

## CHAPTER 1

### INTRODUCTION

#### 1.1 Background

It is important for us to understand the role of Foreign Direct Investment (FDI) in economic development of Malaysia. In the middle of 1980s, Malaysian economy faced the most serious recession since the Independence. Malaysia suffered from a so-called "Twin deficit," that is, the deficit of the Budget and the deficit of the balance of payment.<sup>1</sup> In the beginning of 1980s, the Malaysian Government increased the expenses because of the expectation of the future increase in the revenue from petroleum. However, the price of petroleum fell down in the middle of 1980s. The government faced a serious deficit. In addition to this, the management of the public firms has deteriorated and many of them accumulated deficit.<sup>2</sup> The situation worsened further because the prices of the primary products also fell down. This caused Malaysia to face a deficit in the balance of trade. In order to trade-off the deficit, the Malaysian Government decided to borrow the money from the developed countries. However, this measure made Malaysia one of the countries with the highest foreign debts. The trend of the high interest rates in the middle of 1980s further aggravated the situation with Malaysia's foreign debt.

In order to overcome these problems, the Malaysian Government decided to relax the regulations on foreign investment. First of all, Malaysia suffered the shortage of capital and needed investments and foreign technologies to

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<sup>1</sup> Khor, K.P. (1987), *Malaysia's Economy in Decline. What Happened?, why?, what to do?* Consumer's Association of Penang, Penang.

<sup>2</sup> World Bank (1989), *Malaysia: Matching Risks and Rewards in a Mixed Economy*, The World Bank, Washington, D.C.

utilize the work force and resources.<sup>3</sup> Foreign investments, unlike foreign loans, have not to be paid back. Secondly, Malaysian firms lacked skills in management and production, as well as knowledge of technology and market. Foreign firms were expected to become suppliers or carriers of the knowledge needed to bring the economic development to Malaysia. Thirdly, it was considered that the Malay elite could easier control FDI.<sup>4</sup> Due to the introduction of the Bumiputera policy, the Malaysian Government less encouraged the non-Bumiputera investors. Instead, the "green light" was given to the foreign investors.

The amount of FDI has increased drastically after the changes in the policy towards foreign investors. The amount of approved foreign investment by Malaysian Industrial Development Authority (MIDA) jumped from RM 957 million in 1985 up to RM 4.878 billion in 1988. Then, by 1990, it has sharply increased to RM 17.629 billion; in 1991, it slightly decreased to RM 17.377 billion and reached RM 17.724 billion in 1992, as showed in Chart 1.1.

Accompanied by the Foreign investment, domestic investment also increased from RM 1.873 billion in 1987 to RM 3.562 billion in 1989. In 1990, it doubled and reached RM 10.539 billion, the following year it increased to RM 13.763 billion and decreased to RM 10.003 billion in 1992. High amounts of foreign and local investments allow Malaysia to enjoy a high growth rate of Gross Domestic Product (GDP). This boom is still continuing at the present time.

The boom of foreign investment in the 1990s has different character from the previous boom of FDI. Now, Taiwan is the leading foreign investor in Malaysia. The amount of investment by Taiwan in 1986 was just RM 10 million. In 1987, it soared to RM 200 million. In 1989, the Taiwanese

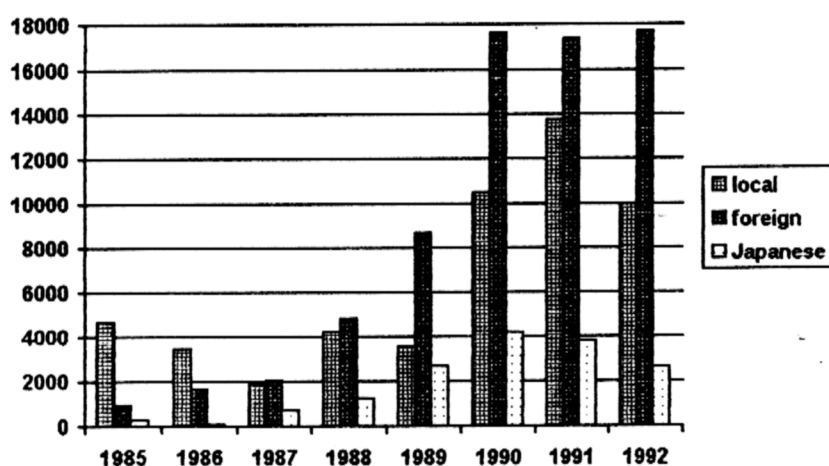
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<sup>3</sup> Ariff, M. (1992), "Foreign Direct Investment in Malaysia: Trends, Determinants and Implications", in Ariff, M. and Yokoyama, H. (eds), *Foreign Direct Investment in Malaysia*, Institute of Developing Economies, Tokyo.

<sup>4</sup> Jesudason, J. V. (1989), *Ethnicity and Economy: The State, Chinese Business and Multinationals in Malaysia*, Oxford University Press, Singapore.

investment amounted to RM 2 billion. In 1990, it increased threefold it became RM 6 billion, or 35 percent of the total FDI in Malaysia. In 1991, Taiwanese investment decreased to RM 3.607 billion and yet decreased again to RM 1.505 billion in 1992. It is interesting to notice that the Taiwanese investment mainly consists of Small and Medium Industries (SMIs). It is easier for the Taiwanese SMIs to establish a tight network with Malaysian firms which are mostly SMIs.<sup>5</sup>

CHART 1.1  
APPROVED MANUFACTURING PROJECTS  
BY LOCAL, FOREIGN AND JAPANESE INVESTORS  
FROM 1985 TO 1992 (RM MILLION)



Source: MIDA

Now let us discuss the role of the Japanese Direct Investment (JDI) during the boom of foreign investment. There were rises and falls in the amount of JDI. Thus, in 1985, the share of JDI among the total FDI was a considerable 27 percent. In 1986, the share of JDI sharply decreased to 7 percent and then in 1987 it soared to 35 percent. During 1988-1990, the share of JDI was

<sup>5</sup> *Malaysian Business*, July 16, 1988.

approximately one-quarter of the total FDI. In 1991, the JDI's share was 21.8 percent and, in 1992, it was 14.8 percent of the total FDI in Malaysia.

Meanwhile, in the middle of 1980s, the economic situation in Japan was dramatically changing. Japan is the sole strong country-exporter in the international economy. She has succeeded in accumulating a high foreign reserve, which caused the United States to face a serious deficit in balance of payment with Japan. US and other developed economies decided to change the foreign exchange rate. As a result of the Plaza Agreement (1985) the Japanese Yen appreciated up to 50 percent against the US dollar.

Many Japanese firms that had exported their production faced serious problems and decided to invest abroad. In 1988, the total amount of JDI all over the world increased by 50 percent and reached US \$ 13 billion. In 1989, the JDI all over the world reached its peak and amounted to US \$ 16 billion. In the beginning of 1990s, JDI slowed down its path and decreased to US \$ 10 billion. For a long time the main destination of JDI has been US. Until 1991, the share of JDI in US was about half of the total amount of JDI all over the world.<sup>6</sup>

However, this trend of JDI's choice of direction has changed. It happened because many Japanese firms in US considered their sales to be lower than they initially expected. Some Japanese firms decided to withdraw investments from US and shift the production base to Asian countries, such as to the countries-members of the Association of South-East Asian Nations (ASEAN) or Newly Industrializing Economies (NIEs). For example, Daihatsu - the company which produces the second Malaysian national car Kancil - withdrew its investment from US in 1992. Another Japanese company, the electronics/electrical multinational OKI, has also closed its main factory in US. Japanese companies in the United States were dissatisfied with the high production cost they had to bear in that country. Besides, the Japanese type of

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<sup>6</sup> Ministry of Finance, Japan (1994), *Situation of Foreign Investment*, Tokyo.



management was not received well by the US workers.<sup>7</sup> An executive of a Japanese multinational said: "We have no problems working in Malaysia. Here we can produce the same level of production as in Japan for just one-third of the cost". So far, no Japanese major firms withdrew their investment from Malaysia. This is a good proof of the success of the Japanese firms' activities in Malaysia.

The statistics show that in 1992, the flow of JDI to US decreased by 20 percent and amounted to US \$ 4 billion. On the contrary, in the same year the inflow of JDI to the Asian countries jumped to US \$ 3 billion. In 1993, JDI to US remained US \$ 4 billion, while in Asian countries it increased again and reached US \$ 3.6 billion. These figures show that Asian countries have become as important a destination for JDI as US. This trend may stretch in a long period of time.

## 1.2 Critique

There is some conventional criticism towards the Japanese investment. The main points of the criticism may be summarised as follows:

- 1) Japanese firms are not willing to transfer technology
- 2) Japanese firms do not contribute much to export creation
- 3) The size of Japanese firms is small.

Some Japanese companies are being criticised for their unwillingness to transfer technology. The typical case is Mitsubishi Motor, the producer of the first Malaysian national car Proton. The company was repeatedly criticized in the mass media. Prime Minister Dr. Mahathir has himself commented on this matter:

Japanese companies should not have any fears of transfer technology to Malaysia since Japan is well ahead of our country in the terms of technological development.

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<sup>7</sup> *Yomiuri Shinbun*, March 1, 1992.

Present technology is not the ultimate, so even if we were to get Japanese technology today, its technology will be old soon.<sup>8</sup>

There are various types of technology transfers. Urata said in an interview to a newspaper: "There are four types of transfer technology through the FDI. First type is the import of capital, second one is training, the third way of technology transfer is the dissemination of information and, finally, the fourth type is setting up of Research and Development (R&D) facilities".<sup>9</sup>

For example, one of the Japanese car audio makers, Clarion in Penang, decided to provide an assistance in setting up an R&D research center. Another Japanese company, National Aircon, established the R&D unit at the special factory in Shah Alam in 1990.<sup>10</sup> These are the first cases when Japanese firms create an R&D division at the factories, but if these projects succeed other Japanese firms may follow the example. According to Japan External Trade Organization (JETRO) research among 202 Japanese firms, the overwhelming majority of them provided on-the-job training for their staff. About 85 percent of the firms provided on-the-job training to their managerial staff, 90 percent of the firms trained their workers on line.<sup>11</sup>

The above-mentioned cases are examples of the direct transfer of technology. There are cases of the indirect technology transfer as well. Thus, the Toray group - it is called the Pen group in Malaysia - has set up the Toray Science Foundation. This institution provides a financial support to the development of the Science activities in Malaysia. Another Japanese firm, Sunny Precision, decided to assist in establishing of a plastic technology institute in Penang.

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<sup>8</sup> *New Straits Times*, November 6, 1994.

<sup>9</sup> *New Straits Times*, May 15, 1992

<sup>10</sup> *Yomiuri Shinbun*, March 29, 1993.

<sup>11</sup> *New Straits Times*, December 9, 1992.

There is another important type of technology transfer, which is done through the subcontracting network. This type of technology transfer is conducted by the Japanese firms which provide some assistance to their subcontractors to maintain the quality of production and includes guidance and teaching production skills and even sometimes on-the-job training. Watanabe said: "After the Japanese companies relocated their factories to the Asian countries, there appeared various types of technology transfer, not only inside, but also outside the factories".<sup>12</sup> In this research an attempt is made to investigate a subcontracting network between the Japanese firms and local firms as one of the ways of transfer technology, without discussing its different types for this has been done by other researches before.<sup>13</sup> The above-mentioned production network seems to be limited to the firms located in Klang Valley or Penang. However, what is the situation at the firms located in the less developed states, such as Kedah?

Let us discuss the second point of the criticism towards the Japanese firms abroad, which states that the Japanese companies do not contribute much to the exports. According to Ariff (1991), the early established Japanese firms were mainly oriented toward the domestic market.<sup>14</sup> In the 1970s, the number of the Japanese firms in Malaysia was limited and many of them were of the import-substitution type. Only some of the electronics/electrical and textile firms located in the Free Trade Zones (FTZs) exported their production.<sup>15</sup> This criticism can be applied to the situation in the past. However, the contemporary situation may have changed in Malaysia since the end of 1980s.

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<sup>12</sup> *Nikkei Shinbun*, July 16, 1992.

<sup>13</sup> Chee, P.L. and Lee, P.P. (1979), *The Role of Japanese Direct Investment in Malaysia*, Institute of Southeast Asian Studies, Singapore.

<sup>14</sup> Ariff, M. (1991a), "The Changing Role of Foreign Direct Investment in Malaysia", in Yokoyama, H. and Tamin, M. (eds), *The Malaysian Economy in Transition*, Institute of Developing Economies, Tokyo.

<sup>15</sup> Jomo, K.S. (ed.) (1988), *Mahathir's Economic Policies*, INSAN, Kuala Lumpur.

It is interesting to investigate the situation at the Japanese firms which are located outside of FTZ or are situated in the rural states, such as Kedah.

Japanese firms are often being criticised for their small size in terms of employment and capital. Being a country with shortage of capital, Malaysia needs investments for the development and to overcome the unemployment problem. The employment creation was one of the main targets of the Malaysian government's economic policy in the middle of 1980s. According to Chee and Lee (1979), the size of the Japanese firms in Malaysia was small in terms of both employment and capital.<sup>16</sup> Has the situation changed since that time? In this study an effort is made to answer this question using the examples of the Japanese firms in Kedah.

These days, there is an additional criticism towards JDI concerning international trade. In the 1980s, Malaysia enjoyed the export-drive development and had a surplus of the balance of payment with many developed countries, except Japan.

With Japan, Malaysia experienced a growing deficit trade balance since 1988. This is attributable to some extent, the appreciation of the yen which has led to the general increase in the value of Malaysia's imports from Japan as well as the relocation of Japanese companies to Malaysia which, in turn, resulted in the increase in import of inputs from Japan.<sup>17</sup>

Malaysia's trade balance with its trading partners is shown in Chart 1.2.

The appreciation of the Japanese Yen is the fact which can not be changed by the Malaysian Government. However, the amount of imported inputs from Japan can be decreased, provided that the Japanese affiliated firms buy the necessary inputs from Malaysia. This fact has prompted the Malaysian Government to adopt regulations concerning the local content. The Government encouraged foreign firms to buy Malaysian products. Certainly, it is cheaper for the Japanese firms to buy local products. However, it is difficult

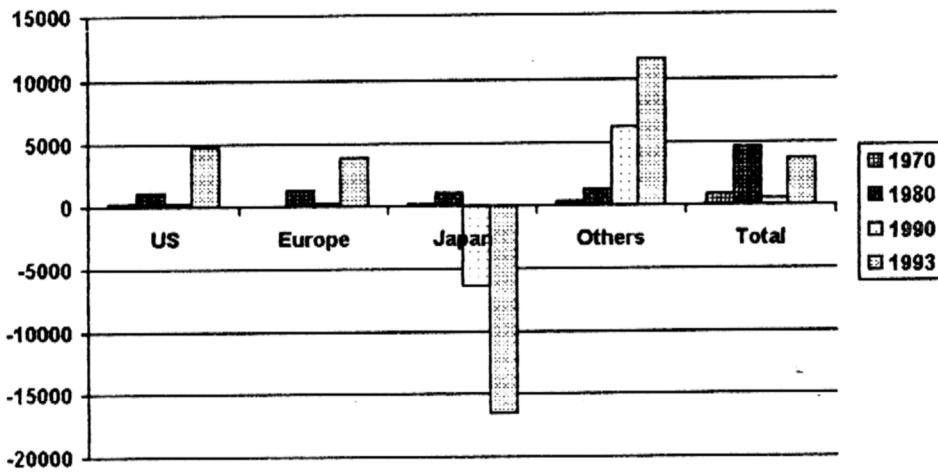
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<sup>16</sup> Chee, P.L. and Lee, P.P., (1979), *op. cit.*

<sup>17</sup> Ministry of Finance, Malaysia (1992), *Economic Report 1992/93*, Kuala Lumpur.

for them to find a suitable supplier of inputs for their production. It may be easier to find a local supplier for the Japanese firms located in industrial areas. On the contrary, it may be more difficult to do so for those Japanese firms which are located in rural areas, such as Kedah.

CHART 1.2  
MALAYSIA'S TRADE BALANCE WITH MAJOR MARKETS  
IN 1970, 1980, 1990 AND 1993 (RM MILLION)



Source: Ministry of Finance, Malaysia. Economic Report 1993/1994

### 1.3 Objectives of Study

The objectives of this study are:

1. To analyse the character of the Japanese Direct Investment in Kedah
2. To analyse the climate for investment in Kedah
3. To examine the character of domestic-oriented and export-oriented JDI in Kedah
4. To examine the character of the Japanese firms by location
5. To analyse the tendency of the Japanese firms by establishment year
6. To analyse the character of the Japanese firms by ownership

7. To compare the character of the Japanese Multinationals' and SMI's production network with local firms.

#### 1.4 Definition

The definition "Manufacturing" is referred to the International Standard Industrial Classification of all economic activities. "Manufacturing" is defined as the mechanical/chemical transformation of inorganic/organic substance into new products and includes the assembling of the components of manufactured goods.<sup>18</sup>

The classification of industries in this dissertation follows that of MIDA. The term of "Foreign Direct Investment" is defined as any investment which is made with the intention of acquiring a lasting interest in an enterprise operating in an economy other than that of the investor's. The investor's purpose to make this investment is to secure an effective voice in the operation and management of enterprise.<sup>19</sup>

Kojima (1978) defined FDI as the transmission to the host country of the package of capital, management skills and technical knowledge.<sup>20</sup> FDI was further divided by Ariff (1991) into the three following categories: 1) Joint ventures; 2) Wholly foreign-owned projects; 3) Turn-key operations. Actually, FDI refers to capital inflows by the giant Multinationals.<sup>21</sup>

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<sup>18</sup> United Nations (1987), *Transnational Corporations & Technology Transfer: Effects & Policy Issues*, United Nations, New York.

<sup>19</sup> Ariff, M. (1991b), *The Malaysian Economy: Pacific Connections*, Oxford University Press, Singapore.

<sup>20</sup> Kojima, K. (1978), *Direct Foreign Investment: A Japanese Model of Multinational Business Operation*, Croom Helm, London.

<sup>21</sup> Ariff, M. (1991b), *op.cit.*

“Multinational” is defined as an enterprise which owns and exerts control over the operation and production in the host country in which the affiliate is located.<sup>22</sup>

## 1.5 Research Methodology

### 1.5.1 Research Criteria

A research on the JDI in Malaysia and Kedah was carried out three times. The first part of the research was conducted on JDI in the whole Malaysia in 1991. The second part of it was carried out in Kedah in the middle of 1992. The final part of the research was conducted from the end of 1992 and through the year 1993.

The first part comprised collecting of data on JDI in Malaysia from the Malaysian government agencies, such as MIDA and Department of Statistics, Malaysia, and the Japanese government or semi-government agencies, such as JETRO, the Embassy of Japan and Japanese Chamber of Trade and Industry, Malaysia (JACTIM).

The second part of the research comprised collecting of data and information on JDI in Kedah from the Malaysian and Japanese government agencies, such as Kedah State Government, MIDA Kedah branch, Consulate-General of Japan and Kedah State Development Corporation (KSDC).

The final stage took the form of data collection through a survey questionnaire from the Japanese companies in Kedah, data processing and analysis.

Clearly, the larger the area of research the more comprehensive and correct the image of FDI is, but time and manpower were limited and it was difficult to manage a large amount of data. That's why the full and comprehensive research on JDI was carried out in Kedah state only. The first stage output was

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<sup>22</sup> United Nations (1987), *op.cit.*

used as a supplementary information. Then, these were integrated through cross-section samples.

### 1.5.2 Selection of Industries

Basically, this thesis follows the classification by MIDA and the industries are divided into 18 categories: 1) food manufacturing; 2) beverage and tobacco; 3) textile and textile products; 4) leather and leather products; 5) wood and wood products; 6) furniture and fixtures; 7) paper, printing and publishing; 8) chemical and chemical products; 9) petroleum and coal; 10) rubber products; 11) plastic products; 12) non-metallic mineral products; 13) basic metal; 14) fabricated metal products; 15) machinery manufacturing; 16) electrical and electronics products; 17) transport equipment; 18) scientific and measuring equipment.

Some industries are represented by a few firms which could be ignored, while the others are represented by many firms. So, here we have selected only 10 industrial groups: 1) wood and wood products; 2) textile and textile products; 3) chemical and chemical products; 4) petroleum and coal; 5) non-metal mineral products; 6) basic metal; 7) fabricated metal products; 8) electrical and electronic products; 9) transport equipment; 10) machinery manufacturing.

Then, to make the categorization of the firms by the industries easier we have grouped several categories of industries into the one category. Thus, chemical and chemical products and petroleum and coal categories have been united into the chemical and chemical products category; non-metal mineral products, basic metal and fabricated metal products have been grouped into the metal and non-metallic products category; transport equipment and machinery manufacturing have been combined.



### 1.5.3 Selection of Firms

A Japanese affiliated firm is usually a firm where a Japanese investor has the initiative of management. This means that Japanese equity participation is likely to be more than 50 percent, in other words it is the largest equity participation in a firm. However, it is difficult to obtain the information on the equity participation. Even some government agencies, such as MIDA, may also have not the precise data. In this research the JETRO list of Japanese companies in Malaysia was used, it includes the firms with the minority Japanese participation as well. Strictly speaking, these firms should be called "the Japanese-related firms".

### 1.5.4 Survey Methodology

There are 29 Japanese firms belonging to six industrial groups in the lists of the Japanese companies in Kedah obtained from JETRO, JACTIM and KSDC. Some of these companies could not be contacted, for they had closed down their factories or they had changed their address. So, we could reach 25 companies.

The survey questionnaire (Appendix 1) was prepared to be sent to the companies. Twenty firms were randomly chosen from 25 Japanese firms and the questionnaire was sent to these companies. Fourteen firms replied the survey questionnaire, this was followed by the interviews.

In this survey the JETRO list does not include the newcomers. The JACTIM list consists only of the members of this chamber. The list of the Japanese companies obtained from the KSDC includes only the wholly owned Japanese firms.

The information given as the answers to the questionnaire is not complete. The Japanese firms are usually reluctant to grant interviews. Nevertheless, the majority of the Japanese companies willingly provided us with data, only the small Japanese firms were hesitant to give the information.

## 1.6 Hypotheses

In this study a number of hypotheses concerning the Japanese firms in Kedah are put forward and examined as outlined below.

Hypothesis 1: The minority Japanese owned firms tend to be less export-oriented than the firms with a bigger Japanese ownership.

Hypothesis 2: The firms oriented toward the domestic market tend to have a high local content, while the export-oriented firms tend to have a low local content.

Hypothesis 3: The Japanese firms located near Penang are of a smaller size in terms of employment compared with those located far from Penang.

Hypothesis 4: The Japanese firms located near Penang have a higher local content than the firms located far from Penang.

Hypothesis 5: The earlier established firms are more domestic market-oriented, while the newer firms are more export-oriented.

Hypothesis 6: The earlier established Japanese firms have a higher local content, while the newly-established firms have a lower local content.

Hypothesis 7: The non-electronics/electrical Japanese firms are more oriented toward the domestic market, while electronics/electrical firms are more export-oriented.

Hypothesis 8: The non-electronics/electrical Japanese firms have a lower local content, while electronics/electrical firms have a higher local content.

Hypothesis 9: Firms with a Japanese majority ownership are of a bigger size, while firms with a Japanese minority ownership are of a smaller size.

Hypothesis 10: Firms with Japanese majority ownership have a higher productivity, while firms with Japanese minority ownership have a lower productivity.

Hypothesis 11: Salaries at the Japanese firms located near Penang are higher and increase more quickly than salaries at the firms located far from Penang.

Hypothesis 12: The Japanese electrical/electronics firms pay higher salaries and increase them more often, while the non-electronics/electrical firms pay lower salaries which increase slowly.

### 1.7 Outline of Chapters

There are eight chapters in this dissertation. Following the Introduction chapter is Chapter Two, which reviews the Japanese Direct Investment in Malaysia. Chapter Three deals with the theories and studies on Foreign Direct Investment in Malaysia. Chapter Four reviews the features of the JDI in Kedah. Chapter Five traces the characters of the JDI in Kedah. Chapter Six presents the hypotheses tests. Chapter Seven reviews the prospects and issues of the JDI in Kedah. Chapter Eight is a conclusion.