

**AN EMPIRICAL STUDY ON THE DETERMINANTS OF FDI IN MALAYSIA
AND ITS LINK TO TRADE (1978-2002)**

**A research paper submitted to the Graduate Studies Unit,
Academic Affairs Department in partial fulfillment of the
requirements for the degree Master of Economics,
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ABSTRAK

Kajian ini bertujuan menganalisa hubungan antara kemasukan pelaburan asing langsung dan perdagangan di Malaysia. Kajian ini menggunakan data siri masa dari tahun 1978 hingga 2002. Metodologi yang digunakan dalam kajian ini ialah model graviti khas untuk mengaitkan hubungan kemasukan pelaburan asing langsung dan perdagangan. Hasil kajian menunjukkan bahawa import memang merangsangkan kemasukan pelaburan asing langsung yang lebih tinggi. Sebaliknya, kemasukan pelaburan asing langsung tidak membawa kepada peningkatan perdagangan melalui import. Secara umumnya, hasil kajian ini adalah selari dengan sorotan karya dan kajian-kajian empirikal lepas yang menyokong teori kaedah kemasukan pelaburan asing langsung. Ini juga bermaksud bahawa syarikat multinasional akan memperkenalkan produk mereka terlebih dahulu melalui import sebelum menjalankan operasi pengeluaran di Malaysia.

ABSTRACT

This paper examines the link between inward FDI and trade and how each affects the other in Malaysia. This study is based on annual time series data from the years 1978-2002. The main method of study is via the gravity model which is normally used to determine the extent of trade flows. This study incorporates the gravity model to measure FDI using an augmented gravity model in order to link trade and inward FDI. The results of this study indicate that imports actually induce higher inward FDI which inward FDI itself does not induce higher trade levels through imports. While the findings are generally in line with the literature and empirical studies, it also serves to validate the earlier theories of FDI namely the factors which determines the entry mode of inward FDI into Malaysia. This means that MNC's would generally prefer to initially penetrate the Malaysian markets via exports before setting up production here. Thus, trade through imports can be said to be a precursor of future inward FDI.

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CHAPTER ONE

INTRODUCTION

1.1 Background on FDI in Malaysia and Economic Overview

Foreign direct investment is a long-term investment that has lasting interest and control of a resident entity in a nation by a foreign investor. FDI may comprise of capital inflows through equity capital, reinvestments and intra-company loans (UNCTAD, 2001). According to Kruger (2001), FDI occurs when an entity from the home country acquires controlling interest in an entity in another host country: operates and manages that entity and its assets as part of the multinational business of the investing entity. FDI is then financed through transfer of funds from the parent company to the new affiliate, or by borrowing in the home country or in the host country. In short, FDI occurs when investors transfer funds from the home country to another country with the intention to control the entity of the business.

Foreign Direct Investment or FDI has been hailed as the most important contributing factor to Malaysia's phenomenal economic performance since the 1970s (Athukorala and Menon, 1995) and is seen as the engine for growth, especially in the export-manufacturing sector. Malaysia is one of the most favored locations of FDI. In 1995, for example, Malaysia was the second largest recipient of FDI among the Asian economies at US\$5.8 billion (UNCTAD, 1996). However in order to comprehend the role and impact of FDI requires an understanding of the major thrusts of industrial policies in Malaysia from the 1970s to the 1990s.

Prior to the 1970s, Malaysia promoted specific industries through tariffs and quotas and the provision of basic infrastructure, and these industries produced for

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