Foreign Direct Investment

Malaysia Needs to Catch Up with Regional Peers - Focus on High Value-Added FDI

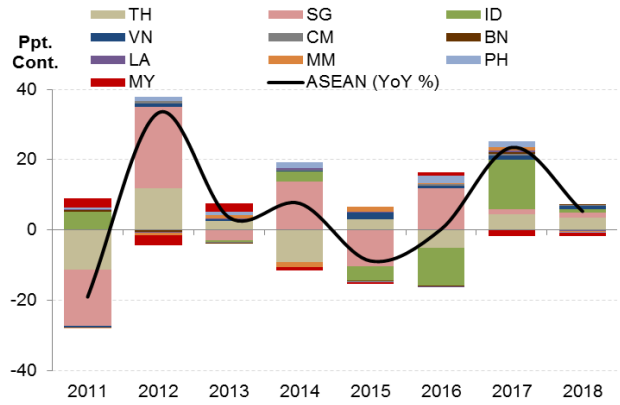
OVERVIEW

- The ASEAN economies have vast potential to attract foreign direct investment (FDI), as evidenced by the continued expansion in FDI into the ASEAN region. In the past decade, the inflow was largely absorbed by three countries, namely Singapore, Indonesia and Vietnam. **Some countries have garnered greater share of the inflow over the years (Vietnam, Philippines) while others have gradually fallen behind (Malaysia, Thailand), suggesting disparity in investment competitiveness amongst the ASEAN economies.**
- While Malaysia outperforms regional peers' average in terms of competitiveness as ranked by the World Economic Forum, the high ranking does not jive with Malaysia's income level and the total FDI it attracts. This supports our view that such ranking should not be the sole measure of a country's potential to attract FDIs, in fact it should only act as a gauge for policymakers to guide its policies to focus on realising sustainable growth, employment and higher income.
- Malaysia's FDI flow performance has been mixed over the last ten years. It has been rising steadily after the Global Financial Crisis in 2008, but it has somewhat deteriorated for the past three years. Net FDI inflow averaged RM33.3b per annum over the last decade. As for this year, t**he FDI performance has been encouraging, with net FDI inflow in 1H19 up by 68.9% YoY to RM26.1b, potentially to outpace the performance in 2018 (RM32.6b).**
- Meanwhile, approved investment for 1H19 jumped 97.2% YoY to RM49.5b, partly reflecting efforts to divert production outlays from China as a result of the prolonged trade feud between the US and China. If the uptrend continues, total approved FDI for this year could potentially exceed RM80.1b recorded in 2018.
- Given the weak global trade and investment environment over the preceding two years, we project total FDI inflow for 2019 to be within the range of RM120b-130b, below 2018's level of RM144.2b. This is premised on the assumption that approved investments implementation timeframe is within 12-24 months. **For 2020, with continued murky global outlook and prospect of a slowdown in the US and China economy, we expect total FDI inflow to remain below RM140.0b.**
- Hence, the government has to step up in coming up with specific measures to ensure Malaysia would remain competitive in attracting high-value added investments over the coming years.
- It is also crucial to prepare the local SMEs to upgrade their know-how and capabilities to be ready to support the advanced industrial ecosystem so as to be able to integrate seamlessly in the global value chain. We expect this would be among the major focus in the upcoming Federal Budget and the 12th Malaysia Plan (12MP) as part of the effort to capitalise on the 4th Industrial Revolution.
- With the onset of technological advancement and industrial revolution, cost-related factors, including low tax rates and low cost of labour have become less important when deciding where to invest. Instead, other F**DI enablers such as political stability and security, legal and regulatory environment and talent and skill availability are valued more by investors.**
- Looking ahead, we expect enhancing political stability and policy clarity to be the government's overarching goal, as they act as an integral base of a conducive investment environment. In addition, as Malaysia targets high-quality and high-value added investments, competing on a "cheaper cost" basis would no longer be part of the main strategy. Instead, **utilising the concept of "product space" would be the best option, in identifying sector that holds the greatest productive value for Malaysia,** and which should be targeted for when crafting the investment attraction strategies.

ASEAN Investment Trends

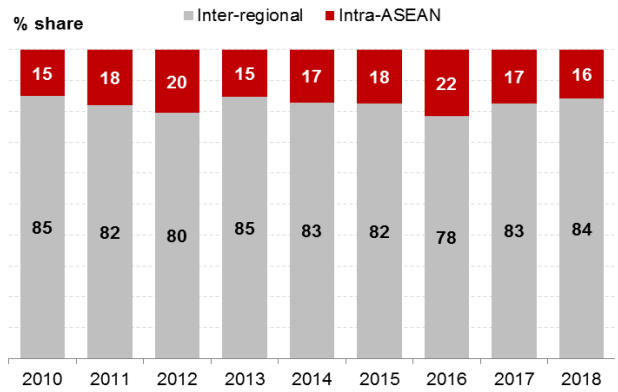
- In an era of relative low investment returns, rising trade barriers and geopolitical uncertainties, it is crucial for countries especially the developing economies to be able to attract FDI into sectors that can generate sustainable growth. This is essential in view of the uncertainty created by constant financial market volatility and disruption brought about by new technologies. Nevertheless, the ASEAN economies still have vast potential to attract FDIs. However, they stand unequal in terms of their ability to lure FDIs as each country has its own niche and appeal.
- **Overall, the inflow of FDI to the ASEAN region has continued to expand, albeit at a softer pace of 5.3% YoY, to an all-time high of USD154.7b in 2018 (2017: USD146.9b; 2010-2017 avg.: USD118.5b).** The growth was mainly underpinned by higher FDI inflow in Thailand (USD13.2b; 2017: USD8.0b) and Singapore (USD77.6b; 2017: USD75.7b). As observed over the years, **inter-regional investment activities remained the main propeller of FDI inflow**, accounting for 84% of overall FDI inflow in 2018, while intra-ASEAN activities sustained its share of 16%.
- **In the context of intra-ASEAN investment, Indonesia and Singapore were the main destination, absorbing as much as 48% and 14%, respectively.** The flows were predominantly sourced from Singapore, Thailand and Malaysia, collectively contributing to 88% of total intra-ASEAN FDI flows.
- On a destination basis**, Singapore accounted for the major chunk of the inflow into ASEAN (50%; 2010-2017 avg.: 52%),** followed by Indonesia (14%; 2010-2017 avg.: 14%) and Vietnam (10%; 2010-2017 avg.: 8%). The FDI was mainly sourced from Japan (14%; 2010-2017 avg.: 12%), followed by Singapore (11%; 2010-2017 avg.: 11%), mostly by multinational corporations (MNCs) that have made Singapore as their regional home base, and China (7%; 2010-2017 avg.: 6%). Of note, the United States' contribution waned significantly to 5%, compared to an average of 15% from 2010 to 2017, largely owing to the US President Donald Trump's wholesale tax reform, which had encouraged American firms to repatriate earnings from abroad.

Graph 1: ASEAN Net FDI Inflow



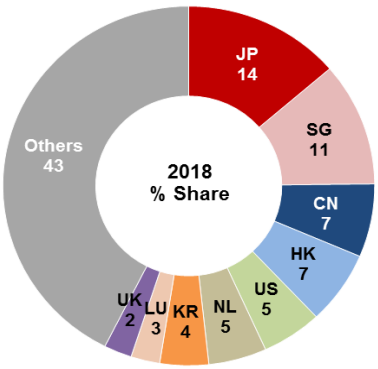
Source: ASEANStats

Graph 2: ASEAN Net FDI Inflow



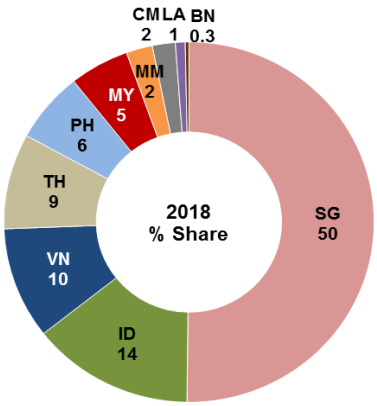
Source: ASEANStats

Graph 3: ASEAN Net FDI Inflow by Source



Source: ASEANStats

Graph 4: ASEAN Net FDI Inflow by Destination



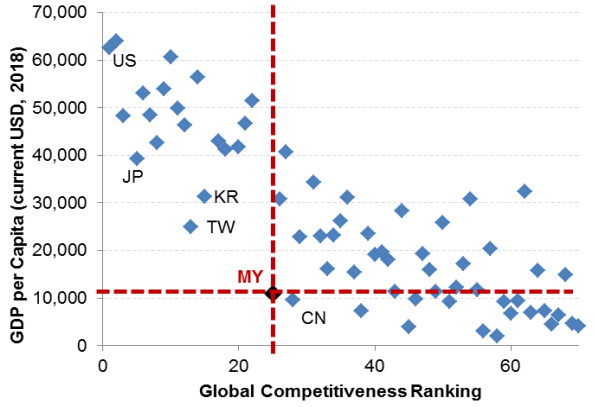
Source: ASEANStats

- **Concentration of FDI inflow in three countries, namely Singapore, Indonesia and Vietnam, has persisted over the years,** with the collective average share of 75% from 2010 to 2018. Analysing country-specific trend, we observed widening share of FDI inflow for Vietnam (7%→10%) and the Philippines (1%→6%), while some experienced a narrowing share relative to 2010 (i.e. Malaysia (8%→5%) and Thailand (14%→9%)). These pointed towards disparity in investment competitiveness amongst the ASEAN economies, with some countries catching up over the years while others gradually falling behind.

Malaysia's Investment Competitiveness - Issues and Challenges

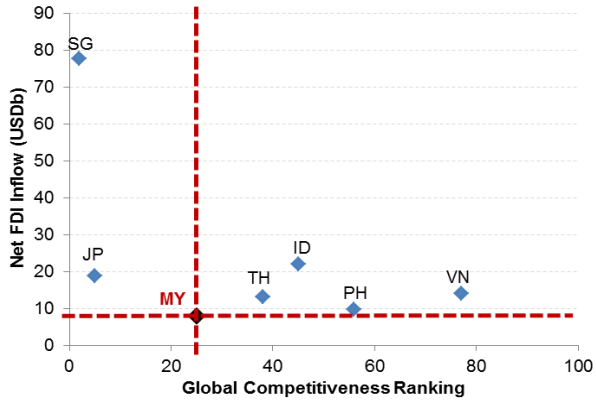
- **Zooming into Malaysia, ranking-wise, Malaysia outperforms regional and income-peers average,** coming in as the 25th most competitive country amongst 140 countries analysed by the World Economic Forum through its Global Competitiveness Report in 2019 (refer to Graph 7). However, looking deeper into the 12 pillars, Malaysia does face some alarming issues, such as relatively low ICT adoption and innovation capability (i.e: quality of research institution). These may exert greater hurdle in elevating and maintaining Malaysia's competitiveness, especially as the country embarks into the era of 4th Industrial Revolution.
- **However, Malaysia's high ranking does not jive with its income level and the amount of FDI it attracts.** After plotting countries' competitiveness ranking against their income level, Malaysia appears to be the odd one out, with its income level not on par with countries that also ranked within the top tier. Specifically, top-30 most competitive countries have an average GDP per capita of USD50,687, far exceeding Malaysia's USD10,942. The gap could potentially be explained by a variable that is missing or not factored into the ranking schema, necessitating us to interpret the rankings reported with a pinch of salt. Similarly, looking at net FDI inflows, there have been cases where countries with lower ranking somehow managed to sap more or the same amount of inflows relative to Malaysia. However, this trend does not hold true for other more advanced nations such as Japan and Singapore, in which their better rankings correlate with the amount of FDI they manage to attract.
- **The above facts reiterate our view that ranking shall not be the sole measure of a country's performance,** in fact it shall only act as guidance for policymakers to gauge the country's position in the global economy, and that focus shall be shifted towards realising the intended outcomes, which in this case is to garner greater foreign investment.

Graph 5: Income vs. Competitiveness Ranking



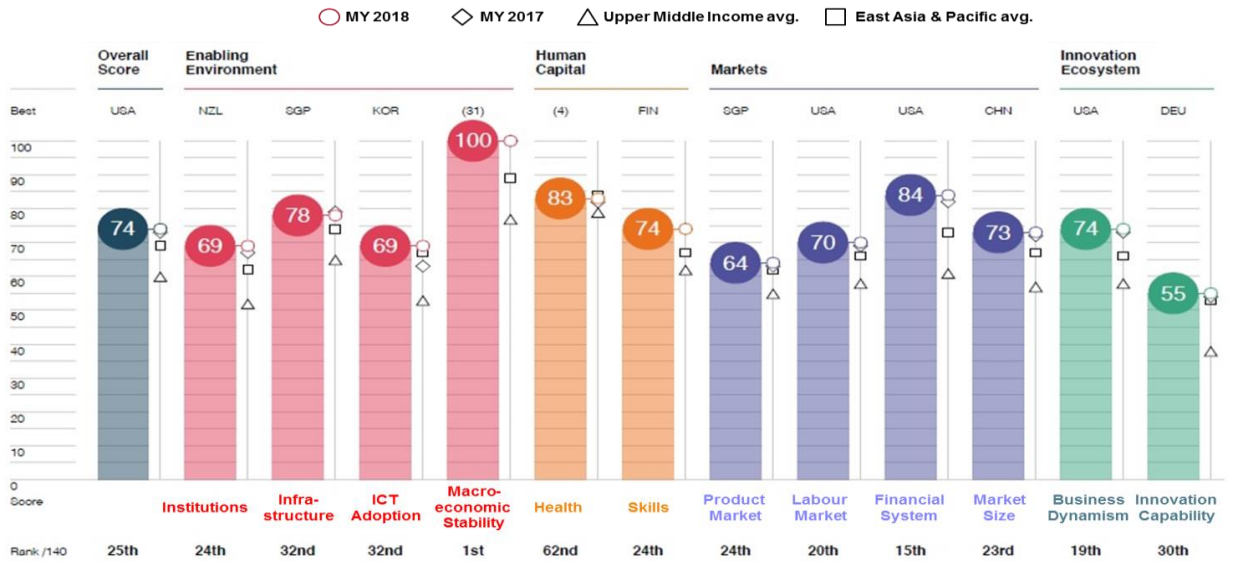
Source: IMF WEO, WEF, Kenanga Research

Graph 6: Net FDI Inflow vs. Comp. Ranking



Source: OECD, WEF, CEIC, Kenanga Research

Graph 7: The Global Competitiveness Report 2018

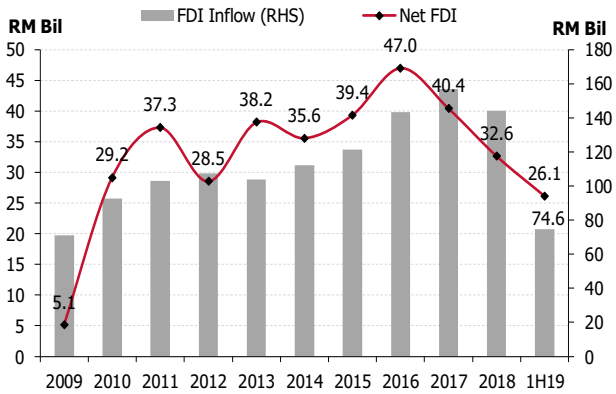


Source: World Economic Forum

Snapshot of Malaysia's FDI Performance and Outlook

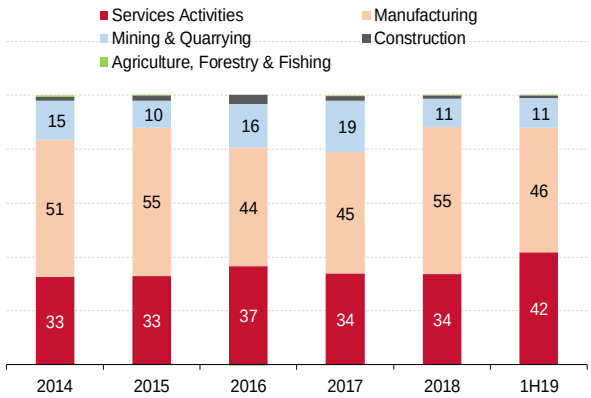
- As an open economy with high exposure to trade and investment, **Malaysia has enjoyed a robust expansion in terms of job creation and income growth.** Exports and FDIs have been the primary contributor to growth progressively transforming the manufacturing and services sector since the 1970s. Over the last ten years, Malaysia registered an average of RM33.3b of net FDI per annum, peaking at RM47.0b in 2016. Northeast Asia and Europe contributed more than 50% of the overall flow. It has been rising steadily after the Global Financial Crisis in 2008, though it has somewhat deteriorated for the past three years
- So far, net FDI flow has been promising, expanding by 68.9% YoY or RM26.1b in 1H19 versus -40.3% YoY (RM15.5b) in 1H18. At the rate it is gaining, total net FDI for 2019 could possibly outpace the RM32.6b registered in 2018. But 2018 wasn't a good year for FDI, it was the second straight year of contraction after the peak of 2016, falling sharply by 19.2% after a decline of 14.1% (RM40.4b) in 2017. The poor performance in the two previous years was largely due to lower investments in the mining and quarrying sector.
- **Manufacturing investment approvals seem to support a reasonably sustainable FDI growth outlook for 2019**. The latest data from Malaysian Investment Development Authority (MIDA) showed that approved FDI for all sectors rose 97.2% YoY to RM49.5b in 1H19, driven by a 275.6% jump in investments into the services industry totalling RM22.4b (1H18: RM9.5b). Meanwhile, approved manufacturing FDI jumped 64.8% to RM25.1b in 1H19 mainly coming from the US (RM11.7b), China (RM4.8b), Singapore (RM3.1b) and Japan (RM2.1b). Total approved FDI in

Graph 8: Malaysia's Net FDI Inflow (RM Bil)



Source: OECD, WEF, CEIC, Kenanga Research

Graph 9: Total FDI Inflow by Sector (% share)

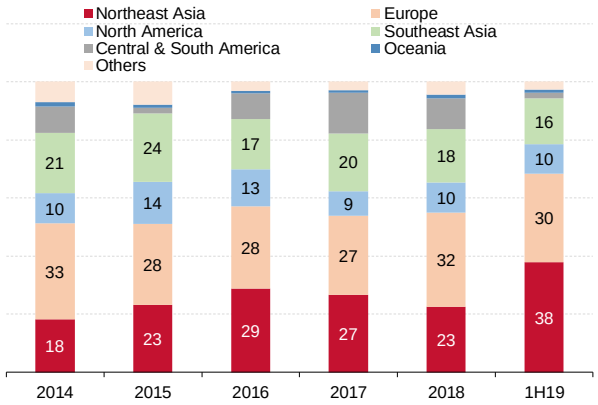


Source: OECD, WEF, CEIC, Kenanga Research

2018 has almost doubled to RM80.1b from RM54.4b in the preceding year. Of the total, FDI in the manufacturing sector accounted for 72.4% of approved investment, followed by the services (20.1%; 2017: 52.4) and primary sector (7.5%; 2017: 8.0%).

- **The increased approved FDI figures partly reflect efforts to divert production outlays as a result of the prolonged trade feud between the US and China.** Interestingly, some of the key approved projects belonged to US-based companies such as Advance Energy Industries, On Semiconductors, Plexus Manufacturing, Micron Technology and Jabil Circuit. According to MIDA, the 1H19 investments (including domestically approved investment) is expected to create more than 59,542 job opportunities, with a breakdown of 30,449 and 28,650 job opportunities in the manufacturing and services sector respectively.

Graph 10: Total FDI Inflow by Source (% share)



Source: OECD, WEF, CEIC, Kenanga Research

- If the uptrend continues, total approved FDI for this year could potentially exceed RM80.1b recorded in 2018, with the manufacturing sector remaining as the primary driver of FDI. This would potentially support private investments and FDI flows. Nonetheless, given the weak global trade and investment environment over the preceding two years we project total FDI inflow for 2019 to be in the region of RM120b-130b below 2018's level of RM144.2b. This is assuming that approved investments implementation timeframe is within 12-24 months. For 2020, with continued murky global outlook and prospect of a slowdown in the US economy, we expect total FDI inflow to remain below RM140.0b. Hence, the government has to come up with specific measures to ensure Malaysia would remain competitive in attracting high-value added investments over the coming years.
- It is also crucial to prepare the local SMEs to upgrade their know-how and capabilities to be ready to support the advanced industrial ecosystem so as to be able to integrate seamlessly in the global value chain. We expect this would be among the major focus in the upcoming Federal Budget and the 12th Malaysia Plan (12MP) as part of the effort to capitalise on the 4th Industrial Revolution.

Table 1: Projects Approved by Major Industry, 1H19 and 2018

Industry	No.		FDI (RM mil)	
	1H19	2018	1H19	2018
Electronics & Electrical Products	48	56	16,038	10,713
Paper, Printing & Publishing	23	30	4,663	4,987
Transport Equipment	25	61	823	692
Food Manufacturing	47	63	806	515
Chemical & Chemical Products	38	68	770	4,436
Plastic Products	38	61	291	1,182
Petroleum Products (incl.Petrochemicals)	7	23	92	19,085
Others	2,328	4,656	26,001	38,525
Total FDI	**2,554**	**5,018**	**49,484**	**80,134**

Source: MIDA

Factors Affecting Investment Decision

- As stated earlier, some countries have built up their investment competitiveness, catching up fast with the rest of their regional counterparts and luring an increasing share of the investment flow into ASEAN. These countries, such as Vietnam, tend to be at the earlier phase of the economic development ladder. To decipher this situation, it is imperative to highlight several key factors that could have influenced investors' decisions.

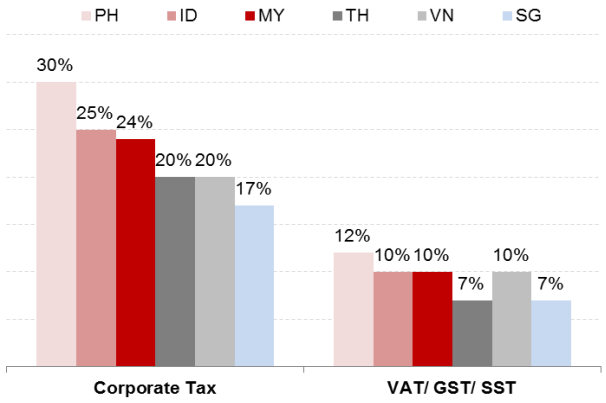
- Cost-wise, Vietnam is able to provide cheaper labour, with an average monthly earning of USD230m, over 60% lower than Malaysia's, made possible by the size of its population that is three times larger compared to Malaysia. Its corporate tax rate of 20% is also at the cheaper side, on par with Thailand, but still above Singapore's 17%. However, with the onset of technological advancement and industrial revolution, we view that cost-related factors are becoming less important. This correlates with findings from a survey conducted by the World Bank on 754 executives of multinational corporations with investments in developing countries, which suggest that **cost-related factors, including low tax rates and low cost of labour have fallen towards the lower-end of top-10 factors when deciding where to invest. Instead, other FDI enablers such as political stability and security, legal and regulatory environment and talent and skill availability are valued more by investors.**
- With regards to political stability, we opine that it is integral in sustaining investor's confidence, by ensuring long term policy continuity and commitment in revitalising and improving the investment climate, emitting a welcoming vibe to foreign investors. One of the effective means of portraying this is by actively pursuing free trade agreements, seeking windows of opportunity to further integrate the country into the global arena, advancing connectivity and reducing the barriers to investment and trade amongst economies. In this case, Vietnam has recently progressed further by ratifying the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) and the EU-Vietnam Free Trade Agreement (EVFTA). Meanwhile, Malaysia is enduring a period of slight political instability, evidenced by its short-term policy risk index of 72.5, lower than Vietnam's. Partly, this was a result of the recent shift in government, which was ensued by a period of vagueness on Malaysia's openness to foreign investment as well as its long-term policy direction.
- Another aspect for consideration is the quality of human capital that a country could offer to the investors. While it would be a tad difficult for Malaysia to compete on the basis of cheap labour, Malaysia could instead offer a productive, skilled workforce, in addition to its golden population structure, of which almost 70% of the population are of working-age. However, though Malaysia's productivity growth has been encouraging, growing by 2.8% YoY in 2018, exceeding other developed countries such as Singapore (2.2%), South Korea (2.0%) and Japan (0.4%), in terms of output per worker, Malaysia is still lagging behind. Amongst the issues at hand is the mismatch between the skills produced by our local education system versus the skills needed by the foreign firms to operate efficiently. Without proper targeting of sectors to attract FDI and continuous streamlining between the investors and educational bodies, this problem could pose greater challenge ahead.

Table 2: Labour Indicators

Population	**96.5m**	**32.0m**	**51.2m**	**5.8m**
Working-age population (aged 15-64)	**68.9%**	**69.4%**	**71.7%**	**74.3%**
Tertiary-educated adults (aged 25-64)	**11.7%**	**22.1%**	**38.8%**	**37.0%**
Avg. monthly earnings	**$230**	**$595**	**$2,956**	**$3,609**
Output per worker	**$3,312**	**$25,223**	**$51,521**	**$98,426**

Source: ILOSTAT, UN World Population Prospects 2019

Graph 11: Tax Rates



Source: PWC, Kenanga Research

Table 3: Political Risk Index 2019

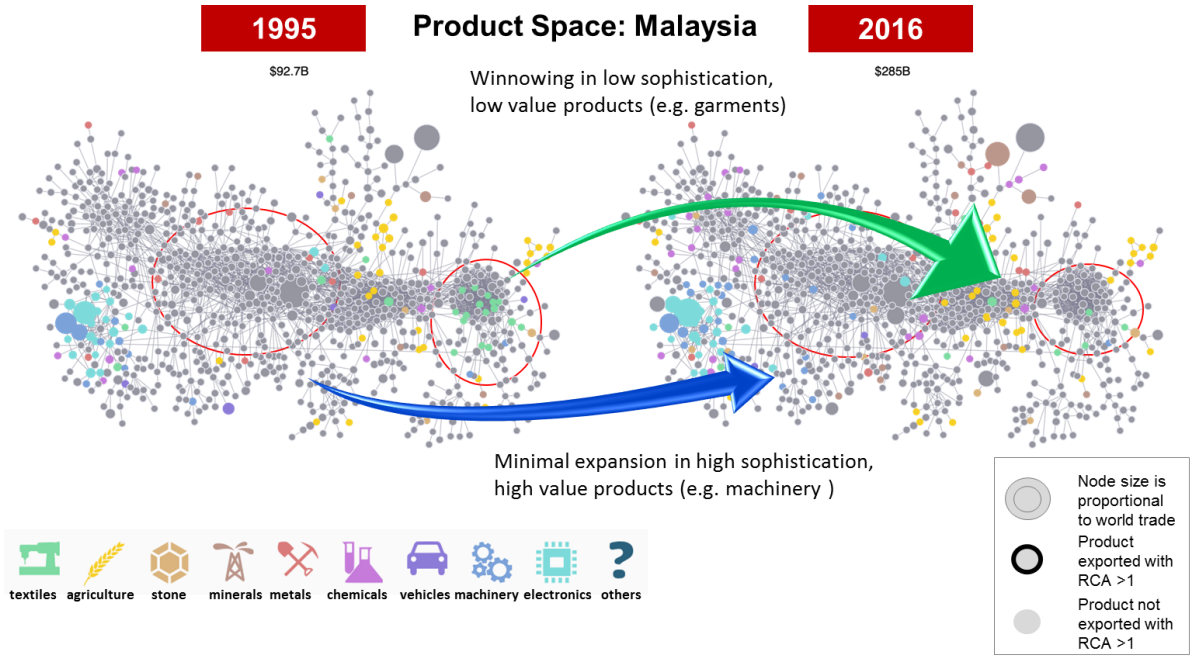
	Long Term	Short Term
SG	81.1	94.8
VN	59.7	82.5
MY	65.2	72.5
ID	63.2	70.6
TH	58.9	70.2

Source: Fitch Solutions

Key Priorities Ahead

- For policymakers, enhancing political stability and policy clarity should be its overarching goal going forward, as they act as integral base of a conducive investment environment. In addition, as Malaysia targets high-quality and high-value added investments, competing on a "cheaper cost" basis should no longer be part of the main strategy. Instead, resources would be better directed into enriching Malaysia's FDI enablers, such as by developing industry clusters and by ensuring the skills and talents produced locally match with those demanded by businesses.
- Last but not least, we would like to highlight the concept of "product space", an **insightful tool which could be utilised by policymakers in identifying sector that holds the greatest productive value for Malaysia, and which should be targeted for when crafting the investment attraction strategies.** This concept was pioneered by Professor Ricardo Haussman, a professor of economic development at Harvard University. The product space depicts the connectedness between products, based on similarities of knowledge or skills required to produce the product. Each product (categorised using HS code) is represented by a node, which is then sized according to the product's share of global trade. Products that are located in a dense space provide wider range of potential product diversification. The coloured nodes (i.e. not grey) are products which an economy has a revealed comparative advantage in, whereby its share of global exports of a certain product is larger than what would be expected from the size of its economy and from the size of the global market.
- **Looking at Malaysia's product space over two time horizon (i.e. 1995 vs. 2016),** we can deduce that while we have been shifting away from low sophistication and low value products such as garments, there has been a relatively minimal expansion in production of high sophistications and high value products, in particular those products that are located at the core of the product space (e.g. motor vehicles parts), with more connected nodes. These represent a huge untapped opportunity for Malaysia to direct their investment into. **Thus, the next step for policymakers is to direct their attention on developing comparative advantage in a dense product space, by tailoring the policy and ecosystem of the targeted industries, to ensure ease of production diversification and sustainability of investment flows.**

Graph 12: Malaysia's Product Space (1995 vs. 2016)



Source: Atlas of Economic Complexity, Harvard

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For further information, please contact:

Wan Suhaimie Wan Mohd Saidie
Head of Economic Research
wansuhaimi@kenanga.com.my

Atiqa Noor Azlan
Economist
atiqa.noorazlan@kenanga.com.my

Muhammad Saifuddin Sapuan
Economist
saifuddin.sapuan@kenanga.com.my

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KENANGA INVESTMENT BANK BERHAD (15678-H)
Level 17, Kenanga Tower, 237, Jalan Tun Razak, 50400 Kuala Lumpur, Malaysia
Telephone: (603) 2172 0880 Website: www.kenanga.com.my E-mail: research@kenanga.com.my