Foreword

This chapter examines the determinants of Foreign Direct Investment (FDI) and its impact on economic growth in Kenya and Malaysia. Both countries have a long history of reliance on FDI in economic development. Prior to their independence, FDI was mainly concentrated in the primary sectors—while after independence, FDI became an important ingredient in their industrialization process. Over the years, Malaysia has remained an attractive location for FDI, having attracted substantial inflows followed by rapid economic growth rates leading to successful industrialization. Kenya on the other hand, although having comparable levels of FDI inflows to Malaysia in the 1970s, lost its appeal and has experienced slow economic growth rates over the same period, consequently failing to industrialize. This observed reversal of fortunes between Kenya and Malaysia, which is also reflected in FDI inflows, necessitates a re-examination of its importance in economic development as well as its determinants.

The literature on determinants of FDI in host countries is vast and examines a wide range of factors. Perhaps one of the most comprehensive frameworks to date for analyzing FDI determinants is the Dunning (1977; 1993) eclectic paradigm. The paradigm, otherwise known as the OLI framework, suggests that multinational corporations (MNCs) contain Ownership- (O), Location- (L) and Internalization- (I) specific advantages, which enable them to compete with domestic firms in host countries. The precise configuration of the OLI parameters facing a particular firm and the response of the firm to that configuration are strongly contextual,
reflecting the features of both the parent and host country, the industry, and the characteristics of the investing firm (Dunning, 2000).

Trade theories have also provided an alternative framework to the business school models for analyzing FDI determinants. These theories, usually based on general equilibrium models, offer explanations for the existence of both horizontal FDI (where multi-plant firms duplicate roughly the same activities in multiple countries) and vertical FDI (where firms locate different stages of production to different countries). Vertical FDI arises when factor endowment differences are large and factor price differences exist (Helpman, 1985), while horizontal FDI is based on the trade-off between maximizing the proximity to customers and concentrating production to achieve scale economies (Horstmann & Markusen, 1987). An integration of streams of literature on both horizontal and vertical FDI has generated the knowledge-capital model, within which FDI is determined by variables considered in both models (Markusen, 2002). Recently, it has also been argued that the determinants and motives for FDI have changed in the process of globalization (Kokko, 2002; Addison & Heshmati, 2003). As a consequence, the traditional determinants of FDI are considered insufficient to induce FDI inflows.

The impact of FDI on economic growth in host countries has also received adequate attention in the literature. The conventional wisdom asserts that FDI plays an important role in capital accumulation and also as a source of knowledge transfer and spillovers (De Mello, 1997). Developing countries suffer from low capital accumulation owing to low domestic savings; hence, FDI meets the savings—investment gap. In addition, FDI can lead to improved balance of payments and offer much-needed employment opportunities to the surplus labour in these countries. FDI is also considered an important conduit for technology transfer, leading to increased productivity of domestic firms through various channels. Furthermore, it can also generate export spillovers, among other benefits to firms within host countries. Hence, based on the neoclassical view, FDI plays an important role in promoting growth and development in host countries. The structuralists, on the other hand, observe that developing countries fail to benefit from FDI owing to existing structural rigidities and advocate for protectionist policies if developing countries are to develop (Burton, 1998). In recent times there has been the new institutionalist theory, which asserts that markets can work only with good institutions. The government therefore plays an important role in providing the institutions, legal framework, incentives, and other related services that facilitate the generation of benefits from FDI (Rodrik, 2004). Finally,