



UNIVERSITI PUTRA MALAYSIA

**FACTORS INFLUENCING FOREIGN DIRECT INVESTMENT
IN THE MANUFACTURING SECTOR OF MALAYSIA**

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by

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LIST OF ABBREVIATIONS

APDC	Asean and Pacific Development Centre
ASEAN	Association of South-East Asian Nations
EEC	European Economic Community
ERP	Effective Rate of Protection
FCC	Foreign Controlled Company
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GNP	Gross National Product
GATT	General Agreement on Tariffs and Trade
IBRD	International Bank for Reconstruction and Development
LCC	Local Controlled Company
LDC	Less Developed Country
MIDA	Malaysian Industrial Development Authority
MEC	Minimum Efficient Cost
MNC	Multinational Corporation
NIC	Newly Industrialized Country
OECD	Organization for Economic Co-operation and Development
RBI	Resource-Based Industry
SPEC	South Pacific Bureau for Economic Cooperation
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme

Abstract of the thesis presented to the Senate of Universiti Pertanian Malaysia in partial fulfilment of the requirements for the degree of Master of Science.

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This study is meant to identify local (country-related) factors that affect foreign direct investment (FDI) in the manufacturing sector of Malaysia. FDI in Malaysia was concentrated in the agricultural and extractive industries until the early post-independent period when efforts to diversify the country's economy were initiated. Generally, industrialization has brought several positive effects however, it also features a few weaknesses such as narrow manufacturing base and manufactured exports and under utilization of local resources. The different rates of investment across the various manufacturing industries in the country can be associated with the pattern of FDI which is



concentrated in certain industries such as electrical and textile. Therefore, it is important to conduct a study on factors affecting FDI in Malaysia so that policy-makers can hopefully benefit from the findings of the study in making the appropriate policies to improve the distribution of FDI across the manufacturing industries. Previous studies show that FDI activities can be explained by theory of comparative advantage, industrial organization as well as investment theory. To determine the factors influencing FDI in the Malaysian manufacturing, both quantitative and qualitative analyses were conducted. In the quantitative analysis, gross national product (GNP), level of external reserve (lagged one year), interest rate, manufacturing output/GNP, current profit of foreign controlled manufacturing companies and total asset of local financial system show significant positive relationship with FDI while public investment rate shows significant negative relationship. The qualitative analysis concludes that economic and social stability; freedom of repatriation; availability of efficient labour force; existence of physical infrastructures; efficiency of financial institutions; tariff and trade protection; currency stability; market availability; and public sector efficiency are among the most important determinants of FDI.



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**FAKTOR-FAKTOR YANG MEMPENGARUHI PELABURAN LANGSUNG
ASING DI SEKTOR PERKILANGAN MALAYSIA**

oleh

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Kajian ini bertujuan untuk mengenal pasti faktor-faktor yang mempengaruhi pelaburan langsung asing (PLA) dalam sektor pembuatan di Malaysia. PLA di Malaysia telah tertumpu pada bidang pertanian dan industri-industri ekstraktif sehinggalah pada peringkat awal selepas kemerdekaan apabila usaha-usaha untuk mempelbagaikan ekonomi negara bermula. Pada amnya, proses perindustrian telah membawa beberapa kesan yang positif, tetapi terdapat juga beberapa kelemahan seperti asas industri dan eksport barangan pembuatan yang sempit dan penggunaan sumber-sumber tempatan yang terhad. Ketidakseimbangan dalam taburan pelaburan di kalangan berbagai industri pembuatan di seluruh negara ini adalah berhubung-kait dengan corak PLA yang



lebih cenderung kepada industri yang tertentu seperti industri pembuatan barangan elektrik dan tekstil. Dengan itu, adalah sangat penting untuk membuat satu kajian tentang faktor-faktor yang mempengaruhi PLA kerana ianya boleh memberi sumbangan yang penting dalam usaha merangka polisi-polisi yang sesuai bagi menyeimbangkan taburan PLA di dalam sektor pembuatan di negara ini. Kajian-kajian yang lepas menunjukkan bahawa aktiviti PLA boleh diterangkan oleh teori faedah berbanding, teori organisasi perindustrian serta teori pelaburan. Untuk mengenal pasti faktor-faktor yang mempengaruhi PLA dalam sektor pembuatan di Malaysia, kedua-dua analisis kuantitatif dan kualitatif telah dibuat. Dalam analisis kuantitatif, keluaran kasar negara (KNK), paras rizab luar negeri, kadar faedah, nisbah jumlah pengeluaran sektor pembuatan/KNK, untung semasa syarikat pembuatan kawalan asing, serta jumlah harta dalam sistem kewangan tempatan menunjukkan perhubungan yang positif dengan PLA manakala kadar pelaburan awam menunjukkan perkaitan yang negatif. Kesimpulan daripada analisis kualitatif menggambarkan bahawa kestabilan ekonomi dan politik; kebebasan pengiriman semula untung dan royalti ke negara asal; kemudahan infrastruktur; tenaga buruh yang cekap; kecekapan institusi kewangan; tarif dan perlindungan perdagangan; kestabilan matawang; kewujudan pasaran; dan kelicinan sektor awam adalah antara faktor terpenting yang mempengaruhi PLA.

CHAPTER 1

INTRODUCTION

Pattern of Foreign Direct Investment in Malaysia

Foreign investors have been involved in the economic development of Malaysia since the beginning of the century with British companies playing a leading role. They were engaged mainly in the agricultural and extractive industries for the purpose of supplying raw materials to the British manufacturing industries (Kanapathy, 1970). In 1936, British investment in plantation industries represented 70 percent of its total investment in Malaya¹, 17 percent in mining and 13 percent in infrastructural development, commerce, banking and transport (Callis, 1942: 109). Involvement by other nationals was very minimal and this too was limited to the American and French who were engaged in a small scale in tin mining, and the Japanese who were in iron ore (Allen and Donithorne, 1954: 124-129). The pattern of investment which was concentrated in the agricultural (plantation) and

¹ Prior to August 31, 1957, Malaya was a British colony. On 16th September, 1963, together with Sabah and Sarawak it formed a new federation called Malaysia



extractive industries prevailed until the early post-independent period when the government started to recognize the need of diversifying the country's economic activities (Maisom, 1977). The diversification was intended to reduce the over dependence of the country's economy on the agricultural and primary commodities during the early post-independent period (Ho, 1983 and Fong, 1990).

To illustrate the extent of the country's dependence on the agricultural and primary commodities (during the early post-independent period), in 1957, agricultural sector accounted for about 46 percent of the total gross domestic product (GDP) and about 62 percent of the total employment. In 1960 and 1965, agricultural sector represented 38 percent and 32 percent respectively of the country's total GDP (Table 1). In terms of export, rubber and tin constituted more than 80 percent of the country's gross export earnings in 1950s, and about 60 percent during 1960 and 1965 (see Table 2 for the detail of Malaysian export components).

The over dependence on the agricultural and primary commodities was not without problems. As Ho (1983) stated, there were four major defects related to the country's over concentration:

Table 1
Malaysia: Gross Domestic Product by Industrial Origin
(as percentage of GDP)

	1960	1965	1970	1975	1980	1985	1989
Agriculture, livestock, forestry, fishing	38	32	32	30	26	21	19
Mining	6	9	6	4	4	10	10
Manufacturing	9	10	12	14	17	20	27
Construction	3	4	4	5	5	5	3
Finance, insurance real estate, business services	6	6	8	7	7	9	9
Other services	38	39	38	40	41	35	32
Total	100						

Source: Malaysia, Ministry of Finance, Economic Report, various issues

Table 2
Components of Malaysian Exports
(as percentage of total value)

Items\ Year	1960	1965	1970	1975	1980	1985	1989
Petroleum	3.7	2.0	16	9	24	27	14
¹ Manufactured Products	na	na	10	17	21	35	54.7
Rubber	44	40	33	20	17.2	8	6.5
Palm Oil	1.7	2.5	5	16	8.9	10	6.7
Tin	16	20.2	20	14	8.9	3.4	1.8
Others	34.6	35.3	16	24	20	16.6	16.3
Total	100						

¹ Manufactured products include food, beverages, tobacco, textiles and clothing, wood products, rubber products, chemicals and petroleum products, non-metallic mineral products, metal products, electrical and electronic machinery and appliances, transport equipment and others.

Source: Malaysia, Ministry of Finance, Economic Report, various issues

(1) It increased the vulnerability of the economy to external fluctuation. Since the Malaysian economy was (in fact it still is) very much dependent on export sector as reflected by the high ratios of gross export proceeds over gross national product (Table 3), the over concentration on the exports and production of primary commodities made the economy vulnerable to external fluctuation on which the government had virtually no control. In other words, the economic condition which was characterized by heavy dependence on export with narrow base (limited to a few primary commodities) was very undesirable and had resulted in a less stable domestic economic condition because the booms and the depressions of the world economy were often translated into fluctuations in the prices of the exported commodities in the world market. The fluctuations in the prices of rubber and tin can be seen in Table 4. The price of rubber (ribbed smoked sheet, RSS1) dropped from 108.08 sen (per lb) in 1960 to 70.04 sen in 1965 and 56.43 sen in 1970, increased to 141.68 sen in 1980 and dropped to 85.59 sen in 1985. Similarly the price of tin (M\$ per tonne) has been fluctuating over the last decades (6509.37 in 1960, 11608.66 in 1965 and 10990.76 in 1970). For crude palm oil, its price (M\$ per tonne) had fluctuated from 679.2 in 1960 to 828.3 in 1965 and down to 787.2 in 1970.

Table 3

**Malaysia: Gross National Product (GNP),
Gross Export Proceeds (GEP)
and Ratio of GEP/GNP**

Year	GNP (\$ million)	GEP (\$ million)	GEP/GNP (%)
1960	6649	3940	59.3
1965	8632	4310	49.9
1970	11473	5602	48.8
1975	16015	9230	57.6
1980	49422	28171	57.0
1985	72039	45716	63.5
1989	96447	65800	68.2

Source: Malaysia, Ministry of Finance, Economic Report,
various issues

Table 4
Average World Prices of Selected Export Commodities

Year\ Items	Ribbed Smoked Sheet (RSS1) (sen per lb.)	Tin (\$ per tonne)	Crude Palm Oil (\$ per tonne)
1960	108.08	6509.37	679.2
1965	70.04 (-35.2%)	11608.66 (+78.3%)	828.3 (+21.5%)
1970	56.43 (-19.4%)	10990.76 (-5.3%)	787.2 (-4.9%)
1975	62.0 (+9.9%)	15935.95 (+45.0%)	1002.2 (+27.3%)
1980	141.68 (+128.5%)	35716.87 (+124.1%)	1211.5 (+20.9%)
1985	85.59 (-39.5%)	29680.00 (-16.9%)	1046.0 (-13.7%)
1989	119.05 (+39.0%)	23020.00 (-22.4%)	822.2 (-21.4%)

Note: Figures in parentheses denote percentage changes

Source: Malaysia, Bank Negara, Quarterly Economic Bulletin, various issues.

(2) The over concentration on agricultural and primary sector in the 1960s was so severe that almost no industrial development took place. The lack of domestic manufacturing activities had made the country so dependent on the imports of manufactured goods to an extent that even relatively simple manufactured consumer items had to be imported. In addition, it was very difficult to modernize other sectors of the economy in the absence of industrial development.

(3) Over dependence on agricultural and primary sector had also led to the creation of a dualistic economic structure. Since tin mines and rubber plantations were located only in certain areas suitable for their development, and as demand for the above two products was entirely from the external sector, there was very limited link between these "modern enclaves" and the traditional agricultural sector. There was almost no transfer of technology or skill from the modern sector to the subsistence sector. As a result, only a small section of the economy benefited from modernization brought about by the development of tin and rubber. This dualistic economic structure had accentuated the serious regional and racial economic disparities since a large portion of the indigeneous population were involved in the traditional subsistence agricultural and not affected by modernization.

(4) The primary sectors, particularly agriculture had difficulties in absorbing the fast growing labour force because they were not able to generate sufficient employment opportunities.

Maisom (1977) also concluded that the Malaysian economic condition during the early post-independent period which specialized in few primary products for export and dependent on food and other consumer manufactured goods on imports, was very undesirable. It is alleged that the average income elasticity of demand for primary products is significantly lower than the average income elasticity of demand for manufactured goods in the international market which implies that when there is an increase in the level of income, the demand for manufactured products will increase more than the demand for primary commodities (Flanders, 1969). Therefore, specialization (by less developed countries) in a few primary products for export and dependent on import of manufactured products from developed countries (major exporters of manufactured goods) will lead to a greater income inequality between the developed and less developed countries (Flanders, 1969: 173). A greater export of primary products is required in order to pay for a specific volume of imported manufactured goods. Thus, Malaysia (during the early post-independent period) was in a way worse off because it was specialized in a few primary products for

exports and dependent on imports of manufactured goods from developed countries.

The above problems related to the over concentration on agricultural and primary commodities provided the impetus for Malaysia to expand the production base and diversify export (Maisom, 1977 and Ho, 1983). In the process of diversifying the country's economy, the government saw industrialization (especially manufacturing sector) as one of the most important elements of diversification (Osman Rani and Haflah, 1990). Consequently, several incentives (will be discussed later) were introduced to attract foreign and local investors into the manufacturing sector (Leong, 1990).

Incentives for Investment in Manufacturing

Since the commencement of Malaysia's industrialization era, there have been several policy instruments and strategies adopted to promote industrial development. Many incentives have been offered to local and foreign investors investing in the manufacturing industries (Asian and Pacific Development Centre (APDC) and South Pacific Bureau for Economic Co-operation (SPEC), 1987; and Yong, 1988).

Initially, right after independence in 1957, Malaysia introduced Pioneer Industries Ordinance (PIO) 1958 (Appendix

