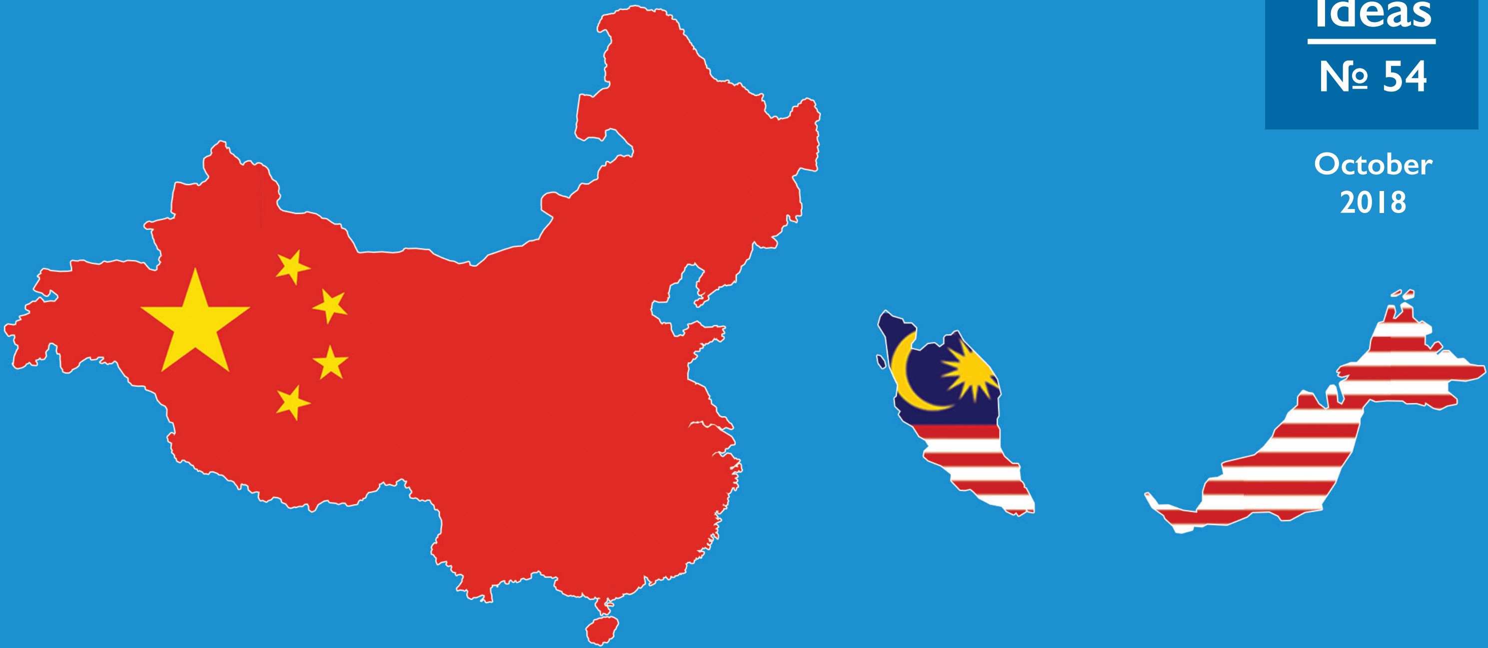
Policy Ideas № 54

October 2018



Impacts of Investment from China in Malaysia on the Local Economy

Laurence Todd
Meghan Slattery

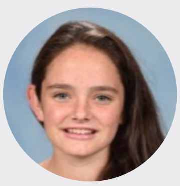
IDEAS
INSTITUTE FOR DEMOCRACY AND ECONOMIC AFFAIRS

Executive Summary

In recent years, Chinese Foreign Direct Investment (FDI) in Malaysia has captured widespread attention with its increased focus on large-scale infrastructure projects. With Malaysia's developed economy and strategic location, it has become a kay nation for China's Belt and Road Initiative (BRI) and has received significant investment from Chinese State-Linked companies as a result. However, the effects of Chinese FDI have been varied, and their role in the Malaysian economy is widely debated. Concerns have been raised over the financing of these projects and the transparency of the procurement process, leading the newly elected government to initiate reviews of these major projects. Another area of contention has been the extent to which these projects support the local economy, especially local Small and Medium Enterprises (SMEs), which comprise a major portion of Malaysian registered companies.

In this paper, we assess the impact of Chinese investment on the Malaysian economy, by focussing on the opportunities created by these projects for local firms, and local SMEs in particular, placing our specific focus on major infrastructure projects involving Chinese State-Linked companies. Our research is based on a review of the literature on the impact of Chinese FDI in other economies, analysis of publicly available data and other information, including media reports, and interviews with industry and researchers.

Laurence Todd is the Director of Research and Development at IDEAS. Laurence is a public policy professional with a wide range of experience in economic policy, business regulation and international trade. Prior to joining IDEAS, Laurence served in a number of different roles in the UK Government, including in Her Majesty's Treasury and the Ministry of Defence.



Meghan Slattery is a junior at Princeton University majoring in Operations Research and Financial Engineering, pursuing certificates in Arabic, Finance, and Technology and Society. Through her summer internship with IDEAS, Meghan confirmed her research interest in foreign direct investment, and hopes to continue studying the topic for university independent work.

Based on this research, we conclude that:

There are conflicting accounts of the impact of Chinese FDI on local firms, and the lack of available data make a comprehensive assessment difficult.

The evidence suggests that the value of new construction contracts created as a result of increased Chinese investment is primarily accruing to Chinese firms, but the construction sector as a whole in Malaysia also continues to grow.

The highly competitive financing of Chinese firms, including through support from the Chinese state, presents a potentially unfair advantage. Competition between Chinese and local firms should be conducted on a level playing field.

There is a wide number of examples and anecdotal accounts of local firms benefiting from increased Chinese investment but so too are their examples of Chinese companies favouring Chinese labour and subcontractors over local options.

The principle reasons identified for why local firms are excluded from projects are: i) skill requirements; ii) differences in working practices; iii) cultural preferences; iv) language barriers; v) local capacity; vi) access to finance; and vii) politically motivated preferences.

Evidence from other countries suggests that FDI is most beneficial to the local economy when there is a high level of technology and knowledge transfer, but this requires the involvement of human capital. There are indications that Chinese firms do not always provide opportunities for such transfers, particularly to local SMEs. The extent to which this is justified by a lack of skills among Malaysian firms is disputed.

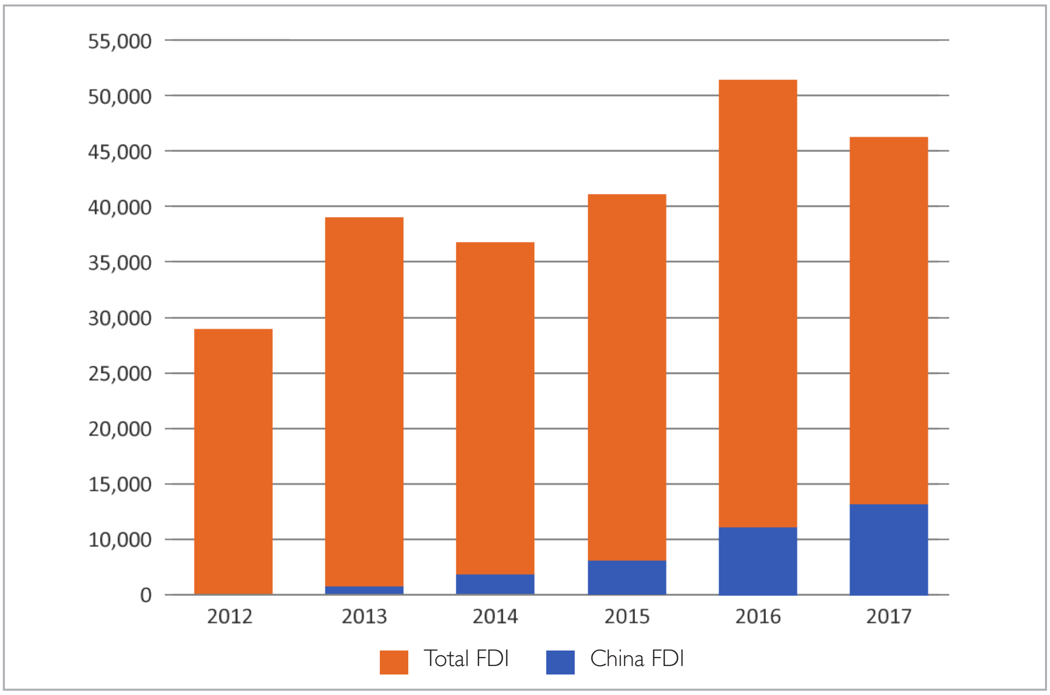
In order to maximise the benefit of Chinese FDI to the local economy, local firms and in particular SMEs, should be involved in the high skilled aspects of these projects, to encourage technology and knowledge transfer. In other words, it is the quality of local involvement, not just the quantity that matters.

Similarly, investments outside of infrastructure and construction and in more human capital-intensive sectors such as IT could create more positive impacts for local firms and in particular SMEs which are overwhelmingly concentrated in the services sector.

Part 1: Chinese FDI in Malaysia

Malaysia's resource-rich environment and strategic location have made it a key nation in China's push towards global influence. The "Belt and Road" initiative (BRI) launched in 2013 is an ongoing drive to bring about the "Silk Road Economic Belt" and the "21st Century Maritime Silk Road" through cooperation between China and neighboring countries. The initiative has a five-part focus on policy coordination, connecting infrastructure, unimpeded trade, financial integration, and people-to-people bonds. In Malaysia's case, each of these tenants has garnered national attention. Chinese immigration has increased greatly, former Prime Minister Najib Razak signed 14 memoranda of understanding with Chinese companies for economic cooperation, trade relations are growing stronger, and the amount of Chinese FDI flowing into the country is at an all-time high. The relationship between the two countries is building, and has been described by China's President Xi Jinping as "being at its best" with praise to the Malaysian government for its commitment towards "One Belt One Road."

Chart 1: Total Net Flows of FDI from China and Other Sources (RM millions)



Major infrastructure and construction projects

The increased Chinese influence in Malaysia has materialised primarily through new construction-based investment projects. It is these projects that we will be focussing on in this report. Located in almost every state, these large-scale infrastructure projects include everything from bridges to full cities and have totalled over 242 MYR billion in investment, as outlined in Table 1 below.

Table 1: Significant Chinese investments in Malaysia

State	Project	Company	Value (MYR, bil)
Penang	Penang Undersea Tunnel	China Railway Construction Corporation	3.7
	Penang Second Bridge	China Harbour and Engineering Corporation	4.5
Selangor	East Cost Railway Link (from Klang to Kota Bharu)	China Communications and Construction Company	5.5
	Xiamen University Malaysia	Sinohydro Investment	1.3
	Edra Power Holdings (various power plants locally and overseas)	China General Nuclear Power Group	10
Melaka	Melaka Gateway (port mixed development)	PowerChina International	15
Johor	Forest City	Country Garden	105
	Various other developments	Various	26
Sarawak	Bakun Dam	PowerChina International	7.5
Pahang	Kuantan Port and Malaysia-China Kuantan Industrial Park	Guangxi Beibu Gulf International Port Group	8
Kuala Lumpur	TRX Signature Tower	China State Construction Engineering Corporation	3.5
	Four Seasons Hotel	China Railway Construction Corporation	2.5
		Total	**242**

This rapid increase in investment has generated controversy. In 2017, the Socio-Economic Research Centre (SERC) explored these concerns by surveying members of the National Chamber of Commerce and Industry Malaysia (NCCIM) and Associated Chinese Chambers of Commerce and Industry of Malaysia (ACCCIM). Their study found that local businesses fear increased competition from Chinese investors. Of their respondents, 41% named "the direct threat to local companies" as the worst impact, while 22% worried more about "the crowding out effect on domestic SMEs." Other concerns included "less employment," "reduced market share," and 8% of companies even considered China's investment "a potential threat to national sovereignty." According to the report, "Small businesses may not even withstand or survive under such environment, especially when China's companies are persistently finding ways to thrive on competitive pricing or price cuts." For SMEs, the biggest fear is that China will complete its investment projects at such an advanced level of operation that local employment will not be necessary. (SERC, 2017).

Aside from increased competition, a major concern of Malaysian companies is that Chinese companies will exclusively award subcontracts to other companies from China. According to a Straits Times article, "Years of sudden and rapid development, coupled with the massive scale of Chinese firms, have ignited fear among Malaysian businesses." As put by SME Association of Malaysia President Datuk Michael Kang, "The problem with China is that it will own and control the entire supply chain."

Significant political attention has also been given to the pricing of these projects and their financing, which often takes the form of loans guaranteed by the Malaysian government. This has led many to argue that these "investments" should not be considered as FDI. The economic rationale for many of these projects has also been questioned. As a result of these concerns, following the 2018 General Election, the terms of some of these projects are now being renegotiated. The new Prime Minister Dr Tun Mahathir Mohamad stated during a press conference, "As far as the leaders from China and the Chinese are concerned, we have made it clear that we are going to look into all these contracts again because they are very costly for the government and will incur huge debts which we cannot pay." Concerns have also been raised over the social impacts of some of these projects. For example the Melaka Gateway project has come under criticism due to the apparent lack of consideration of the impact on local communities and the environment. The project is now being reassessed as a result (The Star, 2018).

In this paper, we will focus on the direct opportunities created by these projects for local firms, and SMEs in particular, rather than the wider concerns over their financing (except where that is relevant) or their economic rationale.

Malaysian SME Involvement with Chinese FDI

Small and Medium Enterprises (SMEs) comprise a substantial portion of Malaysia's economy. According to the most recent definition, a business entity qualifies as an SME as follows:

- "For the manufacturing sector, SMEs are defined as firms with sales turnover not exceeding RM50 million OR number of full-time employees not exceeding 200.
- For the services and other sectors, SMEs are defined as firms with sales turnover not exceeding RM20 million OR number of full-time employees not exceeding 75."

As at 2016, SMEs accounted for 98.5% of all business enterprises in Malaysia, over one-third of the national GDP, and two-thirds of national employment. SMEs are crucial to the Malaysian economy, and their performance is on the rise.

With the increase of FDI from China, added attention has been given to the role of SMEs in these major construction projects. With so many mega projects on the horizon, there is concern about the ability of SMEs to benefit from project involvement through subcontracting. Furthering this point, IDEAS author Wan Saiful Wan Jan states in "Chinese Investments in Malaysia":

> *"There have also been questions about the trickle-down benefits to local SMEs. Prior to the ascendance of the PRC, it was common for Malaysia to issue contracts to Western companies that subsequently subcontract to and source from local companies, thereby generating a trickle-down effect - creating jobs and encouraging technology transfer to Malaysia, but now there are anecdotal complaints from Malaysian SMEs that PRC companies procure almost everything from China, sidelining local firms."*

Part 2: Impact of Chinese FDI – Existing Literature

With similar Chinese investment projects appearing throughout the world, various studies on the impact of Chinese FDI on local businesses have been undertaken. As China continues to invest in its Belt and Road Initiative, its influence has spread to nearly every economic region.

In their paper, *"Chinese Engagement in Africa: Drivers, Reactions, and Implications for US Policy"* authors Larry Hanauer and Lyle J. Morris discuss the mixed responses Chinese investors receive in different African countries. They state, "the lack of transparency or independent scrutiny of many Chinese-funded projects—a corollary of Beijing's no-strings-attached, non-interference policy—makes such initiatives particularly ripe for personal enrichment," later providing the statistics that "roughly 10 percent [of respondents from their survey of five African countries] think Chinese small businesses actively harm African merchants by competing with them. Similarly, despite the fact that 92 percent of Cameroonians polled in 2007 believed that China helped their country's overall economy, 70 percent were 'disturbed' by the 'influx' of Chinese workers and merchants." Local sentiment towards the influx of Chinese business is quite mixed.

In their 2010 paper, *"The Impact of Chinese Outward Investment"* authors Julia Kubny and Hinrich Voss studied FDI impacts in Cambodia and Vietnam, noting that "Chinese manufacturing FDI is concentrated on low-skill, labour-intensive manufacturing and tends to be relatively small-scale." For their study, Kubny and Voss interviewed firms of varying sizes in both countries, as well as some mainland Chinese firms. The focus of their research was the direct and indirect effects of Chinese FDI on local companies, and includes policy recommendations at the end of the writing.

In both Cambodia and Vietnam, the authors found that most Chinese FDI dealt with low-skill industries. Especially in the case of Cambodia, where the garment industry saw the largest FDI inflows, interviews revealed cheap labour as a primary motive. At the lowest level of employment, local residents are the primary hires. In both Cambodia and Vietnam, almost all "shop-floor" workers are local. However, moving up the employment chain, Chinese citizens represented the majority. The authors state that: "Posts typically allocated to Cambodian employees are at a lower management level...supervisors...are predominantly Chinese. This was found to be due to the perception that local candidates lacked skills and experience." The goal of FDI in Vietnam and Cambodia is not to boost the local economy; rather, it is aimed at more efficient means of production for existing Chinese companies. Even where locals are employed (a direct benefit of investment), it is not structured in such a way that it maximises the potential for knowledge and technology transfer.

These findings are supported by research from the International Institute for Sustainable Development (IISD). After reviewing existing literature on Chinese investment, IISD summarised host country concerns stating, "While it is recognized that Chinese enterprises hire local people, the focus of the debate is more on the position and opportunities for training and advancement. Host governments also impose measures to encourage the employment of locals." In other words, FDI offers the most benefit where it is linked to industries or initiatives improving human capital.

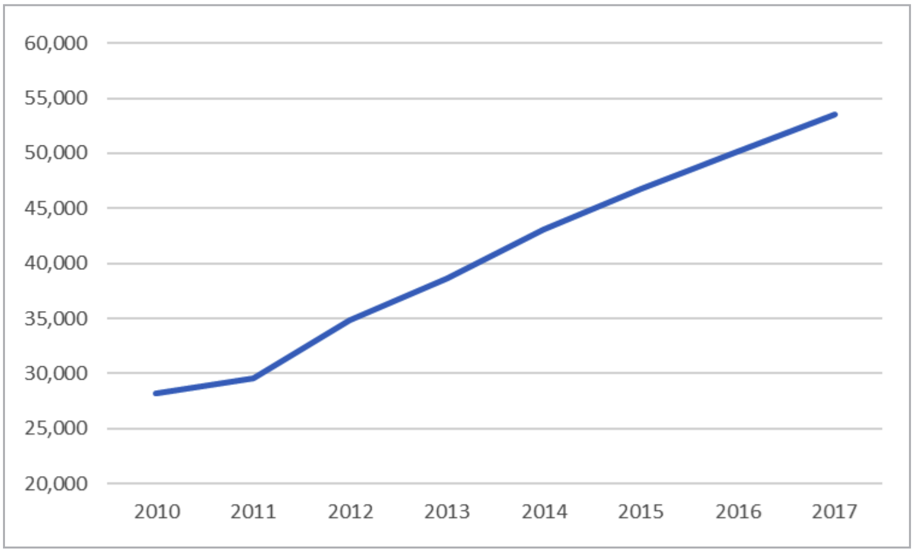
This is also supported by several studies, which have proven a statistically significant relationship between FDI benefit and levels of human capital. In *"How does Foreign Direct Investment Affect Economic Growth,"* Eduardo Borensztein's regression analysis suggests "that FDI has a positive overall effect on economic growth, although the magnitude of this effect depends on the stock of human capital available in the host economy." His findings suggest that "at very low levels of human capital the contribution of FDI to growth is close to nil and that it rises rapidly at higher levels of human capital"(Borensztein et al., 2009). Similarly, Ahmad Zubaidi Baharumshah and Suleiman W. Almasaied's Malaysia-specific study, *"Foreign Direct Investment and Economic Growth in Malaysia"* proved via logarithm that " human capital is very important to upgrading the economy by producing high value-added outputs through innovation." This result is consistent with the economic theory that FDI has the largest positive effect in sectors where human capital is present because it allows for a sustainable transfer of skills and knowledge, resulting in productivity gains.

Therefore, in trying to understand the benefit of Chinese foreign investment, it is important to consider the extent to which FDI projects employ local companies in high human capital areas.

Part 3: Economic Performance of Construction Sector in Malaysia in recent years

As stated earlier our focus is on the recent increase of Chinese investment in the construction of infrastructure. In this section, we therefore consider the overall performance of the construction sector in Malaysia, with a particular focus on the recent years which have seen a significant increase in FDI from China. As we can see from Chart 2, at the level of gross output, the construction sector in Malaysia has performed well in recent years, growing at a consistent rate.

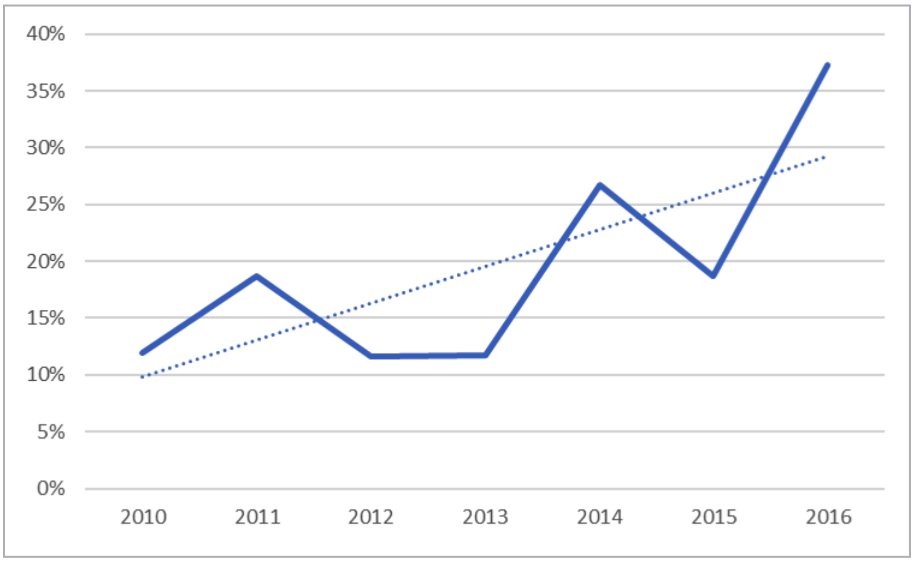
Chart 2: Malaysia - Construction Sector GDP (RM millions), 2010 Constant Prices



This growth has been fuelled by continued development spending by the Malaysian Government and private sector investment.

However, when we consider the share of contracts awarded to local and foreign contractors, we can see that the percentage awarded to foreign contractors has grown significantly in recent years (Chart 3), coinciding with the growth in Chinese FDI.

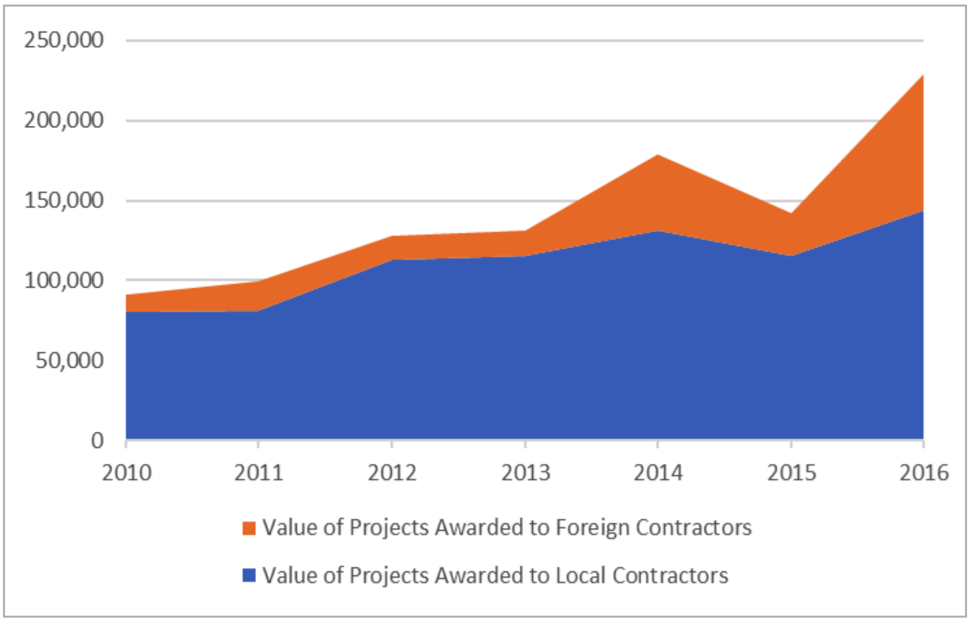
Chart 3: Percentage of Total Projects Awarded to Foreign Contractors (CIDB, 2017)



The percentage of contracts awarded to foreign contractors was around 12% until 2012, but has grown significantly in recent years, reaching 37% in 2016. In terms of value, the Chinese contractors represent the largest share, with 42% of the total value awarded to foreign contractors, comprising 25 projects.

However, this growth in the value of contracts awarded to foreign contractors has not come at the expense of a decline in the absolute value of contracts awarded to local contractors, as we can see in Chart 4 below.

Chart 4 : Value of Projects Awarded to Local and Foreign Contractors (Millions RM), 2010 Prices (CIDB, 2017)



So, the total value of projects awarded to local contractors has continued to grow in recent years, although the gains from the recent growth in total contracts awarded seem to have gone to foreign contractors.

SMEs in the Construction Sector

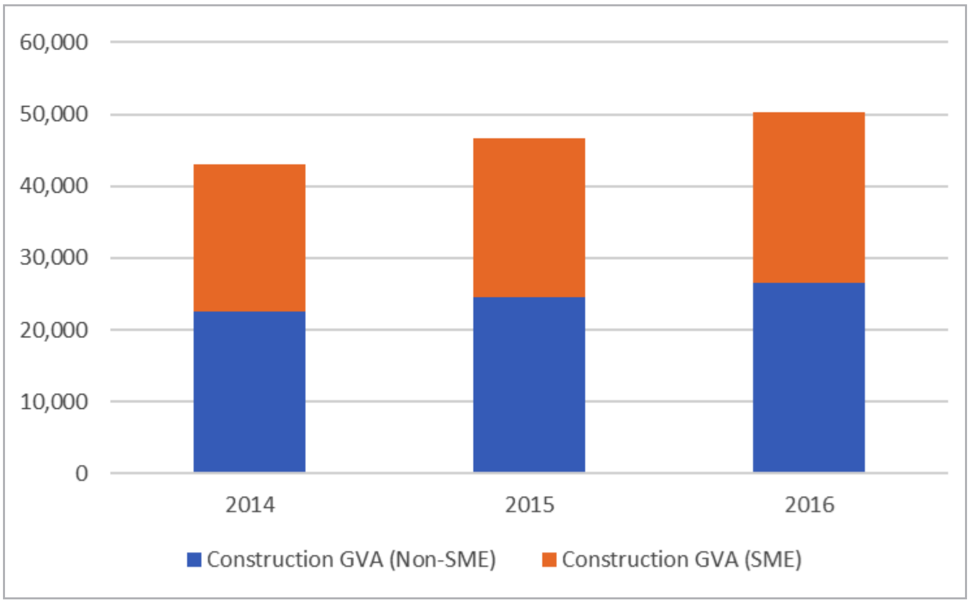
How have SMEs in the construction sector fared over this period? According to figures from SME Corp, the number of SME establishments in the construction sector have nearly doubled from 21,331 in 2011 to 39,158 in 2016. Although, to a large extent this increase is a result of a change in the definition of "SME" introduced in 2014. This increase has also resulted in SMEs in the construction sector now representing a bigger share of the total number of both SMEs and all business establishments, as we can see in Table 2.

Table 2: SME Establishments by industry (SME Corp, 2016)

	EC 2011 (Reference Year 2010)				EC 2016 (Reference Year 2015)			
	Total	SMEs	% of SMES to Total	% of SMEs to Total SMEs	Total	SMEs	% of SMES to Total	% of SMEs to Total SMEs
Services	577,133	570,775	88.0	89.4	818,311	809,126	87.9	89.2
Manufacturing	39,669	38,553	5.9	6.0	49,101	47,698	5.2	5.3
Construction	22,140	21,331	3.3	3.3	40,558	39,158	4.3	4.3
Agriculture	8,829	7,726	1.2	1.2	11,628	10,218	1.1	1.1
Mining & Quarrying	489	405	0.1	0.1	1,026	865	0.1	0.1
No. of establishment	648,260	638,790	98.5	100.0	920,624	907,065	98.5	100.0

In terms of economic output, SMEs in the construction sector have also performed well in recent years. Gross value added (GVA) of SMEs in the construc tion sector grew consistently between 2014 and 2016, accounting for roughly half of total GVA of the construction sector.

Chart 4: Value added in Construction Sector by Non-SME/SME (RM millions), 2010 Prices



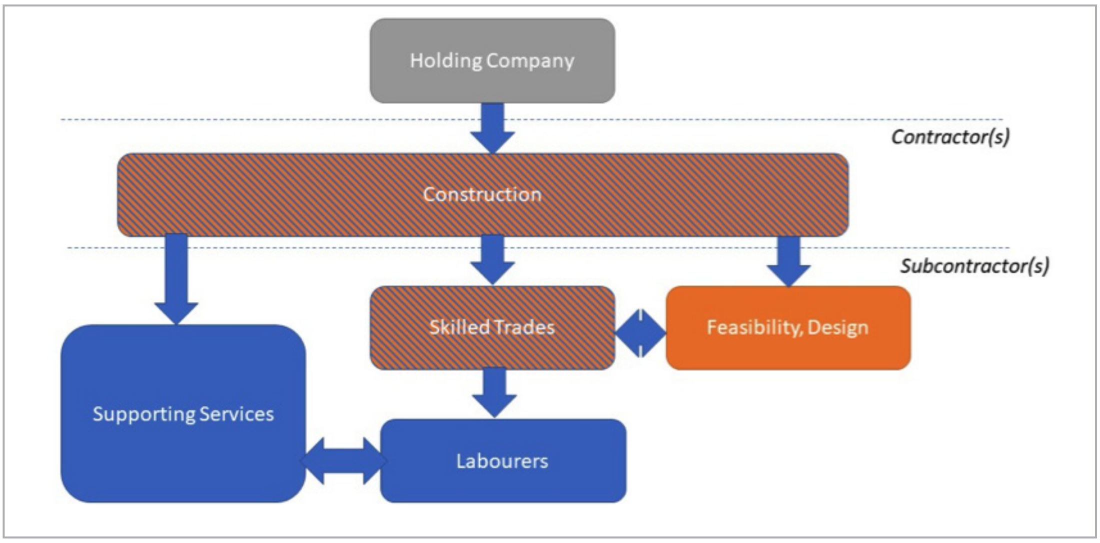
So, at the level of the Malaysian economy as a whole we can see that the construction sector has continued to perform well in recent years. Foreign contractors have benefitted most from this, but so too have local contractors. SMEs in the sector have also performed well, increasing their output in line with overall growth in the sector.

Part 4: Evidence of Local Participation in Chinese Investment Projects

Now we consider the extent to which local companies and SMEs specifically are engaged in major Chinese investment projects. The lack of available data makes a comprehensive assessment of this issue difficult. Rather, we must rely on interviews and whatever information is publicly available about these projects.

First, we must consider the typical structure of these projects. In Figure 1 below, we present the typical structure of a construction project, based on assessment of the projects undertaken and interviews with industry.

Figure 2: Typical Structure of Infrastructure Construction Project



- **Holding Companies** –
  the entity or entities which own and finance the development.

- **Feasibility, Design etc.** –
  the companies which provide the overall design for the project, including architects and consultants.

- **Construction** –
  the companies responsible for the overall management of the construction of the project, sub-contracting as necessary.

- **Skilled Trades** –
  the companies at this stage include electricians, producers, welders, and other craftsmen with skill sets crucial to project completion.

- **Supporting Services** –
  services such as haulage, shipping, rubbish, or catering companies.

- **Labourers** –
  typically includes roles like construction workers and drivers.

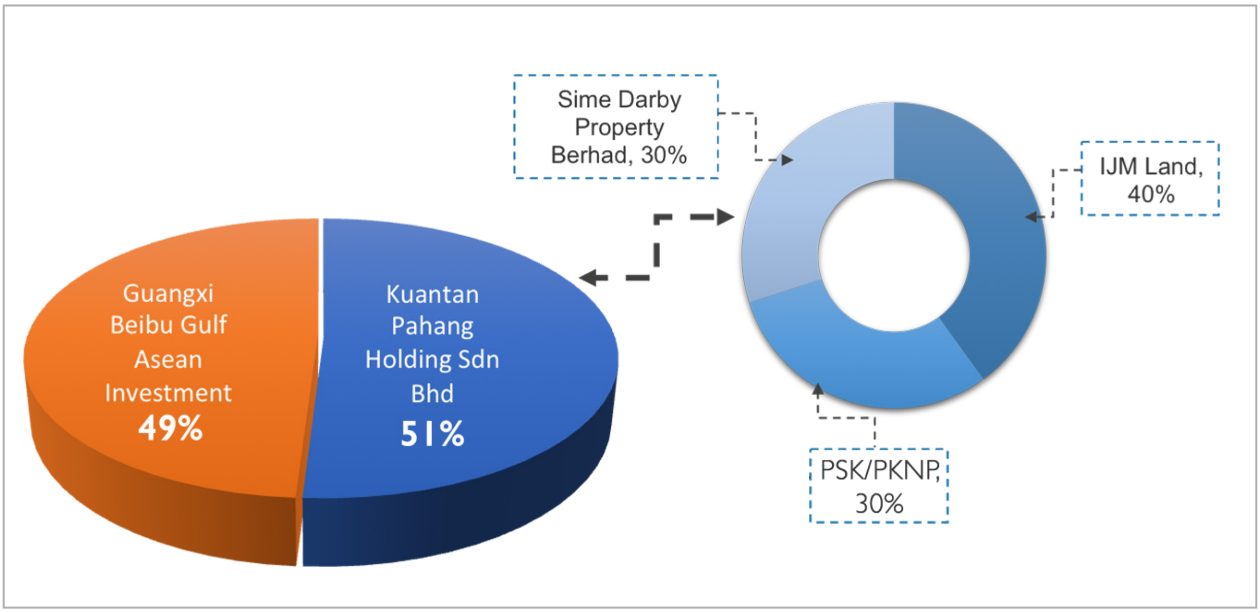
As we identified earlier, the potential benefit to the local economy arising for FDI is greatest where high levels of human capital are involved. We have therefore highlighted those areas that typically involve higher levels of human capital (orange), typically lower levels (blue) and more mixed. This is intended as an illustration only.

Holding Companies and Developers

To what extent our local companies and in particular SMEs, engaged in these projects across these different categories? Firstly, in the case of holding companies, it is clear that Malaysian companies are involved at the highest level, as holding companies.

First, we consider Kuantan Port and the Malaysia-China Kuantan Industrial Park (MCKIP), which is the self-described "sister park of China-Malaysia Qinzhou Industrial Park… strategically located in the East Coast Economic Region, facing the South China Sea, a gateway access to tremendous growth potential of ASEAN and Asia Pacific market, and worldwide markets" (Kuantan Port Consortium, 2016). It is led on the Malaysian side by Kuantan Pahang Holding Sdn Bhd with 51% of the overall ownership shared in a partnership between mega-companies IJM Land Berhad (40% ownership), Sime Darby Property Berhad (30%) and PSK/PKNP, the Perak State Development Council (30%). The other 49% ownership of the project falls under Chinese holding company Guangxi Beibu Gulf Asean Investment.

Figure 3: Malaysia-China Kuantan Industrial Park Investor Breakdown



Like the Kuantan Port/Malaysia-China Kuantan Industrial Park development, Melaka Gateway is joint owned by Chinese investors and well-established Malaysian companies, in this case KAJ Development.

In the case of the Tun Razak Exchange development, the project's "Master Developer" TRX City Sdn Bhd is fully owned by the Malaysian Ministry of Finance, and its highlight TRX Signature Tower is funded by China State Construction Engineering Corporation. The presence of Malaysian entities at the holding company level is common across the major Chinese investment projects. This will likely result in a level of financial return to Malaysian companies and in some cases the Malaysian government. However it is not clear from this involvement the extent to which Malaysian companies are involved as contractors.

Contractors

Next, we need to consider the presence of Malaysian companies at the contractor and sub-contractor level. As we can see from the CIDB statistics in Charts 3 and 4, the increased presence of Chinse contractors in clear, but the value awarded to local contractors has also continued to grow. In their 2017 report *"China contractors: Friend of Foe?"*, DBS Research argues that "[Chinese-led construction] projects are unlikely to take off without the associate funding and hence would still provide orderbook growth via subcontracting roles [for local firms]". The report also notes that Chinese firms often enter the Malaysian market in a joint venture with a local firm. Chinese financing also allowed the previous government to pursue additional infrastructure investment through increasing their liability rather than debt, supporting growth in the sector (DBS Research, 2017).

There are multiple of examples of the increased Chinese presence leading to opportunities for local contractors, including:

- UEM Construction Sdn Bhd and IJM Construction Sdn Bhd secured contracts for work on the Second Penang Bridge, while sub-structure was constructed by the China Harbour Engineering Company Ltd ; and
- IJM Construction Sdn Bhd secured the contract to develop the deep-water terminal in Kuantan Port from by Kuantan Port Consortium which is part owned by IJM Group (of which IJM Construction Sdn Bhd is a wholly owned subsidiary) and Gaungxi Beibu .

These examples demonstrate that Chinese investment has created opportunities for local contractors in addition to competition. However, the competition has also been fierce. Returning to the statistics in Charts 3 and 4, we note that the increased presence of foreign contractors has been very rapid. Updating their earlier assessment that the increased Chinese presence was a "net positive" for Malaysian contractors, DBS Research noted that the increased presence was happening at a "heightened pace and has encroached into projects which were earmarked for local contractors" (DBS Research, 2017). During our interviews, two issues emerged as the principal sources of competition between Chinese and local contractors:

Capacity.
Chinese contractors simply have the capacity to accept multiple large, scale projects.

Financing.
Chinese contractors are able to offer highly competitive financing arrangements and tolerate low margins. This is in part possible due to their support from the Chinese state. As DBS Research notes "[Chinese contractors] enjoy strong support from the Chinese government via cheaper source of funding largely from mainland China lenders and the Export-Import Bank of China (China Exim Bank – China's export credit agency). They are also supported by the China Export and Credit Insurance Corporation (SINOSURE) – China's policy-oriented insurance company that provides export credit insurance (DBS Research, 2017)." In our interviews, this was identified as the primary source of competition.

This increased competition is not necessarily a negative development for the industry - fair competition should encourage innovation and efficiency, as long as it takes place on the basis of a level playing field – which is a particular concern in the case of financing. In their research on Chinese export financing, with a particular focus on Africa, the EU Parliament Policy Department notes that: "[e]ven though there is no public information available on the financial terms offered by Chinese policy banks, anecdotal evidence shows that China usually offers more favourable financing terms than its Western competitors. For example, China's Eximbank loans have longer grace and repayment terms as well as generally lower interest rates" (EU Parliament, 2011). Moreover, China has not adopted the international OECD guidelines on export credit assistance, including maximum repayment terms, minimum interest payments and transparency. There is therefore a risk that this competitive financing provides Chinese firms an unfair advantage vis-à-vis local firms, and is not conducive to healthy competition,

Subcontractors

Of course, none of the companies mentioned so far qualify as SMEs. As with the larger local firms, the increased activity as a result of these new projects will lead to opportunities for smaller local firms too, in particular in subcontracting roles under this heading we also consider the use of local labour and suppliers. Indeed, in most cases the Malaysian government has reportedly negotiated specific clauses that reserves portion of the work for local contractors (typically around 30%). As a result, we do see multiple examples of local firms and workers benefitting from these projects:

- Following the completion of Xiamen University, a number of tenders were awarded to local contractors in March 2018, including for the installation of "Organic Chemistry Laboratory Furniture" and further tenders have been advertised.

- For the Four Seasons, although the main contractor was the China Railway Construction Group, the architects, civil and structural engineers and the mechanical and electrical engineers were local firms.

- Returning to MCKIP, more than 4,000 jobs were advertised by Chinese company Alliance Steel for their new steel plant, including "technical, engineering, supervisory and management positions".

These examples demonstrate that opportunities for local firms have been created. However, there are also numerous cases of Chinese contractors favouring other Chinese firms or labour. For example, it was reported that in Johor, the Immigration Department was reported to have issued 2,485 temporary work permits in addition to 1,682 employment and professional visit passes to foreign workers of Chinese nationals working in four construction locations in Johor, including Forest City project in Gelang Patah. (The Sun, 2017) Indeed, reserving 30% of these projects for local firms, still leaves the majority. Over the course of our interviews we identified the following factors motivating the choice not to subcontract or employ local firms and workers, examples of which can also be seen in cases reported in the media.

Skills and working practices

A common justification given for not using local firms is that they lack the required skills for the project, we will consider this in more detail below. A related argument is that the local firms and workers are not suited to the working practices of Chinese contractors, including the hours worked, speed of work etc.

Cultural preferences

A separate justification given for not using local firms is cultural preferences, this is most evident in the sub-contracting of supporting services and in particular food and catering, as has also been reported in the media.

Language

A similar justification for using other Chinese firms and labour is the requirement to have workers operate in the same language or use equipment with associated language requirements. It was reported that the ECRL contractors had applied to Putrajaya to hire more Chinese nationals due to language requirements, as the manual for the equipment being used was in Mandarin (Malaysiakini, 2018).

Capacity of local suppliers

A justification for the importing of supplies directly from China, rather than locally is that the capacity of local suppliers is insufficient to meet the demands of these projects. Kent Lew, President of the Pahang Hardware and Machinery Merchants Association claimed that Chinese contractors developing the MCKIP "would purchase items such as screws, wood, cement, steel, gravel, iron, plywood and other basic materials from local hardware merchants" but "were never interested in larger and more profitable construction materials or equipment", claiming that these larger orders were imported directly from China (Malaysiakini, 2017).

Political Objectives

An additional factor ascribed to the motivation for Chinese contractors to work with other Chinese firms, workers and suppliers is the political direction (implied or explicit) from the Chinese government to maximise the economic opportunity for Chinese nationals. Although this of course is not given as a justification by the Chinese contractors themselves.

Financing

Finally, an additional factor raised as disadvantaging local firms in financing, similar to the issue raised for the larger local contractors. In this case, SMEs report challenges in securing access to credit whereas, as we have noted, the Chinese contractors can pursue highly competitive financing arrangements and use that to support smaller Chinese players. Local SMEs can also struggle to manage on the low margins that can emerge as a result of the highly competitive structuring of the projects by the Chinese contractors.

The lack of available data makes a comprehensive assessment of the extent to which Chinese contractors are favouring other Chinese firms, workers and suppliers difficult. However, we do want to consider the issue of skills in more detail. As we noted in Part 2, the positive economic impact of FDI on the local economy is partially determined by the scope for knowledge and technology transfer, which in turn depends on the extent to which local human capital is engaged.

Opportunities for knowledge transfer

As we noted earlier, lack of the required skills was raised as a justification by Chinese contractors for not subcontracting to local firms.

Focussing on the involvement of local SMEs and in particular in the higher skilled areas which we have established represent the greatest benefit, we can see examples of a preference for Chinese firms. This point has also been made publicly: when questioned about the opportunities for local firms, China's Ambassador to Malaysia Dr Huang Huikang said that:

> *"These corporations are world-class top players, with sophisticated technical expertise…You can see in two examples. Penang's second bridge, an excellent model for the construction of bridges, is showcasing high standard of expertise. Malaysian firms have yet to reach such level…In the construction of Tun Razak Exchange (TRX), our Chinese company is able to complete one storey in three days. In comparison, the Petronas Twin Towers constructed by the Koreans and Japanese in the 1990s saw one storey per month… These are difficult jobs that require high technical and engineering capabilities". (The Star, 2017)*

In the case of the Melaka Gateway, SinoHydroLimited (M) Sdn Bhd (a subsidiary of PowerChina, the main contractor) was named the project's Engineering, Procurement, and Construction Management (EPC) contractor. This decision was justified on the basis of the skills of the Chinese firms. Sinohydro explains its own role stating, "implementing projects [as an EPC] requires a high-level professional team, solid know-how and ample experience. Through years of development, Sinohydro has equipped itself with all necessary gears to step into the hot zone." In a press release by KAJ Development on 13 May 2017, the partnership is described as follows:

> *"With this investment collaboration agreement securely in place, KAJD and Powerchina stand to gain extensive benefits from Yantian Port Group's and Rizhao Port Group's technical expertise and experience in port construction, operations and management, as well as their extensive network of shipping lines and alliances around the globe. This will catapult Melaka Gateway and Malaysia as a prime location and international maritime gateway to the world. (The Star, 2017)"*

In the case of the Penang Undersea Tunnel, the developer states on its website that, "With CRCC (one of China's largest overseas engineering contractor) as our Engineering Procurement & Construction (EPC) Contractor, the Consortium possess the ability to undertake and manage mega construction projects with complete confidence" (Zenith Consortium, 2014).

In the case of the Second Penang Bridge, it is notable that the China Harbour Engineering Company (CHEC), which was awarded the contract for "Package A" subcontracted the design to Chinese consultants HPDI, whereas for "Package B", awarded to UEM, Malaysian designers were used, though it should be noted that Malaysian consultants were hired for the review of the design under Package A (Jambatan Kedua Pulau Pinang, 2015).

Returning to Kuantan Port/MCKIP, we tried to identify as many companies as possible involved in the project. We were able to identify SMEs only within the "supporting services" group of the Kuantan Port Consortium, with subcategories ranging from "Haulage" to "Tally Clerks". Which suggests where SMEs are involved, they are in supporting rather than high-skilled areas. After the port's completion (MCKIP and a New Deep-Water Terminal are still under construction, but the port itself is active), the Kuantan Port Authority published a list of companies sub-leasing the land immediately surrounding the development. Out of 22 listed companies, only 3 are registered with the SMECorp, and nearly half of the firms are owned by other foreign countries (non-Chinese, non-Malaysian entities).

These examples demonstrate a tendency to use Chinese contractors for the more technically demanding aspects of the projects. But is the claim that Malaysian companies lack the required skills justified? The claim that Malaysian firms lack the required skill to compete with Chinese contractors has also been made by others. Raymond Pang, CEO of construction company Econpile, is reported as saying that "local players need Chinese expertise in the construction of super high-rise buildings" (The Edge, 2017).

More broadly, the Malaysian construction industry has been reporting skills gaps for several years. A survey by Grant Thornton highlighted a range of factors hindering recruitment in Malaysia, such as the "lack of appropriate work experience" (reported by 63% of firms) and also "shortage of general employability skills, particularly teamwork and communication in English" (62%) (Survey by Grant Thornton, reported in Boreno Post, 2013). The problem has been particularly acute in the construction sector, with a 2012 study finding that: "Malaysian construction has problems in the ability to get the source of labour as well as retained skill people and has to depend on foreign worker to respond to the high demand of skilled workers due to rapid development in Malaysia and poor participation from local people" (Zaki et al., 2012).

More recently, the President of the Master Builders Association of Malaysia (MBAM), Foo Chek Lee, has warned of an "acute shortage of labour" in the sector (The Sun, 2017). He has also argued that "local contractors are losing their competitive edge partly due to the shortage of labour, including skilled talent in the industry" (The Malaysian Reserve, 2017).

However, SMEs that we interviewed argued that these skills do exist among local firms but that they struggle to compete with Chinese competitors due to the other factors listed above, contributing to a preference for Chines contractors to work with other Chinese firms.

Establishing whether or not Chinese contractors are justified in importing the skills required across all these major projects would take significant further research, as the skills requirements vary significantly, and it is difficult to establish the level of capability amongst local firms.

However, from the perspective of maximising the benefit for the local economy, and in particular for SMEs, then the scope for local and SME participation in those areas of the projects demanding the highest skills is essential, as this is where there is the greatest scope for knowledge and technology transfer.

**Author's analysis of the company listing on http://www.kuantanport.com.my/en_GB/port-info/supporting-services/ and the listing on http://www.smecorp.gov.my/index.php/en/guides/2015-12-21-10-49-38/list-of-companies (accessed 19 July 2018). Of the 60 companies listed, less than a quarter are registered with SMECorp and only a publicly third directly confirm their involvement with the Kuantan Port/Malaysia-China Kuantan Industrial Park development.*

Beyond infrastructure

Finally, returning to the statistics on SME establishments in Table 1, we can see that less than 5% of SMEs are in the construction sector and nearly 90% of SME establishments in Malaysia are in fact in the services sector. Therefore, in considering how FDI from China or elsewhere can benefit the local economy and SMEs in particular, it is important to look beyond major infrastructure construction projects, to promote investment in sectors where more local SMEs stand to benefit, such as in Information Technology, e-commerce or retail. The Digital Free Trade Zone, being developed in partnership with Alibaba is a good example of this, but the government should look to encourage more and again, promote local participation where the scope for knowledge and technology transfer is greatest.

Conclusions

The debate over the role of Chinese FDI is highly complex and has become politically charged. The debate over the opportunities created for local firms suffers from lack of publicly available data, leading to conflicting accounts. What is clear is that the presence of Chinese contractors has significantly increased in recent years; this has brought opportunity for local contractors but also increased competition. The particular competitive edge that Chinese contractors have is their capacity to take on multiple, large projects and their ability to finance projects at competitive rates, including with the support of the Chinese state.

For smaller local firms, subcontracting opportunities have emerged as a result of these investment projects. But there is also evidence of Chinese contractors preferring Chinese firms, workers and suppliers for a variety of different reasons, namely i) skill requirements; ii) differences in working practices; iii) cultural preferences; iv) language barriers; v) local capacity; vi) access to finance; and vii) politically motivated preferences. Lack of data makes it difficult to gauge the important of these factors and the extent to which they are justified. Most significant, from the perspective of maximising the impact of the local economy, is the extent to which Chinese contractors deny opportunities to local firms because they lack the necessary skills, since the positive economic impact of FDI is partly determined by the scope for knowledge and technology transfer. There are conflicting accounts of whether these skills do in fact exist among local firms.

Going forward, the government should ensure that local and foreign contractors can compete fairly on a level playing field. This includes ensuring that local firms have access to financing and that Chinese investment projects are financed on a fair and sustainable basis.

The government should ensure that local participation in these projects is structured to maximise the scope for knowledge and technology transfer by requiring that local firms are used in the technically demanding and highly-skilled areas of the project wherever possible. In other words, it is the quality of local participation not just the quantity which matters. To ensure local firms are in the best position possible, the government should promote development of the necessary skills within the private sector.

Finally, the government should promote investment beyond traditional infrastructure to support and provide opportunities to local firms and SMEs, most of which are concentrated in the services sector.

Acknowledgements

The authors are grateful to the helpful contributions and comments received on this paper, including from Alvin Camba at John Hopkins University, Dr Zhang Miao at the Institute for China Studies, University of Malaysia, the Socio-Economic Research Council (SERC) and the Malaysia China Chamber of Commerce (MCCC). The authors are also very grateful to those private companies and individuals who agree to be interviewed as part of the preparation of this paper.

Bibliography:

Alliance Bank, Malaysian Economy Construction & Property Outlook, 2017 http://rehdainstitute.com/wp-content/uploads/2017/11/2.-Mr.-Manokaran-Mottain-Chief-Economist-Alliance-Bank.pdf

AllianceDBS Research. "Malaysian Construction Sector." Insights SparX. 27 April 2017. Accessed 08 August 2018. http://ir.chartnexus.com/suncon/doc/analyst/Malaysian-Construction---170427---Insight-SparX---ADBS.pdf

American Enterprise Institute. "China Global Investment Tracker." Accessed 19 July 2018. http://www.aei.org/china-global-investment-tracker/

Baharumshah, Ahmad Zubaidi, and Suleiman W. Almasaied. "Foreign Direct Investment and Economic Growth in Malaysia: Interactions with Human Capital and Financial Deepening." Emerging Markets Finance & Trade, vol. 45, no. 1, 2009, pp. 90–102. JSTOR, JSTOR, www.jstor.org/stable/27750654.

Bernama. "Melaka Gateway Project will not Uproot Portuguese Colony." 07/20/2018. Accessed 01 August 2018. http://www.bernama.com/en/news.php?id=1482202

Borensztein, E., J. De Gregorio , and J-W. Lee. "How does foreign direct investment affect economic 1 growth?" Journal of International Economics vol. 45, 1998, p. 115–135 https://www.olemiss.edu/courses/inst310/BorenszteinDeGLee98.pdf

Boreno Post, 2013. http://www.theborneopost.com/2013/07/07/growing-gaps-in-malaysias-human-capital/

CIDB Malaysia, Construction Industry Quarterly Statistical Bulletin 2012 – 2017, http://www.cidb.gov.my/index.php/en/construction-info/industry-related-act

DBS Research, "China contractors: Friend of Foe?", https://www.dbs.com.sg/treasures/templatedata/article/generic/data/en/GR/062017/170602_insights_malaysia_infrastructure_chinese_constructors_friend_or_foe.xml

DBS Research, "Riskier year ahead" https://www.dbs.com.sg/treasures/templatedata/article/generic/data/en/GR/122017/171204_insights_riskier_year_ahead.xml

Department of Statistics Malaysia (DOSM)

DBS Group. "Malaysian Construction." Malaysia Industry Focus. 04 December 2017.

EU Parliament, Policy Department, 2011 "Export Finance Activities by the Chinese Government", http://www.europarl.europa.eu/RegData/etudes/note/join/2011/433862/EXPO-INTA_NT(2011)433862_EN.pdf

Hanauer, L. and Moris, L. "Chinese Engagement in Africa: Drivers, Reactions, and Implications for US Policy." RAND. 2017.

IJM Corporation. "Corporate Profile." Accessed 18 July 2018. http://www.ijm.com/web/aboutUs/corpProfile.aspx

Bibliography:

ISEAS, Chinese Investment in Malaysia: Five Years into the BRI https://www.iseas.edu.sg/images/pdf/ISEAS_Perspective_2018_11@50.pdf

Jaipragas, Bhavan. "Malaysia's Chinese Projects: Mahathir to Respect all Agreements." South China Morning Post. 17 May 2018. Accessed 08 August 2018. https://www.scmp.com/week-asia/politics/article/2146629/malaysias-chinese-projects-mahathir-respect-all-agreements

Jambatan Kedua Pulau Pinang, 2015, http://www.jambatankedua.com.my/v4/images/template/presentation_md/10-CIRARC-Kuala-Lumpur/CIRARC%20-%20KL%20221015%20-%20Dato%20Ismail%20JKSB.pdf

KAJ Development Sdn Bhd. "About Us." Melaka Gateway. Accessed 20 July 2018. http://melakagateway.com/kaj-development-sdn-bhd/

KAJ Development Sdn Bh. "KAJD Signs Investment Collaboration Agreement in Beijing, China with its Three Strategic Partners on the Investment & Development of Melaka Gateway." KAJD Press Release. 13 May 2017. Accessed 31 July 2018. http://melakagateway.com/wp-content/uploads/2017/07/KAJD-Press-Release-13May2017-Belt-and-Road-Forum-Beijing_final-2.pdf

Kuantan Port Authority. "Sub-lease of land." Accessed 23 July 2018. http://www.lpktn.gov.my/lpktn/index.php/en/port-info/sub-lease-of-land

Kuantan Port Consortium. "Malaysia-China Kuantan Industrial Park (MCKIP)." Accessed 18 July 2018. http://www.kuantanport.com.my/en_GB/industrial-area/mckip/

Kuantan Port Consortium. "Supporting Services." Accessed 19 July 2018. http://www.kuantanport.com.my/en_GB/port-info/supporting-services/

Kubny, J. and Voss, H. "The Impact of Chinese Outward Investment: Evidence from Cambodia and Vietnam." German Development Institute. 2010. Accessed 23 July 2018.
https://www.eu-china.net/upload/pdf/materialien/11-03-02_Impact%20of%20chinese%20outward%20investment.pdf

Lau, Rachel "China's Belt and Road: What's in it for Malaysia?" Borneo Post Online. 03 September 2017. Accessed 05 August 2018. http://www.theborneopost.com/2017/09/03/chinas-belt-and-road-whats-in-it-for-malaysia/

Lend Lease and 1MDB Joint Press Release. "Australian Company to Develop Lifestyle Quarter." 25 June 2014. Accessed 08 August 2018. http://trx.my/press-releases/australian-company-to-develop-lifestyle-quarter

Makkha, Kwamchetsi. "Who'd take a $500 Job in Africa?" New Statesman. 14 March 2005. Accessed 06 August 2018. https://www.newstatesman.com/node/161691

Bibliography:

Malaysia Anti-Corruption Commission. "Sime Darby Berhad." Accessed 18 July 2018. http://www.sprm.gov.my/index.php/en/sime-darby-berhad

Malaysia Department of Statistics. "Table Publication GDP 2010-2016." Accessed 19 July 2018.https://www.dosm.gov.my/v1/uploads/files/1_Articles_By_Themes/National%20Accounts/GDPbyState/Table%20Publication%20GDP%202010-2016.pdf

Malaysiakini, 2018. https://www.malaysiakini.com/news/418204

SME Corp Malaysia. "List of Companies." Official Website. Accessed 18 July 2018. http://www.smecorp.gov.my/index.php/en/guides/2015-12-21-10-49-38/list-of-companies

New Straits Times Online. "Melaka Gateway Developer to Meet Gov't Authorities, Clear the Air." New Straits Times. 18 July 2018. Accessed 01 August 2018. https://www.nst.com.my/property/2018/07/391345/melaka-gateway-developer-meet-govt-authorities-clear-air

Pahang State Development Council. "Background/History." Accessed 19 July 2018. http://www.pknp.gov.my/index.php/en/korporat

Sautman, Barry and Hairong, Yan. "Friends and Interests: China's Distinct Links with Africa. African Studies Review, Vol. 50, No. 3. Dec. 2007. Cambridge University Press. Accessed 06 August 2018. https://www.jstor.org/stable/pdf/27667241.pdf?refreqid=excelsior%3A41cee58d123eda848625f6eb807ec31b

Socio-Economic Research Centre (SERC). "China's investment in Malaysia: Perceptions, Issues, and Prescriptions." 2017. Accessed 08 August 2018. http://acccimserc.com/file/file/2017%20Working%20Papers/Final%20-%20China%20Investments%20in%20Malaysia%20-%20Perception%20Issuess%20and%20Prescript___.pdf

SME Corp Malaysia. "Economic Census 2016: Profile of SMEs." Special Highlights.

Teoh, S. and Leong, T. "Chinese Deals in Malaysia Under Scrutiny." The Straits Times. 07 May 2017. Accessed 23 July 2018. https://www.straitstimes.com/asia/se-asia/chinese-deals-in-malaysia-under-scrutiny

TheTowerInfo. "The Exchange 106 (TRX Signature Tower) Facts and Introduction." 2018. Accessed 08 August 2018. http://thetowerinfo.com/buildings-list/the-exchange-106/
The Edge, 2017. http://www.theedgemarkets.com/article/cover-story-local-contractors-feel-heat

The Malaysian Reserve, 2017. https://themalaysianreserve.com/2017/11/03/local-contractors-losing-foreign-rivals/

The Sun, 2017. http://www.thesundaily.my/news/2017/05/14/2485-temporary-work-permits-issued-chinese-workers-johor)

Bibliography:

The Star, 2017. https://www.thestar.com.my/news/nation/2017/09/10/china-investments-transforming-msia-although-the-influx-of-chinese-investments-is-only-a-recent-phen/

Tun Razak Exchange. "Master Developers and Partners." Accessed 23 July 2018. http://trx.my/master-developer-and-partners

Wan Saiful Wan Jan. "Chinese Investments in Malaysia: Question on the Future of Liberal Democracy and Economic Freedom." IDEAS. Brief no. 7, August 2017.

Wang, Y. and Zadek, S. "Sustainability Impacts of Chinese Outward Direct Investment: A review of the literature." International Institute for Sustainable Development. 2016. (Accessed 16 July 2018). https://www.iisd.org/sites/default/files/publications/sustainability-impacts-chinese-outward-direct-investment-literature-review.pdf

Zaki, Shazwani & Mohamad, Sarajul & Yusof, Zakaria. (2012). Construction Skilled Labour Shortage – The Challenges in Malaysian Construction Sector.

Zenith Consortium. "Corporate Structure." 2014. Accessed 08 August 2018. http://www.consortiumzenith.com/copy-of-corporate-structure-v2

Notes

Notes

IDEAS

INSTITUTE FOR DEMOCRACY AND ECONOMIC AFFAIRS

IDEAS is inspired by the vision of Tunku Abdul Rahman Putra al-Haj, the first Prime Minister of Malaysia. As a cross-partisan think tank, we work across the political spectrum to improve the level of understanding and acceptance of public policies based on the principles of rule of law, limited government, free markets and free individuals. On 2 September 2016, IDEAS was ranked as the 17th think tank to watch globally in a survey of more than 6,800 think tanks in 143 countries by the University of Pennsylvania's 2015 Global Go To Think Tank Index Report.

Please support us by making a donation. You can make a contribution by cheque payable to "IDEAS Policy Research Berhad" or by transfer to our account CIMB 8008852042. We can only survive with your support.

IDEAS Policy Research Berhad
The Lower Penthouse
Wisma Hang Sam, 1, Jalan Hang Lekir 50000 Kuala Lumpur

www.ideas.org.my
Reg №: 1219187-V

Selection of IDEAS' Publications (2017 - 2018)

Policy Ideas

Policy Paper No.52 : Strengthening the ASEAN Single Aviation Market: Implementing the AEC Blueprint 2025 for Air Transport by Dr Jae Woon Lee (September 2018)

Policy Paper No.51 : Affordable Housing and Cyclical Fluctuations: The Malaysian Property Market by Carmelo Ferlito (July 2018)

Policy Paper No.50 : Create or Nurture? Lessons from Cyberjaya: Malaysia's Promised Silicon Valley by Ali Salman (July 2018)

Policy Paper No. 49: Intellectual Property Rights in ASEAN: Developments and Challenges by Marolita Setiati Anwar, and Adi Darmawan (July 2018)

Policy Paper No. 48: Payment Card Reform Framework (PCRF): A Policy Evaluation Study by Dr. Teo Wing Leong (May 2018)

Policy Paper No. 47: Anti-profiteering Regulations: Effects on Consumer Prices & Business Margins by Hafiz Shams (December 2017)

Policy Paper No. 46: Water Provision in Malaysia Privatise or nationalise? by Wan Saiful Wan Jan (November 2017)

Policy Paper No. 45: Government-Linked Companies: Impacts on the Malaysian Economy by Jayant Menon (December 2017)

Policy Paper No. 44: Illicit Trade in Malaysia: Causes & Consequences by Adli Amirullah, Amirah Fazira and Ali Salman (October 2017)

Policy Paper No. 43: Reining in the IGP's Power: Decentralisation as an option by Nicholas Ideas (September 2017)

Policy Ideas No. 42 : Will Our Public Universities Have Financial Autonomy? By Wan Saiful Wan Jan (May 2017)

Policy Ideas No. 41: History and Epistemology of Universities by Munif Zarirruddin Fikri Nordin (May 2017)

Policy Ideas No. 40 : The History of University Autonomy in Malaysiam by Dr. Chang-Da Wan (May 2017)

Policy Ideas No. 39: Autonomy and Accountability in Higher Education: Lessons from Ghana and Mexico by Dr. Sean Matthews (May 2017)

Brief Ideas

Tax in the Digital Age by Laurence Todd, Connor Vance IDEAS No.11 (September 2018)

National Policy on Rare Diseases Living with Dignity: In Search of Solutions for Rare Diseases by Thong Meow Keong, Azlina Ahmad-Annuar IDEAS N0.10 (August 2018)

Post GST Malaysia: Recommendations for a Reformed Sales and Services Tax (RSST) by Adli Amirullah and Ali Salman IDEAS N0.9 (June 2018)

Ownership and Control of Airlines in Southeast Asia: Prospects for an ASEAN Community Carrier Brief by Adli Amirullah IDEAS No. 8 (December 2017)

Institute for Democracy and Economic Affairs (IDEAS)
The Lower Penthouse. Wisma Hang Sam, 1, Jalan Hang Lekir 50000 Kuala Lumpur

IDEAS
INSTITUTE FOR DEMOCRACY AND ECONOMIC AFFAIRS

Website: ideas.org.my Tel: +603 2070 8881 / 8882 Fax: +603 2070 8883