CHAPTER 2

LITERATURE REVIEW ,OBJECTIVE STATEMENTS AND RESEARCH METHODOLOGY

In this chapter, we started by exploring the available literature which had been written on the topic of the impact of foreign owned firms which are sometimes known as multinational enterprises (MNEs) on the host country. In particular, the spillover effects are discussed with experiences gained from all over the world. Much had been written on this subject and we attempt to draw out the two salient questions relevant to this research. The research objective statements and the research methodology will also be discussed here.

2.1 Foreign Direct Investment (FDI) Overview

The rapid growth of foreign companies has aroused much interest for the simple reason that quite a large number of parties are affected when a firm invests in another country via foreign direct investments.

Besides the host country government, the other parties affected by the foreign direct investors include the suppliers, the customers and the competitors. Further to that there are the indirect parties like the surrounding population society in general, non-governmental organisation and so on.

On the other side of the fence, the home country would also be affected by any movement of foreign funds invested in another country.

According to Daniels and Radebaugh (1992), the impact is so great that there has been even pressure groups in both home and host countries that have pushed their governments to implement policies restricting the movement of multinational firms or the latter' plans to have foreign direct investment. It was stated that the main criticism is that the MNEs are inadequately concerned about the national societal interests because of their global bases of operations. Furthermore the sheer size of many MNEs concerns the countries with which they come in contact. For example, in a study done on company data by Wall Street Journal in 1988, the sales of General Motors, Exxon and Mitsubishi exceed the GNP of such medium-sized economies as Argentina, Indonesia, Poland and South Africa.

Many types of impact have been traced as far as foreign investors are concerned but Dunning (1993) has highlighted the following important issues pertaining to this :

1) What are the nature of linkages which affiliates of multinational enterprises (MNEs) forge with the local firms, and to what extent and under what conditions are likely to be socially beneficial?

2) What are the effects of FDI on the competitiveness of indigenous resources and institutions in the host country - particularly on the sectors or industrial clusters in which they are involved?

3) What are the implications of the globalization of production for the international division of labour and , through that, on the structure of economic activity in which MNEs operate? In particular, what is the nature of interaction between the regional and global integration of corporations and that of countries?

4) What are the consequences of MNE activities on the budget of the national exchequers? On one hand, by taxes that they pay, they provide revenue but on the other hand, they receive benefits from the government (e.g. tax free holidays, investment incentives). It is also possible that by manipulating cross border internalised prices, they may add to or subtract from the sales or corporation taxes they provide to governments.

5) What are some of the more important non-economic consequences of MNE activity, in particular, those that impinge on the environment , on the strategic well-being and on the political sovereignty of home and host countries?

2.2 Do MNEs import or procure locally their major inputs?

Dunning(1993) observed that a foreign-owned affiliate would procure its intermediate products from the cheapest and most reliable source if left to its own devices. Also, in the case of imports, additional costs exist in the form of longer delivery schedules , higher transport, inventory costs, increased search, negotiating and monitoring costs and the possibility of supply disruptions from shipping delays and dock strikes, etc. Some costs may be reduced by the parent company (or sister affiliates) internalizing cross-border markets but other risks like disruptions to supply flows brought about by exogenous events will remain. There is also the possibility that the parent company may control purchases centrally for advantages like uniformity, bulk purchase economies or for transfer price manipulation. According to Jenkins (1987b), there are many reasons as to why the parent company should wish to buy inputs for its affiliates.

Other factors determining the proportion of imported intermediate products will be the sourcing strategy of the FDI company, the product's marketing performance and the age of the affiliate. In general, most market-seeking FDI begins with the newly established affiliates undertaking simple finishing operations and importing most of their intermediate upstream products. Gradually, as and when the indigenous technological and productive capacity improve and prices offered are more competitive, the local content ratio will increase. This findings were confirmed in a research done by Williamson (1986) and a separate study done by JETRO in 1989 on Japanese car motor industry FDI in Europe. Another important observation is that when manufacturing affiliates are established to undertake labour-intensive operations of high technological products, it is highly likely that imports are carried out from their parent companies or sister affiliates. By contrast, in large industrialised economies, MNEs may be fully integrated into the national value-added chain whereby intermediate products are sourced domestically.

This has resulted in the setting up of protectionistic policies by governments of developing countries . In Malaysia (as in other developing countries), import restrictions are imposed except where it could be shown that these could not be produced locally. While raising the local content ratio, this policy may increase costs of production especially where domestic firms are protected from external competition. An example of this is the case of the Malaysian government in protecting the Titan Polypropylene and Polyethylene company from external competition by allowing the latter to control competition by authorising them to issue No-Objection-Letters to companies wanting to import the two plastic materials.

Dunning (1993) argued that sometimes protectionism does not help infant industries and he gave examples of certain cases in Japan, Taiwan and Korea.

2.3 Do MNEs buy more or less than indigenous firms from local suppliers?

Dunning found that the purchasing trends of FDIs depended on whether the products manufactured are for local market (market-seeking) or for export market. As such two sub-sections are presented here to highlight the differences.

2.3.1 Market seeking MNE affiliates context

Numerous studies had been done on this issue in the context of market-seeking MNE affiliates context and in one of the earliest investigations undertaken by Lall(1980/1981) for the UNCTC, it was found that for the auto industry in India, ownership of companies was not considered the important determinant of "import or buy locally" decision.
In another related study by Landi (1985), the finding was that the foreign affiliates were more integrated and had a higher propensity to import their intermediate products than their indigenous counterparts. The same conclusion was reached by McAleese and McDonald (1978) and Jo(1980) in their evaluations of the import propensities of foreign affiliates in Ireland and South Korea. But it was noted that the extent of difference varied between sectors and according to the age, experience and size of the foreign affiliates. A survey done by Halbach (1988) indicated that the amount of subcontracting (a form of local sourcing) depended on two factors :

Firstly, the level of indigenous technology and local labour expertise and secondly, the host government strategies pursued. Another interesting observation was that Asian subsidiaries showed greatest propensity to subcontract locally.

Four main conclusions can be drawn from the numerous data as mentioned by Dunning:

1) MNE affiliates find difficulty in establishing linkages in less developed countries mainly due to the lack of adequate subcontracting infrastructure.

2) The percentage of local sourcing by MNE affiliates is positively correlated both to the sophistication of industrial infrastructure of host country and the length of time that affiliates have been operating.

3) In advanced developed economies, MNE affiliates have often forged substantial linkages - but usually as a result of government import restrictions and imposition of local content requirements.

4) As a result of such government policies, the linkages established have often been excessively costly and uneconomic (Little et al, 1970).

2.3.2 Export -oriented manufacturing affiliates context

This second group of studies can be said to be more related to this study because the foam plastic manufactured are supplied mainly to the electronics industry which is mainly export-oriented.

Early findings by Reuber et al (1973) revealed that the backward linkages formed by foreign investors in export-oriented sectors were far fewer than in the case of import-substituting affiliates.

In a study on consumer electronics industry in South East Asia Lim and Pang (1982) found that these linkages were non-existent in Malaysia and minimal in Singapore. But another survey done in 1991 by the same researchers found a the higher rate of local sourcing in Singapore. They had also found that the development of local suppliers in South East Asia owes much to the encouragement and patronage of the MNEs themselves, who find it in their long-term interests to foster a strong indigenous capability. Cohen (1975) also found this to be the case of MNE affiliates in Taiwan, Singapore and South Korea.

Similarly, in a study conducted by MIDA (quoted in Narayanan et. al 1989:11) in 1983, it was found that the average local content for the semiconductor industry was only 1%, for the other electronic components industry was 11% and for consumer electronics was 23% in Malaysia.

According to an updated study conducted by Nazari (1994), the percentage of local content amongst foreign consumer electronics manufacturer was only 12.6% which was lower than the figure quoted by MIDA in 1983. The main cause for this reduction was that the local suppliers had not been able to keep up with the demand for component inputs required by the foreign firms. It was noted that in absolute terms, the amount of components supplied by the local sources had increased but as far as percentage is concern, there was a decrease.

In the case of component electronics , there was an increase over 1983 in that 14.2% inputs were sourced locally and this constituted an increase of 3.2%. The main contributing factor for this was probably the increase in the supporting industry which grew dramatically to serve the increase in demand.

To summarise, we can see that part of the unwillingness of MNEs to establish linkages arises from the perceived inadequacy of local markets or the technological and educational infrastructure, as well as the inability of local suppliers to meet the expectations required of them However, it was noted that much depends on the type of inward investment and whether the international or domestic markets are served with the final product. . Moreover, in some cases, the ability of affiliates to use local suppliers rests mainly on the design requirements of the final product, which is usually paternally controlled. The result is that at varying levels, many countries are worried about the lost of spill-over benefits supposedly to come with the FDIs.

Hence, through this research, we hope to compare to see whether there are any positive effects of spill-over in the case of the foam plastic industry.

2.4 Statements of research objectives

From the non-exhaustive list of issues mentioned above, one can imagine the vast impact of MNEs on both the home and host economies.

This research aims to look into the following two issues in detail:

a) The linkages between foreign joint ventures and local suppliers, b) Are the indigenous suppliers competitive in their supply to the foreign joint ventures in Malaysia.

From the two issues mentioned , we can further examine two constructive and measurable dimensions which constitute our research objective statements and these are :

a) Do foreign owned firms import or procure locally their major inputs to production?

b) Do foreign owned firms buy more or less than indigenous firms from local suppliers?

This research would concentrate on the related procurement characteristics of the foam plastic industry within the Klang Valley. By the end of this research we shall compare to see if we can supplement the findings of the literature review.

2.5 Methodology

Due to the small sample size of the foam plastic manufacturers' population, it was decided that more depth would be carried out rather than breadth

Depth was achieved by having personal interviews with the Executive Management of the foam plastic manufacturing companies. The interviews included face-to-face discussions with two Managing Directors and three General Managers and duration of interview varied from half an hour to one and a half hour. Questions that were raised during the interview included the following:

1) What is the weightage of each purchased input in Ringgit Malaysia (RM) of the three major sources procured : EPS raw material, Plant and Machineries and Moulds.

2) For each input, what was the percentage of local purchase compared to imports for the year 1994?

A lot of time was spent on discussions as to why the materials was purchased in the way as reported. Through these discussions, a clearer picture can be drawn on the present purchasing trends within the foam plastic industry.

All in all, 5 companies were interviewed within the Klang Valley and these includes 3 joint-ventures and 2 wholly local-owned companies.

Due to overwhelming requests from the respondents, the findings were lumped together and presented as two groups : Joint-venture group and Local group. The main reason is that the foam plastic industry is a small one and if any individual results would be presented, the identity of the respondent company would be revealed. The companies participating in this research feared that the competitors would know their strengths and weaknesses if individual procurement information would to be presented in this report.

Nevertheless, the 5 companies chosen constituted the top 5 earners (accounting for more than 80% of sales) in terms of revenue amongst the population of 9 companies within the Klang Valley for the year 1994. In other words, the findings of this report would reflect substantially whether the joint-ventures among the foam plastic manufacturers would purchase their inputs locally or imported and how they fare vis-a-vis their indigenous counterparts.