CHAPTER 1
INTRODUCTION

1.1 Background

External resource can play a critical role in economic development. The early literature (e.g. Chenery and Bruno, 1962) on foreign capital noted the role that foreign resources may play in meeting the shortfall in domestic savings and relaxing the constraint on imports of raw materials and capital goods. External resource inflows can take several forms, such as aids, grants, borrowings and direct investments. Aids and grants are the main components of official sources of external finance and direct investment is the predominant form of private resource flows.

Malaysia had always been a favoured destination for foreign investors. The large extent of foreign involvement especially in the manufacturing sector of the economy has been an important explanation of Malaysia's open economy. There appears to exist a close link between the trade in manufactures and foreign investment activities in the economy. Thus, to a certain extent Malaysia's continuous strong growth phenomenon is linked to the pattern of foreign investment.

1.2 Definitions

Foreign direct investment (FDI) can be defined as investment in which the investor exercises effective control over the operation of a related affiliate or subsidiary in the host country. It is seen as a potential provider of resources – capital as well as technology, entrepreneurship, management and marketing expertise which is normally lacking in the host country, particularly amongst developing countries (Carr, 1978).

Other definition of FDI include:

> "any investment that is made with the intention of acquiring a lasting interest in an enterprise operating in an economy other than that of the investor. The investor's purpose to take this investment is to secure an effective voice in the operation and management of the enterprise".
>
> (Ariff, 1991)

IMF further interprets:

> "When foreign ownership is in the hands of one investor or a group of associates, the percentage chosen as providing evidence of direct investment is quite low – ranging from 25 per cent down to 10 percent".

Foreign investment in Malaysia comprises both direct and portfolio components. Foreign direct investment (FDI) may further be categorized into (a) joint ventures, (b) wholly foreign owned projects, and (c) turnkey operations. The bulk of FDI was formed by joint ventures, although the number of wholly foreign-owned enterprises grew sharply in the late 1980s. There are only a few turnkey projects in Malaysia. Portfolio foreign investment (PFI) has also been playing an increasingly significant role in the Malaysian economy (Ariff, 1991).

Many Japanese firms in Malaysia have shown a great preference for joint ventures in which they have equity ownership even as low as 10 per cent. The small share in equity may be due to the fact that these Japanese firms are established to merely function as a provider of technical and management assistance. Hence, large percentage ownership may not seem to benefit the Japanese investors (Woon, 1990).

Manufacturing is defined as the mechanical or chemical transformation of inorganic or organic substances into new products, whether the work is performed by power driven machines or by hand, whether it is done in the factory or in the workers' homes, and whether the products are sold at wholesale or retail. The assembly of the component parts of manufacturized products is considered as manufacturing except in cases where the activities are appropriately classified under construction (MIDA, 1997).

According to the International Standard Industrial Classification of Economic Activities (1958), outlined by the United Nations under ISIC code (15-37), manufacturing covers all activities involving the mechanical or chemical transformation of organic or inorganic substances into new products, and those involving the assembly of component parts of manufactured products and other repair work (United Nations, 1987).

1.3 Importance of Japanese Direct Investment

The external linkages established by direct investments are much stronger and more lasting. As said earlier, these external resources play an important part in economic development. In Malaysia, FDI has contributed significantly to the economic development of the country not only in terms of structural changes that has transformed Malaysia from basically a primary producer to an industrialising economy. Indeed FDI had delivered the necessary tools for rapid industrialisation such as capital, technology, marketing channels and managerial inputs (Ariff, 1992).

It is thus clear that foreign investment is playing an increasingly important role in the Malaysian economy. During the pre-independence period, foreign investment inflow to Malaysia has been dominated by countries such as United Kingdom, the United States and to a smaller extent, the European Economic Community (EEC). The inflow from United Kingdom is attributed to its historical-political ties with Malaysia. A large number of British investments were concentrated on the opening of new areas for modern economic activities and the development of natural resources. Thus, most of the FDIs appeared to be concentrated in extractive industries, involving agricultural production and export oriented minerals. Meanwhile, American investments in Malaysia were as a result of trade relationships between the two countries.

However, since the seventies, there were evidence on the degeneration of the West as the major source of FDI in Malaysia. Instead FDI in Malaysia were dominated by investors from the Asia-Pacific region. Of course not all Asia-Pacific countries are of equal importance as a source of FDI for Malaysia. Japan, the Asian NIEs (newly industrialized economies) and the United States being the more important ones. Japan heads as the most important source of foreign investment for Malaysia. Japanese investors had actually accelerated their investment ventures sharply since the beginning of the 1970s. In fact, the preponderance of JDI in Malaysia in the 1970s can be compared to that of the United States in Latin America during early years of this century.

Japanese investors had accelerated their investment ventures sharply since the beginning of the 1970s with the comparative decrease in the number of British investors in Malaysia. A major contributory factor was the gradual appreciation of the Japanese yen against US dollar. When the yen appreciated, many Japanese investors found it profitable to relocate just part of their production process abroad in order to reduce production cost. The increase in the yen had actually reduced Japan's competitiveness in the world market. So the relocation of production to countries with lower cost of production was perceived as an effective measure to avoid the loss of it's share in the market and also to maintain price competitiveness.

In 1985, the Group of Five industrial nations agreed to refrain from propping up the US dollar against the Japanese yen (Plaza Accord). The Japanese interest rates were allowed to sink to historic lows, and the Japanese yen exploded over a three-year period. This appreciation of the yen has continued to be the stimulant for further outflow of JDI overseas. In 1989, Malaysia ranked second only to Thailand as Japan's favoured overseas investment venue in South East Asia. Japan has long been the leading source of FDI for Malaysia, although Taiwan has displaced Japan as the most important investor in the country in the early nineties. Nonetheless, it is remarkable that Japan's contribution still remains significant.

JDI was mainly in the industrial sector, with little attention given to other segments of the economy, such as mining, construction and agriculture. In fact in Malaysia, Japanese investors had shown little interest in agricultural production. Thus, there was a massive expansion of Japanese firms in the manufacturing sector. In Hirono's (1972) words, the impetus of this investment expansion was to secure overseas market, to improve supply of services to foreign customers through regional affiliates and to secure the supply of raw materials to Japan.

1.4 Scope of Study

Foreign investment in Malaysia comprises both direct and portfolio components. Portfolio foreign investment, which involves investments in equity and debt securities, has also been playing an increasingly significant role in the Malaysian economy. However, it is the direct investment component that is far more important and interesting in terms of not only volume but also impact. For the purpose of this study, the type of Japanese investment that would be covered is only direct investment in the manufacturing sector.

The study will attempt to cover JDI in Malaysian manufacturing sector since pre-Independence period till the current time. However more emphasis will be given on findings from the late eighties to the current period.

1.5 Objectives

The objectives of the study are:

- To examine the characteristics of JDI in Malaysia.
- To explore the role played by JDI in national development.
- To briefly review the investment environment provided by the government which is relevant in attracting foreign investors.
- To examine the extent of the technology that is actually transferred to the Malaysian manufacturing sector.

1.6 Methodology

In order to achieve the research objectives outlined above, secondary data will be used. Both published and unpublished secondary data will be used. The study will attempt to examine the structure of Japanese manufacturing investments and its role in national development. The secondary data will be obtained from published materials from various library. In addition other sources of data would be from various government agencies. Among those, which were useful, are MIDA and MITI. The data from these sources are more useful as they are updated frequently and closely linked with the Japanese investment. The general features of the JDI in Malaysia are examined by using the data from various organizations, such as Japanese External Trade Organization (JETRO) and Japanese Chamber of Trade and Industry, Malaysia (JACTIM).

1.7 Chapter Outline

The study begins with an introductory chapter on the background, objectives and scope of study. A brief definition regarding FDI is also mentioned in this chapter. In order to provide a theoretical base for FDI, Chapter 2 will discuss the mainstream of the literature on FDI theories. It will be followed by Japanese economists' research on FDI. The chapter would also be highlighting literatures pertaining to FDI in Malaysia. This would be concluded by literature reviews on JDI in Malaysia.

The following chapter will present an overview of the entire Malaysian economy over the period from pre-Independence until current time. Discussions will be based on brief perspectives on key macroeconomic indicators to review past and present trends of Malaysian economy. Chapter 3 would also touch on general characteristics of JDI in the Malaysian manufacturing sector to provide a fundamental understanding of the environment in which JDI operates. Among the variables that would be discussed include motivation of Japanese firms, incentives, location, sectoral allocation and equity structure. Equal emphasis will also be placed on the development of investments in Malaysian manufacturing sector, in which the involvement of the Japanese is highlighted.

In Chapter 4, the discussion would focus on the role played by JDI itself. This is aimed at substantiating claims propounded towards the presence of JDI's influence in Malaysia. Among the various variables touched on would be the adoption of Japanese type management, employment, training and subcontracting and linkages.

Following this, the issues on technology transfer will be discussed in chapter 5. The appropriateness and suitability of the technology that has been transferred to date will be highlighted and evaluated in terms of their effectiveness in gearing the domestic manufacturing industries towards international standards. This is of utmost importance because of the continuous expansion of capital intensive industries, where as a labour intensive or at least an intermediate technology would be more pertinent.

Chapter 6 will attempt to outline JDI's prospect in gearing Malaysia to achieve industrialisation and vision 2020. This would be followed by conclusion, where the findings of the study will be summarised and a general policy framework, which will serve as a guide to maximise the contribution of JDI towards national development will be outlined.