The Contributions Of Foreign Direct Investments In The Development Of The Industrial Sector In Malaysia From 1990-2005

By

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The first part of the current assignment will evaluate the contributions of Foreign Direct Investments (FDI) in the development of the Malaysian industrial sector during the period 1990-2005. The second part will consist of the identification and discussion of the sector's prospects and challenges for the continuation of FDI contribution in Malaysia.

Part I - An Evaluation Of The Contributions Of Foreign Direct Investments (FDI) In The Development Of The Malaysian Industrial Sector (1990-2005)

Definition of Foreign Direct Investments (FDI)

FDI constitutes a long term investment that has lasting interest and control of a resident entity in a nation by foreign investor (Poon, 2004). A distinction must be made that FDI is a long term investment as opposed to short term funds which are speculative in nature.

According to Lehmann (2002), FDI increase domestic capital formation, augment host country stocks of technology and managerial know how, improve access to export markets and is a stable source of external financing.

It is in light of these benefits that the contributions of FDI to the development of the Malaysian industrial sector will be assessed. However, such an assessment will not be complete without first establishing the base for comparison which is the period prior to 1990.

The Pre-1990 Period

Foreign Direct Investments have been a major factor in the Malaysian economy since the British colonial period. During this period, capital from Great Britain investing in the lucrative rubber plantation and tin mining enterprises formed the bulk of FDI inflow. These enterprises were engaged in the extraction of these two raw commodities and no attempt were made to develop downstream manufacturing activities until later. As a consequence of this focus, the manufacturing sector was negligible and non-existent.

Post Independence (1957) saw the government encouraging import substitution manufacturing industries to reduce the nation's import bill. These industries were the precursor to our nation's fledgling manufacturing sector and capital was funded through FDI from our former colonial masters Great Britain and much smaller amount from other countries. British capital in the form of agency houses such as Harper, Guthrie, Harrissons, Inchcape and Sime Darby took advantage position of their commercial linkages and invested in the processing industries.

Ranjit (1985) contended that in 1957, 50% of identifiable capital stock was owned and controlled by foreigners, mainly British and European. A decade after indipendance, foreign capital made up 75% of investment in the rubber and 60% of investment in tin industries.

However, the dominant position of Great Britain as the supplier of FDI to Malaysia eroded with the passage of time, collapse of the tin market and declining price of rubber. By 1985, British investments contributed only 2.8% of total FDI.

Though agriculture was the dominant sector in the Malaysian economy throughout the 70s, the government was already placing more emphasis on developing the manufacturing sector particularly the export industries. Malaysia began to receive a growing amount of FDI from non British sources such as Singapore, USA, Japan, Taiwan and Korea. This was the result of the government's implementation of appropriate and advantageous policies and strategies to encourage investment in the manufacturing sector. During this period, the government established the Federal Industrial Development Authority 1967 and passed the Investment Incentives Act 1968 and the Free Trade Zone Act 1971 which was extended in scope by the Licensed Manufacturing Act 1975.

The transformation of Malaysia from and agriculture to industrialization began in earnest with the era of Tun Dr Mahathir Mohamad's stewardship of the nation as the Prime Minister in 1981. In a shift of paradigm, Tun Dr Mahathir exhorted a reluctant and bewildered government administration to "Look East" towards Japan as a model for economic growth and industrialization. Malaysia's industrialization was key to his personal vision of developing the Malaysia economy and achieving the objectives of the New Economic Policy. This shift of emphasis towards developing Malaysia's industrial capacity and capabilities, came to bear with the drafting of the First Industrial Master Plan (1986-1995). This plan was supported by the Promotion of Investment Act 1986 which provides for tax and other incentives attract FDI.

All these policies coupled with the nation's endowment of cheap and natural resources, low wages, skilled workforce, good infrastructure and stable government resulted in Malaysia becoming increasingly competitive and attractive as a choice destination for FDI.

As a result of the FDI, foreign partners introduced the much needed technology and expertise for new frontier industries. The 80s saw a rapid expansion of heavy industries in the manufacturing sector. Steel, cement, petrochemical and ship building industries were formed between state owned enterprises and foreign partners. As an example, the Malaysian automotive industry began with Proton formed as a joint venture entity between Hicom and Mitsubishi of Japan.

1987, proved to be the watershed year when the manufacturing sector's contribution to the country's GDP exceeded the agricultural sector's contribution for the first time. Thus began the industrialization era of the Malaysian economy.

The 1990-2005 Period

This period saw continued growth of FDI into Malaysia (refer to Table 1). In 2004, value of approved projects by MIDA amounted to approximately RM29 Billion.

Year	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**
Value of Approved Project (RM Million)	17,629	17,055	17,772	6,282	11,339	9,144	17,056	11,473
Year	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	
Value of Approved Project (RM Million)	13,063	12,274	19,848	25,774	18,821	29,144	28,773	

Table 1: Value of Approved Projects 1990-2004 (Source MIDA and BNM)

Continuing the trend from the 1980s, Japan continued to be the major investor in Malaysia in the 90s decade. For example in the early 1990s, Malaysia became Sony of Japan's largest manufacturing base on the back of their investment valued in excess of RM1.2 Billion. Taiwan was also a major investor in the early 1990s with billion RM investment by their Titan group in a JV with PNB, setting up a polymer manufacturing plant in Pasir Gudang, Johor. However, starting from the year 2000, USA overtook Japan's position as the leading source of FDI into Malaysia (refer to Table 2). For the period 2000-2004 investment from USA contributed a total of 23% of the value of approved projects.

	2000		**2001**		**2002**	
	FDI		**FDI**		**FDI**	
COUNTRY	**(RM Million)**	**%**	**(RM Million)**	**%**	**(RM Million)**	**%**
USA	7,492	38%	3,412	18%	2,668	23%
Germany	1,656	8%	2,603	14%	5,055	44%
Japan	2,881	15%	3,366	18%	587	5%
Singapore	1,778	9%	2,228	12%	1,019	9%
UK	772	4%	123	1%	168	1%
Others	331	2%	92	0%	117	1%
TOTAL	19,848	100%	18,907	100%	11,578	100%
	2003		**2004**		**2000-2004**	
	FDI		**FDI**		**FDI**	
COUNTRY	**(RM Million)**	**%**	**(RM Million)**	**%**	**(RM Million)**	**%**
USA	2,182	14%	1,059	8%	16,812	21%
Germany	170	1%	4,724	36%	14,209	18%
Japan	1,296	8%	1,011	8%	9,141	12%
Singapore	1,225	8%	1,515	12%	7,766	10%
UK	3,870	25%	151	1%	5,084	6%
Others	512	3%	1,855	14%	2,907	4%
TOTAL	15,640	100%	13,144	100%	79,118	100%

Table 2: Top 5 Sources of FDI By Country (Source MIDA)

According to MIDA almost all FDI was earmarked as capital investment in the industrial sector. As such, FDI amounting to RM79 Billion for the years 2000-2004 at almost 59% of total the value of capital invested in the industrial sector is significant (refer to Table 3). In other words only 41% of capital formation in the Industrial sector was contributed from domestic sources. Out of total capital investment of RM135 Billion during this period, RM41 Billion representing 31% went into the Electronics and Electrical Products sub-sector making it the fastest growing Industrial sub-sector.

Sub-Sectors	2000	%	2001	%	2002	%	2003	%	2004	%	2000 - 2004	%
Electronics	12,182	36%	10,325	40%	5,651	32%	4,978	17%	8,627	30%	41,763	31%
Basic Metal	787	2%	605	2%	364	2%	8,711	30%	1,925	7%	12,392	9%
Paper & Publishing	1,524	5%	5,023	20%	314	2%	254	1%	4,723	16%	11,839	9%
Transport Equipment	673	2%	1,128	4%	698	4%	6,979	24%	1,324	5%	10,802	8%
Petroleum	2,347	7%	129	1%	4,866	27%	444	2%	1,902	7%	9,688	7%
Others	16,097	48%	8,565	33%	5,983	34%	7,779	27%	10,272	36%	48,696	36%
TOTAL	33,610	100%	25,775	100%	17,877	100%	29,145	100%	28,773	100%	135,180	100%

Table 3: Capital Investment by Industrial Sub Sectors (Source MIDA)

Resulting from the major inflow of FDI, the Industrial sector grew at a fast pace. It was without doubt the engine of growth for the Malaysian economy. During the period 1990-2005, the growth of the Industrial sector outpaced other economic sectors in the Malaysian economy (refer to Table 4). By 2004, the Industrial sector output is valued at RM141 Billion contributing 31% of the GDP. This sector is now the second most significant contributor to the GDP next to the Services sector.

	Manufacturing			GDP	
Year	(RM Mil)	Growth	% of GDP	(RM Mil)	Growth
1989	18,444				
1990	21,340	14%	20%	108,280	
1991	24,307	12%	21%	117,781	8%
1992	26,859	10%	21%	126,311	7%
1993	30,324	11%	22%	137,008	8%
1994	34,782	13%	23%	148,275	8%
1995	39,895	13%	25%	162,361	9%
1996#	45,201	12%	NA	253,733	NA
1997	53,387	15%	NA	281,795	10%
1998@	58,786	9%	NA	284,472	1%
1999	97,914	NA	33%	300,349	5%
2000	111,900	12%	33%	343,215	12%
2001	101,735	-10%	30%	334,404	-3%
2002	110,561	8%	31%	362,012	8%
2003	122,706	10%	31%	395,017	8%
2004	141,172	13%	31%	449,609	12%
Note: # Change in basis for GDP, @ change in basis for manufacturing					

Table 4: Growth of Manufacturing Sector and GDP (Source various BNM publications)

A significant portion of the Malaysian workforce is engaged by the Industrial sector. By 2004, Malaysia was already at full employment levels. New manufacturing industries formed by FDI was a contributor towards the economy's full employment (refer to Table 5). According to MIDA, approved projects in the period 2000-2004 created approximately 400,000 new employment opportunities for the economy.

Prakash (2001) Elaborates this by opining that constant with increasing FDI, employment in the manufacturing sector also increased consistently by 6% per annum between 1991 to 1998. By 1997, 2,3 million workers are employed by the manufacturing sector, which is 28% of total labour force. Unemployment dropped from 4.3% to 2.8% in 1997. There was also higher female labour participation.

Industry	2000	2001	2002	2003	2004	2000 - 2004
TOTAL	88,112	89,440	64,744	77,182	88,634	408,112

Table 5: Potential Employment From Approved Manufacturing Projects (Source MIDA)

FDI also was a source for the regional distribution of economic growth by the formation of new manufacturing industries in industrial parks other than the traditional Industrial hubs of Selangor and Penang. For the period 2000-2004 Selangor attracted Capital Investment valued at RM28 Billion. However, even Kelantan was able to attract investment (refer to Table 6).

	Total Proposed Capital Investment (RM Mil)						
State	2000	2001	2002	2003	2004	2000-2004	%
Selangor	7,802	5,825	3,843	5,059	6,050	28,580	21%
Sarawak	8,115	638	476	8,568	5,901	23,698	18%
Penang	4,460	3,837	2,398	1,923	2,030	14,649	11%
Johor	2,454	2,463	2,333	1,957	3,987	13,194	10%
Malacca	1,002	3,453	573	4,058	1,194	10,280	8%
Perak	3,059	965	452	2,826	1,316	8,617	6%
Kedah	1,016	699	532	879	5,245	8,372	6%
N Sembilan	2,172	2,310	768	1,844	1,054	8,148	6%
Sabah	369	4,789	349	154	339	5,999	4%
Terengganu	94	15	4,740	485	138	5,473	4%
Pahang	2,830	347	271	923	995	5,366	4%
FT	177	229	1,113	386	164	2,070	2%
Kelantan	33	182	10	52	107	383	0%
Perlis	0	14	6	31	1	52	0%
Undecided	-	-	-	-	252	252	0%
TOTAL	33,610	25,775	17,877	29,145	28,774	135,180	100%

Table 6: Total Proposed Capital Investment by State (Source MIDA)

Thus, the Industrial sector was without doubt the engine of growth for the Malaysian Economy for the period of 1990-2004. The strong growth of this sector contributed significantly to the strong GDP growth, higher per capita income and full employment. The basis for the sector's sterling performance was also without doubt the contribution by the inflow of FDI mainly today from USA, Germany and Japan. Almost 60% of total capital formation in the period of 2000-2004 was foreign originating. Capital investment such as these, not only bring funds but it also forms new equipment and technology. Without FDI, it is unlikely that the Industrial sector would have been able to grow at this phenomenal rate outpacing other sectors of the economy and by doing so benefiting the population and nation.

Capital investments made by foreigners are mainly export oriented industries taking advantage of Malaysia's cheaper cost advantage. As such, most of the manufacturing industries output is exported making Malaysia the world's 12th major exporting country. FDI contributed to this happy state of affairs, by providing trade and export linkages and access to foreign markets which would have taken longer for local industries to penetrate and develop (Ariff, 1991).

Additionally, FDI also benefits the nation, economy and the industrial capital by way of the adoption of superior foreign production practices, quality management, technology transfer and the symbiotic development of local SME supporting the major industries. Through this, our nation was able to advance on the knowledge and technology curve at a faster rate than otherwise possible.

Part II - The Industrial Sector's Prospects And Challenges For The Continuation Of FDI Contribution In Malaysia

The effect of a reduction in FDI for Malaysia will be very negative. This is because of the significant contribution of FDI to the Industrial sector and economy. It has been argued by Professor Krugman that the growth of the Malaysian economy was all due to the effect of FDI.

The main challenge facing the Industrial sector is competitiveness. Our competitiveness is being eroded by the stagnant productivity, increasing wages and higher cost of production inputs. This may be compounded by the negative effect of an appreciating RM causing of exports to be less price competitive. The strengthening RM will also cause the higher cost of intermediate goods which is the feedstock to our manufacturing industries.

Due to the above reasons, foreign industries will less likely find Malaysia a favourable destination to set up or relocate production plants. FDI is strongly attracted by the factor of comparative advantage. Malaysia had this advantage in the past which was the reason for the growth of FDI. However, China will prove to be a major competitor for FDI. With China's trade and market liberalization in conjunction with it's entry to WTO will serve a big hurdle to Malaysia. This is because China with its cheaper labour and lower cost of production inputs will be a more attractive destination for FDI compared to Malaysia. In addition to this, setting up a production center in China can also be a strategy to penetrate and access the huge Chinese domestic market. In view of Malaysia's stagnant productivity and rising cost of production inputs, it is not foreseeable how Malaysia can compete against China for

FDI in labour intensive industries. At the present, there are already several industries in Penang which had relocated their production to China.

The appreciating RM due to the recent de-peg of the RM may also have negative consequences for FDI. The appreciating RM will make the cost of investment, production and doing business in Malaysia more expensive in comparison with alternatives such as China and Indonesia.

Nevertheless, the prospect is still good in the short term because of the continued strong export growth which a factor attracting FDI to Malaysia. This is suggested by Kew (1999) in which empirical findings indicate the causality of export growth factor in the model for FDI growth. Therefore FDI will continue to flow into Malaysia as long as exports grow. However, it remains to be seen how much longer will our exports continue to grow in light of our eroding price competitiveness.

A positive turn for the longer term, is the government formulating strategies and policies to transform manufacturing industries from being labour intensive to capital intensive. This is the response to the challenge of stagnant productivity and rising wages because a more capital intensive industry will be more resilient to rising wages.

The government is also encouraging local SMEs to develop the capability and technology manufacture intermediate goods to reduce the reliance on imported intermediate goods. Some of these programs include vendor development programs and technology incubators.

The government through its agencies such as MIDA must continue to actively promote Malaysia as the best destination for FDI. Policies and incentives must be formulated to reflect current economic realities and remain attractive to foreign investors.

Government Bureaucracy need to be nimble, responsive and business friendly. Transparency is also an increasingly important determinant in the foreign investor’s decision matrix. As such the government need to step up in its role and responsibility to promote foreign capital to invest in Malaysia.

It however, a better suggestion is for Malaysia to reduce reliance on FDI as a source of capital investment because FDIs are a source of BOP imbalance. It is also a drain on economy when foreigners repatriate profits and dividends. To reduce reliance, the government should actively promote domestic private investment and the development and commercialization of indigenous technology.

The Malaysian Industrial sector has been a surrogate to foreign industries in the past 3 decades. Within this 3 decades, the Malaysian Industrial sector has developed manufacturing capacities and competencies to be world class. This is proven because Malaysians manufacture world class products for industries such as Motorola, Intel and Sony. Therefore it is timely that Malaysia decides to manufacture world class products bearing our local brands and compete in the international market.

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