for starter firms and current companies that are expanding.

In addition to that, a conducive investment environment was also created to promote FDI inflows, such as the building of good infrastructure and utilities, the establishment of free trade zones, the spread and adoption of ICT, a well-trained and educated workforce, a sound financial system and other supportive policies. Subsequently, this led to the surge of FDI inflows to Malaysia where Malaysia emerged as one of the most popular investment destinations among neighbouring countries. For instance, Malaysia was the top recipient of FDI among ASEAN countries in 1995 with a share of 29.7%, followed by Singapore, 27.1%, and Indonesia with 23% (Poon, 2008). During the 1990s, the foreign investors in Malaysia mainly originated from the United States (US), Japan, Singapore, South Korea, and Taiwan. The influx of FDI was concentrated in the manufacturing sector whereby electronics and electrical (E&E) products accounted for the largest share. Nonetheless, FDI inflows to Malaysia encountered a great fall upon the Asian financial crisis, which recorded a 57% decline from 1997 to 1998 (UNCTAD, FDI

database). Aside from the financial crisis, the sharp contraction was also caused by the liberalization of China and India that posed a competitive threat in attracting FDI inflows.

Table 1.5 summarizes the economic performance of Malaysia from 1980 to 2014. Prior to 1990, Malaysia experienced an unstable economic growth, a high unemployment rate and a substantial fall in inflation rate resulting from the world recession and plunge of commodity prices in tin and petroleum. Nonetheless, Malaysia recovered from the recession rapidly where its economic growth registered a remarkable record of 9.0% to 9.8% in the 1990s before the outbreak of the Asian financial crisis in 1997. Following this strong fundamental growth, the unemployment rate was reduced to around 4.5% and 3.1%, and the inflation rate starting to spike up. After the Asian financial crisis, Malaysia still managed to grow strongly; the unemployment rate and the inflation rate were low in the year 2000. However, an economic downturn occurred in the mid 2000s which dampened the growth and increased the unemployment rate and inflation rate. The unemployment rate remained high at around 3.4% in 2010 though the economic growth began to pick up. In 2014, the economic growth declined to 5.9% and the rate of inflation spiked up to 3.1%. This could be due to the uncertainties in the global economy and the moderating commodity prices as well as the rising cost of living. The rate of unemployment improved despite the fact that the economic growth had dropped.

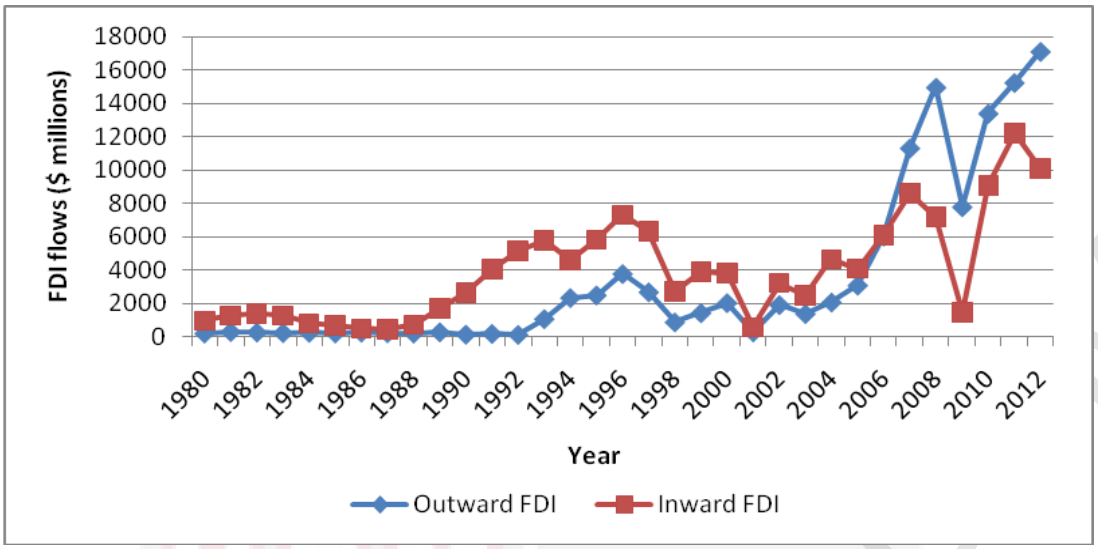
**Table 1.5 : Selected macroeconomic indicators, 1980-2014**

| Indicators | 1980 | 1985 | 1990 | 1995 | 2000 | 2005 | 2010 | 2014 |
|---|---|---|---|---|---|---|---|---|
| GDP growth (%) | 7.4 | -1.1 | 9.0 | 9.8 | 8.8 | 5.3 | 7.4 | 5.9 |
| Unemployment rate (%) | N.A. | 5.6 | 4.5 | 3.1 | 3.0 | 3.5 | 3.4 | 2.0 |
| Inflation rate (%) | 6.7 | 0.3 | 2.6 | 3.4 | 1.5 | 2.9 | 1.7 | 3.1 |

Notes: N. A. denotes Not Available.
*Source: World Development Indicators, World Bank*

## 1.5 Outward FDI from Malaysia

Despite receiving FDI from developed countries, Malaysia has also ventured abroad by investing in other countries. Figure 1.1 exhibits the trends of inward and outward FDI of Malaysia from 1980 to 2012.




*Source: UNCTAD, FDI database*

**Figure 1.1 : Inward and outward FDI flows of Malaysia, 1980-2012**

In the early years of investing abroad, between 1980 and 1992, Malaysian outward FDI remained low with a negligible amount that marked around $200 million in average each year. Thereafter, in 1993, the amount of FDI outflows exhibited an increasing trend and peaked at almost $4000 million in 1996. However, it shrunk substantially to $863 million in 1998 in response to the Asian financial crisis. Though the economy was hit by the Asian financial turmoil, Malaysian outward FDI revealed a slight increase between 1999 and 2000 before it slumped again in 2001. In 2001, Malaysia experienced a sharp contraction in both inward and outward investments as low as $544 million and $266 million, respectively, which corresponded to the global slowdown in FDI flows. Nevertheless, starting from the year 2003, capital outflows of Malaysia witnessed a continuous upward trend till 2011, except for a downturn in 2009, as a consequence of the global crisis. Interestingly, thereafter in 2007, a visible shift struck the FDI landscape of Malaysia where outbound FDI exceeded inbound FDI. The changing trend of FDI transformed the country, which was initially a capital importer, to a capital exporter and also the net capital exporter in the ASEAN region (Menon, 2012).

Figure 1.2 demonstrates the share of Malaysian outward FDI to GDP. Based on Figure 1.2, between 1980 and 1994, the outward FDI stock as a percentage of GDP was around 2% – 3% as the development of investments abroad by Malaysian MNCs was still at an early stage. The companies that were involved in cross-border investments in the 1980s were mainly led by government-link companies (GLCs) such as Sime Darby, Guthrie, and MISC (Malaysia International Shipping Corporation) as well as PETRONAS (Malaysia's national oil company). Since then, there has been a continuous increase in the outward FDI made by MNCs from private non-GLC companies (BNM, 2006).


*Source: UNCTAD, FDI database*

**Figure 1.2 : Malaysian outward FDI stock as percentage of GDP, 1980-2011**

Between 1993 and 1998, the share of outward FDI stock to GDP exceeded 5% and surged to a double digit of 16% in 1998. However, with the imposition of capital control in September 1998 in response to the Asian financial crisis, outbound investment was prohibited that resulted in constant shares of around 16% between 1998 and 2000. The global economic recession caused shares to fall significantly to 9% in 2001. Nonetheless, owing to the liberalization of capital accounts, shares escalated substantially from 2004 and peaked at 41.7% in 2009. Thus, it showed that venturing abroad for investment by Malaysian firms increasingly played a crucial role in the era of globalization.

### 1.5.1 Types of outward FDI ownership

Generally, Malaysian investors who engage in overseas investments can be classified into three types (BNM, 2006). They are:

i) Government-Linked Companies (GLCs) – GLCs are non-financial public enterprises where the government possesses an equity of more than 50% and with a sales turnover of at least RM100 million[1].
ii) Resident-Controlled Companies (RCCs) – private companies which are controlled by residents with an equity stake of more than 50%.
iii) Non Resident-Controlled Companies (NRCCs) – private corporations or branch operations in Malaysia controlled by non-residents (international organization) where the total non-resident shareholding is more than 50%.

The nature of overseas investments performed by these investors is different in accordance to their attributes. Outward FDI by Malaysian-Controlled Companies are initiated by GLCs and RCCs. Between 1999 and 2005, overseas investments

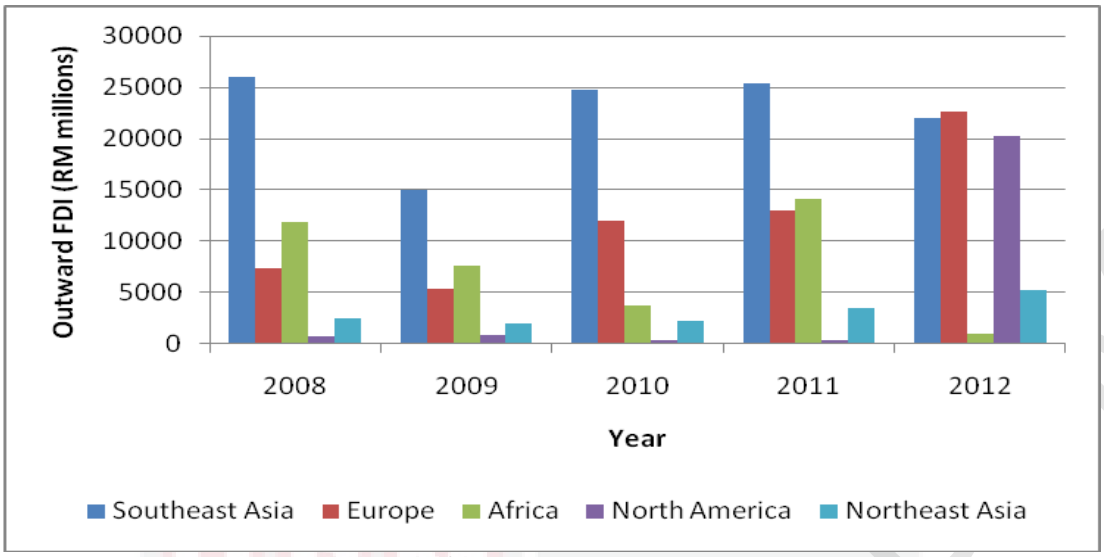
[1] USD 1 = RM 3.50 approximately

made by GLCs and RCCs accounted for 61% of total outward FDI. GLCs and RCCs ventured abroad through the acquisition of equity stakes and joint-ventures with foreign partners as well as investment in greenfield projects. The investments of these GLCs were primarily concentrated in oil and gas as well as telecommunication industries while investments in other industries such as banking and finance, manufacturing, utilities, plantations, construction, and so forth were carried out by RCCs. For instance, four corporations from Malaysia were listed in the top 100 non-financial TNCs in developing and transition economies based on foreign assets in 2009 (UNCTAD, FDI database). GLCs of PETRONAS, Axiata Group Bhd, and Sime Darby Bhd were ranked 6, 37, and 70, respectively; while Genting Bhd, as a RCC investor, was ranked 38. The investments conducted by GLCs and RCCs were mostly heading to developing countries and the investments were distributed to ASEAN and African regions as well as to other countries such as China, India, Sri Lanka, Pakistan, and some West Asian economies.

Outward FDI by Non-Resident Controlled Companies (NRCCs) accounted for 39% of total direct investments abroad during 1995-2000. However, the share of NRCCs outward FDI fell from 35% to 17% over the same period as the overseas investments had been substituted by the increased participation of GLCs and RCCs. The investments were mainly channelled to the manufacturing sector. Specifically, the manufacturing of semi-conductor and other electronic components accounted for 53% while the manufacturing of radios, television sets, video recorders and other equipment accounted for 20%. The preferred destinations of NRCCs are the United States, Singapore, and Belgium.

### 1.5.2 Destination and sector

Malaysian outward FDI are scattered to various countries including developed countries. Figure 1.3 highlights a few selected destinations of Malaysian overseas investments by blocks of countries between 2008 and 2012.

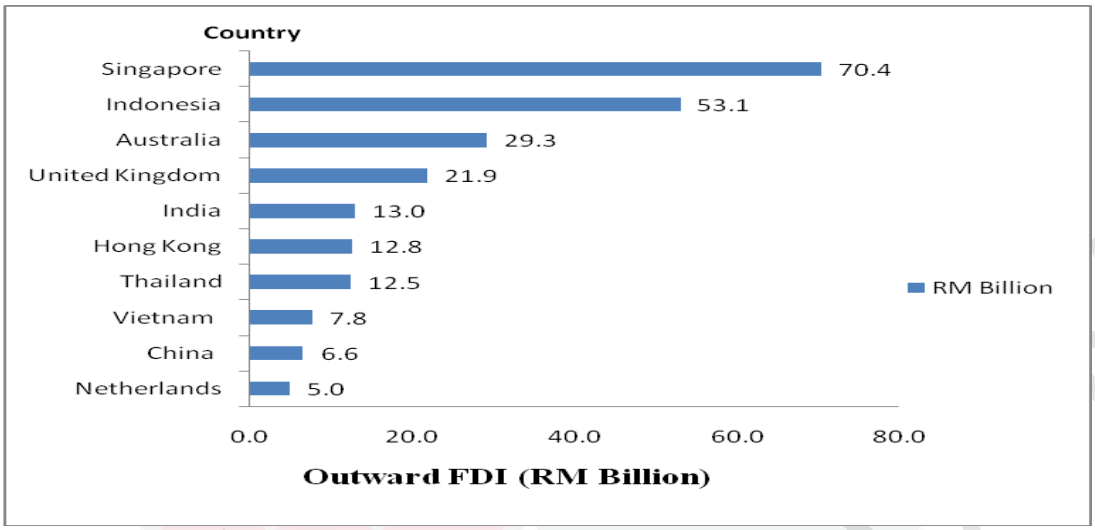



*Source: Direct investment abroad by blocks of countries, BNM online*

**Figure 1.3 : Geographical distribution of Malaysian outward FDI, 2008-2012**

Investing in neighbouring countries, namely Southeast Asian economies (Indonesia, Thailand, Singapore, Philippines, Vietnam, and Cambodia) was the most favourite destination of investment. Investment in these countries registered a constant amount of RM25,000 million in average a year, except for a decline in the year 2009. On the one hand, European countries (the Netherlands, Germany, and the United Kingdom) were ranked as the second top destination after Southeast Asia. Likewise, over the same period, the amount invested in Africa and North America encountered a dramatic change. Investment in Africa fell substantially from the highest amount of RM14,166 million in 2011 to the lowest point of RM953 million in 2012. The contraction was partly due to the declining share of investments in Mauritius. On the other hand, investments in North America, namely the United States, showed a tremendous increase over a year from a low of RM380 million in 2011 to RM20,302 million in 2012. Northeast Asian economies (China, Taipei, and Hong Kong) received a moderate and constant amount that ranged between RM2,000 million to RM5,000 million during the 2008-2012 period(BNM online).

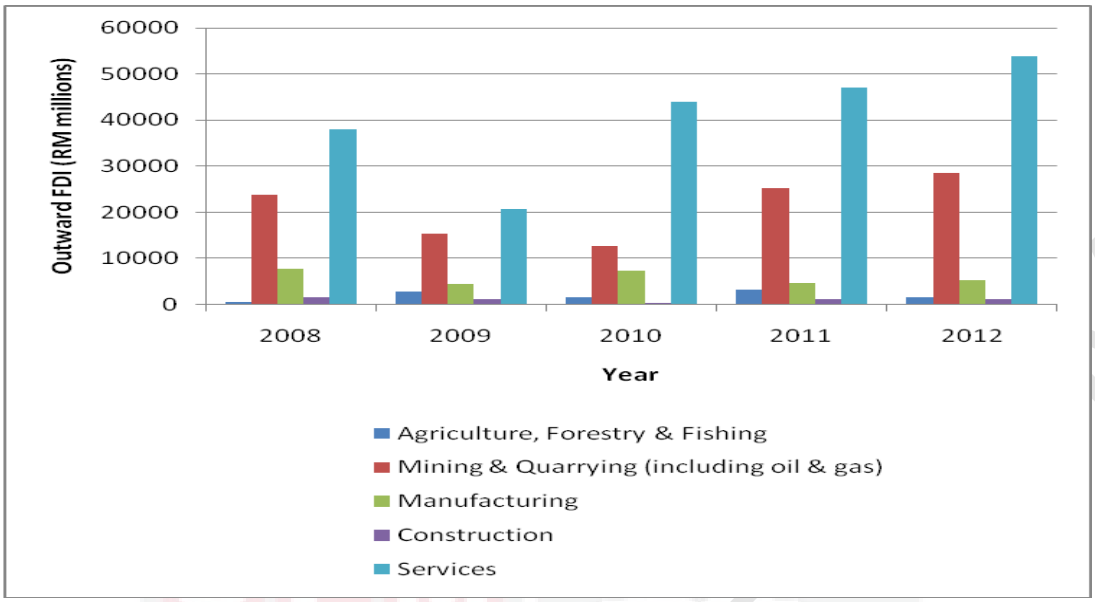
In the meantime, Figure 1.4 displays the top ten destinations of Malaysian outward investment in year 2014. Based on Figure 1.4, the top ten destinations that attract Malaysian outward FDI in 2014 consist of neighbouring countries and also developed countries. The highest amount of investment, RM 70.4 billion, flew to Singapore and followed by Indonesia as much as RM 53.1 billion. The developed countries such as Australia and United Kingdom were ranked third and fourth, respectively, right after the neighbouring countries. Thus, it can be seen that the interests of Malaysian investments were not only focus in developing countries, but also developed countries.




*Source: Department of Statistics, Malaysia*

**Figure 1.4 : The top ten destinations of Malaysian outward FDI, 2014**

Turning to the distribution of outward FDI by sector, Figure 1.5 presents the pattern of sectoral distribution of Malaysian outward FDI over the period of 2008 to 2012. Over these five years, the services sector, which includes wholesale and retail trade, finance and insurance, and information and communication, accounted for the most intensified overseas investment, particularly in the financial and insurance industries. The amount invested in the services sector ranged between RM40,000 million to RM50,000 million and the amount increased starting from the year 2010. The second sector that attracted Malaysian investors was mining and quarrying which was dominated by GLCs such as PETRONAS. The manufacturing sector was ranked after the mining and quarrying sector with a moderate amount not exceeding RM10,000 million, while the agriculture and construction sectors received a negligible amount (BNM online).




*Source: Direct investment abroad by sector, BNM online*

**Figure 1.5 : Sectoral distribution of Malaysian outward FDI, 2008-2012**

### 1.5.3 The role of the Malaysian government

The initiatives from the government in promoting investments abroad evolved along with the structural change in the economy and world globalization. Prior to the 1990s, cross-border investment was literally low. Nonetheless, to align with the objective of the New Economic Policy (NEP) in restructuring the social economy of Malaysia, the first wave of Malaysian outward FDI was undertaken by a state owned agency, namely Permodalan Nasional Berhad (PNB) in acquiring British owned agency houses in Malaysia, for instance Sime Darby, Guthrie, and Boustead (Ragayah, 1999; Jomo, 2002; Ariff and Lopez, 2008). These British owned agencies possessed business interests that engaged in the tin mining sector, agriculture and the plantation sector as well as trade in the Southeast Asian region. At the same time, the government introduced the Industrial Coordination Act (ICA) 1975 that set up a licensing requirement for manufacturing activity in Malaysia that was mainly concerned with the distribution of equity. Under this provision, Malaysian firms owned by non-Bumiputera are required to allocate 30% of their equity to Bumiputera while foreign firms had to offer at least 70% to Malaysians, of which 30% are stipulated for Bumiputera (Lee, 2002; Ariff and Lopez, 2008). This Act has resulted in capital flight from non-Bumiputera firms that push them to diversify their operations abroad (Gomez and Jomo, 1999).

When it came to the 1990s, the government actively facilitated investments abroad by introducing a series of promotions that included tax incentives and non-financial support. In regards to tax incentives, all income remitted by Malaysian companies investing overseas, except from banking, insurance, and sea and air transport business, are fully exempted from income tax (Ragayah, 1999; Tham, 2007; Ariff and Lopez, 2008). Furthermore, an additional incentive was established as a means to encourage the acquisition of foreign-owned companies abroad for high-

technology production, or venturing into new markets for exporting local products (Malaysia South-South Association, 2005; Tham, 2007; Ariff and Lopez, 2008). Moreover, the former Prime Minister of Malaysia, Tun Dr. Mohamad Mahathir, once urged Malaysian firms to "relocate overseas, go large scale and shift into high technology" (Chan, 2005; Goh and Wong, 2011).

Apart from tax incentives, financial support is equally crucial in inducing overseas investments. For instance, the Export-Import Bank of Malaysian Berhad (EXIM Bank) was established in 1995 to grant medium and long-term credit to Malaysian exporters and investors as well as to foreign buyers of Malaysian goods. As of December 2004, almost 25% of loans was granted for overseas project financing, primarily in property, manufacturing and infrastructure in Southeast Asia and Northeast Asia (Tham, 2007). In Budget 2007, a huge amount of RM2 billion was injected into EXIM Bank to ease the costs of local firms doing business overseas and to assist them to bid and secure contracts overseas (BNM, 2006).

Government agencies such as MITI, MIDA, and MATRADE provide non-financial support in the form of advisory and consultancy services. These agencies organize trade and investment missions with other governments to promote and enhance economic and industrial cooperation through bilateral agreements and negotiation. Nevertheless, the goal of promoting outward FDI is ambiguous as most of these missions are likely inclined towards trade and inward FDI (Tham, 2007).

Malaysia adopts a liberal financial policy towards overseas investments. Prior to the Asian financial crisis in 1997, no restriction was imposed on the remittances in foreign currency for overseas investments, except for remittances that were financed through domestic borrowings which were required to obtain approval from the central bank of Malaysia. However, after the Asian financial crisis, capital control was introduced in September 1998 where Ringgit Malaysia (RM) was pegged at RM 3.80 to US$1. As a consequence, capital was restricted from flowing out of Malaysia and this subsequently froze overseas investments.

In 2001, capital control was relaxed but RM remained pegged to the US$. At the same time, exit levy was lifted where residents were allowed to invest abroad. In 2005, capital control was fully removed and the pegged RM was liberalized that changed to the managed-float system (Lim and Goh, 2012). With the liberalization of capital account in 2005, restrictions on capital outflows were removed to facilitate investments abroad and also to ease the pressure on the RM appreciation that was gained from trade surplus and capital inflows after the Asian crisis (Hannoun, 2007; Khor, 2009; Goh and Wong, 2011). Subsequently, this has resulted in a drastic spur in investments abroad. From 2007 onwards, Malaysia has even become the net capital exporter in ASEAN (Menon, 2012) whereby outward FDI has surpassed the inflows of FDI.

## 1.6 The drivers of outward FDI

In the theoretical framework discussion, we rely on the Investment Development Path (IDP) theory and the Eclectic Paradigm, or the Ownership, Location and Internalization (OLI) theory, to explain the factors that drive a country to invest abroad. The IDP theory is used to analyze the internal factors or push factors that prompt local firms to venture abroad. Likewise, the Eclectic Paradigm or the OLI theory explains the pull factor, or external factor, that reflects the attractiveness of a host country in providing location-specific advantages to investors.

The IDP states that outward FDI are affected by the changes in the home country's macroeconomic environment as a nation develops. The economic fundamental changes in a nation are the income of the home country, domestic savings, saturated home markets, cost of production, scarcity in the factors of production, competition pressure from globalization to internationalize production, the home institutional factor and so forth.

On one hand, the OLI theory asserts that one of the factors that motivate local firms to engage in outward FDI is locational advantages offered by the host country. These advantages are a large market size, low production cost, availability of natural resources, advancement in technology and managerial skills, host government incentives and others. The selection of host countries is also associated with the motives of investment which are market-seeking, resource-seeking, efficiency-seeking, and technology-seeking. To further explain the drivers of outward FDI from Malaysia, we discuss the push factor between the home institutional factor and the outward FDI, and the pull factors that determine the location choice decision of investing firms.

### 1.6.1 Home institutional factor and outward FDI

Malaysia has always been the top destination of FDI from developed countries. A great receipt of FDI has become a catalyst of economic growth and employment generation. Nonetheless, in recent years, the country's competitiveness in hosting FDI has deteriorated as FDI inflows to Malaysia began to decline. One of the major reasons is due to the emergence of new attractive locations such as China and India that are enriched with a low-cost factor of production and huge market size (Goh and Wong, 2011; Masron et al., 2012).

Even though Malaysia is a recipient of FDI, it has also been engaged in investments abroad since 1980 with a negligible amount. From 2007 onwards, a visible shift has struck the FDI landscape in Malaysia where outward FDI has exceeded inward FDI. Following this, Malaysia is claimed to be a net capital exporter in the ASEAN region (Menon, 2012). The tremendous increases in outward FDI by Malaysian firms are attributed to several reasons. Rapid economic development, high domestic savings rate, rising cost of production, domestic market expansion constraints, openness in trade, competitive pressure from globalization, liberal investments and foreign

exchange policies and so forth have prompted domestic firms to invest abroad. Furthermore, in response to the declining domestic market and lower profit margins, Malaysian firms have resorted to venture abroad (Chen and Zulkifli, 2012). They relocate production to seek newer markets that enable them to earn some cost advantages and market expansion.

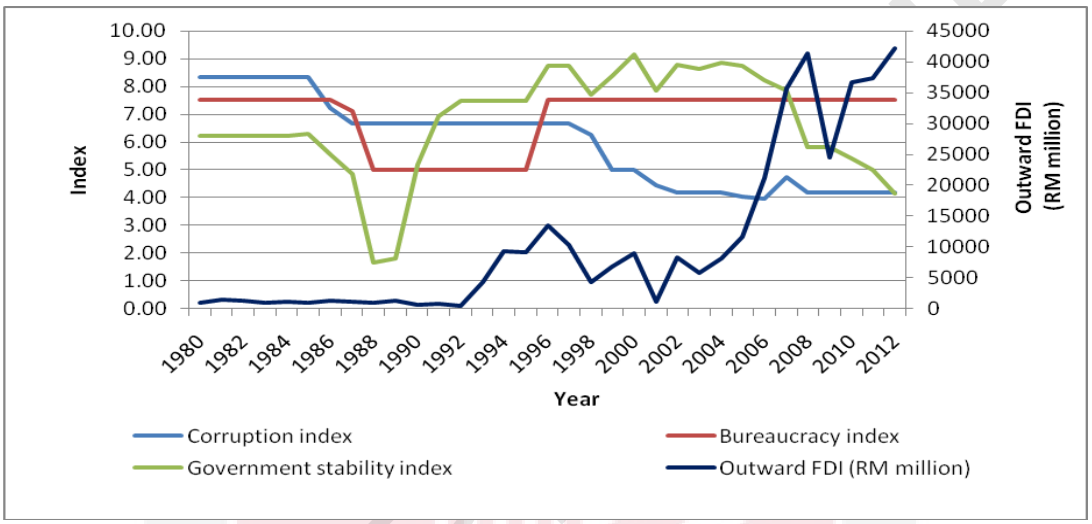
Apart from macroeconomic factors that push domestic firms to be involved in cross-border investments, the home government policy is also one of the factors. Banga (2007) stated that the initiatives practised by the home government in developed countries act as a key instrument in motivating investments abroad. They adopt several measures as encouragement to promote overseas investments such as granting fiscal and financial incentives, providing better economic fundamentals of the host countries and improving their social welfare by developing human resources and transferring technology to the host economies.

In contrast to the outward FDI from developing countries, the initiatives from the home government are not as intensive as that of developed economies. Though the home government provides several measures as encouragement to invest abroad to enhance the competitiveness of domestic firms in the global production network, the home policies are still not as significant as the macroeconomic factors in influencing outward FDI. Until recently, the Central Bank of Malaysia (Bank Negara Malaysia) demonstrated a remarkable step in liberalizing the financial policy towards overseas investments. This can be observed in the liberalization of the capital account after the Asian financial crisis where the restriction on capital outflows was eased. Prior to the Asian financial crisis, residents without domestic borrowings were free to remit any amount in foreign currency for overseas investments. On the other hand, individuals and firms were permitted to invest abroad through remittances of domestic borrowing up to the equivalent of RM100,000 and RM10 million, respectively, per calendar year. After the breakout of the Asian financial crisis, Malaysia implemented capital control from 1998 until it was completely abolished in 2005, and then embarked on a managed-float regime.

Following the removal of capital control, the prohibition of investing abroad was lifted and domestic firms were allowed to invest abroad. Furthermore, the policies pertaining to overseas investment were more liberal than that of before the Asian financial crisis. Domestic firms that carried domestic borrowings were permitted to invest abroad using foreign currency funds maintained in Malaysia or offshore. Moreover, domestic firms were allowed to hedge the foreign exchange risk of their existing and new overseas investments (BNM, 2006). Subsequently, outward FDI increased substantially that even surpassed the inflows of FDI.

On the one hand, the quality of the institutions or governance in Malaysia has also become the focus of public attention. According to the report of the 10th Malaysia Plan 2011-2015 (Economic Planning Unit, Malaysia), Malaysian firms encountered a tangle of regulations that impede innovation and growth. Furthermore, The Global Competitiveness Report 2009-2010 (The World Economic Forum) revealed that

inefficient government bureaucracy, corruption, and policy instability are the challenges faced by business firms for doing business in Malaysia. Figure 1.6 illustrates selected institutional indicators of Malaysia. The government of Malaysia was in chaos in 1988 when the indexes, particularly government stability, fell substantially. This was due to the political disputes in the ruling Barisan National (BN) coalition together with the rising unemployment rate. After 1991, Malaysia bounced back to a stable track. Nevertheless, instability in government and corruption have been revealed again in recent years. At the same time, outward FDI rose substantially since 2003 when the indexes of government stability and corruption were dropping, showing poor institutional quality.




Notes: The maximum index is 10, where a high index indicates good quality of government institution and vice versa.
*Source: International Country Risk Guide (ICRG)*

**Figure 1.6 : Malaysia: Selected institutional indicators and outward FDI, 1980-2012**

Besides, the corporate tax rate in Malaysia is relatively high in the East Asian region. It can be seen from Table 1.6, that in 2010, Thailand's corporate tax rate was higher than that of Malaysia. Malaysia, China, and Vietnam shared the same tax rate. But Thailand and Vietnam had gradually reduced their rates. This left Malaysia and China having the highest corporate tax rate in the region. High tax rate is a cost disadvantage to the business firms that may reduce competitiveness in attracting and sustaining both domestic and foreign investments.

**Table 1.6 : Corporate tax rate in selected countries, 2010-2014**

| Countries /Year | Corporate tax rate (%) | | | | |
|---|---|---|---|---|---|
| | 2010 | 2011 | 2012 | 2013 | 2014 |
| Malaysia | 25 | 25 | 25 | 25 | 25 |
| Cambodia | 20 | 20 | 20 | 20 | 20 |
| China | 25 | 25 | 25 | 25 | 25 |
| Thailand | 30 | 30 | 23 | 20 | 20 |
| Vietnam | 25 | 25 | 25 | 25 | 22 |
| Singapore | 17 | 17 | 17 | 17 | 17 |

*Source: http://www.kpmg.com/global*

Following the tremendous increase in outward FDI and an unfavourable institutional environment, we doubt whether Malaysian firms are engaging in outward FDI as an escape response to shun away from institutional burdens. Therefore, it is our interest, from both the theoretical and policy perspectives, to examine how the home country institution affects Malaysian outward FDI.

### 1.6.2 Locational decision of outward FDI

Dunning's (1977, 1980, 1993) Eclectic Paradigm explained that the emergence of FDI is attributed to ownership, location and internalization (OLI) advantages. This means that before a firm ventures abroad, the firm must demonstrate competitive or ownership advantages (O) such as brand name and technology that are developed in the home country. With the ownership advantage acquired, the firm attempts to expand its business and investment opportunities in the foreign market. The internalization advantage (I) occurs when firms attempt to protect their ownership advantage in foreign markets by having foreign production facilities. Besides that, firms have to decide the destination for engaging in FDI, or the locational advantages (L) offered by the host economies.

The locational advantages (L) reflect the attractiveness of the host countries to the MNCs (Kang and Jiang, 2012). In fact, the choice of location-specific advantage offered by host countries is dependent on the motives of the MNCs engaging in foreign investments. The four primary economic motives of investing abroad are market-seeking (or rent-seeking), natural resource-seeking, efficiency-seeking, and strategic-asset seeking (Dunning, 1977).

Market-seeking outward FDI is mainly motivated by accessing new markets. It is also designed to serve the demands of particular foreign market (Dunning, 2000). For instance, Sime Darby from Malaysia, acquired palm oil processing plants from Unilever in Rotterdam, and set up plants in India and China (Rasiah et al., 2010). Natural resource-seeking investments aim to utilize the availability of raw materials and the factor of production in the host countries. When the resources are gradually scarce in the home country, firms are forced to seek resources in other countries as

an alternative (Ariff and Lopez, 2008). For instance, the Malaysian national oil company (PETRONAS) has invested in high risk countries such as Sudan and Chad in search of oil and gas exploration and extraction (Rasiah et al., 2010).

Efficiency-seeking FDI tends to reduce the cost of production that arises in the home market. For example, Malaysian companies, particularly in the manufacturing and textile sectors, have shifted their production to new low-cost economies such as Laos, Cambodia, and Vietnam that offer low factor prices to maintain competitiveness (Ariff and Lopez, 2008). The motive of strategic-asset seeking investment is to acquire new technology and knowledge to augment the existing weak ownership or technology in the home country. Strategic-asset seeking FDI is mostly concentrated in advanced economies to access the superior foreign technologies. For example, the automotive manufacturer of Malaysia, Proton, acquired UK Lotus in1997 with the motive of upgrading its engine and body styling technology (Rasiah et al., 2010). Besides that, the Malaysian government provided additional incentives in 2003 to local investors for them to acquire foreign owned high technology firms abroad (Malaysia South-South Association, 2005; Ariff and Lopez, 2008; Rasiah et al., 2010).

Malaysian overseas investments are scattered in various countries. The decision of choosing a location or host country is closely associated with the motives of investing abroad. Investors tend to exploit foreign markets and factors of production to overcome resource scarcity in the home country, and acquire foreign technologies. Thus, each location is equipped with its own attributes that fulfil the investors' interest. In this sense, developing countries, specifically Southeast Asia neighbouring countries, become the most favourite destinations for Malaysian investors. As illustrated in Figure 1.4, most of the top ten destinations of Malaysian investment are located in the neighbouring countries. Does this show that geographical distance play a significant role in bringing higher chances of survival and success that attract investors to venture substantially in developing economies? Besides that, though most of the investments are concentrated in the developing countries, developed country such as United Kingdom was also one of the top ten destinations. In this context, we are uncertain if sharing a common colonization between Malaysia and the host countries could also be one of the factors to be considered in making location choice. Thus, do non-economic factors such as geographical proximity or, distance, and common colonization, which are not included in the Eclectic Paradigm (Dunning, 1977), are relevant in selecting host countries?

Apart from that, the government institutional environment of the host country should also be taken into account in deciding a location choice. The institutional factor is crucial as it is deemed as one of the transaction costs. A good institution reduces the degree of uncertainties and lowers the transaction cost. In this regard, investors would prefer to invest in host countries with good governances that provide better security and protection to the investments. Nonetheless, an adverse selection may occur where host countries with poor institution quality can also attract the inflow of FDI. As we can see, developing countries are the main destinations for Malaysian

investing firms. The institutional qualities of developing countries are viewed as weak, yet they still receive FDI. Does this demonstrate that Malaysian investing firms are attracted to the region that shares a similar environment of poor institutions instead of host countries with good governance? Therefore, we are uncertain if Malaysian firms respond differently to the institutional environment of host countries.

Therefore, apart from considering the four motives of investment as stipulated in Eclectic Paradigm (Dunning, 1977), the transaction cost-specific factors need to be taken into account, such as common colonization and geographical proximity between home and host countries as well as institutional factors of host countries. Furthermore, we are not sure if the factors affecting the selection of host countries will be different according to regions or country groups.

## 1.7 The impacts of outward FDI

When domestic firms engage in investments abroad, its effects on the home country output become the central point of debate. Moon et al. (2011) pointed out that outward FDI contributes to home country economic growth in a few channels. First, the incomes earned from investments abroad are repatriated to the home country and this improves the country's balance of payments. Second, investing abroad increases the home country's exports due to the demand from foreign markets. Last but not least, outward FDI enhances the local firms' ownership disadvantages through new knowledge, skills, and technology that are acquired from foreign affiliates (Moon and Roehl, 2001). With the improvement in ownership advantages, the productivity of firms increases and brings the nation further to a higher level of economic growth.

In fact, outward FDI could have positive or negative effects on domestic income. These effects are dependent on the role of outward FDI in the domestic market. In the event that outward FDI is a substitute to domestic production, investing firms relocate their production facilities abroad and this reduces the domestic output, employment, and economic growth as well (Stevens and Lipsey, 1992).

On the contrary, if outward FDI is complementary to domestic investment, it stimulates the local production (Desai et al., 2005). This can be seen when investing firms are involved in exploring new markets, importing intermediate inputs from foreign affiliates, producing final goods in foreign affiliates at lower costs, and accessing foreign technology. The combination of foreign and local productions lowers the cost of production and increases the competitiveness of investing firms. As a result, it would benefit the overall domestic market with the associated spillover effects to local firms (Herzer, 2010). Nonetheless, the impact of outward FDI on the development of a country is subject to the absorption ability level of the home economy, as well as the rate of technological gap between investing firms or multinational firms (MNCs) and non-MNC domestic firms (Denzer, 2011).

Besides that, the impact of outward FDI on international trade is also ambiguous. Mundell (1957) initially showed that FDI and exports are a substitute for each other, indicating that outward FDI reduces trade. However, the recent studies have demonstrated that FDI and exports are not necessarily a substitute for each other; instead they can be complementary. This shows that as outward FDI increases, international trade also increases. In fact, the nature of the investment is the key in explaining the substitution or complementary relationship between FDI and trade. As claimed by Markusen (1984) and Markusen and Venables(1995), the market-seeking investment which penetrates into foreign markets to avoid trade cost tends to have a substitution relationship with trade. Likewise, Helpman (1984) and Helpman and Krugman (1985) pointed out that FDI and trade are complementary when efficiency-seeking investment takes place where the fragmentation of production is geographically dispersed according to the countries that provide the cost advantages for that particular stage of production.

### 1.7.1 The impact of outward FDI on employment

Investments abroad have raised the concern of the public pertaining to employment in the home country. The public fear losing jobs following the relocation of plants to other countries. This is because investing abroad is perceived as job-exporting (Yamashita and Fukao, 2010) that adversely affects employment in the home country. Before discussing the impact of outward FDI on employment in Malaysia, it is better to take a look at the employment structure in Malaysia. The employment structure discusses how the changes in economic activities affect the sectoral and occupational distribution of employment in different periods of time. In this context, jobs or occupations can be categorized as skilled and unskilled employments. Given that the gap between skilled and unskilled employment in Malaysia is relatively large, this has motivated us to investigate whether outward FDI has a possible impact on the distribution of skilled and unskilled employment in Malaysia. The following sections discuss the structure of employment and the linkage between outward FDI, skilled and unskilled employment in Malaysia.

### 1.7.2 Employment in Malaysia

The employment structure in Malaysia is closely tied to the economic activities or output structure that changes over time. The employment structure can be grouped into three sectors, namely, primary, secondary, and tertiary. Agricultural, forestry, fishery, mining and quarrying activities are grouped under the primary sector. Manufacturing and construction belong to the secondary sector, while service activities belong to the tertiary sector. The changes in these economic activities reflect their importance in contributing to the country's GDP and employment distribution.

Table 1.7 illustrates the employment distribution by sector from 1982 to 2014. During the 1970s, agricultural, forestry, mining, and quarrying activities accounted for the major contribution to GDP, given that Malaysia is a natural resource-rich economy. Thus, the primary sector was the main source of employment that created

56% of the total employment in 1970, and 50% in 1975 (Poon, 2006). When it came to the 1980s, the share of employment in the primary sector continued to decline to nearly 32%, 26% in 1990, and further reduced to 11.3% in 2010. The unstable prices of commodities such as rubber and tin, as well as depleting natural resources, caused the employment in the primary sector to shrink. However, there was a little increase in the primary sector in 2014 as the unemployment rate decreased.

**Table 1.7 : Percentage of employment by sector, 1982-2014**

| Sector | 1982 | 1990 | 2000 | 2010 | 2014 |
|---|---|---|---|---|---|
| Agriculture, fishery, forestry. | 31.2 | 26 | 15.2 | 11.3 | 12.3 |
| Mining | 1.0 | 0.6 | 0.4 | 0.3 | 0.6 |
| Manufacturing | 15.5 | 19.9 | 27.6 | 28.7 | 16.7 |
| Construction | 7.2 | 6.3 | 8.1 | 6.3 | 9.1 |
| Services | 45.1 | 47.2 | 48.6 | 53.4 | 61.3 |
| Total (%) | 100 | 100 | 100 | 100 | 100 |
| Total employed ('000) | 5249 | 6686 | 9271 | 12255 | 13532 |
| Unemployment rate (%) | 3.4 | 4.5 | 3.0 | 3.3 | 2.9 |

Notes: The services sector includes electricity, gas and water; wholesale and retail trade, restaurants and hotels; transport, storage, communication; finance, insurance, real estate and business services; education; government services.

*Source: Economic Report (various issues).*

Following the reduction in employment opportunities in the primary sector, the government diversified its strategy in the industrial sector with the purpose to cushion the impact of the volatility of prices in commodities and implement the Industrial Master Plan (IMP) that was developed in 1985. The IMP was introduced to support manufacturing activities as Malaysia aimed to progress towards an industrial country. Therefore, the employment in the manufacturing sector recorded a continuous increasing trend and greatly surpassed the employment in the primary sector in 2000. Export-oriented promotion and incentives provided to local and foreign investors have accelerated the output growth in the manufacturing sector that opened up wider job opportunities in the secondary sector.

While the manufacturing sector experienced rapid growth, the engagement in the service sector is also important to further strengthen and uplift the value added of manufacturing exports. The employment in the services sector expanded rapidly and accounted for the largest proportion in total employment with 61.3% in 2014. Within the service sector, wholesale and trade were the primary contributors to employment.

As the distribution of employment varies across the sectors, it also affects the distribution of employment by occupation. Occupation refers to the types of work performed or jobs such as engineer, clerk, and carpenter. Occupation classification reflects the level of skills and the level of educational attainment. For example, architect is categorized as a professional group with the highest level of skills and tertiary education attainment, while a general clerk falls into a low-skilled job that requires no vocational qualification (Malaysia Standard Classification of Occupation, 2008). Table 1.8 presents employment by occupation from 1985 to 2012. In the

1980s when economic activities were mainly dominated by the primary sector, the agricultural occupations accounted for the largest share with 30.4% of the workforce. Production related jobs ranked the second highest with 27.5%, while professional groups and administrative workers accounted for only 7.5% and 2.3%, respectively. Nonetheless, with the modernization of the agricultural sector and the progress towards an industrial country, the demand for workers in agricultural sector gradually declined, where the share dropped from 30.7% in 1985 to 9.23% in 2012. Thereafter, in 1990, the share of production workers overtook the agricultural workforce. Though occupation in the manufacturing sector was far higher than in other jobs, the share declined in 2000. This may have been caused by the Asian financial crisis in 1997 and the loss of competitiveness in attracting FDI, resulting in job retrenchment in the manufacturing sector.

Meanwhile, the demand for skilled workers such as professionals and an administrative workforce expanded throughout this period in small proportions. The trend indicated that the occupations with high educational attainment and professional training grew to accommodate the higher value-added activities and the rising use of ICT in most sectors. The share of sales and service workers also recorded an increasing trend that was consistent with the expansion in the wholesale and trade activities.

**Table 1.8 : Percentage of employment by occupation, 1985-2012**

| **Occupational groups** | **1985** | **1990** | **1995** | **2000** | **2005** | **2010** | **2012** |
|---|---|---|---|---|---|---|---|
| Professional, technical and related workers | 7.5 | 7.8 | 9.9 | 11.0 | 18.1 | 20.4 | 19.8 |
| Administrative and management workers | 2.3 | 2.2 | 3.2 | 4.2 | 7.7 | 7.2 | 5.4 |
| Clerical and related workers | 9.8 | 9.8 | 10.9 | 10.9 | 9.8 | 9.9 | 9.2 |
| Service and sales workers | 22.4 | 22.7 | 22.0 | 24.1 | 14.7 | 16.5 | 20.6 |
| Production and related workers, transport equipment operators and labourers. | 27.5 | 31.3 | 33.9 | 32.8 | 36.8 | 34.3 | 35.6 |
| Agricultural, animal husbandry and forestry workers, fisherman and hunters. | 30.4 | 26.2 | 20.1 | 16.9 | 12.3 | 11.6 | 9.23 |
| Total (%) | 100 | 100 | 100 | 100 | 100 | 100 | 100 |

Notes: The accuracy of the data is dependent on the category of occupation. The category of occupation from year 1982 to 2000 is classified according to the Dictionary of Occupational Classification 1980. The category of occupation from year 2001 to 2010 is classified according to the Malaysia Standard Classification of Occupations (MASCO) 1998. The category of occupation from year 2011 to 2012 is classified according to the Malaysia Standard Classification of Occupations (MASCO) 2008.

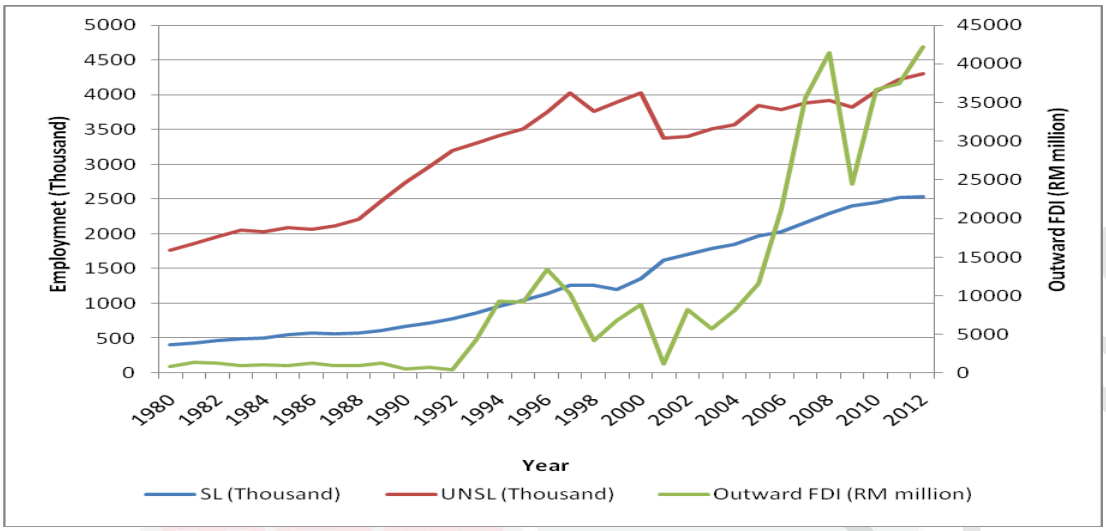
*Source: Department of Statistics, Malaysia.*

As a conclusion, the transformation of the country has changed the sectoral and occupational distribution of employment. The role of the primary sector gradually subsided while the manufacturing and tertiary sectors are on the rise. In recent years, the tertiary sector accounted for the largest share across the sectors. This shows that Malaysia is experiencing the transition from a production-based to a knowledge-based economy. Despite this, the percentage of skilled intensity occupational groups, such as professionals and administrative workers, is still relatively low compared to other occupational groups.

### 1.7.3 Outward FDI effects on Malaysian employment

At the time being, unemployment is not a serious problem in Malaysia. However, the retrenchment of workers in recent years deserves our attention. For instance, between year 2007-2009, the number of retrenchment was increasing and the manufacturing sector reported the highest number of retrenchment. The record shown that in 2007, the number of retrenchment was 42,336, and it increased to 47,145 in 2008, and further climbed up to 64,516 in 2009 (Gomes, 2016). One of the reasons of retrenchment was because the firms were resorted to cutting cost and shifting their businesses to other developing Asian countries (Kaur, 2016). Thus, this motivates us to inspect the impact of outward investment on employment in a disaggregate level according to skilled and unskilled employment.

Figure1.7 shows the trends of outward FDI, skilled and unskilled employment in Malaysia from 1980 to 2012. As we can observe, the unskilled labour exceeded the skilled labour throughout this period. From 1990-2000, the gap between skilled and unskilled labour was large given that the manufacturing sector was the major source of employment where it required a substantial number of production workers that was mainly dominated by unskilled workers. At the same time, the volumes of outward FDI were small, yet they fluctuated. However, after 2003, the outward FDI started to climb up and the gap between skilled and unskilled labour was getting smaller. We postulate that outward FDI would cause a reduction in the demand for unskilled labour as a result of firms shifting the labour-intensive part of production to other low-cost countries. For instance, the manufacturing sector registered the highest number of retrenchment at 76.9% in 2007 (Economic Report 2007/2008) primarily due to firms' restructuring and realigning their operations to increase productivity and profitability. At the same time, outward FDI registered a tremendous increase in 2007. So, we are uncertain if this retrenchment is part of the motives of firms in searching for cost-efficiency by shifting plants abroad.




Notes: SL is skilled labour: UNSL is unskilled labour.
*Source: Department of Statistics Malaysia and author's own calculations.*

**Figure 1.7 : Malaysia: Outward FDI, skilled and unskilled employment, 1980 - 2012**

Likewise, investments abroad increase the demand for skilled labour in the home country. This is because knowledge-intensive operations are based in the home country that requires more managerial and professional workers to accommodate the increasing supervisory to serve foreign operations. As a result, it will increase the demand for skilled labour to support managerial-related jobs in the home country. Similarly, Malaysian outward FDI is mostly concentrated in the service sector where the nature of jobs in the service sector is characterized as skill-intensive function. As shown in Figure 1.7, as the outward FDI increased thereafter 2003, the number of skilled employment also increased. Hence, an increasing outward FDI that requires skilled labour poses a challenge to unskilled labour where unskilled labour is the major workforce in Malaysia. We are not sure if outward FDI will reduce the local employment, particularly unskilled labour. Therefore, we examined the possible effects of outward FDI on home employment, in particular skilled and unskilled employment.

## 1.8 Problem statement

Malaysia has always been the top recipient of FDI among neighbouring countries. The spur of FDI to Malaysia greatly complements domestic investment that allows the country to experience resilient economic growth and high employment rates. Nonetheless, in recent years, the trend of FDI in Malaysia has changed. Based on Figure 1.1, the inflow of FDI is growing at a slower pace, while the outward FDI of Malaysia demonstrates an upward trend. Furthermore, the outward FDI is even greater than the inward FDI since 2007. The drastic change in the FDI landscape has transformed the country, which was initially a capital importer to a capital exporter. Having witnessed this transformation, we are curious to investigate the factors that lie behind the rise of Malaysian outward FDI.

There are a number of literatures that attempt to seek, from a home country's perspective, an explanation of what drives developing countries to invest abroad. Most of the studies include only macroeconomic variables in the models. Lately, some studies have begun to highlight the role of the home country government institution in determining outward FDI. This is because institutions could either act as governmental promotions or institutional escapism in the context of outward FDI (Luo et al., 2010). In other words, institutional forces may either ease or hinder firms' international expansion. In this relation, the quality of institution or governance in Malaysia has also become the focus of public attention. According to the report of the 10th Malaysia Plan 2011-2015 (Economic Planning Unit, Malaysia), Malaysian firms encountered a tangle of regulations that impede innovation and growth. Furthermore, The Global Competitiveness Report 2009-2010 (The World Economic Forum) revealed that inefficient government bureaucracy, corruption, and policy instability are the challenges faced by business firms for doing business in Malaysia. As shown in Figure 1.6, the index of corruption and government stability are poorly performing in the recent years. Besides, the corporate tax rate in Malaysia is relatively high in the East Asian region, as presented in Table 1.6. A high tax rate is a cost disadvantage to business firms that may reduce their competitiveness in attracting and sustaining both domestic and foreign investments.

Following the tremendous increase in outward FDI, Malaysia is claimed to be the only net capital exporter among ASEAN countries (Menon, 2012). ln this regard, we are uncertain if Malaysian firms engaging in outward FDI are driven by an escape response to shun away from institutional burdens, as there are some indications that Malaysian firms experience high regulatory costs. Therefore, a study is needed to investigate if home country institution is crucial in explaining outward FDI from Malaysia.

Malaysian overseas investments are scattered in various countries. The decision of choosing a location or host country is closely associated with the motives of investing abroad. According to Eclectic Paradigm (Dunning, 1977), there are four motives of investments which are market-seeking, efficiency-seeking, resource-seeking, and technology-seeking. Hence, each location is equipped with its own attributes that fulfil the investors' interest. In this sense, developing countries, specifically Southeast Asia neighbouring countries, become the most favourite destinations for Malaysian investors. As illustrated in Figure 1.4, most of the top ten destinations of Malaysian investment are located in the neighbouring countries. Does this show that geographical distance play a significant role in bringing higher chances of survival and success that attract investors to venture substantially in developing economies? Besides that, though most of the investments are concentrated in the developing countries, developed country such as United Kingdom was also one of the top ten destinations. In this context, we are uncertain if sharing a common colonization between Malaysia and the host countries could also be one of the factors to be considered in making location choice. Thus, do non-economic factors such as geographical proximity or, distance, and common colonization, which are not included in the Eclectic Paradigm (Dunning, 1977), are relevant in selecting host countries?

Apart from that, the government institutional environment of the host country should also be taken into account in deciding a location choice. The institutional factor is crucial as it is deemed as one of the transaction costs. A good institution reduces the degree of uncertainties and lowers the transaction cost. In this regard, investors would prefer to invest in host countries with good governances that provide better security and protection to the investments. Nonetheless, an adverse selection may occur where host countries with poor institution quality can also attract the inflow of FDI. As we can see, developing countries are the main destinations for Malaysian investing firms. The institutional qualities of developing countries are viewed as weak, yet they still receive FDI. Does this demonstrate that Malaysian investing firms are attracted to the region that shares a similar environment of poor institutions instead of host countries with good governance? Therefore, we are uncertain if Malaysian firms respond differently to the institutional environment of host countries.

Therefore, apart from considering the four motives of investment as stipulated in Eclectic Paradigm (Dunning, 1977), the transaction cost-specific factors need to be taken into account, such as common colonization and geographical proximity between home and host countries as well as institutional factors of host countries. Furthermore, we are not sure if the factors affecting the selection of host countries will be different according to regions or country groups.

Investments abroad have raised the concern of the public pertaining to employment in the home country. The public fear losing jobs following the relocation of plants to other countries. This is because investing abroad is perceived as job-exporting (Yamashita and Fukao, 2010) that adversely affects employment in the home country. At the time being, unemployment is not a serious problem in Malaysia. However, the retrenchment of workers in recent years deserves our attention. Between year 2007-2009, the number of retrenchment was spiking up and the manufacturing sector recorded the highest number of retrenchment (Gomes, 2016). At the same time, thereafter 2007, the outward FDI of Malaysia surpassed the inward FDI. We postulate that outward FDI would cause a reduction in the demand for unskilled labour as a result of firms shifting the labour-intensive part of production to other low-cost countries. Hence, we are unsure if the retrenchment is part of the motives of firms in searching for cost-efficiency by shifting plants abroad.

On the other hand, investments abroad would increase the demand for skilled labour in the home country. This is because knowledge-intensive operations are based in the home country that requires more managerial and professional workers to accommodate the increasing supervisory to serve foreign operations. As a result, it will increase the demand for skilled labour to support managerial-related jobs in the home country. Similarly, Malaysian outward FDI is mostly concentrated in the service sector where the nature of jobs in the service sector is characterized as skill-intensive function. As shown in Figure 1.7, as the outward FDI increased since 2003, the number of skilled employment also increased and the gap between skilled and unskilled employment was getting smaller. Hence, an increasing outward FDI that requires skilled labour poses a challenge to unskilled labour where unskilled labour

is the major workforce in Malaysia. Therefore, it is important to investigate the effects of outward investment on employment in a disaggregate level, which is skilled and unskilled employment.

## 1.9 Objectives of the study

This study generally aims to explore the factors affecting outward FDI from Malaysia and its effect on Malaysian employment. Specifically, the objectives of the study are:

a) to examine the effects of the home country institution on Malaysian outward FDI;
b) to determine the factors affecting location decisions of Malaysia MNCs; and
c) to investigate the effects of Malaysian outward FDI on home country employment.

## 1.10 Significance of the study

The empirical study in examining the development of outward FDI from Malaysia is relatively limited in comparison to the studies from other developing countries such as China. Earliest studies on outward FDI from Malaysia generally investigated the trends, the patterns, and the determinants of outward FDI based at firm level due to the lack of secondary data. The macro-level studies were then updated by Kueh et al. (2009) and Goh and Wong (2011) using the vector error correction model (VECM) framework with a sample of quarterly data starting from Q1 1991 to Q4 2005 and Q1 1991 to Q4 2008, respectively. Kueh et al. (2009) examined only the macro-level data while Goh and Wong (2011) introduced home government policy, which is measured by trade and foreign exchange liberalization reforms. However, this variable captures a very limited aspect of the home institutional environment. Moreover, Goh and Wong (2011) included both push and pull factors in one regression model. Putting push and pull factors in one regression is inappropriate to accommodate two different theoretical frameworks. Thus, in a striking contrast to previous literatures, we separate push and pull factors into two different pieces of work with their respective frameworks, adopt different econometric methods, and the period of study is extended from annual basis data from 1980 to 2012.

This study is crucially important as our study is among a few that takes a closer look at the home institutional factor in explaining empirically outward FDI. If findings show that outward FDI from Malaysia is driven by escape response, then policy makers should propose measures to strengthen institutional quality to improve the efficiency of government services and assistance to increase participation of the private sector in the economy. Otherwise, expansion abroad will turn into an exit strategy from the home country instead of an entry strategy into foreign markets. Eventually, this will probably result in a shift of headquarter operations from the home country to overseas, which retards economic development.

Identifying the factors of location choice decisions of investors is crucial as the risks embedded might influence the internationalization strategy of firms such as mode of investment, amount of investment, source of financing and so forth. To provide more protection to the investing firms or success in business expansion, home and host governments could collaborate and coordinate investment projects through bilateral negotiations. Besides that, bilateral diplomatic ties could also help to secure foreign investments by disseminating information and knowledge about investment opportunities of the host country.

The service sector provides the major source of employment in Malaysia which accounted for 60.5% of total employment in 2016 (Economic Report 2016/17). Despite this, the percentage of skilled labour is still relatively low compared to unskilled labour which accounts for 70% of total employment. Hence, outward investment could be a potential platform in helping government to produce a more skilled labour force and reduce the dependency on foreign unskilled labours, particularly in the manufacturing sector. The government could introduce some training and technical programmes as well as SME development to support the adjustment in employment.

## 1.11 Scope of the study

The purpose of this study is to investigate the effects of the home country institutions on outward investment, factors determining location choice of Malaysian investors, and the effects of outward FDI on home employment.

The first and third objectives of the study were examined based on time series data that used annual secondary data started from 1980 to 2012 and applied in autoregressive distributed lag (ARDL) framework. The category of skilled and unskilled employment used in this study was subject to the occupational groupings that governed by Malaysia Standard Classification of Occupations (MASCO, 2008), Ministry of Human Resources. The data were obtained from Department of Statistics, Malaysia.

For the second objective, this study used panel data that consist of two country groups, that were, 18 developing countries and 16 developed countries. The period of study covered from 2000 to 2009 and this study employed the panel static method to generate the findings. The data used in the study were collected from various sources such as Department of Statistics Malaysia, UNCTAD, World Bank, and International Country Risk Guide (ICRG).

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