

CHAPTER 2

LITERATURE REVIEW

2.1 Introduction

In accordance with the increase in the international flow of investment, researchers started to pay more attention to FDI. This had led to more literature on FDI in Malaysia. Basically western economist had played an important role in introducing and developing the theory of FDI. These economists were mainly interested in determinants or economic significance of FDI, especially of FDI by the MNCs. Some attempts to modify the theories on FDI or to introduce new elements to it were made by Japanese economists. This chapter will review FDI together with MNCs followed by the mainstream of the literature on FDI. Some emphasis will be paid on FDI research by Japanese economists, particularly, JDI in Malaysia.

2.2 FDI Theories

Among the earliest literature on FDI was by Schumpeter (1939) who attributed the existence of internationally related business to the development of transportation and telecommunication. In his words,

"Such a process as the railroadization or the electrification of the world transcends the boundaries of individual countries in such a way as to be more truly described as a worldwide process than as the sum of distinct national ones".

Following this, the modern theory of international capital movement by neo-Classical economists, Heckscher (1950) and subsequently by Ohlin (1956) and Samuelson (1968) consider that international movement of capital in and out of countries occurs in response to the interest rate differential. They believed that interest rate would be decided by the difference in the factor endowment and capital moves from low interest rate to high interest rate countries. Under the perfect international capital market, there would be one

Some economists have examined the MNCs and discovered their peculiar characteristics. For example Horst (1972) argued that the firms that have a well-established brand name and other forms of product differentiation tend to invest abroad on a bigger scale. Gray (1972) conducted a research on the MNCs in Canada and concluded that these MNCs were research intensive and produced differentiated products. Dunning (1973) investigated the US firms operating in UK and discovered that the US firms were concentrated in the export oriented industries and were technologically more advanced than the UK firms. These empirical findings have conclusions similar to that of Horst's findings.

Vernon (1966) introduced the new and comprehensive theory of FDI, **the product life cycle model**. He explains the behaviour of FDI using the concept of "stage of production life cycle". Vernon divides the production's life cycle into three stages. In the first stage, technology is still unstable and sales are only to the domestic market. In the next stage, the technology stabilizes and production increases, export increases as well and competitors begin to produce similar type of products. In this stage, the aim is to defend the export market against tariff barriers. Many such firms relocate their production base to the countries with low labour cost. In the third, and final stage of the production life cycle, technology becomes standardized and there appears the need to relocate production base to low cost countries. This theory can help us understand the behaviour of FDI and gives a good explanation of various features of FDI. It also provides an adequate explanation of the character of FDI in Malaysia.

Knickerbocker (1973) wrote about the **bandwagon** character of FDI. He stated that if some firms invested abroad, the rival firms will also follow suit in order to protect their markets. It is important for a firm to maintain its markets, because if the market is protected from the competitors, a firm can enjoy a bigger scale of production and larger sales. This point of view can be applied to the foreign firms in Malaysia, especially to the electronics/electrical companies. The bandwagon theory explains why all leading Japanese semi-conductor firms invested in Malaysia.

Rugman (1979) introduced the **risk diversification theory**. He said that MNCs started to invest abroad because of the risk diversification. He further explained that if the sales were solely for the domestic market, the firms would be vulnerable to the economic situation in their country. To avoid this risk, MNCs invest abroad. This theory explains one of the reasons why companies invest abroad, but it seems to be generally insufficient.

Some economists have investigated the relationship between location and activities of firms. Two pioneer theoreticians of the economics of location are Weber (1929) and Losch (1954). According to Weber, the firm's decisions on location usually relate to costs, such as production costs or transportation costs. The best location for a firm is a place where it can operate with minimum cost. Meanwhile Losch said that the distribution of market or rival companies affected the locational decision of firms. He concludes that the best location for a firm is a place where it has monopolistic control of the market. It seems that Weber's theory can be applied to the situation with FDI in Malaysia as well. Losch's theory can be applied to horizontal investment, but not to Malaysia, where investment is mainly vertical.

According to Dunning (1970) it is reasonable to assume that the firm will invest abroad as long as the marginal rate of return is greater than that could be earned elsewhere (allowing for differences in risk). In other words, it means that as long as there are inherent benefits in terms of cost or market access, MNCs will produce in other countries. Otherwise they would opt to export from their own country.

Both the MNCs and the host countries are able to derive inherent benefits from the flow of FDI. The expansion of FDI is having a very substantial impact both on patterns of economic growth of individual business enterprises and on national economies of investing and recipient countries. The MNCs and investing economies stand to gain higher returns for their investments resulting in improved revenue generation, whereas for local enterprises and recipient countries, it brings access to new technology,

management know-how, employment generation and overall economic development.

Consequently, the most dominant approach within the FDI theories are the internalization approach (Dunning 1981, Rugman 1981). The eclectic paradigm suggested by Dunning (1981), proposes that FDI is undertaken by firms possessing specific advantages like technological, marketing, production or R&D skills, which are not possessed by other firms. He went further to add that, MNCs normally tend to take advantage of the markets by exploiting the imperfections in the external markets themselves rather than sell or lease them. This means that MNCs internalize the use of their specific advantages, which may lead to overseas production or FDI. We have to admit that the both the MNCs and host nations gain from this internalization. Host countries benefit as they acquire technology, know-how and assets. In return, the firms gain by getting access to cheap labour, market and other forms of investment incentives.

2.3 JDI Theories

Yoshihara (1978) in his studies on the Japanese Direct Investment (JDI) in the South East Asia region has emphasized comparative advantage as the main determinant of JDI. The development of JDI could be explained by the changing of comparative advantage and other determinants, such as a revaluation of the Japanese Yen and various incentives. He used a historical approach to analyze JDI and applied the *push factors* and *pull factors* theory to explain FDI.

Push factors are factors that caused Japanese firms to invest abroad. Yoshihara explained that Japan was in need of raw materials and export markets. However, the Japanese Government was against Japanese companies investing abroad. But all this changed after 1965, when Japan's balance of payment ran into surpluses, the Japanese Government considered the need for the constant supply of natural materials, especially oil, and abolished the regulations on FDI for Japanese companies. In addition, in the

1970s Japan's comparative advantage started to shift due to the increase in wages of Japanese workers. This in fact, forced the Japanese companies to invest more heavily abroad. Meanwhile, the *pull factors* are factors that attracted the Japanese firms to invest in ASEAN. ASEAN countries with relatively low cost of labour and abundant natural resources is an attractive destination for JDI (Yoshihara, 1978).

Another Japanese economist, Ozawa (1979) seems to agree with Yoshihara. According to him, in the end of 1960s Japan faced a shortage of land and natural resources. The continuous economic development had caused pollution, congestion and ecological destruction in urban areas. All these problems, especially the lack of natural resources, were the catalyst for the expansion of JDI. After the oil crisis in 1973, the Japanese Government encouraged Japanese MNCs to invest in order secure the natural resources needed. So, MNCs started to invest in oil rich Middle East countries and Indonesia. Ozawa's research is useful in analysing the resource oriented JDI. However, it is not useful to explain the export oriented or market oriented type of JDI. Ozawa also had stressed the role of the Japanese Government in the development of JDI. Nevertheless his rationalization may adequately reflect the situation in the 1970s, a period when Japanese MNCs were not as powerful as they are now and needed to be protected by the Government. However, the situation is different now, the Japanese MNCs have become strong and usually follow their own decisions on investments.

Akamatsu (1962) suggested a ***Catch-up theory*** to explain the movement of FDI. There is some similarity in this theory with the Vernon's production life cycle theory. However Akamatsu's main concern is limited to giving explanation of the trade oriented type of FDI, not of the material oriented type of FDI. According to this theory, at first the developing countries just import products from the industrialized countries. Then, when demand for the products becomes big, the import substitution type of FDI comes to the scene. In the next stage, governments introduce tariffs or incentives in order to protect infant domestic industries. Finally, these domestic industries in their turn start to export production abroad. Compared with the production life cycle

theory, Akamatsu's interpretation lacks depth, because it fails to explain the connection between the FDI and the stage of production.

Kojima (1978) discussed another established theory on FDI. Kojima's main contribution was to offer a theory of foreign direct investment based on supposed differences between Japanese and Western practices. Kojima argued that Western firms, especially United States Direct Investments (USDI) pursued oligopolistic direct foreign investments generally harmful to host countries, whereas Japanese firms were more likely to invest in ways beneficial to host countries. He divided JDI into resource-oriented, labour-oriented and market-oriented.

However, this changed with the new forms of JDI to Southeast Asia. Nakakita (EXIM 1990) estimates that almost a third of all Japanese investment projects in Southeast Asia in mid 1980s were of the new types. These new forms include technology contracts, management contracts, franchise arrangements, turnkey projects and production sharing. At this stage, JDI was beginning to more closely resemble USDI, unlike the contrast presented by Kojima.

As for Malaysian case, Kojima's theory hardly explains the nature of FDI in Malaysia, where many Japanese firms such as Sony and Matsushita use advanced technologies and is oligopolistic and the USDI is concentrated in the semi-conductor assembly and tends to create the trade. Kojima's theory is interesting and acceptable in many cases. However, there are many exceptions from this theory because various types of FDI and JDI have different tendencies.

Sekiguchi (1979) made a study of the prognosis of the JDI's future, based on the analysis of the political context. According to him, the support of the Japanese Government had enabled the resource oriented JDI to expand. However, Sekiguchi argued that the expansion of this type of JDI causes a conflict with host countries. In addition to the memory of the World War II, some countries feared Japanese capital. The ASEAN and Japanese leaders

are well acquainted with Western culture and education, but not very familiar with each other. Sekiguchi's rationale, which is based on a political content, is very interesting and enlightening. However, the feelings towards the Japanese are not identical in all ASEAN countries. For example, Indonesia and Thailand have or had a very strong anti-Japanese stance, but this cannot be said about Malaysia.

2.4 Literature Review on FDI in Malaysia

The number of academic researches on FDI in Malaysia has also increased in recent years. However, the lack or unavailability of the data on FDI makes it difficult to come to the definite conclusion on the subject. More information is needed to have a clear vision on the FDI in Malaysia. In this section, we shall discuss the academic literature on FDI in Malaysia.

Lim and Nathan (1969) stated that the FDI was traditionally important to Malaysian economy and the foreign ownership was substantial. The political stability and generous incentives by Malaysian government had led to increasing FDI in the manufacturing sector. The sharp growth in the manufacturing sector contributes to job creation and increase in the level of productivity. In their opinion, the most important contribution of FDI is the creation of externalities such as technological knowledge, management skills and engineering techniques. Their conclusion stresses the importance of FDI as means of technology and skills transfer.

Kanapathy (1971) did a study about the role of FDI in the history of Malaysia's economic development. In the pre-Independence period, the Japanese investment exploited extractive industries even though British investment still dominated until 1960's. After Independence, the Malaysian Government encouraged foreigners to invest not only in extractive industries, but in the manufacturing sector as well. This was in order to develop the country's economy. Kanapathy went further to suggest that the political stability was a necessary but not a sufficient factor for attracting foreign investors.

Kulasingam and Tan (1982) in an effort to analyse the new trends of FDI in Malaysia conducted a research on this area. They concluded that the prevailing new trends of FDI were no-equity participation, the so-called 'turn-key operation', licensing agreement and joint ventures with minority participation. However, this contradicts with other researchers' opinions. Different period and scope of the study may have caused this.

Lim (1983) mentions government's incentives given to the foreign investors after the implementation of the Pioneer Industrial Ordinance (1958) and Investment Incentive Act (1968). In Lim's opinion these measures are inadequate as the government failed to understand the motivations or rationale of foreign investors. In addition he felt that the government failed to protect the national interests against the unscrupulous firms.

Jesudason (1989) in a study on the issues and prospects of the development of Malaysian economy, wrote about the role of MNCs. The Government expects the MNCs to play a stronger role in carrying out the goals of restructuring the country's economy. In the author's opinion, the MNCs help to keep the economy afloat by absorbing the labour and providing ownership opportunity to the Malays. However, Malaysia's failure to generate the linkage between manufacturing sectors had caused it to be highly dependent on the commodity sectors.

In another research on FDI in Malaysia, Beaumont (1990) mentions that there are changes in global economy that affects the pattern of FDI. International investment could be adversely constrained by the downturn of economy, international debt crisis and volatility in foreign exchange. He also mentions that FDI is being treated as a partner in the economic development. In these circumstances, transfer of technology is crucial for Malaysian economy and it represents the most tangible contribution of FDI to Malaysia. He concluded that FDI was playing an important role in the industrial development through subcontracting network.

Lim and Pang (1991) conducted a research on the FDI and industrialization in Malaysia, Thailand, Taiwan and Singapore. It was noticed that the Malaysian state corporations favoured the joint ventures with foreign partners, especially with Japan. The Malays generally had a positive attitude towards foreign investors. This may be due to the employment opportunities provided by foreign firms, and also under the NEP, it gives them a chance of business partnership as well. However there was an ambivalent attitude to foreign investment among Chinese businessmen. Small enterprises considered them as a threat to their business, while larger enterprises tried to establish relations with them in order to gain access to the new technologies and markets. The information about their different attitudes towards FDI among various groups of Malaysians makes it new and thought provoking.

Ariff (1991b) mentions that Malaysia has always had a favourable disposition towards FDI, and it is difficult to imagine that Malaysia can acquire the NIE status without FDI's assistance. The author stated that FDI, being engaged in export oriented activities, provides a link between investment and trade. The intra-industry trade is on the increase and it is believed that intra-industry trade consists of intra-firms sales.

Ariff (1992) considers FDI as an ingredient of the development of Malaysian economy. This is because foreign firms bring to Malaysia modern technology, management skills, and access to the international market. Ariff points out that the effect of FDI's inflow on balance of payment is positive, because it allows generation of foreign exchange. The article helps us understand the issue and prospects of FDI in Malaysia. This conclusion is similar to that of Lim and Nathan (1969) which stressed the importance of FDI as means of technology and skills transfer.

According to Ariff (1992a), FDI's character has changed in recent times. The *new* investments differ from the *old* ones in terms of sources of supply, scale of operation, market orientation, externalities, factor intensity and geographical dispersion. The growing presence of the SMIs in the FDI profile in Malaysia has been noticed. Even the Japanese investors seem

inclined to set up SMIs that would cater to the needs of the Japanese MNCs operating in Malaysia. The author concludes that the realisation of the Vision 2020 will depend to a considerable extent on the role that FDI can play. Therefore, Malaysia needs to guard against overly strong nationalist sentiments and must continue to adopt liberal policies towards FDI.

2.5 Literature Review on JDI in Malaysia

Among the first work on JDI in Malaysia was done by Chee and Lee (1979). It was a fundamental study on the subject of JDI in Malaysia. The study provided important information on the size of firms, determinants, training of staff and subcontracting network of the Japanese firms. According to Chee and Lee, the most important factor that influenced the Japanese companies' decision to invest in Malaysia were political stability and social stability. The Japanese firms mostly are located in more developed states, such as, Selangor and Penang. They are mainly concentrated in industries such as, electronics/electrical, wood products and textile products. Chee and Lim also pointed out that only a handful of the Japanese firms were wholly Japanese owned and the rest were joint ventures. They were more involved in import substitution category.

Apart from this study on JDI in Malaysia, Sekiguchi (1983) and Yoshihara (1978) also had shown some interest in Japanese economic development in the Southeast Asia (SEA) region. They attempted to describe the nature of Japanese joint ventures in SEA countries. However, in these studies, references to JDIs in Malaysia have not been exclusively dealt with. In fact Yoshihara had omitted Malaysia in his study.

Another work on JDI in Malaysia was by Woon (1990) which is concerned with the development of JDI in the Malaysian manufacturing sector. The author pointed out that, an eminent feature among the Japanese manufacturing firms is that most of the Japanese manufacturing companies in Malaysia operated as joint ventures. This is in line with the Malaysian government's policy that discourages the establishment of wholly foreign

owned firms to instigate greater local participation, particularly from the Bumiputera community. It was pointed out that, there were growing emphasis of JDI in export-oriented industries as the number of Japanese export-oriented firms and also the volume of their investment were rising.

The author also concluded that Japanese show a high tendency of transmitting their technology via a *package* mechanism that involved simultaneous transfer of capital, management and technical know-how. This is because they alleged that local investors are not capable of providing these supporting resources. Woon had also pointed about the effectiveness of technology transfer from Japan. It is no doubt that local workers have received considerable amount of knowledge from the Japanese but the extent and spread of the knowledge is still meagre and little compared to the number of years the Japanese have established themselves here.

Fumitaka (1995) conducted a research investigating the character of JDI in Kedah state. According to him, JDI was not small in terms of investment and employment. The JDI in Malaysia was mainly concentrated in the electronics/electrical industry. Fumitaka identified the political stability as the most important factor among the *pull factors* that attracted the Japanese investment to Malaysia. This is followed by the availability of cheap and quality labour force and incentives. However it is evident now that the labour force in Malaysia is not as cheap as considered by Fumitaka. According to him also, the appreciation of the Japanese yen is the most important *push factor*, followed by the shortage of labour force in Japan.