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**Title:** Reversed fortunes in the south : a comparison of the role of FDI in industrial development in Kenya and Malaysia  
**Issue Date:** 2013-03-07
Introduction

This thesis compares the industrialization experiences of Kenya and Malaysia since independence, with a special emphasis on the role of foreign direct investment (FDI) in industrial development. It is part of the Tracking Development Project, an international research project on the comparative development trajectories of South East Asia and Sub-Saharan Africa for the last 50 years. The remarkable success of the East Asian countries during this period has received much attention from policy makers. This culminated in the publication of “The East Asian Miracle” by the World Bank in 1993, which brought to the fore the debate about the kind of policies that contributed to their success and, most importantly, the conditions under which they worked. The new insights generated from the subsequent debates were hoped to play an important role in assisting jumpstart the economies of developing countries that had stagnated or even declined during the same period. Many of these countries happened to be in Sub-Saharan Africa.

The lack of progress by these countries, which were considered to have shared similar experiences and characteristics in terms of initial conditions – colonial legacy among other things – raised much interest among many scholars and policy makers alike, who wanted to understand why the two continents diverged so sharply. In fact, Collier & Gunning (1997) noted that, in the 1960s, Africa’s future looked bright, and – on the basis of Maddison’s estimates of per capita GDP for a sample of countries in 1995 – during the first half of the century Africa had grown considerably more than Asia: by 1950, the African sample had overtaken the Asian sample. This positive trend lasted until the early 1970s, when Africa’s economies first faltered and then started to decline. While this happened, nations in Asia slowly improved on their economic performance, which eventually culminated in most of these countries being considered among the newly industrialized countries in the 1990s. Hence, there has been a reversal of fortunes between Asia and Africa if a comparison is made for the period 1960 and 2011. African countries during this period became poorer.
The neoclassical economists have attributed growth in the newly industrialized countries to government success at “getting the prices right”, by letting free-market-based price signals determine the most efficient allocation of resources for national economic growth. To this end, some policy makers have promoted relatively open economies, avoided the provision of more incentives to some industries than others, and generally limited government’s economic role (Donor 1991). Critics of the neoclassical economists have suggested limits to the explanatory usefulness of their views. Some have asserted that economic success in these countries was a result of governments providing selective incentives and “getting the prices wrong”, deliberately engineering price distortions to create comparative advantage where none existed at all (Wade 1990; Amsden 1994; Lall 1995). Others, while acknowledging that economic growth requires market-conforming policies, emphasize the need to explain why and how such policies have been implemented in certain countries and times and periods but not in others (Haggard 1990).

In Sub-Saharan Africa, the poor economic performance has been attributed to many factors, such as droughts, wars, internal conflict, political instability and adverse terms of trade, a heavy debt burden, poor economic policies, landlockedness, tropical climate, and unfavourable initial conditions (Sachs & Warner 1997; Wood & Mayer 2001; Easterly 2002). More recently, within the Tracking Development Project, it has been argued that economic stagnation in Sub-Saharan Africa was due to lack of macroeconomic stabilization, pro-poor, pro-rural public spending and economic freedom for peasant farmers and small entrepreneurs, conditions which in its view were fulfilled in South East Asia. In addition, it identifies three principles which seem to underlie both the choices of these policies and their successful implementation: The principle of outreach, emphasizing “quantity and not quality”; the principle of urgency, stressing “priorities and not plans”; and the principle of expediency – that is, “results and not rules” (van Donge et al. 2012).

These factors, apart from negatively affecting development in agriculture – which has for decades supported the majority of the population – and resulting in high poverty levels, have also affected the industrialization efforts. According to Lall & Wangwe (1998), the industrial sector in Sub-Saharan Africa has remained uncompetitive internationally as a result of poor policies. In their view, a broad range of government policies affects industrial development, from general macroeconomic management, through trade and competitive policies, human resource development, and specific industrial development and technology policies. An abuse of one or more of these policies by governments has the potential of hurting industrial development. Others, like Karshenas (2001), have attributed Africa’s failure to industrialize to limited supply of labour and a relative abun-
dance of land, with non-agriculture sectors facing relatively high and steep wage curves. This is in contrast with Asia, which is argued to have had an abundant labour supply in agriculture, which allowed fast rates of industrial growth to take place at low and competitive wages.

Nevertheless, although these proximate causes are important in explaining the differences between countries, they do not sufficiently address the important question of why some countries have less human capital, physical capital, and technology and why they make worse use of their factors of production and opportunities. This necessitates the need for the examination potential fundamental causes that may underlie these proximate differences across countries, especially for the interest of sound policy making. Towards this end, Acemoglu & Robinson (2010: 141) have identified institutions as one of the fundamental causes of economic growth and differences across countries. Three kinds of institutions are identified: Economic, political power, and political institutions. Economic institutions matter for growth because they shape the incentives of key economic actors in a society. Political institutions, like economic institutions, determine constraints and incentives of key actors, but in the political atmosphere. Political power can emanate from political institutions in a society (de jure) or may originate from both the ability of groups within the society to solve its collective action problem and the economic resources available to them (de facto). Aside from institutions, other fundamental factors identified in literature include geographical and cultural factors (Acemoglu et al. 2002; Murshed 2010: 18).

Although the long-term growth determinants are important, the proximity causes of growth are more important to policy makers who have to make decisions in the short term. It may take time to fix institutions, change culture, or even overcome geography, but economic policies can be altered to address problems in the near future. This thesis contributes to this debate by examining industrial experiences of Kenya in Sub-Saharan Africa and Malaysia in South East Asia. These two countries are both former British colonies which became Western allies during the Cold War. They were perceived to pursue broadly market-friendly economic policies and remained relatively peaceful despite ethnic tensions arising from the presence of ethnically diverse populations. Both countries have been among the most economically successful in their respective regions. However, from a comparative perspective, Kenya’s economic growth performance began to falter in the 1970s and has since fallen further behind that of Malaysia (see Figure 1.1 below).

Throughout the entire period 1960-2010, Malaysia has largely maintained a growth rate of above 5 per cent, except during the periods of crisis such as the oil crisis in the 1970s, global world recession in the 1980s, the Asian economic crisis in the 1990s, and the recent global economic crisis in 2008. In contrast, Kenya
registered the highest economic growth in the early 1970s and has consistently experienced low growth of below 5 per cent compared with Malaysia throughout most of the period. By 1990, Malaysia was considered among the industrialized countries and was hoping to have achieved the status of a fully developed country by 2020. Kenya, on the other hand, finds itself in an awkward position, having established its “Vision 2030” in 2007, aimed at achieving the status of a middle-income country many years after Malaysia and other newly industrialized countries, which 50 years ago were at the same level of development as it is today, suggesting a reversal of fortunes.

Figure 1.1 Economic growth rates of Kenya and Malaysia

As part of the wider debate on industrialization in South East Asia, the industrial success in Malaysia has been attributed to several reasons, among them being the reliance on FDI, which resulted in the expansion of exports in manufactured goods, employment creation, and generation of spillovers (Athukorala & Menon 1996). Others, like Drabble (2000: 187), assert that the main impetus came from exports of primary products in the 1960s as the early development plans, together with the boom in timber production, began to pay off. This continued in the 1970s, with the unit values of most primary exports steadily rising particularly in the latter part of the decade. However, at this stage, manufacturing output also became increasingly important. Lall (1995) attributes this success not only to exports-led growth, driven mainly by electrical and electronics’ products produced by multinationals (MNEs), but also to domestic-oriented industrialization, facilitated by moderate protection and state ownership of heavy industry. Thus, although Malaysia’s industrial success has been attributed to many factors, there appears to be consensus that FDI has played an important role in its indus-
trial transformation from dependence on primary commodities to manufactured goods.

A comparison of FDI inflows to Kenya and Malaysia in Figure 1.2 shows that in the 1970s, the two countries attracted significantly low levels. However, over the years, Malaysia has been able to attract high levels of FDI compared with Kenya, whose FDI inflows are almost negligible. Kenya’s economic slowdown as well as its failure to attract high FDI levels has been attributed to many factors, the most common being poor policies, corruption, bad governance, and negative ethnicity (Vandenberg 2003; Mwega & Rose 2005; Rasiah and Gachino 2005). In addition, some studies have shown that investments of MNEs in Kenya have sometimes resulted in increased unemployment and regional inequality among other ills (Langdon 1975; Phelps et al. 2009).

**Figure 1.2** FDI Inflows in Kenya and Malaysia

![Graph showing FDI inflows in Kenya and Malaysia](image)


The need to understand the reasons behind the economic divergence observed between Kenya and Malaysia has motivated this current research. Certainly, there are many dimensions in understanding why some countries succeed while others do not. Since an examination of all the causes of divergence in development would be an impossible task to embark on in a thesis, this study devotes attention to understanding the role of FDI in economic development and, as Figure 1.1 suggests, FDI inflows to the two countries capture the existing divergence observed. Moreover, existing literature about FDI and development is inconclusive and has recently attracted a lot of attention, especially in developing countries as they seek new ways to accelerate economic growth and reduce poverty.
Definition of foreign direct investment and classification
According to the Balance of Payments Manual (Fifth Edition), FDI refers to an investment made to acquire a lasting interest in an enterprise(s) operating outside of the economy of the investor. Further, the investor(s) aim is to gain an effective voice in the management of the enterprise. A threshold of 10 per cent of equity ownership qualifies an investor as a foreign direct investor. Moreover, since the aim of the investor is to acquire some form of control in the enterprise, only capital that is provided by the investor either directly or through other enterprises related to the investor should be classified as FDI. The forms of investment by the direct investor which are classified as FDI are equity capital, the reinvestment of earnings, and the provision of long-term and short-term intra-company loans between parent and affiliate enterprises.¹

Nevertheless, this definition is not adequate due to several reasons. First, it suggests that FDI involves international transfer of money, ignoring situations where FDI capital could be raised in the host country. Second, the definition of FDI flows is expressed in terms of money capital when it incorporates the transfer of other income-generating assets such as new technology and management skills. It is also a substitute for domestic capital and skills. Third, the definition does not take into account the new organizational forms that have appeared in the global economy over the last three decades, especially those arising from the international fragmentation production resulting in intra-product specialization, where various phases of production can be separated and may be located in different regions. Firms today can exercise various forms of control over distance enterprises without direct ownership (Winder 2006). Fourth, the FDI measures are considered sufficiently accurate only in the short term.² Finally, the definitions used by statistical agencies may differ from the legal treatment of multinational firms in international treaties such as the World Trade Organization, which aim at reducing legal barriers to FDI (Contessi & Weinberger 2009). Redefining FDI is therefore required in order to take into account non-monetary aspects of FDI as well as new forms of control that have emerged with multinationals changing strategy to cope with globalization.

On measurements, the macroeconomic time series available for FDI are mainly the nominal value of the flows in or out of the country and stock values. Both measures have problems that sometimes undermine the cross-country comparability of the series, especially because statistical agencies of different countries may use different definitions of FDI. A second problem with datasets avail-

² This is because the valuation of capital stock changes over long periods because of inflation and the exchange rates, causing problems with the adjustment.
able from international organizations such as the IMF, the World Bank and UNCTAD is that they often have missing data points, particularly for developing countries. A third issue with the use of aggregate data in studying FDI is that the records may not capture a part of the investment in the foreign project, especially when the project is financed from local sources in the host country. Bergeijk (1995) assessed the extent of the measurement errors in generally accepted figures on international transactions supplied by the IMF and the OECD and found that the implicit minimal measurement errors in bilateral data for Germany and the Netherlands appear to be about 1.5-3 per cent. In addition, FDI data for 20 OECD countries in the period 1950-1989 showed that their accuracy had improved little if at all since the 1970s: in 15-25 per cent of cases, implied minimal measurement errors were in excess of 10 per cent. The study concluded by observing that recognizing the extent of error and indeterminacy in our empirical base will be a first step in the direction of economics as an exact science.

Although acknowledging the difficulties in addressing most of the challenges identified, this study employs both macro- and firm-level FDI datasets to answer various questions of interest.

For several decades now, attempts to establish whether FDI promotes economic development have been controversial. According to Theodore et al. (2005: 2), conventional wisdom presented by the neoclassical economists asserts that FDI is unequivocally “good” for development as long as investors do not pollute the environment or abuse workers, among other vices. The more FDI the host country can attract, the better (de Mello 1997; Blomström & Kokko 1998). The second source of conventional wisdom is reflected in academic scepticism that any noteworthy relationship between FDI and development exists. From this perspective, “(o)ne dollar of FDI is worth no more (and no less) than a dollar of any other kind of investment” (Williamson 2000). The third and final source of conventional wisdom is found in the renewed conviction among some developing countries that host-country development objectives can be achieved only by imposing performance requirements on multinational investors (Lall 2004; Rodrik 2004).

Over the years several authors have taken stock of the empirical literature related to FDI and its importance to development. Blomström & Kokko (1998) found a lack of comprehensive evidence on the exact nature and magnitude of multinational effects in host countries, although spillovers may vary systematically between countries and industries. Although early studies did show positive effects, the increasing international division of labour within MNEs has complicated the analysis. Gorg & Greenaway (2004) observed that although economic
theory can identify a range of possible spillover channels through which FDI can affect growth and development, there is no robust empirical support of positive spillovers. Others such as Herzer et al. (2008) find neither a long-term nor a short-term effect of FDI on economic growth in many developing countries. The contradictory results could be due to country and regional specific factors (such as a lack of absorption capacity) or data characteristics, differences in the length of the time periods, methodologies and control variables. In particular, the magnitude, significance and direction of spillovers from FDI could be systematically influenced by alternative methods in the research design, the methodology and the data. In addition, ignoring unobserved time, firm and industry specific factors may affect the findings of particular studies (Lall & Narula 2004; Smeets 2008; Mebratie & Bergeijk 2012).

Theoretically, the link between FDI and economic development can be summarized as in Figure 1.3. The case for countries’ increased efforts to attract FDI stems from the belief that it has several positive direct effects, which include provision of capital desperately needed to bridge the savings-investment gap, boosting countries’ balance of payments (BOP) position, creating jobs, increasing productivity gains through technology transfers, and introducing new processes in the domestic market, managerial skills and know-how, employee training, international production networks, and access to markets. In addition, its relative stability has also increased the emphasis on FDI among all capital flows.

Figure 1.3  Linking FDI to economic development
Most importantly, FDI may also generate indirect effects through externalities to the host country. Through learning by observation or by doing, foreign production may increase domestic productivity and the overall economic growth and development in the domestic economy. Domestic firms may benefit from accelerated diffusion of new technology if foreign firms introduce new products or processes to the domestic market. In some cases, domestic firms might benefit from just observing these foreign firms. In other words, technology diffusion might occur just from labour turnover as domestic employees move from foreign to domestic firms. Moreover, MNEs may also create forward and backward linkages between themselves and domestic suppliers or customers. These direct and indirect effects of FDI can play a role in modernizing the national economy and thereby promote growth (Blomström & Kokko 1998; Alfaro et al. 2004; Gorg & Strobl 2005a).

Research objectives and organization of chapters

This dissertation therefore aims at generating a pool of knowledge on the role of FDI in economic development by comparing Kenya and Malaysia. The thesis addresses four main research questions:

1. What has been the role of government in industrial development in Kenya compared with Malaysia?
2. Why has Malaysia been successful in attracting FDI compared with Kenya?
3. What has been the impact of FDI on economic growth in Kenya compared with Malaysia?
4. What has been the impact of FDI on domestic firms in the manufacturing sector in Kenya compared with Malaysia?

By addressing these questions, this thesis contributes to the industrialization debate in both South East Asia and Sub-Saharan Africa from a comparative perspective. The industrial sector generally includes four divisions of the United Nations International Standard Industrial Classification: mining, manufacturing, construction, and public utilities. Although this thesis sometimes refers to industry as a whole, it is mainly concerned with the manufacturing industry. It is a collection of five papers, each addressing a specific issue.

Chapter 2 contains a review of the literature on the role of FDI in economic development. There are many theories to explain various aspects of FDI, and in this study they are classified into five groups. In each section, a brief description of a core model that exemplifies the type is set out and a general survey of other papers in the same category is provided. First is the core of the old growth and old trade theories, taken from Brems (1970), Findlay (1978) and Burgastaller & Saaverdra-Rivano (1984). Second are the industrial organization theories of FDI,

Chapter 3 contains a historical overview of the industrial development in both countries. It presents their industrial experience from the 1960s to the present. The discussion is based on the industrial strategies adopted in each phase of their industrialization process. In Kenya four phases are identified. The first phase runs from 1955 to 1969, when Kenya officially introduced the import substitution strategy (ISI). This strategy was continued in the next period (1970-1979) with devastating effects, unlike the previous period when agriculture flourished and the manufacturing sector was established. The third phase marks the introduction of the Structural Adjustment Program (SAPs) in 1980, a process that continued through the 1990s until the end of President Moi’s era in 2001. During this period, the export industrialization strategy was introduced, achieving little result. The final phase starts from 2002, when a new government was elected to power. It initially pursued an economic recovery strategy program, which was later replaced by “Vision 2030”. Similarly for Malaysia, four phases are identified. The first phase marks the introduction of the ISI during the period 1955-1970, while the second phase runs from 1971-1980 when the export promotion industrialization (EOI) strategy was adopted. These two strategies were repeated in the 1980s, with the second round of ISI running until 1985 and the EOI reintroduced thereafter.

Chapter 4 examines the determinants of FDI and its impact on economic growth in both countries. A vector autoregressive model is estimated using time series data for the period 1960-2009. Apart from examining the traditional determinants of FDI, this study also examines the importance of institutional factors which have been largely ignored in Malaysia. Moreover, apart from two studies in Kenya which employ a cross-country approach, no other studies exist on FDI determinants. In addition, FDI’s impact on economic growth has also not been examined.

Chapter 5 investigates the existence of productivity spillovers from foreign-owned firms to domestic firms in both countries, using firm-level data for the period 2000-2005. Existing studies in both countries have investigated various aspects of productivity in the manufacturing sector. However, only two studies – Gachino (2006) in Kenya and Khalifah & Adam (2009) in Malaysia – have examined the existence of productivity spillovers from foreign-owned firms to domestic firms, and both differ in methodology. Moreover, only the Kenyan study
examines the transmission channels of these spillovers. Indeed, as Gorg & Strobl (2005a) have observed, spillovers are difficult to measure since they do not leave a paper trail by which they may be measured or tracked. Hence, the approach taken mainly in empirical literature largely avoids the question of how spillovers occur and instead focuses on the simpler issue of whether or not the presence of foreign-owned firms affects productivity of domestic firms. Hence, in that sense, this study is unique because it examines these spillovers and their transmission channels using various proxies and similar techniques for comparison purposes.

Chapter 6 investigates the presence of export spillovers from foreign-owned firms to domestic firms as well as their transmission channels. A firm’s export decision is estimated using a probit model based on pooled, random, and fixed effects using panel data. This is the first study of its kind in the two countries to estimate export spillovers and their transmission channels both individually and in a comparative perspective. The approach taken involves first estimating the determinants for exports in both countries, then establishing whether they vary depending on whether a firm is foreign – or domestic-owned, and why. Finally, different measures of foreign presence are used to establish if foreign-owned firms influence the exporting behaviour of domestic firms and through which channels.

Finally, the last chapter presents a summary based on the existing development debates including Tracking Development’s view on the possible reasons for economic divergence between Sub-Saharan Africa and South East Asia. Special attention is devoted to the empirical findings from the preceding chapters on the possible causes of divergence between Kenya and Malaysia, using the FDI experience. The study concludes by drawing some policy lessons for developing countries.

The first paper is presented in the next chapter, which is a review of the literature on the role of FDI in economic development.