

Report on a Survey of Investment Climate Assessments by Japanese and Western Electrical Equipment and Electronics Companies in Malaysia¹

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Abstract

The term “investment climate” has various meanings. A number of surveys on factors pertaining to investment climate and research projects on factors behind investment decisions (site selection) have taken place. No report, however, has examined investment climates from a business point of view, including the concepts of “valuation” and “value chain.”

In this report, we examine investment climates through valuation and value chain frameworks, thus offering new perspectives in the evaluation of investment climates. Through our analysis, we determine the characteristics of Japanese companies in their evaluations of investment climates and compare them to Western companies.

In comparing Japanese and Western companies, we set out to make initial conditions as similar as possible. We took Malaysia as a sample for a common investment climate and designated the electrical equipment and electronics industry as a sample industry to survey. Our study confirmed that Japanese companies in Malaysia evaluate investment climates more narrowly than Western companies, due to differences in the process of investment decision

making and differences in the missions of these companies in Malaysia. Moreover, the study identified that the Malaysian investment climate itself is moving away from the view of Japanese companies in their evaluation or perception.

Taking into consideration the recent expansion of the value chain by some Japanese companies in Malaysia, we suggest that these companies expand their value chains to cope with this movement in the investment climate.

Key words: investment climate, valuation, Japanese/Western companies

Introduction

There have been a number of works on private FDI activities and surveys on investment climate, which are often used as reference for overseas expansion strategies and local management.² Investment climate factors considered in those reports and surveys, however, vary between them. For example, IDA (2002) based its principal analysis on such basic factors as fiscal policy, financial stability and gender, while those identified by the Japan Business Council for Trade and Investment Facilitation (2002) included more practical items including restrictions on foreign

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1 This report is a summary of the “Phase III Study of Asian Expansion by Western Corporations and Response from Japanese Manufacturers,” a survey commissioned from ABeam Consulting Ltd., by the Japan Bank for International Cooperation. The project surveyed foreign affiliates in Malaysia of the electrical equipment and electronics industries over the thirteen weeks from September 10, 2003 to November 28, 2003. During this period, management personnel of seventeen Japanese and nine Western-affiliated companies in the Penang and Kuala Lumpur regions were interviewed over the course of two weeks, in addition to a questionnaire being collected from thirteen Japanese and ten Western affiliates in Penang. Japanese surveyees ranged from integrated electronics companies to AV equipment manufacturers and semiconductor makers, while Western surveyees mostly included companies in the fields of computers, semiconductors and electronic devices. We would like to extend our most sincere thanks to those from the surveyed companies and other participants for their gracious cooperation in the survey, while their names are kept anonymous for privacy reasons.

capital, requirements for technological transfer and restrictions on land ownership.

These differences arise due to some approaching investment climate from the viewpoint of economic development of developing countries, and others from that of day-to-day operation of local affiliates. Regardless, however, past reports fell short of evaluating the investment climate with consideration given to such financial issues as days needed for customs clearance affecting cash flow and, ultimately, cost of capital, and few classified the investment climate according to the different roles that each local affiliate assumes, ranging from manufacturing and sales to research and development, so that the same locality in the same country may be classified differently depending on the function of an affiliate.

This report is based on a framework using the Valuation model to sort investment climate factors into three categories, in particular those of sales, manufacturing cost, and risk.³ Within this framework, we have compared the views of Japanese and Western companies on the investment climate through the analysis of data and information gathered from surveys and interviews in Malaysia.⁴ Our findings include the fact that Western companies see investment climate from a wider perspective than Japanese companies and that, behind such a tendency, Western companies aim to achieve broader expansion of the value chain in Malaysia.

In Chapter 1, we illustrate the difference in investment stance in Malaysia between Japanese and Western companies. Chapter 2 then analyzes differences in the breadth of view of the investment climate between the two groups by contrasting their decision-making processes and evaluation benchmarks⁵. In Chapter 3, we reveal the mismatch between the investment climate that Japanese

companies seek in Malaysia and the actual situation. Finally, in Chapter 4, we show that value chain expansion is an effective measure for overcoming the mismatch, and make specific suggestions.

Chapter 1: Current Status of Activity of Japanese and Western Companies in Malaysia

1. Japanese and Western Affiliates in Malaysia

Let us start our discussion with an examination of the background to Japanese and Western affiliates in Malaysia in terms of 1) history 2) parent companies and 3) local operation.

1) History

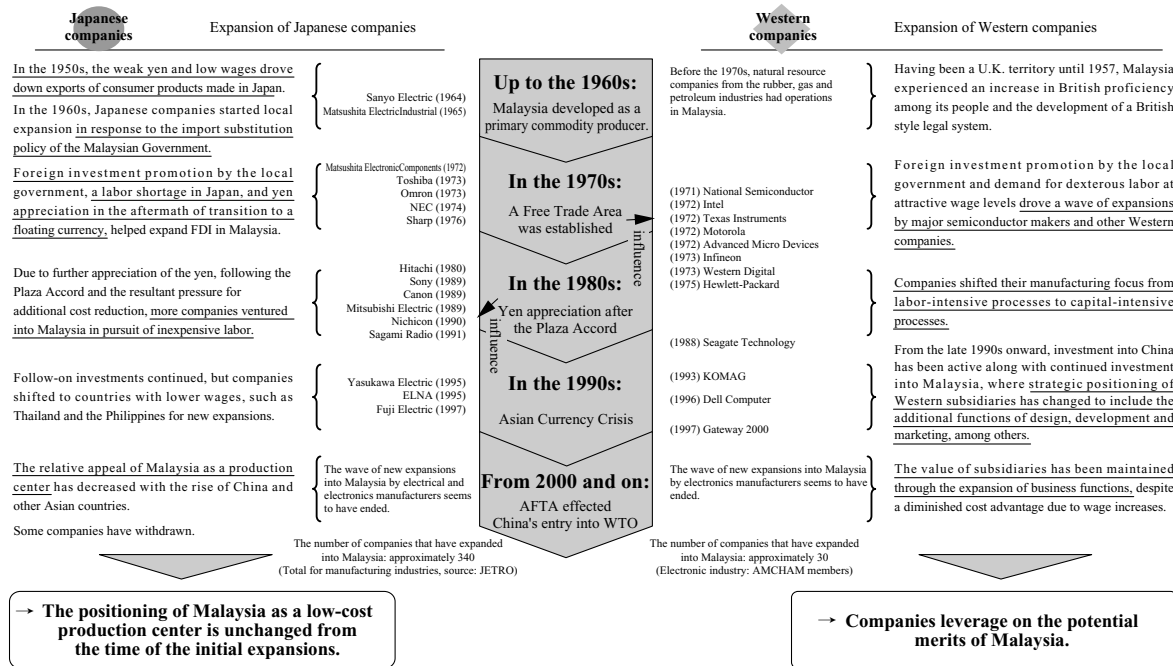
Both Japanese and Western companies first expanded their operations into Malaysia in pursuit of inexpensive labor for manufacturing labor-intensive products. Thereafter, however, their policies diverged. Western companies increasingly localized the management and expanded the function of their Malaysian operations in recognition of new potentials of Malaysia. Japanese companies, on the other hand, seem to continue to view the country as a source of inexpensive labor. (See Figure 1.)

2) Parent Companies

Major Japanese electrical and electronic manufacturers that have affiliates in Malaysia develop, produce and market a very wide range of goods including semiconductors, electronic devices, PCs, AV equipment and home appliances. Most of their Western counterparts specialize in electronic devices and appliances, and include chip makers represented by Intel, Texas Instruments, Infineon

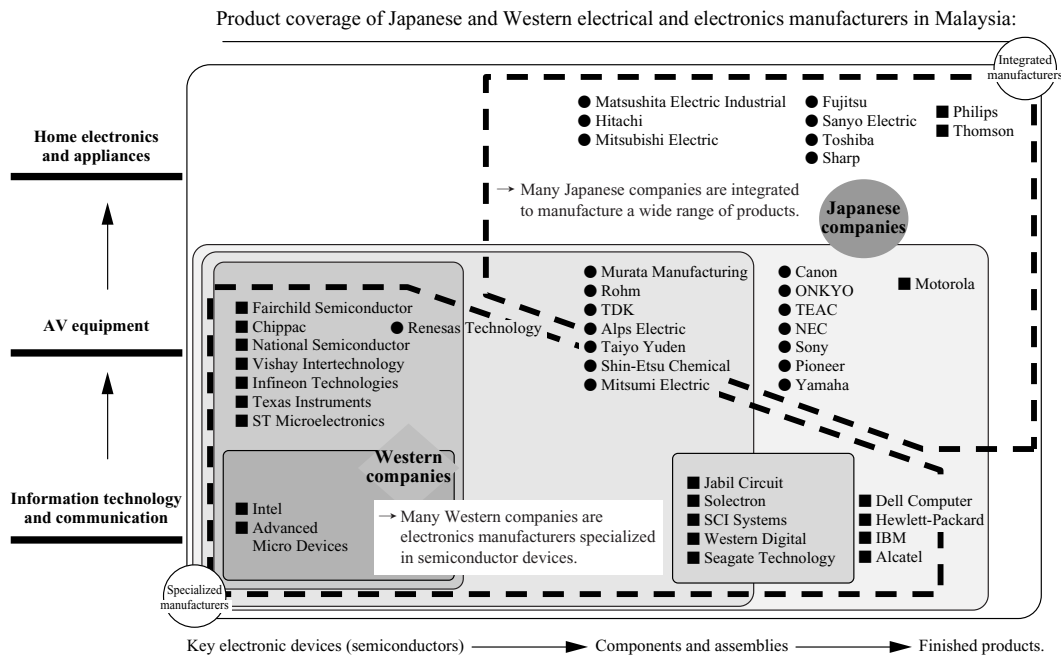
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- 2 Select reference materials on investment climate can be found at http://www.fias.net/investment_climate.html. Representative studies of firms' decision making on foreign direct investment include Lee, H.L. and Houde, M.F. (2000), Caves, R.E. (1996), Dunning, J. (1997), Aggarwal, V.K. (1980), Lizondo, S. (1990), Petri, P.A. and Plummer, M.G. (1998). In Japanese, the Japan Business Council for Trade and Investment Facilitation (2002) and JETRO's reference pages on overseas business and investment. <http://www.jetro.go.jp/biz/world/> are abundant and useful sources of information. JETRO (2002b) and Marugami et al. (2004) give comprehensive and insightful survey results. The JBIC Institute (2002, also available in Japanese) offers a summary of these and other works.
 - 3 In formulating this framework, references have been made to Tom Copeland, et al. (1994).
 - 4 The survey and interviews were conducted in October 2003. The surveyees included thirteen Japanese and ten Western companies, and interviewees included seventeen Japanese and nine Western companies.
 - 5 These refer to so-called Key Performance Indicators (KPI).

Figure 1 Background of expansion into Malaysia



Source: ABeam Consulting

Figure 2 Parent companies of subsidiaries in Malaysia: types of business



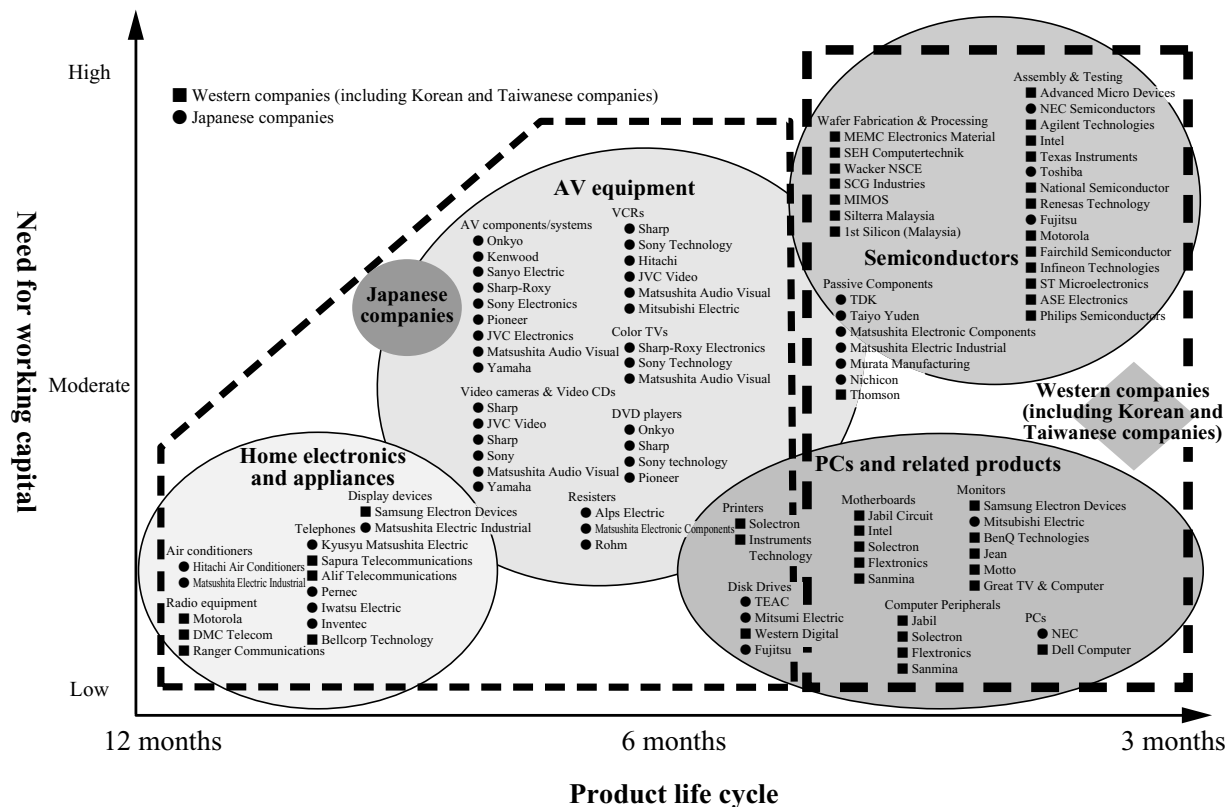
Sources: ABeam Consulting

Technologies and Advanced Micro Devices, PC manufacturers represented by Hewlett-Packard and Dell, and electronic manufacturing services providers represented by Jabil Circuit and Soletron. (See Figure 2.)

3) Local Operation

According to the categorization based on product life cycles, Japanese electrical and electronic manufacturers that have operations in Malaysia typically specialize in products with relatively long

Figure 3 The positioning of Malaysian subsidiaries



Sources: ABeam Consulting

life cycles and low cash requirement. Western manufacturers, on the other hand, tend to focus on products that require inventory management and cash commitment, including semiconductors and PCs.⁶ (See Figure 3.)

2. Decreasing Number of Japanese Affiliates and Declining Performance Satisfaction

According to “Survey Report on Overseas Business Operations by Japanese Manufacturing Companies”, JBIC Institute, 2002, some Japanese companies decided to postpone business expansion in the Asian region, including ASEAN-4 countries, over the following three years on the ground that “cost reduction is hard to achieve”, and the same was reported in the 2003 Survey.⁷ In contrast, Western companies have in recent years tended to be active in

investing and in expanding operations in the same region and countries.

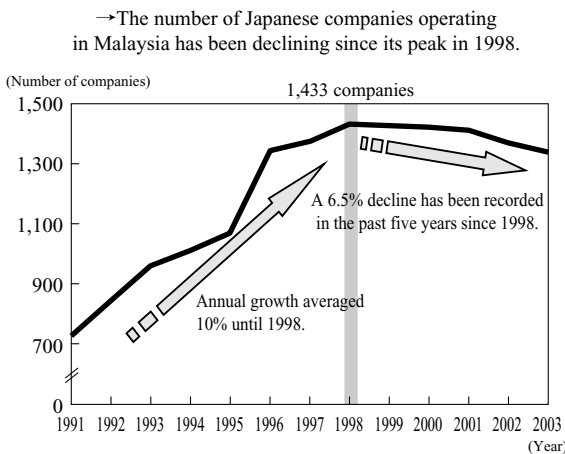
After growing by an average of 10% per year from 1991 to 1998, the number of Japanese affiliates in Malaysia has recently been leveling off or declining. It peaked at 1,433 in 1998 and has decreased by 6.5% during the subsequent five-year period. (See Figure 4.)

Another survey report by the Japan Bank for International Cooperation showed that performance satisfaction of Japanese affiliates in Malaysia had been on a downward trend since 2000. Evaluation of satisfaction with profitability and with sales declined from 3.37 and 3.11 in 2000 to 2.87 and 2.80 in 2003, representing a substantial drop over the three-year period (see Figure 5). According to the survey report, the percentage of Japanese affiliates that responded as intending to “reinforce or expand Malaysian

6 Due to these differences, Western companies exhibit stronger tendencies to expand the value chain and make a deeper commitment to establishing efficient supply chains and improving cash flows in Malaysia. These points will later be discussed in more detail.
 7 Refer to Marugami, Takashi, et al. (2003) and ditto (2004).

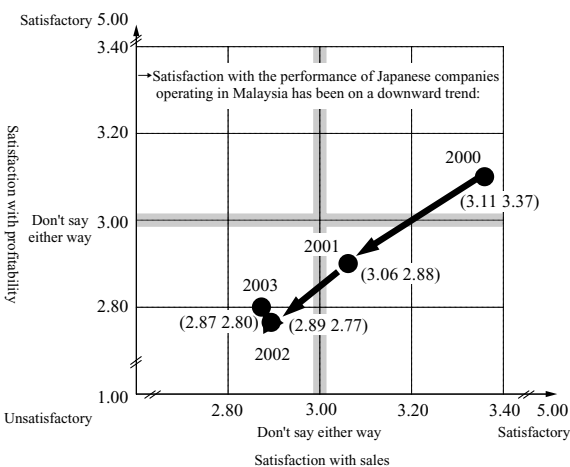
operations among ASEAN countries” has been decreasing, while the percentage of those responded as intending to “withdraw from or shrink Malaysia operations” has been increasing⁸ (see Figure 6). Additionally, the JETRO Economic Research Department reported in JETRO (2001) that 21.7% of Japanese companies responding to their survey had “plans to move manufacturing to China from other parts of Asia, including Japan”(see Figure 7.). Future business activities of Japanese companies in Malaysia are thus seen to moderate, or at least not to intensify.

Figure 4 Japanese companies operating in Malaysia



Source: ABeam Consulting, based on data provided by JETRO Kuala Lumpur.

Figure 5 Performance satisfaction of Japanese companies operating in Malaysia:

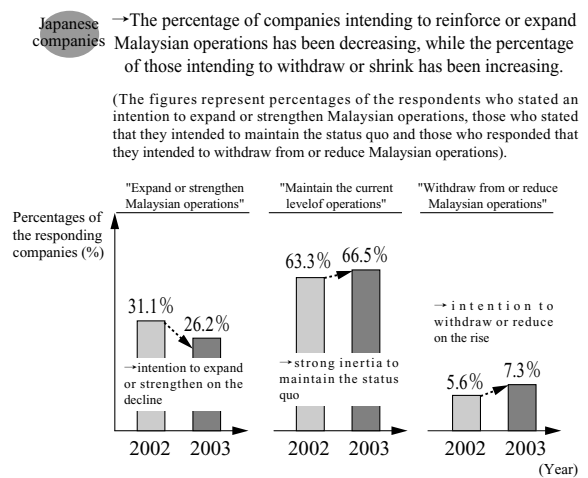


Source: “Survey Report on Overseas Business Operations by Japanese Manufacturing Companies,” JBIC Institute, 2000-2003

3. Western Companies Seen to be Increasing Activities in Malaysia

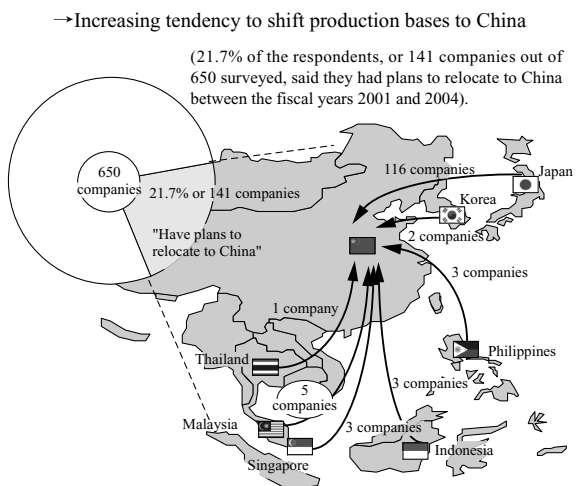
In contrast to the negative attitudes shown by Japanese corporations to business expansion in Malaysia, Western companies are increasing their commitment and aggressively expanding operations there. Executives from leading companies including Intel, Agilent Technologies and Dell commented that Malaysia played a central role in technological

Figure 6 Future directions for the Malaysian operations of Japanese companies



Source: ABeam Consulting, based on, “Survey Report on Overseas Business Operations by Japanese Manufacturing Companies,” JBIC Institute, 2000-2003.

Figure 7 Relocation of Japanese companies to China



Source: JETRO, “FDI Strategy of Japanese Corporations in the Twenty-first Century: Current Situation and Outlook,” 2001, edited by ABeam Consulting

8 In the 2003 survey, the largest percentage (7.3%) of the responding companies answered that they intended to “withdraw from or shrink operations” in Malaysia.

development, marketing and the supply chain, showing their commitment to the country. (See Figure 8.)

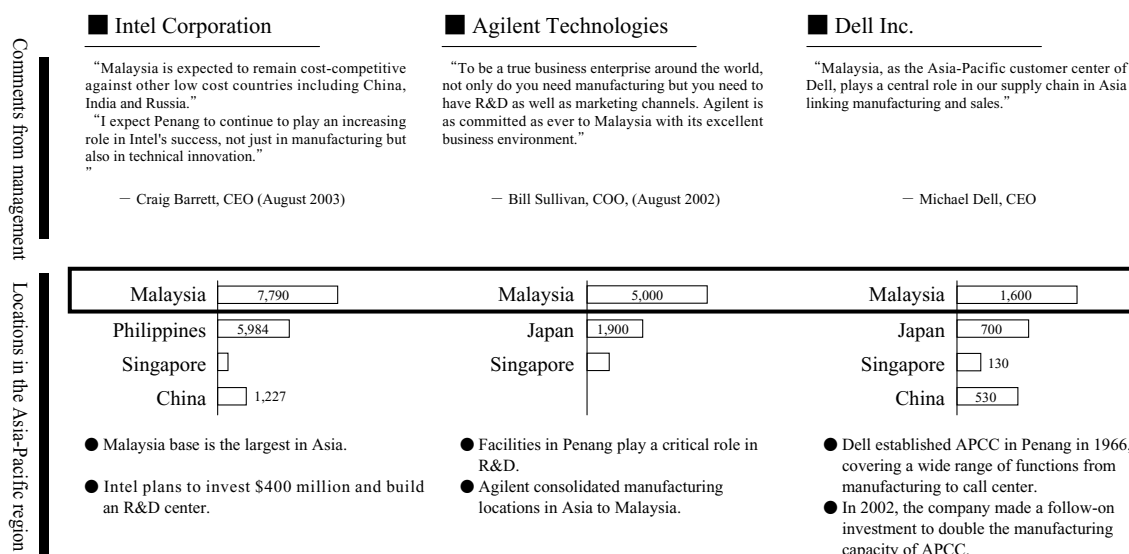
4. Differences in Attitudes to Malaysia Between Japanese and Western Companies

The following summarizes the differences in attitudes to business development in Malaysia between Japanese and Western companies.

Japanese Companies

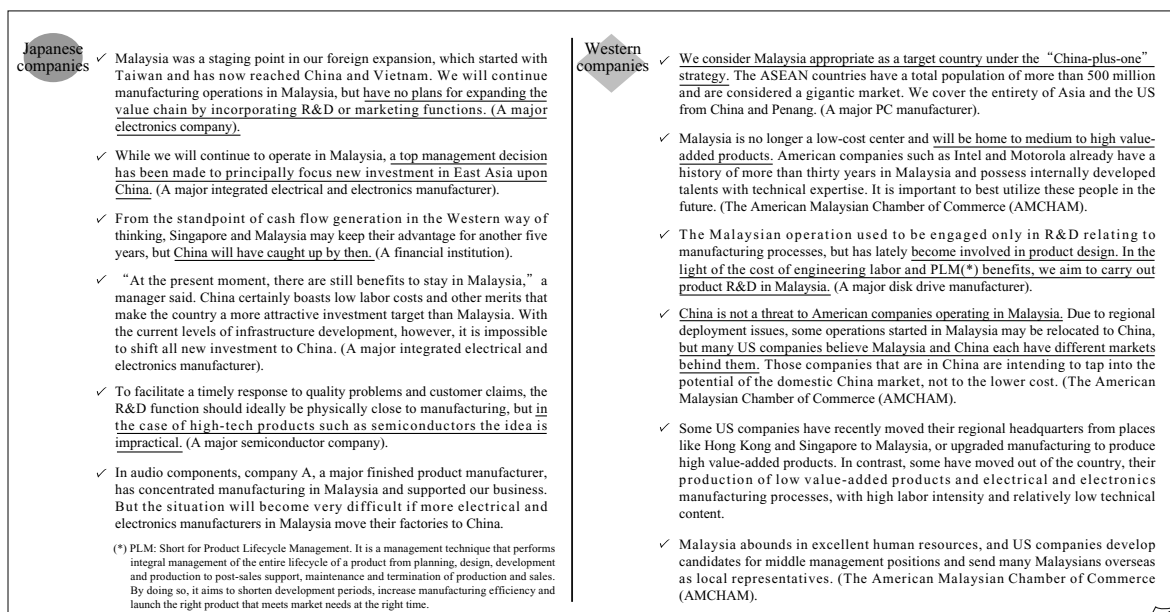
- 1) The number of Japanese affiliates in Malaysia peaked in 1998 and has since shown a decreasing trend.
- 2) Japanese affiliates have been showing an increasing trend to withdraw from or shrink operations in Malaysia.
- 3) Satisfaction with sales and profitability has been declining in recent years among Japanese companies operating in Malaysia.

Figure 8 Western companies Increasing Commitments and Activities in Malaysia



Source: ABeam Consulting

Figure 9 Excerpts from interviews



Source: Interviews and various other materials, compiled by ABeam Consulting

- 4) Japanese companies are reassessing the roles of business operations in Malaysia in view of the economic growth of China and changes in the investment climate of Malaysia, including the rise in wage levels.

Western Companies

- 1) Leading Western companies including Intel, Dell and Agilent Technologies tend to make commitments in Malaysia as a core for technological development, marketing and the supply chain.
- 2) Western companies are maintaining aggressive business attitudes to Malaysia while showing increasing willingness to invest in China. These arguments could also be supported by interviews with top and local management of Japanese and Western companies (see Figure 9.). Characteristically, Western companies are aggressively expanding operations in Malaysia along with a willingness to invest in China, while Japanese companies are more or less maintaining the status quo.

In the next chapter, we will discuss where the differences arise between Japanese and Western companies in their stance towards Malaysia, focusing on 1) differences in the investment decisions of Japanese and Western companies, and 2) Western companies’ evaluation of the investment potential of Malaysia and their plans to exploit it. (See Figure 10.)

Chapter 2: Analysis of Investment Climate Evaluation by Japanese and Western Companies

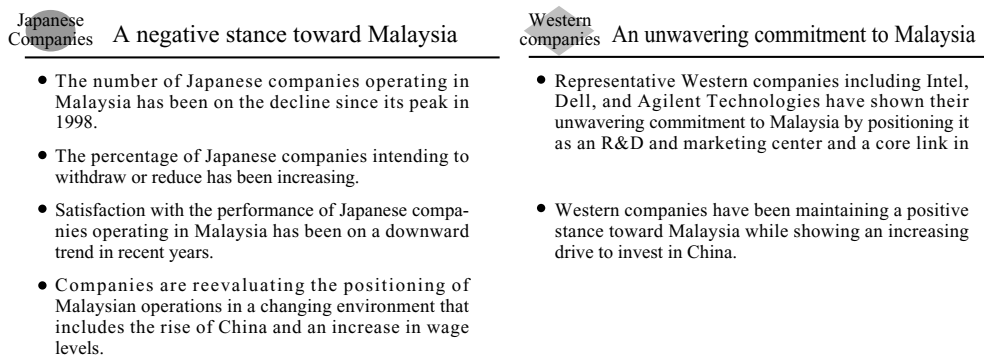
1. Framework of Survey and Analysis - Applying Valuation model for evaluation of investment climate-

In the previous chapter, we mentioned the difference in business attitudes between Japanese and Western companies. The former are poised to maintain the status quo in their operations in Malaysia and their satisfaction with profitability is declining, while the latter, especially multi-national corporations, are aggressive in their investment in Malaysia. In the current chapter, we explore and analyze the background and reasons behind this difference in investment attitudes.

In the Valuation method, the net present value of a business investment is generally defined as business income, or future free cash flow determined by sales and business cost, discounted by a factor that incorporates the risk associated with the investment as to potential profit generation. (See Figure 11.)

In conducting the survey, we paid special attention to the difference of investment climate factors that Japanese and Western companies each weighed heavily in their investment decision making regarding Malaysia. This is based on a belief that the difference in importance of investment climate factors should, in the Valuation model, reflect

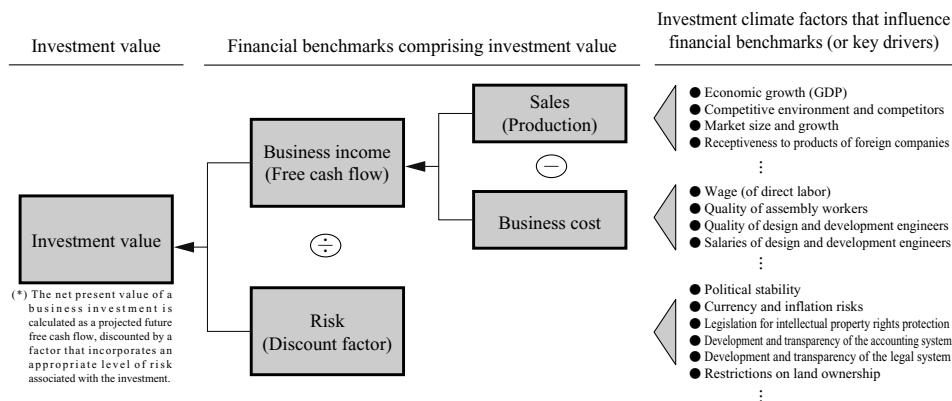
Figure 10 Differences between the investment climate evaluation of Japanese and Western companies



Question : Where do the differences arise between Japanese and Western companies in their stance towards Malaysia?

- What are the differences in investment decisions between Japanese and Western companies?
- How do Western companies evaluate the investment potential of Malaysia and plan to exploit it?

Figure 11 General framework of survey and analysis



Source: ABeam Consulting

different financial benchmarks on which companies place greater weight.⁹ For example, if logistics factor such as “transportation infrastructure” and “speed of export and import procedures” are given greater importance in the investment decision making process, a company is thought to prioritize business cost, or the finance cost for short term operation. If the legal framework for intellectual property rights protection is focused upon, a company is strongly aware of risk pertaining to infringement of intellectual property rights and therefore is regarded as stressing business risk.

This survey report first sets out a framework that relates various investment climate factors to relevant financial benchmarks of Valuation model and uses the framework to analyze differences in the investment attitudes of Japanese and Western companies¹⁰ (See Figure 12.) The following sections discuss the results of the analysis by explaining the differences for each key financial benchmark - sales, business cost and business risk.

2. Relative Importance of Local Markets

From the results of the survey in Malaysia, Japanese companies can be seen to place greater importance on the market size and its growth of Malaysia and other Asian markets, while Western companies are less interested in those markets.¹¹ It seems that Western companies are operating in Malaysia with the aim of exporting products worldwide, including but not limited to ASEAN countries. This would explain the relatively low interest they show in local markets.¹² (See Figure 13. and 14.)

3. Relative Importance of Business Costs

1) Survey Results

There is a general tendency for Japanese companies to put greater emphasis on the wage levels of direct labor, while Western companies take into consideration a wider range of cost elements among the investment climate factors, including design and development cost, transportation and inventory costs, and administrative costs, as well as manufacturing and processing cost. (See Figure 15.)

9 In that investment climate factors influence financial benchmarks, investment climate factors are referred to as key drivers of financial benchmarks.

10 In this survey report, investment climate factors are broadly categorized into “state of the country,” “institutions and policies,” “human resources,” “business environment” and “life and culture.” Lee and Houde (2000), translated by Konaka et al. (2002), summarized them into six different categories, namely “market size and prospects for economic growth,” “abundance of natural and human resources,” “physical, financial and technological infrastructure,” “openness to international trade and access to overseas markets,” “integrity of regulatory and institutional framework and policies” and “protection and promotion of investment.”

11 This may have been influenced by the fact that the Japanese companies that answered the questionnaire included many component manufacturers serving assembling companies in Malaysia.

12 See Figure 1 for the history and background of expansion by Japanese and Western companies into Malaysia.

Figure 12 Detailed framework of survey and analysis

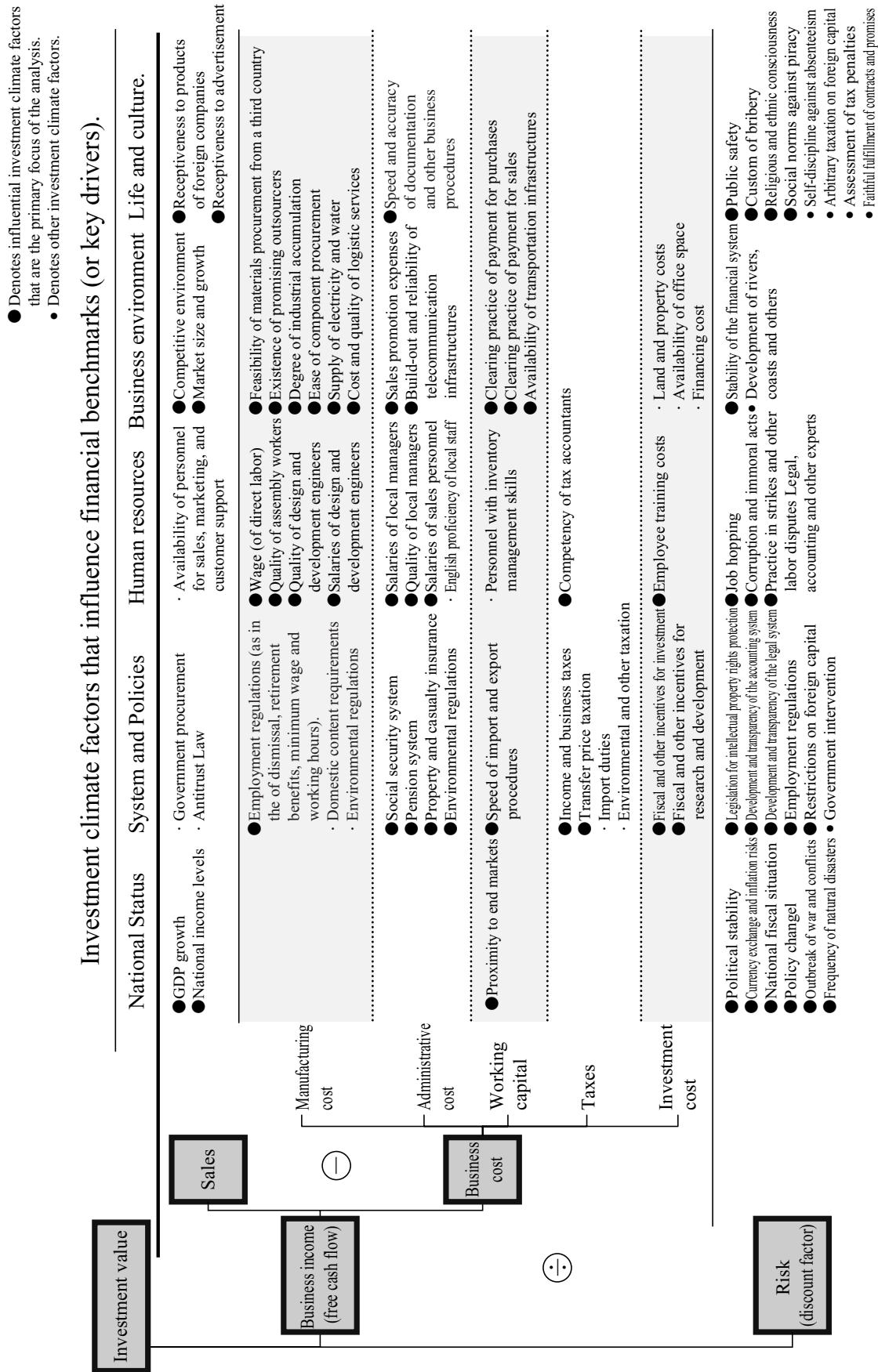
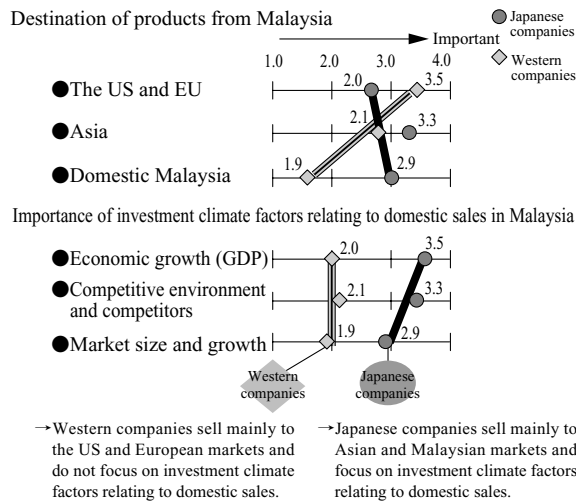


Figure 13 Questionnaire results: Relationships between exposure to local markets and relative importance of investment climate factors relating to sales - a comparison between Japanese and Western companies



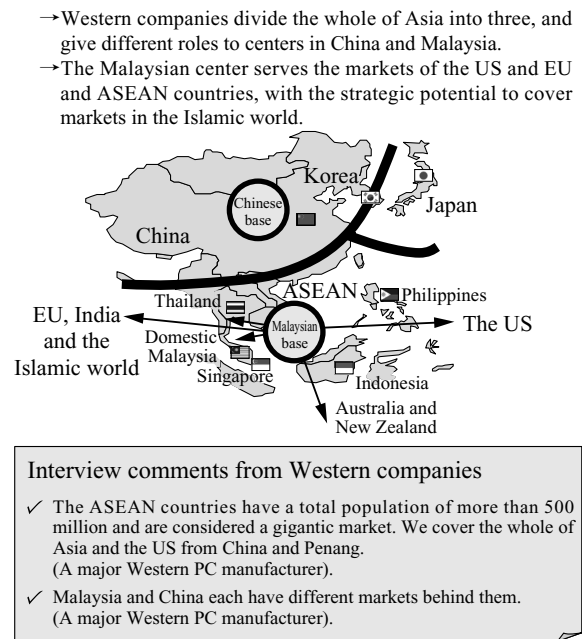
Source: ABeam Consulting, based on the questionnaire survey

2) Different Views on Costs

Based on the survey, let us compare the respective ranges of cost factors that Japanese and Western companies take into consideration in evaluating investment climate. Business cost in the electrical and electronic industry is broken down into principal elements as shown in Figure 16. Japanese and Western companies operating in Malaysia share the same main objective of creating cost competitiveness through overseas production. In expanding their business overseas, Japanese companies care most about materials procurement cost and manufacturing and processing costs, which accounts for approximately only 18% of the total business costs and could both be driven down by low local wage rates.

Western companies, in contrast, do not consider low wages as a single source of competitiveness in evaluating an overseas production plan, but typically aim to reduce the total business cost, ranging from product development cost to inventory management and administrative costs.

Figure 14 Manufacturing centers and product destinations of Western companies



Source: ABeam Consulting

3) Focus on Labor Costs by Japanese Companies

As stated above, labor costs continues to be an important evaluation measure for Japanese companies. According to a survey of Japanese companies conducted by the JBIC, a majority of respondents listed labor costs increase as a principal management challenge in Malaysia, which indicates that labor costs are among the most important issues for local Japanese affiliates. (See Figure 17.)

From the 1970s through the late 1980s, for those Japanese companies which were in search of inexpensive labor and a shelter from the impact of yen appreciation, Malaysia was a natural choice because it afforded both. However, even today they still seek the same benefit of inexpensive labor from Malaysia, because the notion of Malaysia as a manufacturing base is firmly set in their minds.¹³ (See Figure 18.)

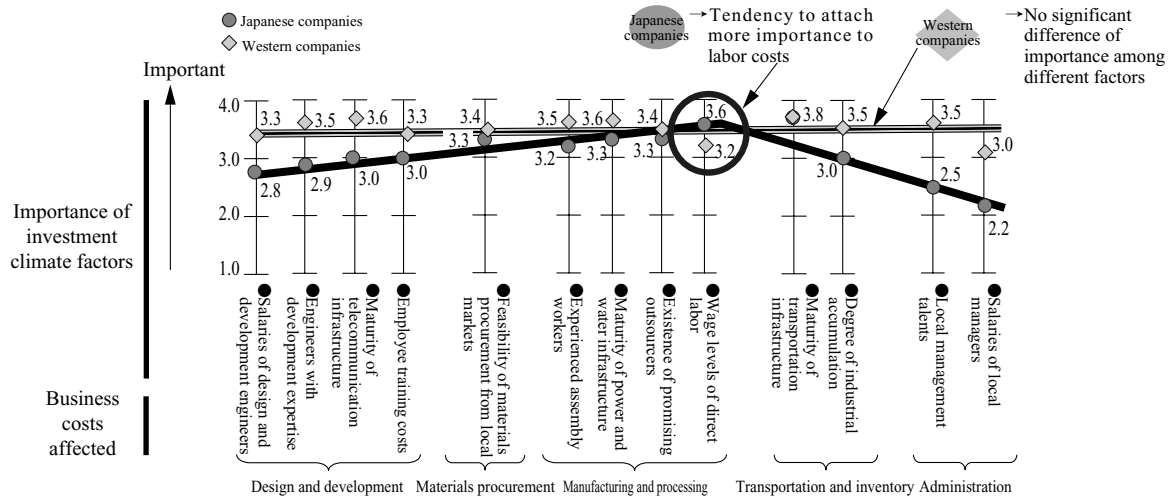
4. Relative Importance of Business Risks

1) Survey Results

According to our survey, awareness of risk measures is generally higher among Western companies than it is among Japanese companies. Western companies

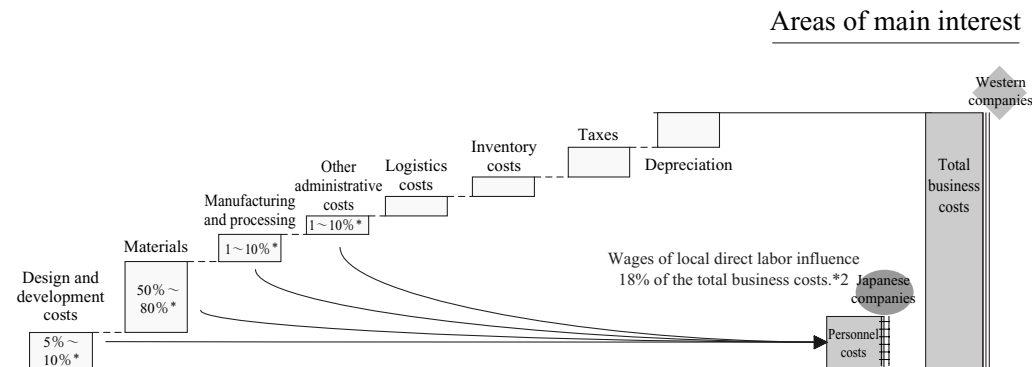
13 In this respect, we will later discuss changes in the position of Malaysia as an investment target.

Figure 15 Questionnaire results: Levels of importance in cost-related investment climate of Japanese and Western companies.



Source: ABeam Consulting, based on the questionnaire survey

Figure 16 Structure of operating costs in electrical and electronics manufacturers



Source: ABeam Consulting

*1 Figures represent the central tendency of each cost as a percentage of business cost (total cost), estimated by ABeam Consulting based on interview results and financial statements of Japanese electrical and electronics manufacturers.

*2 According to the input-output table published by the Ministry of Economy, Trade and Industry of Japan, personnel costs, including that for both direct and indirect labor, accounted for 18% of the total costs in the electrical and electronics manufacturing industry.

Figure 17 Management issues in Malaysia as perceived by Japanese companies

2002	2003
Political and social situations 28.6%	Severe competition with other firms 47.6%
Severe competition with other firms 25.0%	Increase in labor costs 23.8%
Foreign capital restrictions 25.0%	Foreign capital restrictions 23.8%
Securing of local labour (management level) 25.0%	Restrictions on foreign exchange transactions and repatriation of funds 19.0%
Increase in labor costs 21.4%	Higher taxation 19.0%

Source: ABeam Consulting, based on "Survey Report on Overseas Business Operations by Japanese Manufacturing Companies," JBIC Institute, 2000-2003

This result may have been influenced by heightened interest in political and social situations in 2002, triggered by the 9/11 terrorist attacks and the retirement of Prime Minister Mahathir.

Figure 18 Interview comments

Interview comments by Japanese companies indicate their keen awareness of labor cost issues.

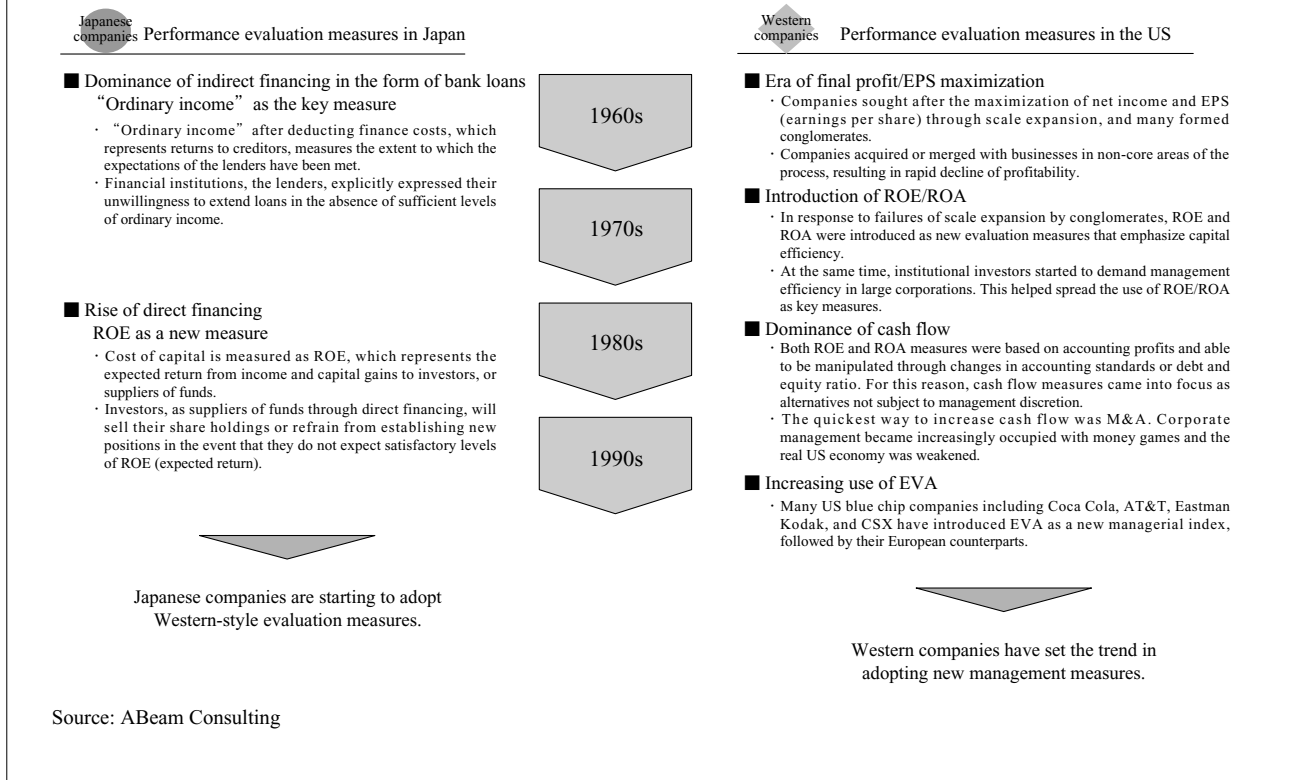
- ✓ In the decision making process for FDI, we first consider labor costs, followed by procurement cost of materials. (A major Japanese integrated electrical and electronics manufacturer).
- ✓ Currently, labor accounts for 6-7% of the total expenses, but continues to be perceived as an important cost item. (A Japanese electrical and electronics manufacturer).
- ✓ We came to Malaysia primarily because of the expansion of a finished product manufacturer to whom we sold. The second reason was low labor costs. (A major Japanese component manufacturer).

Source: ABeam Consulting, based on interview results

<Column 1> Changes in performance evaluation measures

Figure 26 illustrates changes in the principal performance evaluation measures that Japanese and Western companies have used. Even though an increasing number of Japanese companies have recently been adopting cash flow-based measures of enterprise value, including EVA, at an enterprise level, such measures are not widely utilized at business unit or subsidiary levels. This is possibly due to the fact that their Malaysian subsidiaries are primarily positioned as manufacturing bases and preclude the need to introduce overall management measures as mentioned above.¹⁴

Figure 26 Changes in performance evaluation measures



are keenly aware of risks associated with piracy and other infringements against intellectual property rights in investment target countries. (See Figure 19.)

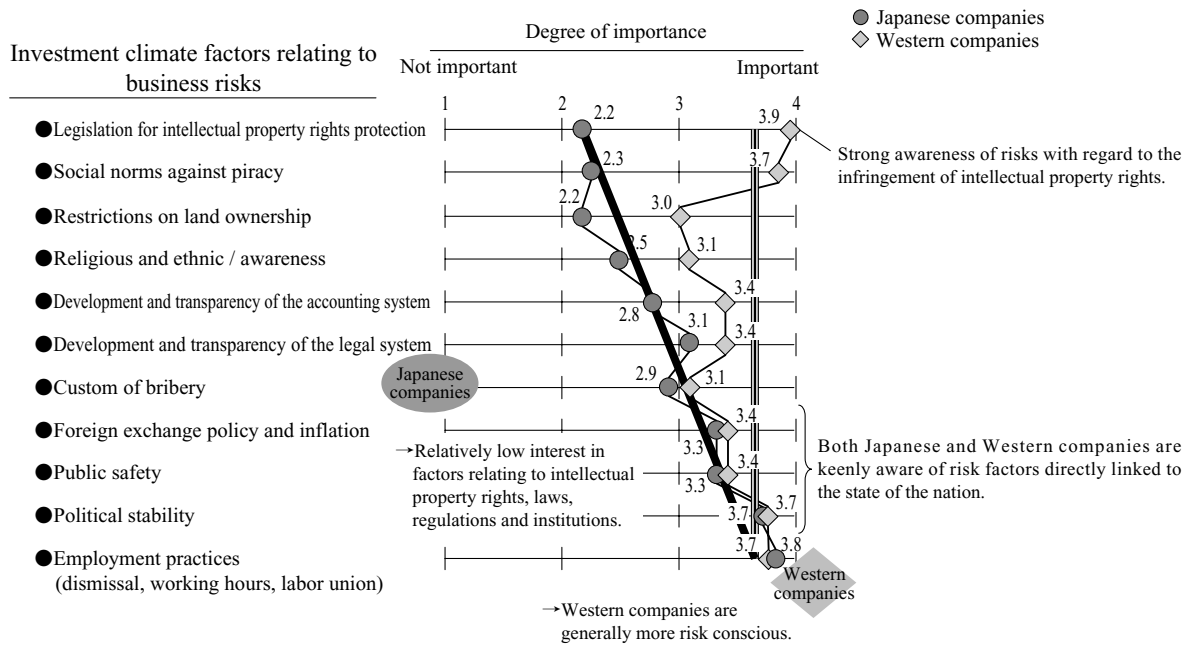
This can be partly explained by the fact that some Western companies have transferred product development and design functions to Malaysia. At the same time, Western companies generally exhibited

strong interest in accounting and legal systems that have an importance on local management risk.

Knockout (or critical risks) factors for business operations, such as security and political stability, are high on the list of both Japanese and Western companies.

¹⁴ During our interview at one of the electrical and electronic manufacturers, the respondent said, "Profit margin and cash flow are key criteria for evaluating local operations. We considered introducing EVA a few years ago but decided not to on the ground that EVA was a benchmark that was derived from the results of a business operation, not a benchmark against which one could measure performance and act accordingly. If you tell people on the floor to improve EVA, they do not know what to do and there will be no improvement. Rather, they understand and respond better to calls to lower costs, reduce inventory days below a certain number, and so on. That is, local management goals should be simple. Thus, EVA was turned down." This situation would likely change as local operations start to assume multiple functions including logistics, customer support, and research and development, in addition to manufacturing alone.

Figure 19 Questionnaire results: Levels of importance in risk-related investment climate evaluated by Japanese and Western companies



Source: ABeam Consulting, based on the questionnaire survey

Figure 20 Differences in relative importance of risk factors in the investment decision making process - a comparison between Japanese and Western companies.

	Investment decision making entity	Site selection	Investment planning	Investment execution and post-investment risk management
Japanese companies	<p>Manufacturing division</p> <ul style="list-style-type: none"> ✓ The division often lays out a plan in cooperation with the planning department. 	<p>Qualitative risk evaluation</p> <ul style="list-style-type: none"> ✓ Risk evaluation is often only qualitative in nature. For example, evaluation of site selection is sometimes given only on a yes-or-no basis. 	<p>Measures and responsibilities for risk management are left ambiguous.</p> <ul style="list-style-type: none"> ✓ Measures and responsibilities for managing the situation in the case that anticipated risk events should happen are left ambiguous. ✓ Plans are typically vulnerable to fluctuations in demand. 	<p>Local management is responsible for improvement in quality, cost and delivery (QCD).</p> <ul style="list-style-type: none"> ✓ A manager with factory management expertise holds responsibility for QCD improvement.
Western companies	<p>Specialist team and top management</p> <ul style="list-style-type: none"> ✓ FDI specialists and outside experts evaluate a plan with the involvement of top management. ✓ Local affiliates do not participate in plan development because of a lack of objectivity. 	<p>Quantitative risk assessment</p> <ul style="list-style-type: none"> ✓ Knockout factors, such as political instability or severe restrictions on foreign capital, are the focus of the assessment. ✓ Benefits of investment and risks are quantitatively analyzed by using NPV, etc. 	<p>Risk minimization efforts</p> <ul style="list-style-type: none"> ✓ Companies proactively negotiate with the local government to minimize risks. ✓ Risk management plans are developed for all conceivable risk events, with conditions for withdrawal clearly defined. 	<p>Management of business risks</p> <ul style="list-style-type: none"> ✓ Top management of local affiliates is primarily held responsible for the overall business risks of the operation. ✓ Internal audit teams carry out regular examinations of the operating performance and financial condition of the local operation.

Source: various interviews

2) Different Risks Evaluation Frameworks in the Investment Decision Making Process

In this section, we discuss how Japanese and Western companies evaluate risks in their investment decision making process. (See Figure 20.)

Decisions in Japanese companies as to their foreign direct investment are primarily made by business units (manufacturing divisions). Risk evaluation is often only qualitative in nature. For example, evaluation of site selection is sometimes given only on a yes-or-no basis.

Western companies usually have a team of specialists in foreign direct investment involved in the evaluation process and often retain outside experts to obtain an objective and expert opinion on investment risk and return, reflecting their strict attitude to these issues. As with business risks, country risk is often quantified and incorporated into a discount rate to calculate the net present value of an investment. Some companies even negotiate with the local government at the feasibility study stage, prepare measures against all potential risks and define the

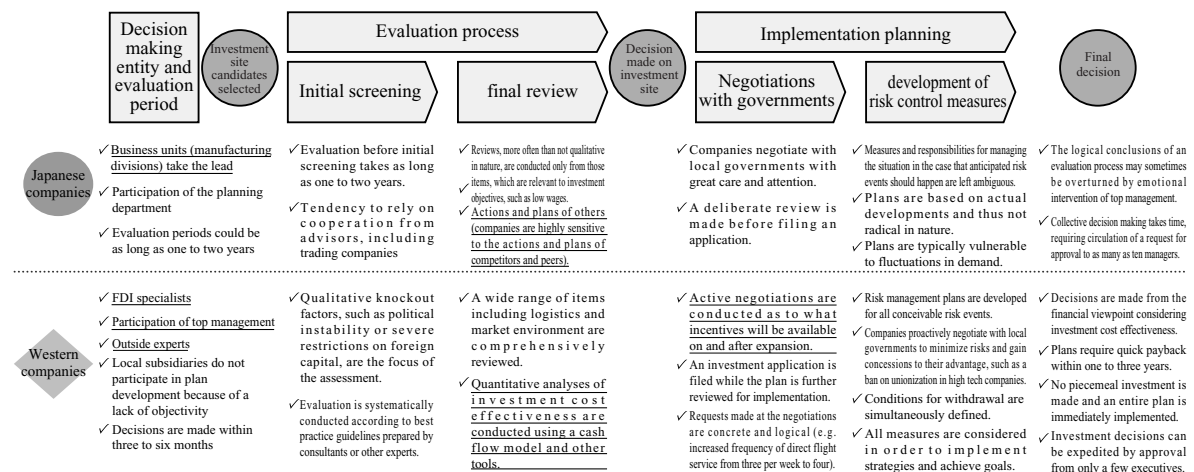
<Column 2> Investment decision-making process

Differences in the investment decision making process between Japanese and Western companies are depicted in Figure 21, based on interviews and other materials.¹⁶ Decisions in Japanese companies as to their foreign direct investments are primarily made by business units (manufacturing divisions), while Western companies usually have a team of specialists in foreign direct investments involved in the evaluation process and often retain outside experts to obtain an objective and expert opinion on investment risk and return.

In the evaluation process, Japanese companies often draw upon investments made by competitors as a reference, and rely on cooperation from advisors including trading companies. Western companies, in contrast, make an analysis based on their individual conditions in order to differentiate from other companies and strengthen their competitiveness. For example, a major semiconductor company conducts their evaluation in two steps, first by checking knockout factors, i.e. critical factors that can make or break the investment, and next by making an objective analysis using a cash flow model and other tools.

Lastly, in implementation planning, Western companies “think on the run” filing applications and negotiating incentives from an early stage of evaluation. Japanese companies, on the other hand, tend to be more cautious. They take time in evaluation and wait until plans are definite before starting incentive negotiations. Depending on circumstances, however, they will likely need to be more proactive by lobbying local governments, investment promotion organizations, and other bodies to improve the investment climate.

Figure 21 Differences in investment decision making process



Source: various interviews

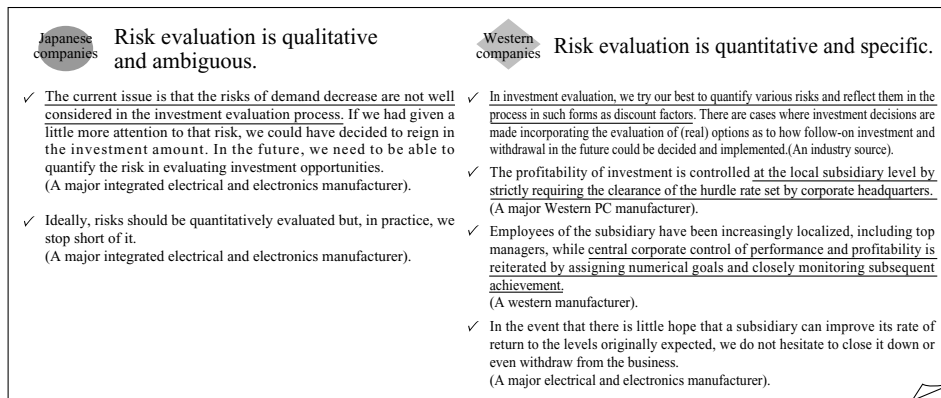
responsibilities of each manager clearly.¹⁵ Risk management on a post-investment basis is also cited

as a principal responsibility of the top management of local affiliates.

15 According to interviews by the authors. See Figure 21 for details.

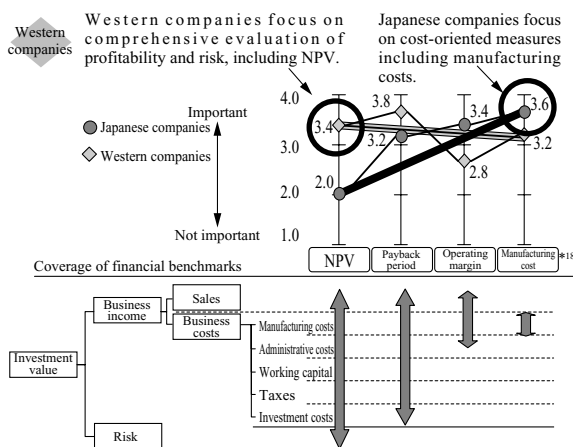
16 A respondent from a Japanese electrical equipment manufacturer stated that there basically are no differences between Japanese and Western companies in respect of their investment decision making process. Our focus, however, is not on the formality of the process, but on the actual key factors that influence such decisions. It should be noted that we do not mean to suggest the relative merits of Japanese or Western companies.

Figure 22 Comments on risks by Japanese and Western companies



Source: Interviews and other materials, compiled by ABeam Consulting

Figure 23 Questionnaire results: Relative importance of financial benchmarks in the investment decision making process - a comparison between Japanese and Western companies.

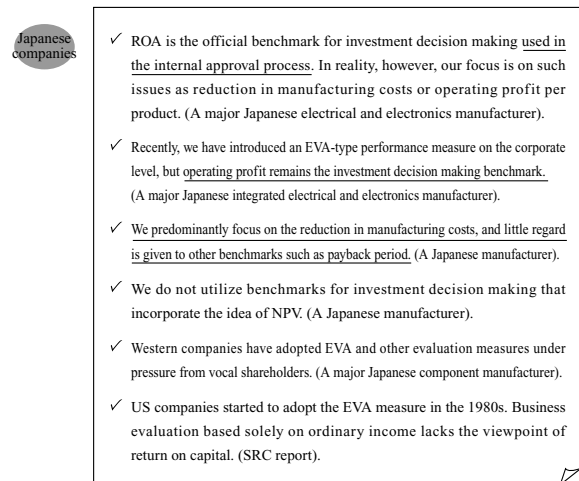


Source: ABeam Consulting, based on the questionnaire survey

3) Case Studies: Risk Evaluation

Case studies of the risk evaluation of Japanese and Western companies were conducted based on interviews, and their results are summarized below. Generally speaking, Japanese companies do

Figure 24 Interview comments



recognize risks but only on a qualitative basis, and those risks are often not reflected in the financial analysis upon which an investment decision shall be based.¹⁷ (See Figure 22.)

17 As a result, post-investment risk tends to be loosely managed. This view was supported by a comment from a Japanese company that pointed out low awareness of risk as a cause for deterioration in the results of their overseas operation. There was a case where a company implemented an FDI plan based solely on revenues from one prospective client without taking into account the risk of reduced demand from the specific client, and consequently suffered a significant loss.

At a Western company, in contrast, a manager in charge of investment planning was not held liable for the consequences of risk realization but actually promoted, as the manager had conducted a thorough examination of latent risks for the plan.

18 The following is the explanation of each benchmark.

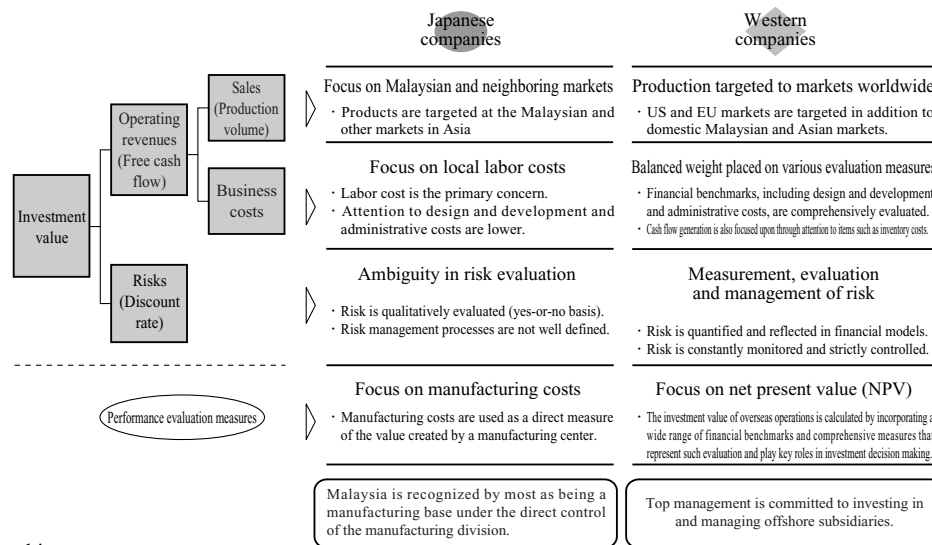
Net present value (NPV) refers to the present value of future cash flow, discounted by a rate that incorporates time and risk factors.

Payback period indicates the number of years necessary to recoup initial investment. Time value of money and risks are not taken into consideration.

Operating margin is a measure of profit that is calculated as gross profit less sales, general expenses and administrative expenses, and which indicates the profitability of a business.

Manufacturing costs include costs of raw materials, labor, logistics and administration.

Figure 25 Summary: Differences between frameworks for investment climate evaluation of Japanese and Western companies



Source: ABeam Consulting

5. Summary: Investment Climate Evaluation and its Relationship with Selected Financial Benchmarks

Differences in stance in evaluating the sales, business costs and business risks, manifest themselves as the difference in the financial benchmarks which companies focus on. According to our questionnaire survey, Japanese companies emphasized financial benchmarks such as operating margin and manufacturing costs, which are greatly affected by labor costs. Western companies, however, prioritized financial measures that show comprehensive business performance, including net present value and payback period. In other words, the scope of investment climate evaluation is greatly influenced by what financial goals a company pursues. (See Figure 23, 24 and 25.)

these evaluation methods and the actual investment climate in Malaysia.

In Figure 27, labor costs, the main focus of Japanese companies, is measured on the vertical axis. Risks, in which Western companies lay emphasis and which is represented by country risks with multiple effects on business performance, is measured on the horizontal axis. The chart will be utilized for mapping various Asian countries according to their attributes as manufacturing bases.

As a general rule, a country moves from upper left to lower right on the chart as its economy develops and matures. At an early stage, when its economy is still immature, a country will be mapped in the upper left corner of the chart, where inexpensive labor can be effectively utilized in jobs with a low skill requirement such as assembling. As the economy develops and business infrastructure is improved, country risks decline and labor costs rise, gradually moving the plot of the country on the chart toward the lower right, ultimately to the point where companies are required to build their competitiveness on an enterprise-wide basis across many functions, not solely on low wages.

Using this framework, we mapped various countries on a chart and divided them into five groups according to their attributes as manufacturing bases.¹⁹ (See Figure 28. and 29.)

Chapter 3: Malaysia - History and the Future

1. Asian Countries as Manufacturing Base

1) Classification

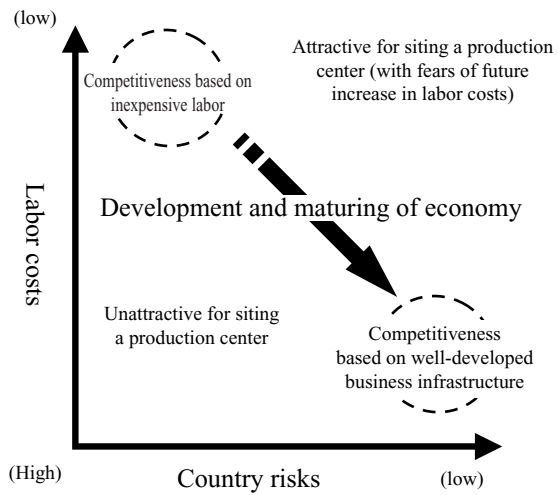
In Chapter 3, we found that Japanese companies in Malaysia focused on manufacturing costs, especially labor cost, while Western companies stress total business cost and levels of risks expressed in a discount rate. We now make a comparison between

19 The positions are for illustrative purposes of contrasting various countries, and are not based on precise definitions.

2) Investment Trends in Countries in Different Positions

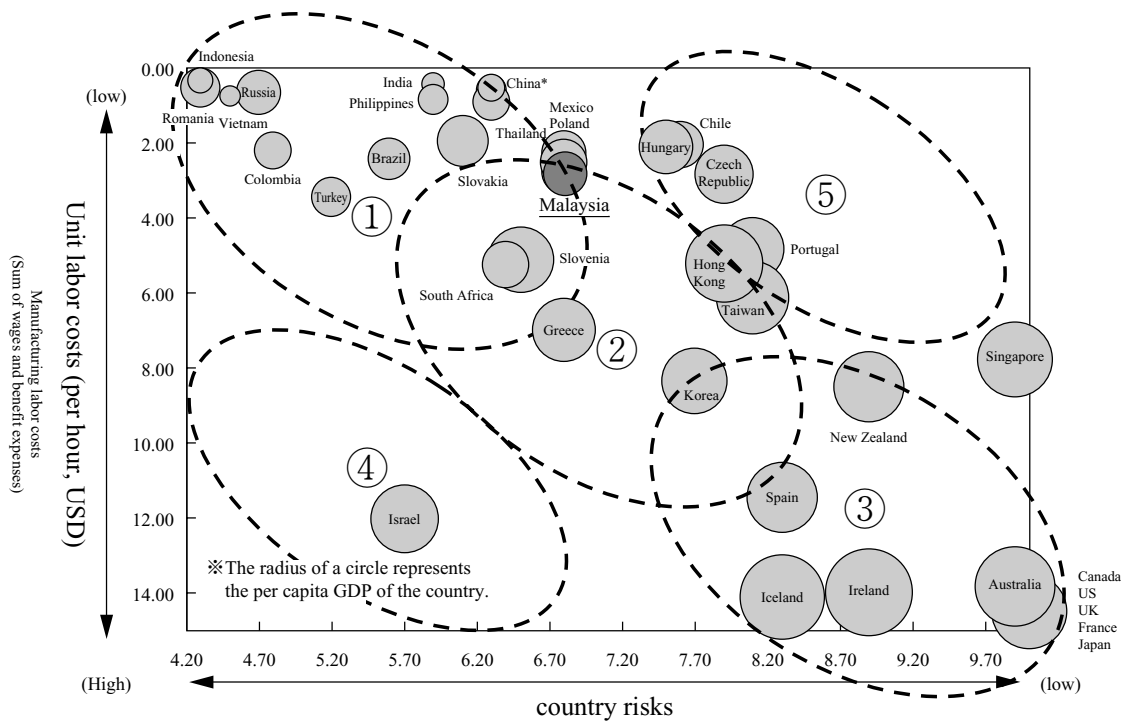
Investment trends in some countries in different positions are summarized in Figure 30. Vietnam, in position 1, for example, is experiencing an increasing flow of Japanese transplants attracted by inexpensive labor and industrious people. Korea, in position 2, has transformed from a labor-intensive investment site to a knowledge-intensive site, laying a foundation for attracting controlling hubs. Eastern European countries in position 5 enjoy an evaluation of moderate business risk with low labor cost, increasingly attracting direct investment from Western corporations that include automakers and electrical and electronic manufacturers.

Figure 27 Positioning as manufacturing center



Source: ABeam Consulting

Figure 28 Positioning of various countries as manufacturing centers²⁰



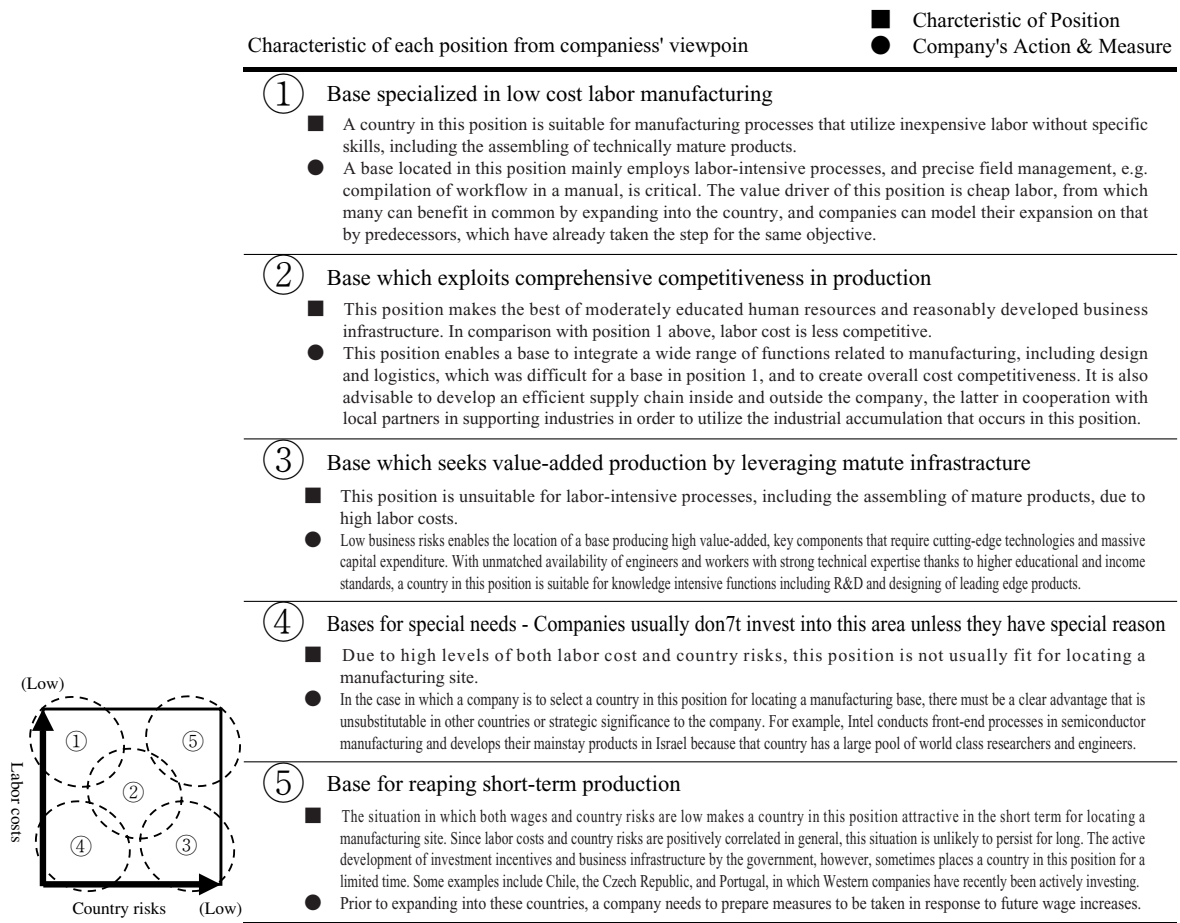
Source: Analysis by ABeam Consulting, based on data from R&I Country Risk Survey 2003 and IMD: The World Competitiveness Yearbook 2003

20 Labor cost (vertical axis): Each country was plotted based on labor cost of workers in the manufacturing sector published as Business Efficiency - Compensation Levels in IMD (2003).

Country risk (horizontal axis): Country risk is a benchmark that measures risk associated with carrying out manufacturing activities through direct investment in a given host country, and is meant to reflect the comprehensive political and economic situation of each country. It was planned based on overall country risk rating calculated from data by Rating and Investment Information Inc. (2003). The calculation incorporated a total of fifteen factors, including risk of civil strife and revolution, political stability, industry maturity, fiscal policies, risk of war, external solvency and foreign exchange policies. The rating was scaled to a maximum of 10.0, and risk of each country was so rated that a larger index number indicated a lower risk level. Japan was not included in the above mentioned analysis, and was assumed to represent the same level of risk as other major industrialized countries.

Countries subject to positioning: Countries subject to positioning were selected from ASEAN-4 countries, NIES-4 countries, G-7 plus Russia industrialized countries, three Nordic countries, Central and South American countries, East European countries, Oceania countries, and countries in other regions including Africa and the Middle East. From the countries listed above, those which 1) have no comparable statistical data available for the same time and based on the same standard as the others, 2) take extreme values in comparison to the other countries, i.e. countries with the hourly wage of workers exceeding USD20 and those with country risk rating at or below 4.0, were excluded.

Figure 29 Characteristic of each position



Source: Analysis by ABeam Consulting

3) Basic Investment Principles According to Different Positions

As a manufacturing base, each position possesses a different source of competitiveness. In making foreign direct investment, one must clearly understand the differences among positions and ensure that the type of business, organization, evaluation framework and staffing best suit the investment climate in a given position. For example, in investing in a country in position 1, local control for risk management is indispensable. Evaluation should be centered on manufacturing cost. In shifting to position 2, effective expansion of the value chain holds the key. This, in turn, necessitates transformation of the evaluation framework to one based on total costs and overall business efficiency, in which local operations are rated according to their productivity and certain authority is delegated to local management in order to promote autonomy. Excluding the exceptional positions 4 and 5, the type

of business and organizational structure that best fit each position are summarized in Figure 31.

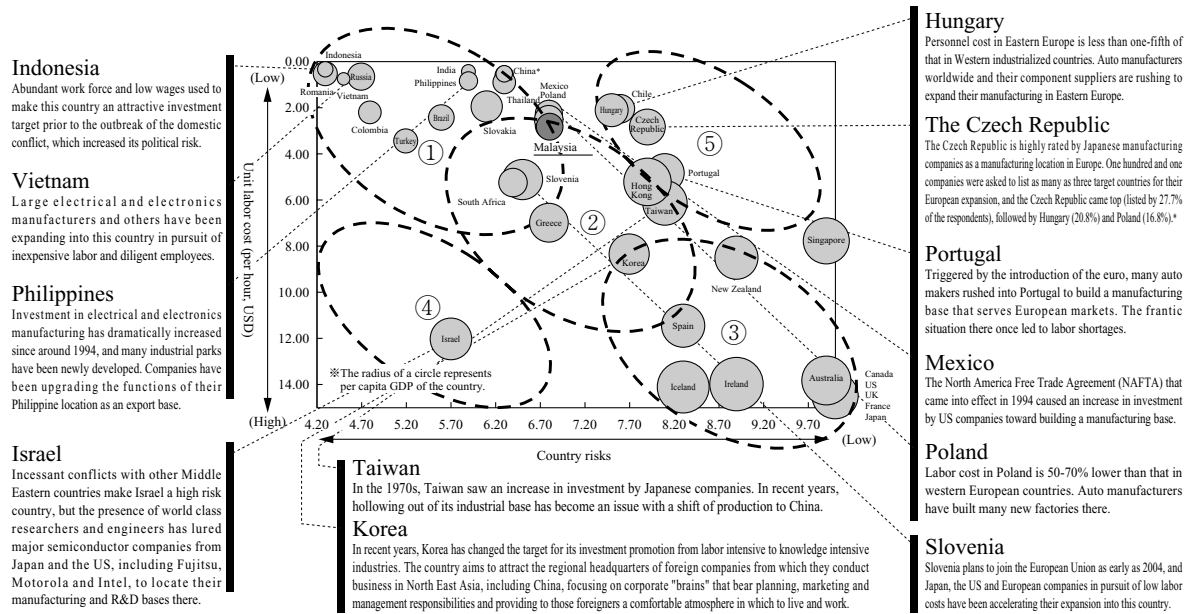
2. Changing Position of Malaysia

In the framework as depicted above, the position of Malaysia has been changing like many other countries. We now examine this by looking at how the labor costs and risks of the country have shifted. In recent years, labor costs in Malaysia has been steadily rising, making it increasingly difficult to attain cost competitiveness based on low wages (see Figure 32). At the same time, the country risks of Malaysia, despite temporary fluctuations, has been on a long-term declining trend (see Figure 33.). These observations lead us to believe that Malaysia has been moving from position 1 to position 2. (See Figure 34.)

3. Summary

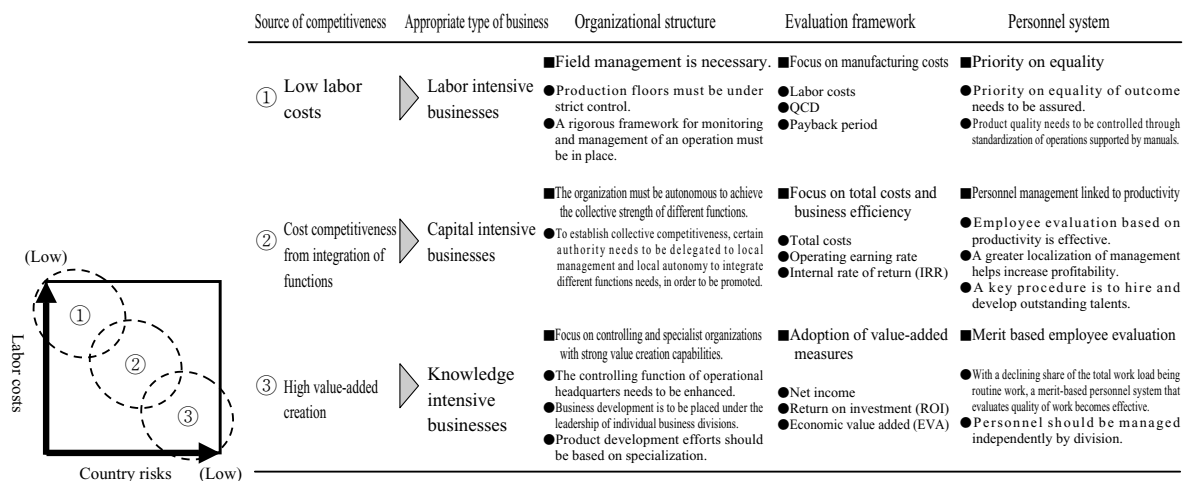
In this chapter, the positions of different countries as

Figure 30 FDI developments in countries / regions in different positions



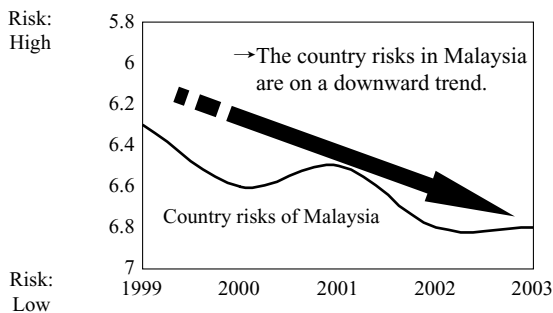
Source: Nihon Keizai Shimbun, Nikkei Industrial Daily, Nikkei Marketing Journal and Nikkei Financial Daily
* Based on the results of a questionnaire survey jointly conducted by Nihon Keizai Shimbun and Nikkei Research.

Figure 31 Basic Investment Principles According to Different Positions



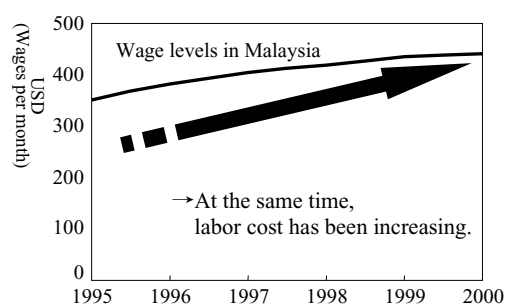
Source: Analysis by ABeam Consulting

Figure 32 Changes in country risks of Malaysia



Source: R&I Country Risk Survey, 2003

Figure 33 Changes in wage levels in Malaysia



Source: ABeam Consulting, based on materials and data by the International Labor Organization and JETRO.

Figure 34 Difference in business development in Malaysia between Japanese and Western companies

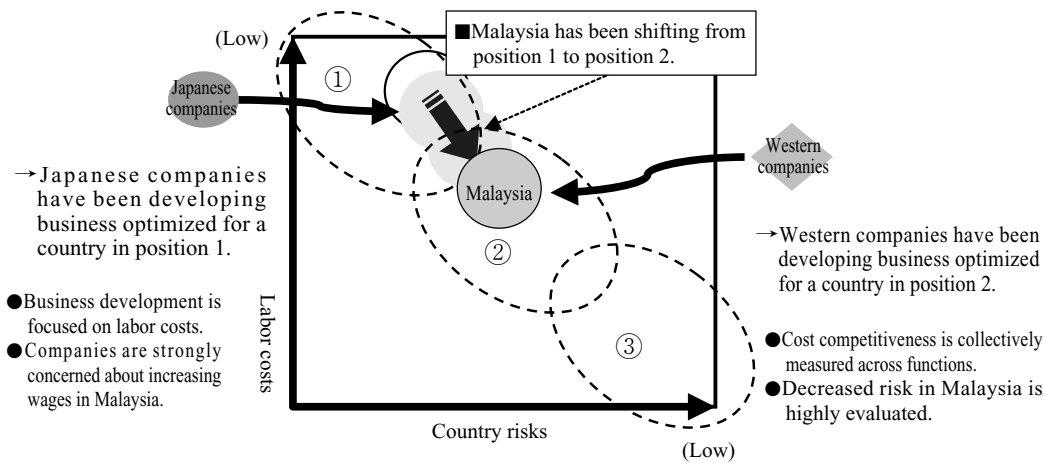
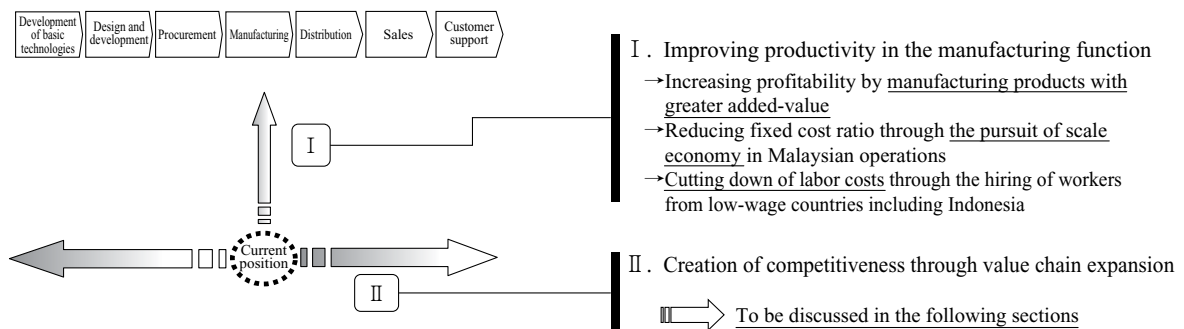


Figure 35 Future directions to create competitiveness



Source: ABeam Consulting

manufacturing bases have been evaluated based on two factors - labor costs and country risks. Labor costs are the key driver in position 1 and, as a country moves to position 2, local operations need to enhance business functions by taking advantage of the improved business infrastructure that has been made possible by the lowering of risks. We have also demonstrated that Malaysia is shifting from position 1 to position 2.

Previously, in Chapter 2, we revealed that Japanese companies conducting business in Malaysia tend to focus on manufacturing costs, especially labor costs, while Western companies evaluate local operations based on total costs and place great importance on the low risk level of the host country.

Putting these findings together, one can conclude that the business stance and investment climate evaluation of Japanese companies, which are based on the assumption that Malaysia remains in position 1, are causing a mismatch with the reality of

the country shifting to position 2. It is safe to say that this mismatch is causing Japanese companies to take the stance of maintaining the status quo in their investment and business development in Malaysia, while Western companies, in contrast, have in place a business expansion strategy that effectively functions in a country in position 2, and have thus been making an aggressive commitment to Malaysia.

Chapter 4: Proposals to Japanese Companies

1. Measures to Create Competitiveness

As noted in the previous chapter, Japanese companies in Malaysia need to change their business strategy which does not solely rely on low wages to maintain and enhance their competitiveness in the coming years. In this section, we explore the possibility of increasing manufacturing productivity and creating competitiveness through value chain expansion as

measures to achieve the objective²¹. (See Figure 35.)

Increase in manufacturing productivity can be achieved through three different ways. They are, first, to shift the production to high value-added products; second, to enlarge production scale in order to offset the impact of labor cost increase; and, third, to hire workers from neighboring countries with low wage levels including Indonesia.

Creation of competitiveness through value chain expansion refers to measures to create new sources of competitiveness by integrating additional functions, including design and marketing, with the manufacturing function of an existing location.

In the rest of this chapter we discuss the potential benefits of value chain expansion, and the issues and challenges of the implementation of the measure.

2. Issues and Challenges of Value Chain Expansion

1) Issues for Discussion and Challenges to be met

Prior to examining the detailed measures for value chain expansion in Malaysia, one needs to check the validity and feasibility. We raise and answer the questions of whether value chain expansion is an effective measure for solving the problem faced in the country, and whether it can be successfully

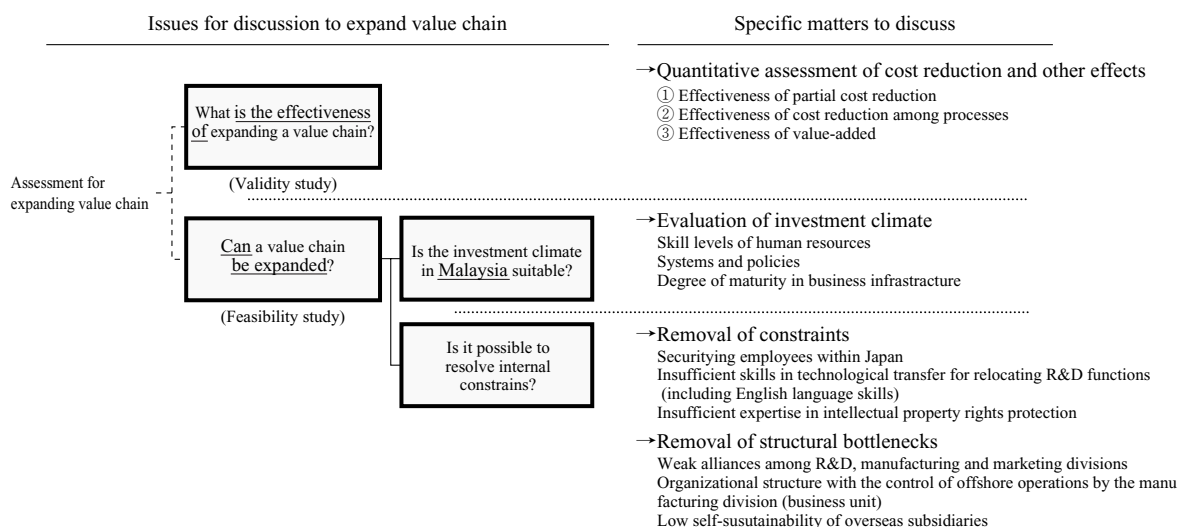
implemented (see Figure 36). In the validity test, certain measures and estimates are introduced that quantify the costs and effect of transferring non-manufacturing functions, including design and development, customer support, and repair, to Malaysia.

We then study the feasibility of value chain expansion in Malaysia by evaluating its investment climate, such as labor skills and business infrastructure, with due consideration of the constraints and restrictions specific to Japanese companies.

2) Creation of Competitiveness Through Value Chain Expansion

The creation of competitiveness through value chain expansion starts with cost reduction effects within each process and between adjacent processes (see Figure 37.). Decentralizing value-added and control functions to Malaysia by taking advantage of the improving business environment of the country, and thus establishing an effective value chain, should potentially add to the overall productivity of Japanese corporations. (See Steps 2 to 5 in Figure 37.)

Figure 36 Issues for discussion to expand value chain



Source: ABeam Consulting

²¹ Measures for sales promotion (opening of new markets) will not be discussed in this report, whose focus is on the manufacturing competitiveness of Malaysian operations. It should be noted, however, that some companies pointed out the potential of Malaysia as a marketing hub serving as a gateway to the Islamic world including the Middle East.

3) Estimation of the Effects of Value Chain Expansion

In deciding whether to expand a value chain, rather than relying on subjective assessment it is helpful to carry out a simplified simulation that quantifies the effects of such expansion. The effects of value chain expansion express themselves in the different steps of that expansion - Reduction of costs specific to individual functions in Step 2, Reduction of latent costs between different functions in Step 3, and Cash flow improvements in Step 4, are among cost reduction effects. In Step 5, the effects manifest themselves in increased profitability as a result of the timely launch of new products that meet the demands of the market or customers and produce higher customer satisfaction, leading to the Creation of added value. One needs to conduct concrete, quantitative and objective analyses of each of these effects.²²

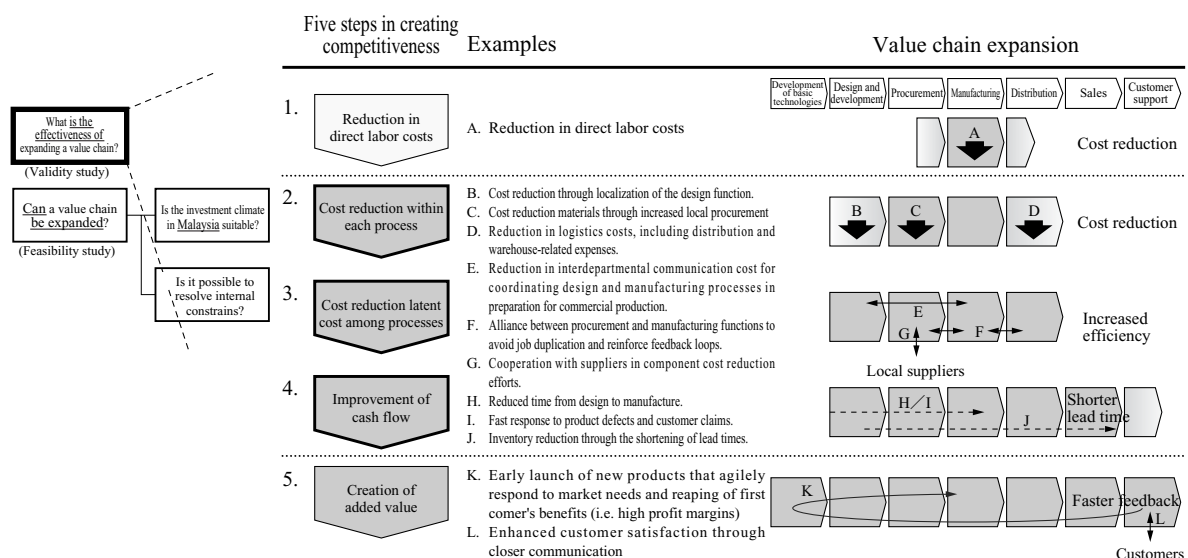
Looking into the details of each effect (see Figure 38.), taking as an example Step 2, Reduction of costs specific to individual functions, the personnel costs for engineers and managers who undertake research and development and

management of local subsidiaries and affiliates is at levels 35 to 40% of that in Japan. This means that substantial cost savings can be achieved by transferring research and development functions to Malaysia or hiring local management.

Also, with regard to Step 3, Reduction of latent cost between different functions, a survey shows that interdepartmental communication takes up as much as 13% of total annual indirect labor input.²³ Based on this, by moving design and other indirect functions to Malaysia a radical reduction in communication cost between the head office and office/factory in Malaysia can be expected.

Lastly, turning to Step 5, Creation of added value, a 25% reduction in the lead time for a new product launch by shortening the time necessary for the design-to-manufacturing process is estimated to improve profits by 6 to 8%.²⁴ This finding is a good quantitative example of the positive effect of reduction in lead time from value chain expansion.

Figure 37 Five steps in creating competitiveness



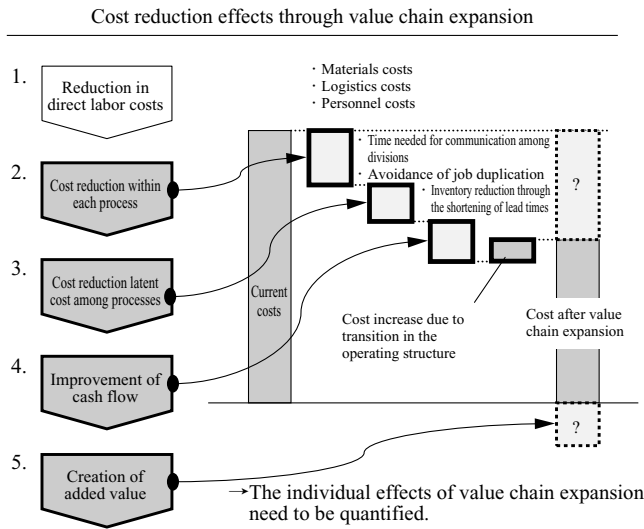
Source: ABeam Consulting

22 Furthermore, in estimating the effectiveness of value chain expansion, it is necessary to consider the cost increase factors due to transition in the operating structure.

23 Based on analysis by ABeam Consulting.

24 Based on analysis by ABeam Consulting.

Figure 38 Cost reduction effects through value chain expansion

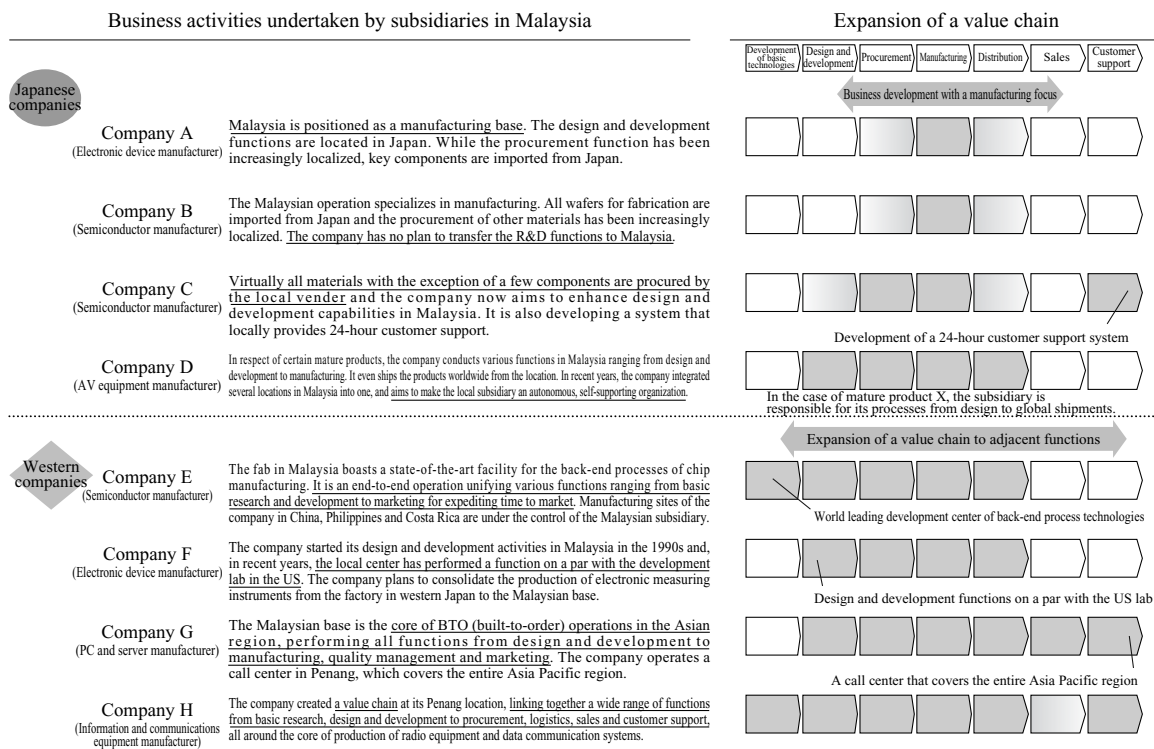


Examples of the analysis of cost reduction effects

2. An example of cost reduction effects within each process
 → The labor costs of Malaysia (engineers/managers) is at levels 35-40% of that in Japan. This means that substantial cost savings can be achieved by transferring certain peripheral functions from Japan to Malaysia.
3. An example of cost reduction effects between adjacent processes
 → Time required for communication among divisions in manufacturing industry represents 13% of total annual indirect labor input. Based on this, by moving design and other indirect functions to Malaysia a radical reduction in communication cost between the head office and office and factory in Malaysia can be expected.*
5. An example of the effects of creating added-value
 → A 25% reduction in the lead time for a new product launch by shortening the time necessary for the design to manufacturing process is estimated to improve profits by 6-8%.*

* Analysis by ABeam Consulting

Figure 39 Case studies of Japanese and Western companies



Source: ABeam Consulting, based on interview results, various materials and the questionnaire survey.

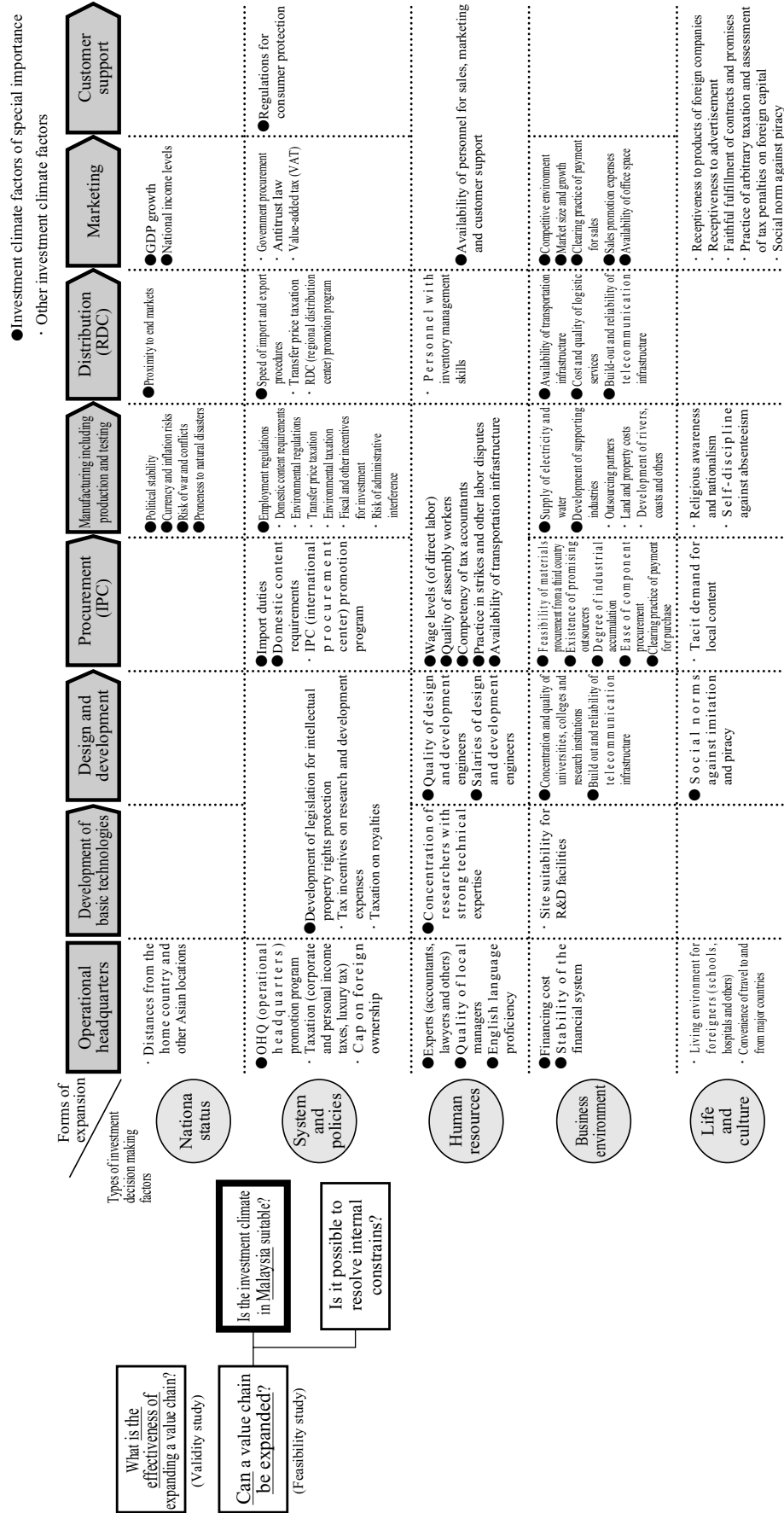
4) Current Status of the Investment Climate in Malaysia

In order to successfully expand a value chain, it is essential to identify investment climate factors needed for additional functions to be incorporated through planned expansion, and to ensure that these

requirements are ready in place. A framework showing the relationships between the configuration of the value chain and corresponding requirements among investment climate factors are summarized in the chart below. (See Figure 40.)

A review by use of the framework indicates that

Figure 40 Important investment climate factors for different value chain functions



Note: Some investment climate factors that affect all functions are omitted. Source: ABeam Consulting

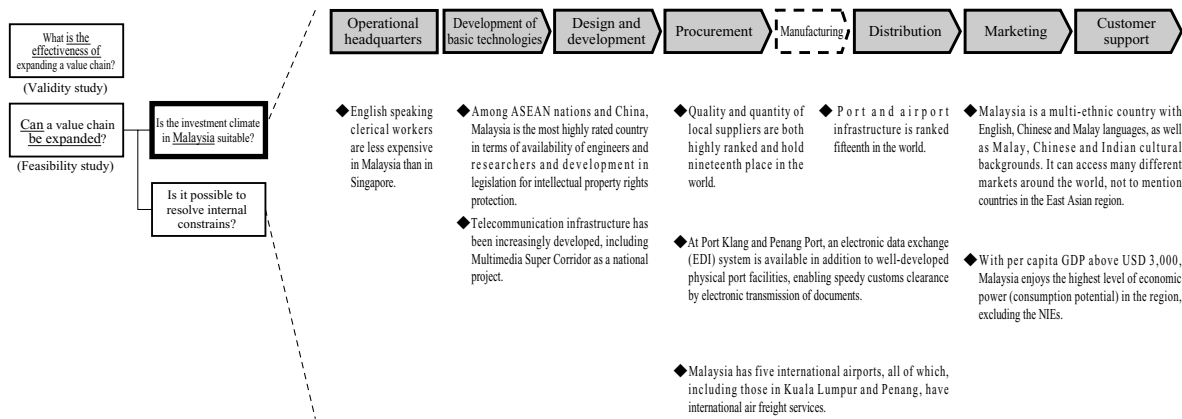
the investment climate in Malaysia has been improving to a level at which the country can accommodate new functions including marketing, customer support and design and development, in addition to manufacturing. Important to note, a number of companies, represented by Western affiliates, give high marks to Malaysia for its multi-ethnic, multilingual capabilities that are indispensable for cross-border marketing, its engineering talent for design and development, its business infrastructure, and its legal framework for intellectual property rights protection. This means, as the value chain is expanded, an increasing number of investment

climate factors need to be checked. (See Figure 41.)

4. Constraints and Restrictions Specific to Japanese Companies

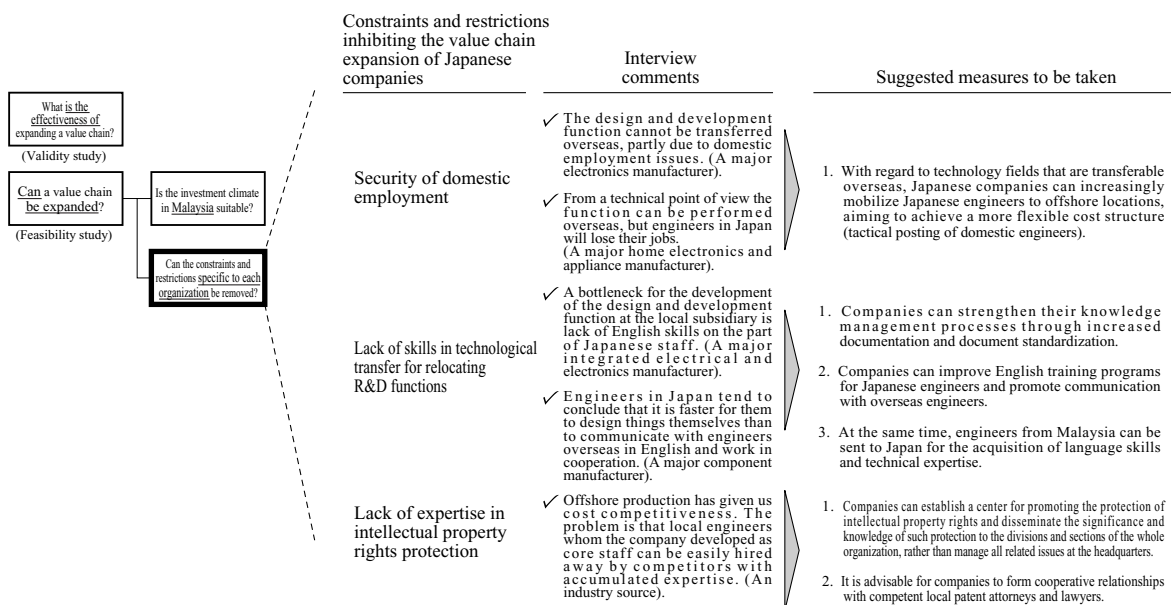
In addition to the local investment climate factors mentioned above, other constraints and restrictions specific to each organization need to be considered before expanding a value chain. In the case of Japanese companies, potential constraints and restrictions include 1) domestic employment issues 2) lack of skills in technological transfer for relocating R&D functions and 3) lack of expertise in intellectual property protection. (See Figure 42.)

Figure 41 Current conditions in Malaysia from the viewpoint of value chain expansion



Source: ABeam Consulting, based on interview results and other materials including those by the World Economic Forum.

Figure 42 Constraints and restrictions inhibiting the value chain expansion of Japanese companies



Source: ABeam Consulting, based on interview results and other materials

As potential solutions, the following bear consideration: the domestic employment issue can be relieved by training domestic engineers in transferable technological fields in Japan before posting them elsewhere and, thus, mobilizing labor across borders; technological transfer can be better facilitated by improving the English capabilities of engineers and promoting communication between engineers in Japan and overseas; and in order to improve intellectual property protection, it is important to disseminate the significance of and knowledge of such protection to the divisions and sections of the whole organization, rather than to manage all issues at the headquarters. These measures can be seen to reduce the difficulty in value chain expansion by easing restrictions.

5. Initiative by Corporate Headquarters

Many Japanese companies face different issues regarding value chain expansion at different levels of organization, from corporate headquarters²⁵ to divisions, to local subsidiaries and affiliates. In order for Japanese companies to continue to grow and develop their operations in Malaysia, organizational barriers at various levels need to be removed as described in the diagram below. (See Figure 43.)

6. Autonomy of Local Affiliates

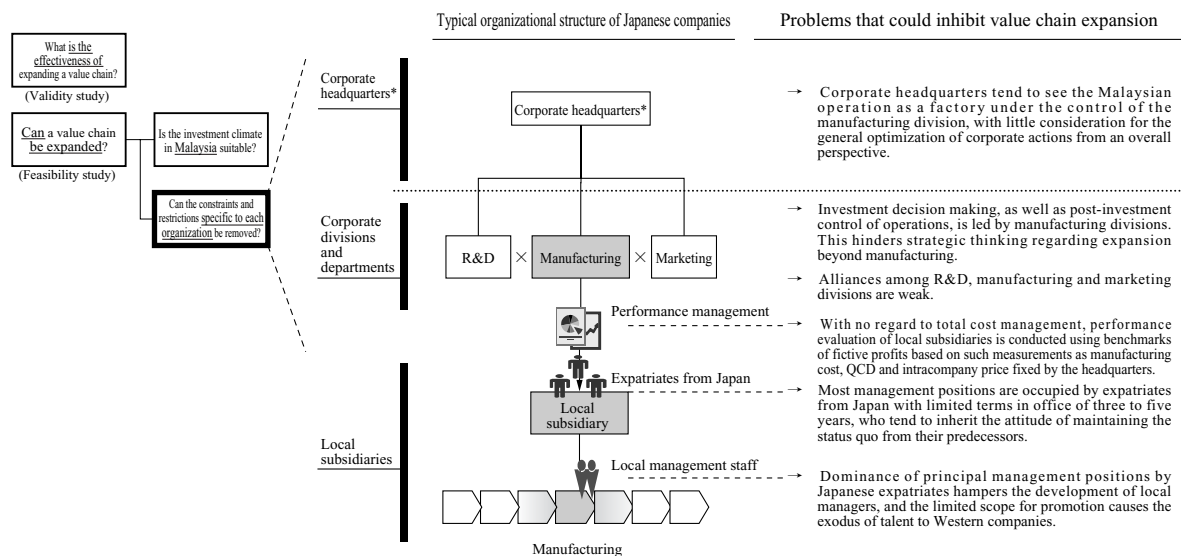
In order to solve the organizational problem that Japanese companies face, corporate headquarters need to control overseas entities and bring about coordination of the company as a whole, while local affiliates need to proactively expand the value chain. With these objectives in mind, we suggest that Malaysian affiliates be made autonomous managerial bodies directly under the corporate headquarters, that performance benchmarks be changed to cash flow and other profitability measures from QCD (quality, cost and delivery) and manufacturing costs, and that authority for product development and scale expansion be delegated to local management. (See Figure 44.)

Conclusion: Proposals for Japanese Companies

Local affiliates, Japanese and Western alike, expanded into Malaysia with the same goal in the same period from the 1970s to the 1980s. Their roles, however, are now different. Most Japanese companies continue, as they have since day one, to see their affiliates as a manufacturing base taking advantage of inexpensive labor. Many of their Western counterparts, however, have been aggressively expanding the business functions of their local affiliates.

A possible reason for this is the rigidity of

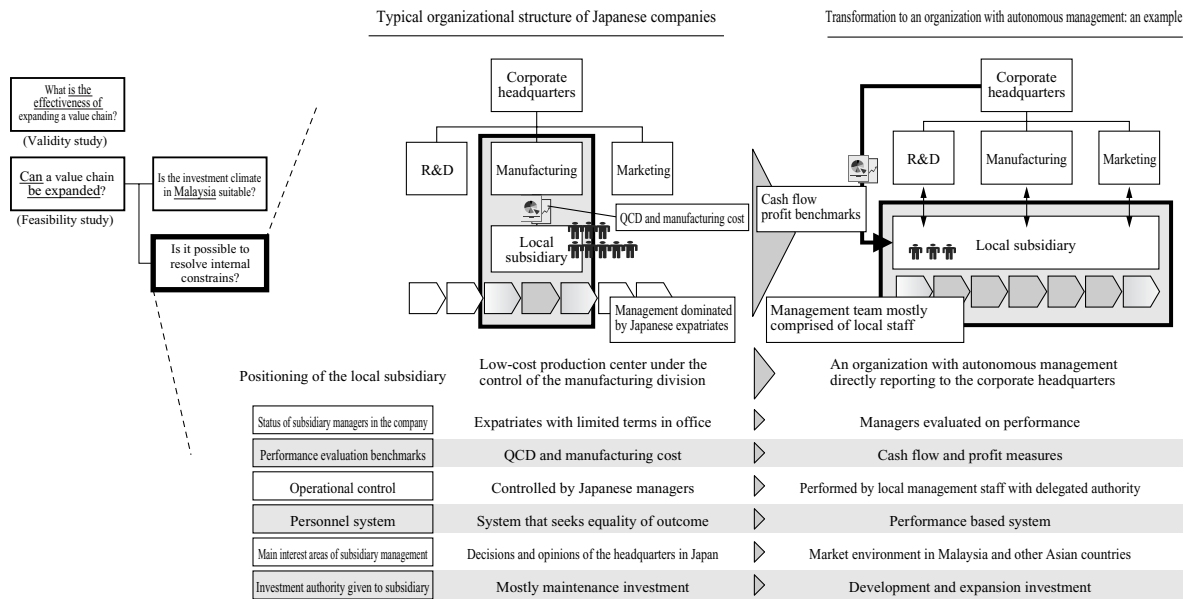
Figure 43 Typical organizational structure of Japanese companies



Source: ABeam Consulting, based on interviews and other materials

25 The term 'corporate headquarters' refers to the entire management and control functions of the head office.

Figure 44 Transformation to autonomous management: an example



Source: ABeam Consulting

organization on the part of Japanese companies, and their inertia to maintain the status quo. A three- to five-year rotation of local management by delegated from head quarter in Japan makes it difficult to swiftly adjust operations in response to the changing local environment and to proactively develop business. Close relationship between local affiliates and manufacturing divisions hinder the self-motivation for enhancing design and development functions and promoting sales to the rest of Asia. Performance evaluation based on cost-oriented measures including QCD and manufacturing cost leads to partial optimization within manufacturing divisions only, instead of an overall development of local operations. It is not uncommon to see more than

ten manufacturing and marketing subsidiaries and affiliates established respectively in Malaysia within a single corporate group, as a result of both divisions forming alliances with their respective partners.²⁶

Such operations, however, are reaching the limit. External factors affecting local affiliates, or the positioning of the host country, are constantly changing and developing, requiring structural reforms in response by corporations.²⁷

Needless to say, different soil needs a different farming style. It will not be long before the approach based solely on labor costs will reach its limit in Malaysia. Vietnam may take over its status as a manufacturing base, or China may leap ahead in capital-intensive industries. Even in China, there may

26 These structural issues associated with overseas business operations may be rooted in the differences in the relationship between shareholders, or owners, and management. At Western companies, rapid decision making at the top is required for the maximization of returns to shareholders. Foreign direct investment falls under the direct command of top management, who decide on such investment from the bird's-eye view and subsequently widen the scope of operations in order to enhance the valuation of overseas business. Conversely, when they determine that the business creates no value, they lose no time in deciding on withdrawal. In fact, according to data provided by JETRO, the business survival rate of Western companies in Malaysia is as low as 50%.

In comparison, Japanese companies have traditionally given priority to long-term growth rather than to short-term profit payback. Consequently, basic business principles have emphasized business continuity more than profitability. The priority of continuity has given rise to a corporate culture of maintaining the status quo. Consequently, under the influence of a bottom-up decision making process and, specifically, manufacturing-led decision making on foreign direct investment issues, radical changes based on the enterprise value of the entire firm have tended not to happen regarding the positioning of foreign subsidiaries.

27 Peter F. Drucker wrote, "What one truly needs to know about the outside world is its changes, not its tendencies." (Literally translated from the Japanese text.)

arise a mismatch between the investment climate in the country and the evaluation method employed by Japanese companies. It is clear that the agility to grasp the changes in other Asian countries, or ability to accurately evaluate their investment climate, is what is most needed of Japanese companies today.

Against this backdrop, this report analyzed investment climate factors in the two frameworks of financial valuation and value chain. We would hope that these analyses serve as a guide for Japanese companies to broaden their scope and build a new organizational structure that frees overseas affiliates from the sole role of manufacturing base and promotes their autonomous growth.

Appendix: Limitations and Issues Regarding the Survey

1. Diversity in Corporate Structure among Electrical and Electronic Manufacturers

Japanese and Western electrical and electronic manufacturers have diversified types and sizes of operations, ranging from component factories with tens of employees to global multinational companies hiring thousands of people. Their products encompass a wide variety of components, home appliances, IT equipment and semiconductor devices. The difference in types and sizes of operations, or nature of businesses, inevitably has a great influence on investment strategy. It therefore needs to be noted that the influence of differences in the nature of business could not be entirely removed from the effort to analyze the investment attitudes of Japanese and Western companies and to obtain unaffected results.

2. Asian Investment Strategy of Western Electrical and Electronic Manufacturers

Compared with Japanese manufacturers, Western companies are generally less willing to disclose information on their investment strategy, which is a key component of corporate planning, thereby limiting the quality and quantity of such information. Due to geographic limitations, we did not conduct interviews with managers of Western companies at

their headquarters (please note that we conducted interviews with their Japanese counterparts). Such interviews are regarded as effective and informative, given that those headquarters effectively make decisions on foreign direct investment. Regarding Western companies, the analysis was instead based on local interviews, survey questionnaires and secondary information.

3. Cost Structure Analysis in a Value Chain

Japanese and Western companies both classify cost structure by product as a trade secret, and this varies greatly according to factors including product specification, target market and timing of research and development, rendering it difficult to find details for creating a model. We therefore decided not to conduct an analysis of cost structure by value chain factor and quantitative measurement of cost reductions from value chain expansion.

4. Restriction on Information Disclosure Pursuant to Confidentiality Agreement

Pursuant to the confidentiality agreement we entered into prior to interviews with Japanese and Western companies, disclosure of individual company names or such information by which individual company names can be specified was restricted, provided that pertaining information had not previously been made public via other media.

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