The competitiveness of malaysia in attracting fdi

1. 1 Abstract

This report investigates the competitiveness of Malaysia in attracting Foreign Direct Investment (FDI). More specifically the study investigates the relationship of FDI with Malaysia's economy, analyzes the reasons that affected the FDI into Malaysia, and evaluates each possible reason with relevant supportive data. The study will further evaluate the effectiveness of government policies in attracting FDI into Malaysia.

1. 2 Malaysia and the FDI

Malaysia has a policy of mixed economy whereby the countries attract FDI into the country to drive its economy and to ensure growth. Most of the empirical studies on the function of FDI in countries suggest that FDI is an important source of capital, complements domestic private investment, enhancement of technology transfer, and increase overall economic growth in countries where higher economic growth will creating sound investment environment which attracts investment from market-seeking firms (Karimi et al., 2009). According to Krugman and Obstfeld (1994) FDI functions as one way to bridge an inter-temporal gap of capital demand and supply, and like other capital inflows, increase the production frontier of developing countries, which normally suffer a shortage of capital. FDI also lead to increase the employment rate through the expansion of the economy and job creation. Insufficient funds for investment are the main reason to seek FDI and normally, less-developed countries lack of fund for investment (Har, Teo, & Yee, 2008). Therefore by having the FDI, it can help them to develop their countries and improve their standard of living by creating more domestic employment and increase the economy.

Besides FDI creating more job opportunities, inflow of FDI has been an important source of knowledge transfer in technology, management skills and international linkages for Indonesia, Malaysia, and Philippines and Thailand (Yussof & Ismail, 2002). FDI is considered to be an important vehicle for transfer of new technology which contributes to growth more than domestic investment (Borensztein et al., 1998). FDI provides the fastest and most effective way to deploy new technologies in developing host countries, through the process of technology transfer, the foreign multinationals also contributed to the development of the technical capabilities of the locals (UNCTAD, 2000). Moreover, through training of employees and hands-on learning, FDI can raise the skills of local manpower and as a result, increasing their productivity level (Marial & Ngie, 2009). Furthermore, FDI's role is to fuel exports growth whereby the production of products and services are to cater both domestic and international markets.

The government's effort by introducing more liberal incentives including allowing a larger percentage of foreign equity ownership in enterprise under the Promotion of Investment Act (PIA)1986 and followed by the establishment of Free Trade Zones (FTZs) during the Second Malaysia Plan (1971-1975) in order to attract a larger inflow of FDI. Since then, Malaysia has attracted a large portion of the investment dollar that flowed into Asia. Between 1986 and 1996, it resulted to a large inflow of FDI at an annual average rate of 38. 7% after 1987. In 1995 for instance, Malaysia was the second largest FDI recipient among Asian economies with US$ 5. 8 billion (UNCTAD, 1996).

FDI Inflows to Malaysia, (in million dollars) 1990-2009

The figure above shows the trend of FDI inflow to Malaysia. Malaysia has received a lot of FDI since the 1990s and FDI has become an important contributor to the growth and the transformation of Malaysia's economy whereby FDI could create job opportunities for the countries' citizens. The FDI flow in Malaysia is inconsistent and fluctuates randomly. For the record, Malaysia has recorded RM 152 billion in net FDI inflows during the period 2000-2009 higher than RM 134 billion from 1990-1999. But actually Malaysia's performance starts to grow up impressively by 1990s compared with the years before 1990s and it show that may be the investor confidence had improved. However, the lowest figures of FDI inflows recorded in 2001 were due to the global trend and followed by the collapse of technology bubble (The star newspaper, 25 March 2010). As for 2009, the FDI inflow into the Malaysia had drastically dropped 81% to US$1. 4bil from US$7. 3bil in 2008, which reported by the World Investment Report (WIR). According to the chief economist of RAM Holdings Bhd Dr Yeah Kim Leng, the reason why the FDI have contracted sharply due to lack of confidence as the result of the global financial crisis in 2008 and 2009 (The star newspaper, 13 March 2010). In 2007, FDI inflows peaked, when it reaching US$1. 8 trillion, up 30% from 2006, bringing the worldwide stock of FDI to US$15 trillion.

FDI is an important contributor to the growth and the transformation of Malaysia's economy, particularly in establishing new industries, enhancing production capacity, employment, trade and technological capability. Malaysia has attracted a steady inflow of net FDI in the recent decade, averaging 3% of GDP per annum with a peak of 4. 5% of GDP in 2007 (Har,

et. al., 2008). However, relatively lower FDI inflows were recorded in 2001 and 2009, similar to the global trend, following the collapse of the technology bubble and the global financial crisis respectively.

According to the World Investment Report 2010, Malaysia's FDI was dropped more than 81 percent in 2009 on Year-on-Year basic, from US$7. 32 billion in 2008 to US$1. 38 billion in 2009. The FDI inflow into Malaysia of the entire year of 2009 was even less than half of the annual average total FDI inflow between the years of 1995 to 2005, which included the long recovery period after the 1997 Asia Economic Crisis. Besides, Malaysia's FDI inflow in 2009 was also lower than Singapore, Thailand, Indonesia, Vietnam, and the Philippines. This is the very first time in the history where the Philippines's FDI total is more than Malaysia's FDI.

1. 3 Malaysia Economy Background

Malaysia was a strong performer in economic growth within the South-East Asia region in the early and mid-1990s. However, the country's economy was hit hard during Asia Economic Crisis, which began in July 1997 started from Thailand. The crisis caused Malaysia economy contracted by 7. 4 percent, and the Ringgit slipped by more than 40 percent until the country decided to implement currency and capital control, as well as pegged it currency- RM3. 80 to USD1. However, the economy was able to recover strongly, particularly in 1999 and 2000, as the result of increased government spending and highly increased export sector. Malaysia had successfully to register averaged annual GDP growth rate at 5. 9 percent since 2001. The country economic growth are transforming from depending on government spending

and exports to become more driven by private consumption and investment, particularly in the services sector.

Malaysia had taken the initiatives to reconstruct it economy, especially financial sector since 1997 Asia Financial Crisis. This enabled Malaysia's economy did not hurt badly by the global financial crisis which began on November 2008 in US. However, the country's economy is facing several problems internally and externally. These include of potential decreasing exports demand, higher commodity prices (due to Quantitative Easing (QE) Policy- worldwide, and Quantitative Easing 2 (QE2) – US), lower competitiveness in attracting FDI inflows, and challenges in gaining the high income country status.

Malaysia's government had introduced 5 economic regions within the country (Iskandar Malaysia (Iskandar), North Corridor Economic Region (NCER), East Coast Economic Region (ECER), Sabah Development Corridor (SDC), and Sarawak Corridor of Renewal Energy (SCORE)) within the year of 2008. Also, the Malaysian's government has promised to commit to an open economy, increase the country's competitiveness and promote more freedom for foreign investors to the country. However, the introduced of 5 economic regions and the promises given by the Malaysian's government did not responded positively by foreign investors, as the FDI inflow into Malaysia was dropped shapely in the year of 2009.

Malaysia aims to become a developed country in 2020, yet the country need to grow at least 7 percent annually for the 10 years to come. Malaysia have been focused in several sectors in 9th Malaysia Plan and 3rd Industrial

Master Plan, which includes of Islamic Finance, IT & ICT, Education, Tourism, Biotechnology, and Multimedia. However, the 10th Malaysia Plan and the Malaysia Budget 2011 are both focused on the blueprint on addressing income distribution, retaining affirmative action policies for native Malays, while developing and improving the agriculture and social services sectors.

1. 4 Malaysia Country's Facilities

According to World Investment Report 2008, MNCs often invest in countries with well established network of transportation and communication facilities. Malaysia is ready to fulfill the needs of logistic and communication within the country's boundary, especially in the Peninsular of Malaysia. PLUS-highways and KTM railways are both linking the major towns in peninsular. Malaysia is famous with cheaper ports services than Singapore provided in southern Johor, as well as in Klang. Besides, the leading budget airlines- Air Asia, which selected Malaysia as the hub of it networks also increased the competitiveness of Malaysia in term of transportation. As for communication, Malaysia is moving toward to implement National Broadband Initiative (NBI), other than the MSC projects. According to SKMM (Malaysia Multimedia and Communication Commission), 95% of peninsular lands and 55% of East Malaysia areas are covered by fixed line broadband. Besides, there are with 29. 6 Million cellular subscription (Q3, 2009), with 95% of area coverage in Peninsular and 77% of area coverage in East Malaysia.

1. 5 FDI. Why and How?

FDI in general can help to create jobs opportunity and reduce the poverty rate in a developing country. There are many ways in which FDI can help to enhance a country's manufacturing and export competitiveness. In order to

attract export oriented FDI and to ensure that such investment translates into development gains, a country needs to find the most effective ways to make the choice of locations as well as the target segments, conducive to the kind of export activities the MNCs aim to foster.

One of the biggest tools for economic integration is FDI. FDI moves towards low technology production and labour intensive in developing countries, but they flows in high technology production towards developed states. FDI usually depend on different views of investments such as the sector of investment whether it's manufacturing or services, the size of multinational investor or company. When the firms, which relocate only a part of its production's process, but not the whole production's line, then there is with possibilities for more FDI inflows in future, as the firms might continuously to relocate other production's process. Natural resources, specific skills, inexpensive labour and infrastructure will usually be the motivator to the foreign investors to relocate their production's line. On the other hand, the investors will invest heavily in an advantaged location to increase their competitive advantages.

In today's rapidly globalizing world, successful exporting needs not only competitive products, but also marketing expertise and access to international markets. Giving greater access to FDI can provide major benefit in this respect especially in markets in which established brand names and large distribution networks are important assets. FDI can also be effective means of providing resources, such as skills, training, technology, capital goods and intermediate input needed to exploit a country's existing comparative advantages.

As for developing countries, FDI play a major role in the manufacturing sector for exports. This contributes to direct and indirect impacts to the domestic companies, in which direct impacts occur when FDI establish backward linkages with domestic companies. The indirect impacts occur when the domestic companies are able to copy the operations and the management's styles from the foreign companies, opportunity to recruit skilled employees of foreign companies, and taking advantages from reductions in trade barriers, as well as the improvements in local infrastructure.

FDI is the vehicle by which firms achieve their strategic objectives. A company must posses some asset such as product and process technology or management and marketing skills that can be used beneficially in the foreign affiliate in order to invest in production in foreign markets. According to Kindle Berger (1969), " For direct investment to thrive there must be some imperfection in markets for goods or factors, including among the latter technology. Or some interference in competition by government or by firms, which separates markets". The industrialized nations have remained the major contributor as well as the major recipient of FDI though FDI flows to the developing world have more than doubled between 1990 and 1999.

2. 0 LITERATURE REVIEW

2. 1 The FDI

FDI is generally defined as ownership of a country's business or properties by entities not domiciled there (BusinessDictionary. com). In this 20th century, the improved technologies and consolidated economies make a greater mobility of peoples, goods, capital and ideas from one country to another

country. Such exchange of goods, services, knowledge and cultures between countries brings us to a world without boundaries and it is popularly known as globalization (Global Education). As the tendency of world towards globalization, FDI plays an extraordinary and growing role in global business (Graham & Spaulding, 2005). In terms of FDI, the host country is the country which receives the investment from the source country or home country, which is also known as the foreign investor. The inflows of FDI into a host country can drive to a significant development of economy by providing an external source of capital, new technologies, management skills, and process.

According to Graham & Spaulding, FDI is classically defined as a company from one country making a physical investment into building a factory in another country. A direct investment is about investing in buildings, machinery, and equipment while indirect investment is refer to undertaking a portfolio investment. In current year, the definition of FDI has been expansive to include the acquisition of lasting management interest in a company outside the investing firm’s home country, investing in a joint venture, or construction of facility, or league with a local firm with the following input of technology and licensing of intellectual property (Graham & Spaulding, 2005). Besides, the form of FDI has much different from the pass in terms of the size, scope and methods of execute due to the expansion in technologies, changes in market’s capital structure as well as the gradually aggrandizing liberalization of national investment regulatory framework.

The expanding of FDI in current year proposed different view point to different people. Adherents of FDI indicate that the exchange of investment flows profits both the host country and the home country while opponents hold that multinational collaboration are able to exert greater power over smaller economies and would lead to larger local competition (Graham & Spaulding, 2005). Since the flows of investment in a country’s economies does brings about great impact, most governments, especially for those in industrialized and developed nations really put much attention to FDI. In the United States, the Bureau of Economic Analysis, a section of the U. S. Department of Commerce, is responsible for collecting economic data about the economy including information about FDI flows (Graham & Spaulding, 2005). By going through this data, the influence of such investment on the overall economy can be determined and the impact on industry segments will be assessable.

The FDI embodies two typical assets: first, capital and second, technology or a number of intangible advantages. So, FDI is more likely to be important in industries with significant firm-specific, intangible, knowledge-based assets. FDI contributes most to the development process when affiliate is wholly owned and fully integrated into the global operations of the parent company. Once the parent investors commit themselves to incorporate the output from host country into a larger strategy to meet global or regional competition- there is evidence of a dynamic “ integration effect”, which creates innovative and creative technology and techniques, as well as closer positioning along the top of the best management practises and highest industry standards.

2. 2 The benefits of FDI

In general, FDI will improve competitiveness and create employment, as well as increase the development of the host nation. This is a result of inward investment increasing the number of entrants in the indigenous industry which forces all competitor firms in the industry to become more competitive by reducing costs and improving efficiency and quality. In the analysis of Bosworth and Collins (1999) found that about half of each dollar of capital inflow can converted into an increase in the domestic investment. The result of the analysis show that the transferring of foreign resources equal to 53-69 percentage of the inflow of financial capital. The rest are transferred to reserves accumulation or capital inflows.

In addition to the contribution of joint ventures, foreign firms can serve as a catalyst for other domestic exporters. In an empirical analysis, the probability of domestic factories will be exported is considered to be actively associated with the nearby multinational companies (Aitken et al. 1997). One implication is that the government may encourage potential exporters to be close to each other, creating export processing zones, duty-free import of inputs given as to fund infrastructure, special offers or tax-free to help reduce the cost of domestic enterprises to foreign countries to break the market. Export processing zone is a useful broad-based reform, but may introduce spatial distortions, the government in the wrong place to find the area. Much FDI activity is achieved by way of a joint venture between a foreign company and an indigenous company and this may bring advantages such as risk diversification, capital requirement reductions and lower start-up costs.

Besides, foreign firms will bring in superior technology and enable free spreads of technology to the existing firm for extent of benefit to the host countries. FDI will manifest itself in the creation of spill over and linkages – typically in suppliers and customers – whereas the dynamic impact will affect the competitive environment. In addiction, both adherents and opponents support their respective view point regarding to the implication and effect of growing in FDI. Adherents stand the point that exchange of investment flows benefits both the host country and the home country (Graham & Spaulding, 2005). This enable the mutual benefit between both countries where the enterprise in host country providing the new technologies, capital, management skills, and facilities as needed by the home country while the home country investor invest money in the host country to achieve their common goal, making profit from their collaboration. In spite of the perspective mentioned above, some proposed that FDI helps in economic development of the particular country where the investment is being made and especially applicable for the economically developing countries (EconomyWatch). Supporters vouching for FDI say that it is stable and is a source of advanced technology and better managerial practices, so it is good for developing economies (Peter Nunnenkamp, 2002). Optimism about the consequences of foreign investment, coupled with heighted awareness about the importance of new technologies for economic growth, has contributed to wide-reaching changes in national policies on FDI and it helps accelerate the process of economic development in host country (Gordan H. Hanson, 2001). For most nations that were developing form the economic perspective, FDI is considering as one of the major foreign source of financing during 90s. Besides, there is an observation shows that FDI has played an important role

in helping several countries when they were confronted by economic difficulties. For example, during the financial problems of 1997-1998 that the amount of FDI made in countries in East Asian region was pretty steady and similar observation has been made in the 1980s and in Mexico in 1994-1995 (Economy Watch).

The presence of foreign corporate in a host developing economy produces a positive externality that is the transfer of technologies. As a research for technology transfer, there are four correlated channels which are vertical linkages with suppliers and purchasers in the host countries, horizontal linkages with competing or complementary companies in the same industries, migration of skilled labors, and the internationalization of R&D (OECD, 2002). With the presence of Multinational Enterprise (MNE), the technology transfers have been demonstrated that existing particularly through vertical linkages however the weighty of horizontal linkages is still the subject to argue (OECD, 2002). Moreover, technology transfer can only be accomplished through FDI since trading of goods and services and investment in financial source are unable to fulfill this goal.

The countries that get FDI from another country can develop the human capital resources by getting their employees to receive training on the operations of a particular business (Economy Watch). According to the overview of OECD, this human capital enhancement is not only occurring through the efforts of MNE whereas it arises from government policies seeking to attract FDI via enhancement of human capital (OECD, 2002). Besides the effects of MNE in human capital development, the other enterprise which has a direct business relationship with MNE such as their

supplier may also produce positive influences on the human resource quality. This effect can have a further movement which labor move to another firm or become entrepreneurs. In addition, it is possible for the host country to receive corporate taxes revenues when there is any profit generated by the FDI in that country.

2. 3 The Factors that affecting FDI

FDI movement is basically derived from financial transactions and non-transaction factors such as price changes, foreign exchanges and other changes during the reference period. In other words, the movement is derived from the differences between the closing and opening positions of the year.

There are three factors that make Malaysia attractive to FDI, which have been identified are: (1) Malaysia's undervalue currency; (2) lower cost of labour; and (3) fairly low interest rate (Oti-Prempeh, 2003).

Generally, firms are always looking that overseas expansion as a necessary way to reach a more effective access in the markets which have low representation. Investments often lead to increased trade flows indicating that trade flows and investments are complementary (Tyler and Miranda, 2007). A set of region determinant is chosen from the literature on the location of US service industries to state the pattern of the Foreign Service firms FDI activity in the US. These determinants are the share of metropolitan population, the agglomeration of domestic producer services, the value of commercial and industrial property and population growth.

About their study in the location of FDI and state characteristics within the US, Coughlin et al. (1991) assumed that a foreign firm company will choose to invest in a special state depends on the levels of its characteristics that influence profits relative to the levels of these characteristics in the other states.

Besides that, Qian Sun et al. (2002) find proof that the value of the FDI determinants flows through the time period. Facility and labour quality are also important determinants of the distribution of FDI. The good infrastructure and labour quality will attract the attention of the foreign investors. Besides, the political stability and openness of that country to the foreign world are also as the important dimension to drawing in the foreign capital.

Inward investment is likely to stimulate the production of global competitors in the recipient country. Market size and growth, barriers to trade, wages, production, transportation and other costs, political stability, psychic distance and host government's trade and taxation regulations, performance requirements, cultural distance, GDP per capita and infrastructure are factors affecting FDI location. While economic growth and technology transfer to the host country are important consequences of FDI, development of technological infrastructure and human capital are critical prerequisites and so antecedents for FDI.

Moreover, while psychic distance has been pertinent so far in FDI decisions, its importance might gradually reduce with increasing globalization and development of new digital economy. " Institutional and strategic factors into

theory . . . need to be considered in tandem to explain the change in trend of FDI flows" (Sethi et al , 2002),.

The inflow of FDI includes a raise in the production base, the introduction of new skills and technologies and the creation of employment. Foreign investors increase productivity in host countries and FDI is often a catalyst for domestic investment and technological progress. Increased competition associated with the entry of an MNE upgrades the competence and product quality in national companies, and opens up possibilities for export (Ahn and Hemmings, 2000).

2. 4 Globalisation and the FDI

Since the early 1960s a large number of theories on FDI have emerged. This proliferation was to a large extent, due to Hymer 1976, and the subsequent recognition that FDI is a manifestation of market imperfection and firm specific advantages. This is the implicit and explicit assumption in most modern theories. The multiplicity of factors involved in production, combined with barriers to the free movement of goods and services, together with the differences in production environment, are also been an increasing number of studies regarding other modes of foreign investment (FI). These new forms of FI activities – such as join venture, licensing, franchising, etc seem to have taken on an increasingly important role in recent years everywhere, including developing countries (Oman, 1984).

There is increasing understand that trade and FDI are the vehicle that moves globalization. The nature and quantity of determinants and factors that determine FDI inflows into a country depend largely on the barriers-to-trade.

In order to encourage globalization, all countries must try to eliminate the barriers-to-trade and provide opportunities for attracting FDI inflows into the country. As the race for FDI inflows among the nations intensifies, the conditions for attracting FDI inflows continue to increase and multiply as well.