Luring FDI Flows into Malaysia
By Quah Boon Huat

Remaining attractive to FDI: For a start, tackle the issues of institutional inefficiencies and labour skills mismatch.

AMONG the various forms of capital flows, foreign direct investment (FDI) gets the most attention. It is one of the most reliable components of capital flows and is widely regarded as having a stronger positive impact on economic development and growth than any other.

The direct effects of FDI on the host economy include job creation, capital accumulation, technology transfers, and trade flows. Its indirect effects - the technological externalities - include higher productivity gains for domestic firms.

The UNCTAD World Investment Report 2006 revealed that global FDI inflows rose substantially by 29% to US$916bil in 2005, while South, East and South-East Asia saw a 19% rise to US$165bil during the same year, which was itself a new high.

Against this backdrop of higher global and regional FDI growth, Malaysia's inward FDI dipped 14% to US$3.97bil in 2005, the only Asean country to register a decline. The report generated much debate about the competitiveness of Malaysia's investment climate.

A closer analysis of the UNCTAD report, however, shows that the massive FDI increase largely reflected a significant increase in cross-border mergers and acquisitions (M&As).

M&As may not necessarily result in any immediate additions to investment or employment. Their growth was fuelled by the investments of collective investment funds (e.g. private equity and hedge funds), which typically have a short time horizon in contrast to greenfield FDI projects by the traditional multinational companies (MNCs).

Also, Malaysia has been very selective with regard to the type of FDI to admit. FDI projects that were lower down the value chain and largely dependent on cheap labour were turned away.

In fact, quite a number of such projects ended up being located in neighbouring countries, this being one possible reason why they did better than Malaysia in the FDI rankings.

Notwithstanding the above, Malaysia needs to intensify its efforts to attract more FDI of the right kind. The Ninth Malaysia Plan forecasts economic growth during the period 2006-2010 to average at 6% per cent per annum. To perform at its potential level, the Malaysian economy needs to grow at an estimated rate of 6.5% per cent per annum. An increase in inward FDI could thus help.

FDI also has an important role of keeping the economic pie growing, and any decline in FDI inflows would be felt not only economically but also socio-politically. Empirical studies overseas have shown that economic, social and political factors are important determinants of FDI inflows. It cannot be very much different in the case of Malaysia.

One factor that does matter a lot to foreign direct investors when making location choices is the quality of the domestic institutional environment.

For the effective, smooth and efficient functioning of the economy, issues like economic freedom, good governance, judicial credibility and effectiveness and transparency are important.

The government won the 2004 general elections on the back of pre-election promises to, among other things:

- combat corruption and improve the quality of government services;
- enhance parliamentary democracy;
- respect the separation of powers under the constitution;
- respect the rule of law; and,
- set up a first class governance system.

These issues need to be tackled in the long term, and the government will need all the political will it can muster to keep the efforts sustained. Negative perceptions about Malaysia's institutional efficiency will no doubt continue to persist and maybe even strengthen if events like the recent approved permits (APs) issue continue to find their way into the limelight.

Human resource development (HRD) is another key factor that determines the volume of FDI inflows. An enhanced HRD increases the attractiveness of a country's investment climate, as it both upgrades the skill level of the workforce and improves the socio-political climate in the country.

It is possible that FDI inflows will in turn boost HRD in the host economy since MNCs themselves can be active providers of education and training. There could thus be complementary effects that lead to a virtuous circle of HRD and FDI.

The Ninth Malaysia Plan recognizes quality of human capital as a key determinant in the achievement of the Plan's goals and objectives. There are however flaws in the education system which needs to be revamped. Rote learning, pressure to pass exams, and an emphasis on uniformity are the norm.

For the economy to move up the value chain, attributes such as creativity, risk taking, entrepreneurship, and adaptability are necessary. Only an education system that promotes problem-solving skills, communication, and teamwork can inculcate these types of attributes.

The quality of teaching also needs to be seriously looked into. This would require increasing the motivation and stature of the teaching profession.

Besides the aforementioned two factors - the institutional environment and HRD -

other factors that affect FDI flows include infrastructure availability, quality of the banking system, characteristics of trade and competition policy and public security. We should also add policy consistency and predictability to the list.

It should be noted, however, that being able to lure new FDI flows into Malaysia is only half the game. Integrating FDI into the host economy as well as putting in place policies that can increase its economic impact is just as important.

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