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THE IMPACT OF FDI ON THE MALAYSIAN MANUFACTURING SECTOR

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ABSTRACT

Over the past two decades Malaysia with a decisive development policy-shift from an agricultural economy to the industrialized economy has experienced one of the highest Gross Domestic Product (GDP) growth rates in the region. Since 1980-1997, the economy has grown at 7.4 percent per annum while the manufacturing sector grew at 9.7 percent. It is claimed that the development of the manufacturing sector is driven by foreign direct investment (FDI). Thus, this study examines the impact of FDI in promoting the growth of the manufacturing sector with the concomitant effect on trade creation and its ownership patterns and trends. The method of analysis is basically descriptive though some econometric techniques are also applied to supplement the findings. It is found that during 1980-1997, FDI has helped the manufacturing sector to grow tremendously with a great impact on its export promotion. Similarly, the empirical findings also conclude that FDI compared to domestic investment is more significant in promoting the real manufacturing output. It is found that compared to short run in the long run FDI exhibits a strong positive effect on the manufactured exports while reducing the manufactured imports comparatively. At the outset, this study found an overwhelming dominance of foreign investors in the Malaysian manufacturing sector. However, this trend is found to be declining recently. Thus, the most efficacious way of encouraging FDI is then to implement the policies what will improve the investment climate with nondiscriminatory favors towards the local investors.

الخلاصة

منذ العقدين الماضيين لقد جرّبت ماليزيا الدرجة الإنتاجية العليا في الإنتاج الأهلي الشامل (GDP) في المنطقة، مع تطوّرها الأكيد وتحوّلها من الاقتصاد الزراعي إلى الاقتصاد الصناعي، فمن عام ١٩٨٠م إلى عام ١٩٩٧م بلغ الإنتاج الاقتصادي ٧,٣٪ سنوياً، بينما قامت الدوائر الصناعية بإنتاج ٩,٧٪ في هذه المدة. ويُدّعى أن الاستثمار الخارجي المباشر (FDI) قاد هذه الدوائر الصناعية.

وهذه الدراسة تفحص أثر الاستثمار الخارجي المباشر (FDI) في إحداث التنمية في الدوائر الصناعية، وتقوم بتوضيح نفوذه الملازم للتكوين التجاري وعيّناته الملكية واتجاهاته. وعلى الرغم من أن هذه الدراسة اعتمدت على طابع المنهج الوصفي التحليلي إلا أنها وظّفت تقنية المناهج المتضمنة للوسائل الاقتصادية الأخرى.

ومنهجية البحث تقوم في الأساس على المنهج الوصفي إلاّ أنّ هناك حالات تستخدم فيها تقنيات الاقتصاد السياسي لغرض تدعيم نتائج البحث.

وقد توصل البحث إلى أن (FDI) [الاستثمار الخارجي المباشر] قد دعم قطاع الصناعة في الفترة ما بين ٨٠-٩٠ بصورة مشجعة مع تأثير كبير في إشهار التصدير لهذا القطاع. وكذلك أثبتت النتائج العملية أن الاستثمار الخارجي المباشر يعد أكثر فعالية وتشجيعاً إذا ما قورن بالاستثمارات الأصلية المحلية. وقد توصلت الدراسة إلى أنه بالمقارنة مع الاستثمار القصير الأجل، فإن الاستثمار الطويل المدى يعد إيجابياً ومؤثراً في المصنوعات المصدرة وخفض من المصنوعات المستوردة.

في الخلاصة توصلت الدراسة إلى أن هناك تأثيراً قوياً وهيمنة شبه كاملة للاستثمارات الخارجية في قطاع الصناعات الماليزية.

مع ذلك فإن هذا الاتجاه بدأ يتراجع في الفترة الأخيرة. ولهذا فالسبيل الفاعل الذي يشجع الاستثمار الخارجي المباشر (FDI) هو تطبيق سياسات تحسن مناخ وبيئة الاستثمار دون الإنقاص من قيمة وأهمية المستثمرين المحليين.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a thesis for the degree of Master of Economics.

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DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. Other sources are acknowledged by footnotes giving explicit references and a bibliography is appended.

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Dedicated

To My Family
and
The Person Who Always Trusted on Me

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CHAPTER ONE

INTRODUCTION

1.1 INTRODUCTION

Money begets money. This is a time-tested axiom of capitalism. It is pertinent to production where capital is *sine qua-non* for growth and expansion. Among economists, support for the free movement of this capital is an article of faith. Like free trade it is argued that the free flow of capital across borders can increase economic efficiency. Capital from affluent region will flow to the most productive investment opportunities thus increasing competition will create vigilant environment for efficient production and leading economic growth to the less developed area. In international trade, Foreign Direct Investment (FDI) is one form of capital inflow which moves across the regions.

Generally by foreign direct investment we mean when a firm (with intangible assets) expedites its operation of physical assets with a direct control and ownership in a foreign country, thereby, implying an international capital movement. It is a difference between the assets owned by the residents of a country A, and capital stock K, located in the country (say in per capita terms, Hein, 1992). Thus, the amount of investment per capita

Z can be considered as the potential net liabilities of the country to the rest of the world in per capita term.

Foreign direct investment (FDI) is considered by many countries to provide the catalyst for growth, particularly in the developing countries where FDI has for a long time provided needed capital, technical know-how and managerial expertise lacking in the developing countries. In the long-term, inflows of foreign capital reduce external resource costs by helping to promote exports and import substitution. Thus, FDI promotes economic development through export promotion and employment creation and fosters self-sustained growth.[1] However, during 1970s the commercial bank lending assumed an important role as a source of financing development. But in the early and mid-1980s, there was a sharp decline in the voluntary commercial bank lending.[2] As a result, developing countries continued to encounter difficulties in servicing past debt with a large balance of payment deficits.[3] As a result, the prospects for the Official Development Assistance (ODA) also dwindled and the demand for foreign direct investment as a means of financing development increased significantly.

However, FDI is not an unmixed blessing. Generally, there are two basic arguments against FDI. Despite their potentials to provide capital it may reduce domestic savings

[1] This self-sustained growth approach was postulated by Rosenstein-Rodan (1961) while arguing in favor of foreign capital in his savings gap approach. His argument follows that foreign capital will fill gap and ultimately marginal propensity to save exceeds the average savings rate and it rises as income rises. Eventually domestic savings will be sufficient to finance the desired growth without foreign inflow and this is self-sustaining growth.

[2] It was mainly due to the recession in the industrialized nations.

[3] The past debt problem has risen mainly due to the under and mis-utilization of foreign capital.

and hence investments. FDI may also contribute to generating income for those with lower savings propensities which, in turn, may mean lower investment potentialities. FDI can reduce the foreign exchange earnings by substantial importation of intermediate products and capital goods with a large repatriation of profits, interest, royalties, management fees etc. (Todaro, 1992). Besides that, the over dominance of foreign investors in the local market can inhibit the growth of indigenous entrepreneurship. Thus, the costs and benefits of FDI have been debated for a long time. Since the fundamental premise of this study is that FDI has the potential of making significant contribution to the economic development we will concentrate to explore its positive effects particularly on Malaysia's development process.

In the case of Malaysia, together with the external bank lending problems the global recession of early 80s caused a severe drop in the prices of the exported primary commodities and a sharp decline in oil prices aggravated the deficit in its current account. On the other hand, to boost up the economy the government had undertaken a large structural adjustments program. To finance those developmental efforts, government debt to outside world has risen from 20 percent of GNP in 1980 to 76 percent in 1986 and thus exacerbating the growing savings-investment gap (Eng, 1998). Consequently, with the interplay of all these forces the dire need for an alternative financing source was identified and the government had started to adopt aggressive incentives to attract more FDI.

During the same period the sharp appreciation of the Japanese yen which began in September 1985 reduced Japan's competitiveness in the world markets. In an attempt to hold on to the market share of her products Japan was in an urgent need to relocate the production process and also to reduce the factor cost. Together with the Japanese FDI, the NICs (Newly Industrialized Countries, basically Taiwan and Singapore) also started to relocate their production locations to maintain their own competitiveness. The "flying geese" style of regional industrial restructuring remains the driving force behind the intra-regional investments of this area with more and more countries taking part.[4] This, in turn, caused other developed nations such as US and European communities to move into Asia, specifically to Malaysia, Indonesia and Thailand where unskilled and semi-skilled labor were relatively cheaper with abundance in supply resulting from the inflow of labor from labor surplus neighbouring countries. Henceforth, all these countries were in competition to present themselves with more lucrative incentives towards foreign investors. So the openness of the economies with liberal trade and investment regimes and the adequacy of basic infrastructure brought a substantial amount of FDI into this region.

Given the incentives, the inflows of FDI into South, East and South East Asia rose by 25 percent in 1996, to a record US$81 billion (World Development Report, 1997). It represents about two-thirds of all developing country FDI inflows. Inflows of FDI into four ASEAN member countries (Indonesia, Malaysia, The Philippines and Thailand)

[4] "Flying geese is popularly used to describe a regional pattern of economic development in East and South East Asia, capturing a phenomenon in which a group of economies, closely interacting in a synergistic manner with one another through the medium of trade and MNC's activities, advance together, led by a predominant economy as the major provider of technology, complementary inputs, and markets, followed by progressively less developed economies in a hierarchical pattern" (Rowthorn, 1996b, p.1).

increased by 43 percent in the respective year (1996) to an estimated US$17 billion. The share of FDI inflows in gross fixed capital formation for the entire region in 1995 was 9 percent. Malaysia with 17.9 percent was the third in the rank following China and Singapore (25.7 and 24.6 percent respectively). Malaysia had the highest ratio of inward FDI stock to GDP (52.1 percent in 1995 compared to 33 percent in 1990) followed by Singapore, Indonesia, Hong Kong and China. This large inflow of FDI can thus be attributed to the significant growth experienced by Indonesia, Malaysia and Thailand. This, in turn, contributed to the export expansion of most of the economies in terms of reducing the current account deficits.

FDI's effect on Malaysia is very apparent. The large inflow of FDI in Malaysia was directed to the growing manufacturing sector which contributed significantly to the economic development of the country not only in terms of GDP growth but also in terms of structural changes.[5] Thus, the economy has undergone rapid structural transformation from a producer of primary commodities to an industrialized one. The drastic drop of FDI in the first half of the 1980s contributed much to the recession the Malaysian economy experienced in the mid-1980s (Ariff, 1992). Again, the sharp increase in FDI inflows since 1986 led to a sustained economic expansion. The economy during the 90s has grown at a rate of 8.7 percent compared to 5.8 percent in 1980s. Thus, FDI in Malaysia is likely to show a high causal relationship with the economic growth. On the other hand,

[5] Structural changes mean when a country shifts its status from a primary commodity base to manufacture based economy in terms of its contribution to GDP, employment and foreign exchange etc.

significant structural changes have shifted the importance of composition of output (from the agricultural sector) to the industrial sector. Manufacturing sector in terms of output growth, exports, value added and employment generation took over the predominant position in the economy. The composition of exportable goods has shifted from agriculture to manufactured one. As an example, since 1985, the electrical and electronic machinery sub-sector has accounted for just over 50 percent whereas in 1970 it accounted for only 3 percent of manufactured exports. Likewise, the employment creation by the manufacturing sector has also increased from 16 percent in 1980 to 28 percent in 1997 while the share of agricultural sector has reduced from 37 percent to 17 percent in the same time period. Indeed, it is clear that foreign direct investment plays an increasingly vital role in the Malaysian economy particularly in its industrial development. In fact, it is argued that if not for the FDI, the development that Malaysia achieved by now would have taken much longer period (Ariff, 1991). However, one must not take it for granted that the expansion of FDI will continue to flow at the same rate as it did during the 80s and early 90s.

How much contribution the FDI can make depends also in the first instance on the policies of the countries and the practices of Multi National Companies (MNC)[6](Balasubramanyam et.al., 1996 and Hein, 1992). Given this potential there is little doubt that it is germane to pursue the domestic policies which facilitate the increase in foreign direct investment over time and assure that its contribution to economic development is maximized. The purpose on which this study is based to examine the role of foreign direct investment as a contributing source for development in the Malaysian economy to promote growth resulting the promotion of trade particularly in the manufacturing sector.[7]

The significance of the study lies in that it is concentrating mainly on the manufacturing sector to explore the benefits of FDI within the sector and their salutary effect on overall economic growth. To establish the arguments, the study is mainly based on descriptive form while analysing the tables and graphs. However, using some empirical models will be more helpful to understand FDI's significant contribution to the rapid structural transformation of the economy with manufacturing sector as the engine of development.

1.2 OBJECTIVES OF THE STUDY

Having all the positive effects of FDI on the Malaysian manufacturing sector, the objective of this study is to substantiate them with empirical evidences.[8] This study will have three objectives:

1. To analyze the ownership structure and pattern of FDI in Malaysia,
2. To examine the manufacturing growth and savings effect of FDI, and
3. To explore the trade effects of FDI through export-promotion and import-creation in the manufacturing sector.

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[6] Loyne (1995, p. 17), defined Multi National Corporations as "Business enterprises that own and manage affiliates located in two or more different countries."
[7] We have already highlighted earlier that there are also some negative effects of FDI. However, as far as our study is concerned we will concentrate empirically on its favorable effects.
[8] We also assume here that while explaining the effects of FDI, the structural effect means the effect of state of development of the country together with other domestic effect as given.

1.3 ORGANIZATION OF CHAPTERS

This study is divided into seven chapters. The first chapter discusses the general background of the study. It gives an overview of the trend of FDI in the context of the region in general and Malaysia in particular.

Chapter two deals with the literature review. It is divided into four parts. First part defines the concept of FDI from different perspectives, second part reviews FDI theories, third part includes the studies done on FDI in reference to other countries and the last part deals with the studies of FDI done in the Malaysian context. Reviews cover both the theoretical as well as the empirical studies available for instance.

Chapter three describes the methodology. The topics highlighted include the nature of the study, source of data, period under study and the techniques of analysis.

Chapter four discusses the ownership trend, pattern and structure of FDI in Malaysia. In this chapter we explain the FDI in Malaysia from different perspectives such as FDI by ownership, by source, by industry, by incentives, by top seven countries as well as the equity/loan ratio.

The contribution of FDI to the manufacturing sector growth is discussed in chapter five. It discusses how the inflow of FDI over the period 1980-1997 has increased the economic growth through the improvement of manufacturing output. This part also shows the performance of the manufacturing sector in terms of growth, output, and value added compared to other sectors. Lastly, it shows the savings-investment gap and how FDI helps to minimize it.

Chapter six examines the effect of FDI on trade creation. It examines how the export as well as import is promoted in the manufacturing sector through FDI. This chapter also discusses the foreign- exchange gap and its implications.

Finally, chapter seven sheds some lights on policies to improve the manufacturing sector. It suggests further diversification of export sector for ensuring sustainable growth with the diversification of foreign direct investment (FDI) and the improvement of the local investments.

CHAPTER TWO

LITERATURE REVIEW

2.1 CONCEPTS OF FDI

Foreign direct investment means when a firm (with intangible assets) expedites its operation of physical assets with a direct control and ownership in a foreign country (Seiji Naya, 1990). The definition of direct foreign investment is an inherently practical set of guidelines given that financial data are an imperfect proxy for the complex business linkages that can exist within the multinational firm (Clegg, 1987). The IMF defines FDI as an investment conferring a

"Lasting interest in an enterprise operating in an economy other than that of the investor, the investor's purpose being to have an effective voice in that management of the enterprise"(Clegg, 1987). So FDI consists of investment abroad in subsidiaries (majority and minority owned) and branch. According to the US department of Commerce, foreign direct investment is

"The movement of long term capital to finance business activities abroad, whereby investors control at least 10% of the enterprise"(Stephen Meyer and Tao Qu, 1995).

The definition of FDI used in the World Investment Report (WIR, 1997) is:

"An investment involving a long-term relationship and reflecting a lasting interest and control of a resident entity in one economy (foreign

direct investor or parent enterprise), in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate).”

According to Lall and Streeton (1977), in foreign direct investment, the word “direct “is generally thought to mean; ***at least 25 percent participation in the share capital of the foreign enterprise, i.e. a large enough share to imply operational control of the enterprise rather than portfolio investment.”***

Luiz R De Mello. Jr. (1997), defined FDI conventionally as

“A form of international inter-firm cooperation that involves a significant equity stake in, or effective management control of foreign enterprises.”

The definition of FDI given by Malaysian Industrial Development Authority (MIDA) is:

“Foreign equity plus loan attributed to foreign interest. Loan attributed to foreign interest is apportioned from the total loan according to the percentage of the foreign share in the equity of each project.”

All the above definitions of FDI that we have discussed so far are common in one thing, that is, the operational control of the firm. Though in terms of the share of equity percentage they differ like some argues for at least 10 percent while some for 25 percent but in one point they have unanimously concluded that the share of the foreign participant should be enough to have the voice in the management decision for the parent firm.