WORKING PAPER

NEW NORMAL IN CHINA'S FDI: A RATIONAL LOOK INTO THE PATTERNS OF CHINESE INVESTMENTS IN MALAYSIA

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Abstract

As a response to growing public concerns over the surge in investments from China, we seek to understand the motivation behind these financial inflows from the Chinese point of view. We call for a more rational understanding of the nature of China's foreign direct investment (FDI) as we believe there is a more systematic and educated explanation on this topic. We first explore the global patterns in China's FDI, followed by an analysis of the industries in Malaysia where China's investments dominate.

First, we found that the surge in China's overall FDI coincides with the change in policies, notably the Belt and Road Initiative (BRI) and also the "new normal" policy goals to transform the Chinese economy from a resource driven to a service-based economy that is on par with advanced nations by 2050. Secondly, we observed a rising trend in China's FDI outflows for the past 20 years and that the outflow gap between China and Western countries, especially the United States has narrowed rapidly since the Great Recession of 2007-08. A regional breakdown of China's FDI shows that countries in Asia receive the largest pie of the FDI. Also, China has now contributed more in investments to the rest of the world than it received, with a greater focus on greenfield investments compared to merger and acquisition (M&A) investments. Thirdly, the increase of China's accumulated investments in Malaysia - the second largest greenfield FDI recipient among ASEAN countries, also coincides with the introduction of BRI.

This working paper concludes by raising the glaring absence of China's service-oriented FDI in Malaysia and questions if this is a sign of incompatibility in the innovation ecosystem between the two countries. There are also important issues that should be considered such as the potential financial contagion effect from China's FDI and also negative spill-over effects.

Section 1 – The Background

Introduction

Concerns have built up in recent years over the surge in China's investments into Malaysia. On 1 November 2016, Prime Minister Najib Razak witnessed the exchange of fourteen business agreements between Malaysian and Chinese companies with proposed investments estimated at RM144bil - a deal whom Mr. Najib has since proclaimed to have set "a new high" in the bilateral relations between the two countries.[1]

"… Chinese perspectives need to be first understood, specifically with regards to the changes in policies leading to an overall spike in China's outward (FDI), not just in Malaysia, but globally too."

Yet, many have raised doubts about the wider implications of obtaining these investments, in particular the expected rise in national debt level as a result of soft loans undertaken, as well as concerns of undue Chinese influence over domestic and foreign policies, given the larger loan exposure from Chinese state-owned financial institutions.[2] Also, the purported benefit of these mega-projects in creating high-skilled jobs is being questioned too.[3]

So how should we come to view and understand the roles of Chinese investments in the Malaysian economy? In this paper, we are of the opinion that the Chinese perspectives need to be first understood, specifically with regards to the changes in policies leading to an overall spike in China's outward foreign direct investment (FDI), not just in Malaysia, but globally too.[4] Then, we seek to identify if there are discernible patterns in the areas that Chinese companies have chosen to invest in order to establish the rationales and motivations behind China's investments. Lastly, we deep dive into two industrial sectors with huge Chinese presence, mainly manufacturing and construction, and then discuss China's strategic focus in the two categories of FDI: greenfield investments, and merger and acquisition (M&A) investments.[5]

It is our hope that by producing this paper, we are able to encourage a more rational discussion about the nature of foreign investments into Malaysia rather than basing our arguments solely on the perceptions that one may have about the country of origin for these investments.[6]

[1] See https://www.thestar.com.my/business/business-news/2016/11/01/malaysian-and-chinese-firms-sign-14-agreements-worth-rm144bil/ (accessed 12 January 2018)
[2] See https://www.themalaysianinsight.com/s/12213/ and https://www.malaysiakini.com/news/361440 (accessed 12 January 2018)
[3] See http://www.theedgemarkets.com/article/ensure-chinese-investments-offer-locals-highskilled-jobs-too (accessed 12 January 2018)
[4] FDI is defined as an investment reflecting a lasting interest and control by a foreign direct investor, resident in one economy, in an enterprise resident in another economy (foreign affiliate). Data on FDI can be reported as FDI flows (capital received by a foreign direct investor from a foreign affiliate) and FDI stocks (accumulated FDI flows over a period of time and reported at book value)
[5] Greenfield FDI relates to investment projects that entail the establishment of new entities and the setting up of offices, buildings, plants and factories from scratch. M&A FDI entails the taking over or merging of capital, assets and liabilities of existing enterprises. For a detailed definition of FDI, see UNCTAD Training Manual on Statistics for FDI and the Operations of TNCs.
[6] The authors echo the views expressed by leading economists in this matter. See http://www.thesundaily.my/news/2099261 and http://www.themalaymailonline.com/malaysia/article/view-chinas-investments-rationally-zeti-tells-skeptical-malaysians#5fFcjVwsLD0FlBQW.97 (accessed 1 December 2017)

Section 1 – The Background
China's FDI: An Overview

At the 19th Communist Party Congress, China's President Xi Jinping reaffirmed the country's "new normal" policy course, first introduced in 2014, of higher quality, but slower economic growth. Mr. Xi also laid out his vision of China becoming a nation with pioneering global innovation and influence by 2050.[7] The change is a break with China's decades-long extractive, factor-driven model which has given rise to its reputation as the world's factory. The Chinese economy had been growing at double-digits between 2003 and 2007, but in the process of doing so, it has also become the world's biggest polluter.

"This win-win approach is consistent with Mr. Xi's Belt and Road Initiative (BRI) announced in 2013 to create a modern day trade and services route spanning 65 countries and 70% of the world's population."

The 2007-08 Great Recession has exposed the downside of China's over-dependence on exports and debt-fuelled investments for growth, prompting Mr. Xi to ditch the practice of setting gross domestic product (GDP) target in favour of an alternative model which emphasizes on consumer-led innovation and for firms to expand beyond borders. On the other hand, rising protectionism and anti-globalisation sentiments in the Western democracies have come at a time when the economic centre of gravity is gradually shifting towards Asia.

A "Chinese approach", according to Mr. Xi, offers an alternative source of funding assistance for developing countries while maintaining their sovereignty.[8] This win-win approach is consistent with Mr. Xi's Belt and Road Initiative (BRI) announced in 2013 to create a modern day trade and services route spanning 65 countries and 70% of the world's population.

The surge in China's FDI globally coincided with the timing of the government's USD588bn stimulus package during the 2007-2008 crisis as means to spur economic recovery by increasing liquidity of domestic investors.[9] One of the side effects of this stimulus plan is the overcapacity of industrial firms in China, notably in steel manufacturing where China continues to be the world's largest producer. Therefore, it is suggested that outward-looking policies such as the BRI and acquisition of foreign assets are implemented in order to absorb excess domestic credit and output.[10]

A key risk in accepting large amount of Chinese investments within a relatively short time span, especially for construction projects that are typically longer-term and important to nation-building, is the possibility of a financial contagion as a result of deleveraging reforms in the Chinese financial market. The building up of debt primarily by inefficient state-owned companies during the good years has reached a boiling point, where the total outstanding debt is now 260% of China's

[7] To be more specific, Mr. Xi's vision is to see China becoming a top ranked innovative nation by 2035 with a large middle-income population and narrower wealth gap. But for the purpose of discussion in this paper, we interpret China's 2050 vision as becoming on par (or better) than most advanced economies who are generally services-oriented.
For news report, see http://www.chinadaily.com.cn/opinion/2017-11/22/content_34838838.htm (accessed 28 Jan 2018)
[8] See http://www.straitstimes.com/asia/east-asia/19th-party-congress-7-key-themes-from-president-xi-jinpings-work-report (accessed 14 Jan 2018)
[9] Yu, R. 2010. *Bank of China reports 41% rise in first-quarter net profit*. Wall Street Journal
[10] Cai, P. 2017. *Understanding China's Belt and Road Initiative*. Lowy Institute for International Policy

GDP, thus prompting a downgrade in the country's sovereign credit rating by Moody's for the first time in nearly three decades.[11] So, if the scaling-back of credit triggers widespread panic in the Chinese financial market, then the Chinese-funded construction of infrastructure projects may be significantly derailed.

In 2016, China's total outward FDI was worth USD170bil (+44.1% year-on-year). Asia was the largest recipient (60% of total) worth USD101.9bil while ASEAN countries received about USD9.3bil (or 5.5% of total).[12] Meanwhile, China's accumulated investments to ASEAN between 2003 to 2015 could be further categorised into greenfield investment (USD74.6bil), and M&A investment (USD41.5bil) with Malaysia being the second largest greenfield FDI recipient among ASEAN countries, estimated at USD11.8bil.[13]

"China sees a role in enhancing infrastructure connectivity in ASEAN, particularly in power and electricity, resource development, and manufacturing, in order to fully exploit the cost-competitiveness of the region."

Apart from Malaysia's strategic location along China's "maritime silk road", we need to also account for other factors that may explain the general increase in Chinese investments into ASEAN as a single region. Wang and Li explained that ASEAN is strategic to China because of its abundant natural resources and a relatively cost-competitive labour market. According to the 2016 Global Manufacturing Competitiveness Index by Deloitte, a consultancy, the "Mighty Five" of Malaysia, India, Thailand, Indonesia, and Vietnam are set to inherit China's role as the 'World's Factory' in the next five years.[14] Among the factors given are young populations, a supportive policy environment, and a minimum level of education for all workers.

But, Wang and Li also clarified that China sees a role in enhancing infrastructure connectivity in ASEAN, particularly in power and electricity, resource development, and manufacturing, in order to fully exploit the cost-competitiveness of the region. This view is consistent with the Asian Development Bank (ADB)'s report which estimated an infrastructure funding gap of USD1.7trn per year until 2030 in order to maintain growth in the developing Asian economies.[15] Of course, we support the view that China's expanding presence is guided, to a large extent, by rational political and economic calculations rather than sheer benevolence.

Therefore, given China's increasing economic might and growing Western disenchantment with multilateralism, would not it be more logical for Malaysia to expect larger share of investments coming from China? Asking counterfactually, what does it mean to Malaysia as an investment destination if China's FDI remain stagnant or declining just as when our regional peers are registering higher inflow?

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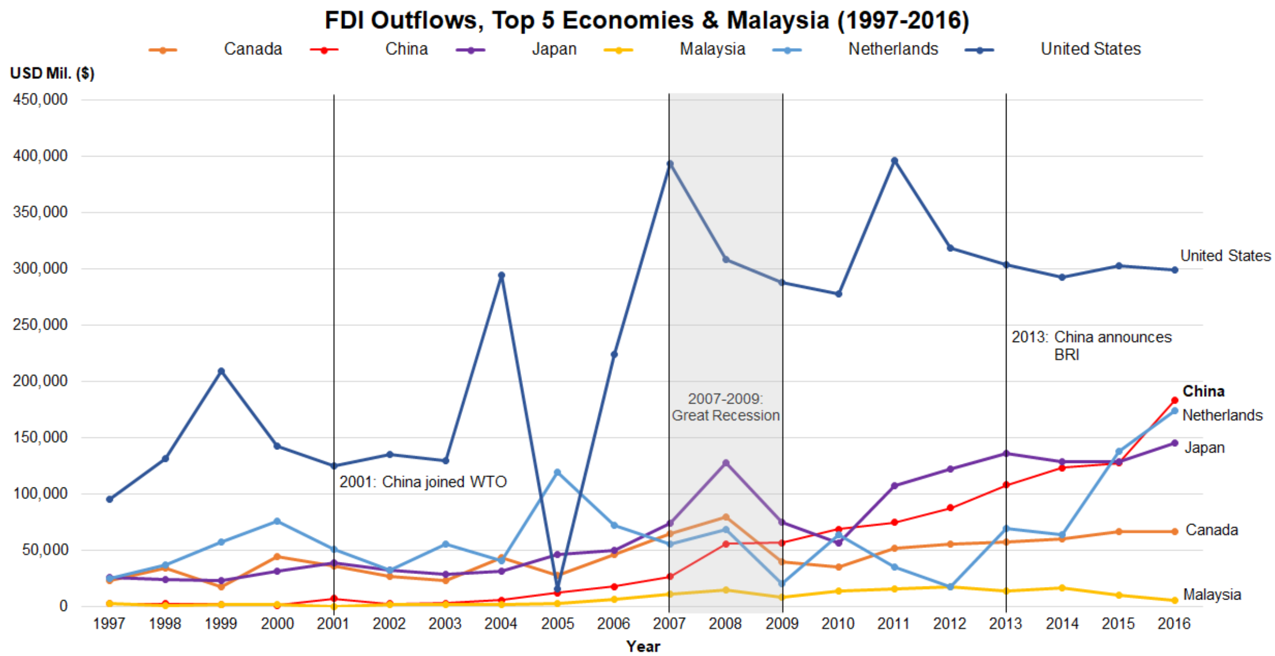
[11] See https://www.moodys.com/research/Moodys-downgrades-Chinas-rating-to-A1-from-Aa3-and-changes--PR_366139 (accessed 28 January 2018)
[12] MOFCOM
[13] FDI Intelligence. See Wang & Li (2017), p. 8. During the period, Indonesia had been the largest ASEAN recipient of Chinese Greenfield FDI estimated at USD27.9bil, according to the same source.
[14] To download the full report, please see https://www2.deloitte.com/global/en/pages/manufacturing/articles/global-manufacturing-competitiveness-index.html (accessed 28 January 2018)
[15] To download the full report, please see https://www.adb.org/publications/asia-infrastructure-needs (accessed 29 January 2018)

Chart 1: Top 5 countries with most FDI outflows, and Malaysia (1997-2016)



Source: UNCTAD, FDI/MNE Database

Chart 1 shows China's rising trend in FDI outflows for the past 20 years, including even during the 2007-2008 crisis, and eventually becoming the second largest FDI provider after the United States. But, the chart also shows that China is narrowing its gap with the United States fast, especially since the announcement of BRI in 2013.

Table 1: FDI Overview of 5 countries with most investments involved, and Malaysia, 2016

FDI Purpose	Country	Inflow (Millions of USD)	Outflow (Millions of USD)
Cross-Border M&A	World	868,647	868,647
	Developing Economies	69,315	149,857
	United States	360,797	77,949
	China	5,887	92,221
	Netherlands	11,838	119,574
	Japan	20,888	80,646
	Canada	11,652	56,541
	Malaysia	3,908	1,635
Announced Greenfield Investment	World	827,670	827,670
	Developing Economies	515,744	321,222
	United States	58,156	155,153
	China	62,495	110,356
	Netherlands	5,244	10,500
	Japan	8,463	48,449
	Canada	10,734	15,810
	Malaysia	19,890	20,165

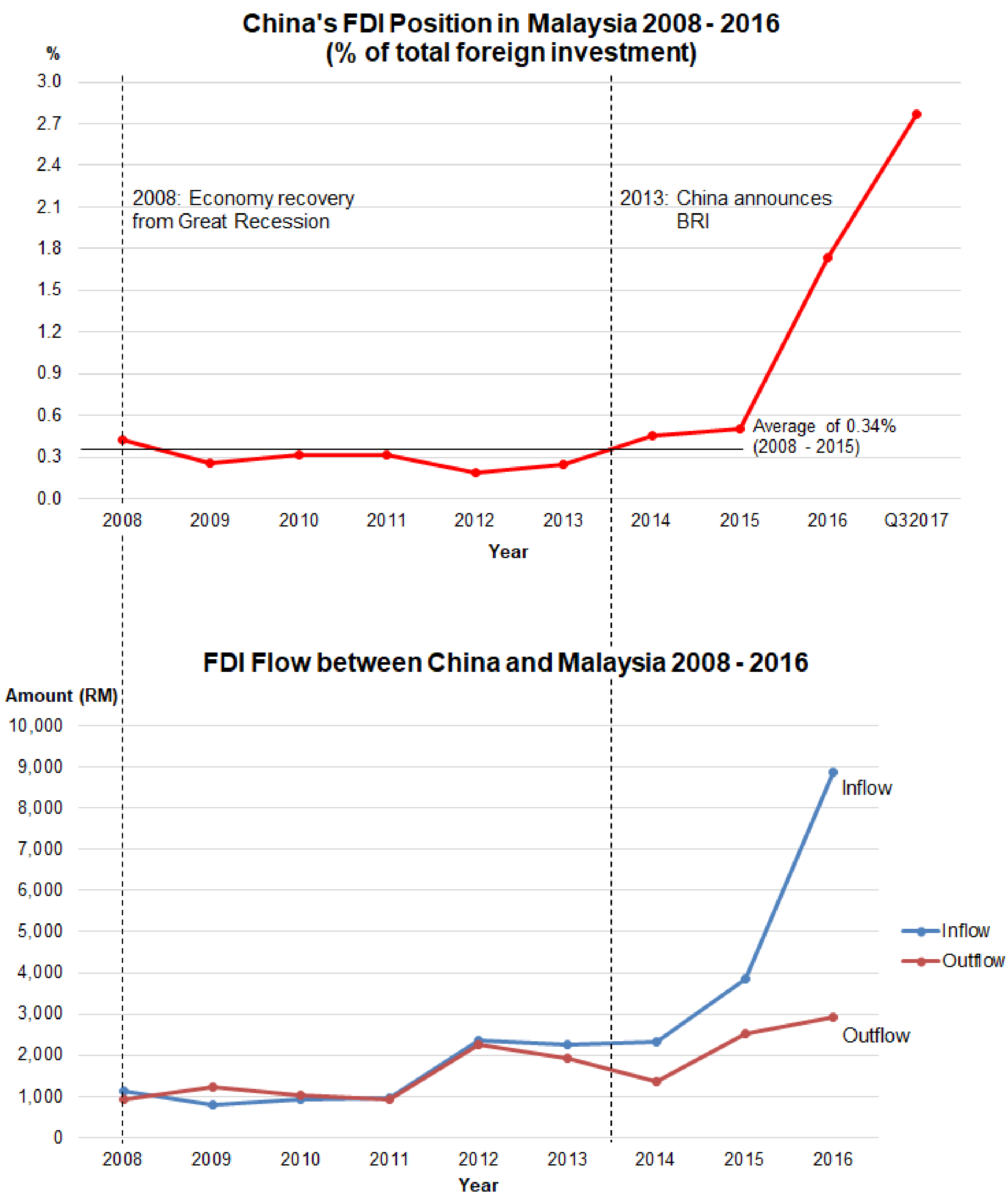
Source: UNCTAD, World Investment Report 2017

"Between greenfield and M&A investments, China has demonstrated a larger appetite in greenfield investments than M&A…"

Table 1 shows that China has now contributed more to the world in both greenfield and M&A investments than it receives. Between the two types of FDI, China has demonstrated a larger appetite in greenfield investments than M&A, while other top FDI countries such as Netherlands, Japan, and Canada are scooping up more foreign assets than starting from scratch. It is also possible that these countries are attempting to acquire assets from the same country - the US given its size of M&A inflows while developing economies receive the larger share of the world's greenfield investments.

Trends in China's Investments in Malaysia

Chart 2: China's FDI Flow and Position in Malaysia, 2008 - Q32017



Source: Department of Statistics Malaysia (DOSM)

“Therefore, the “new normal” in the investments relationship between the two countries deserves a re-thinking and also a richer discussion…”

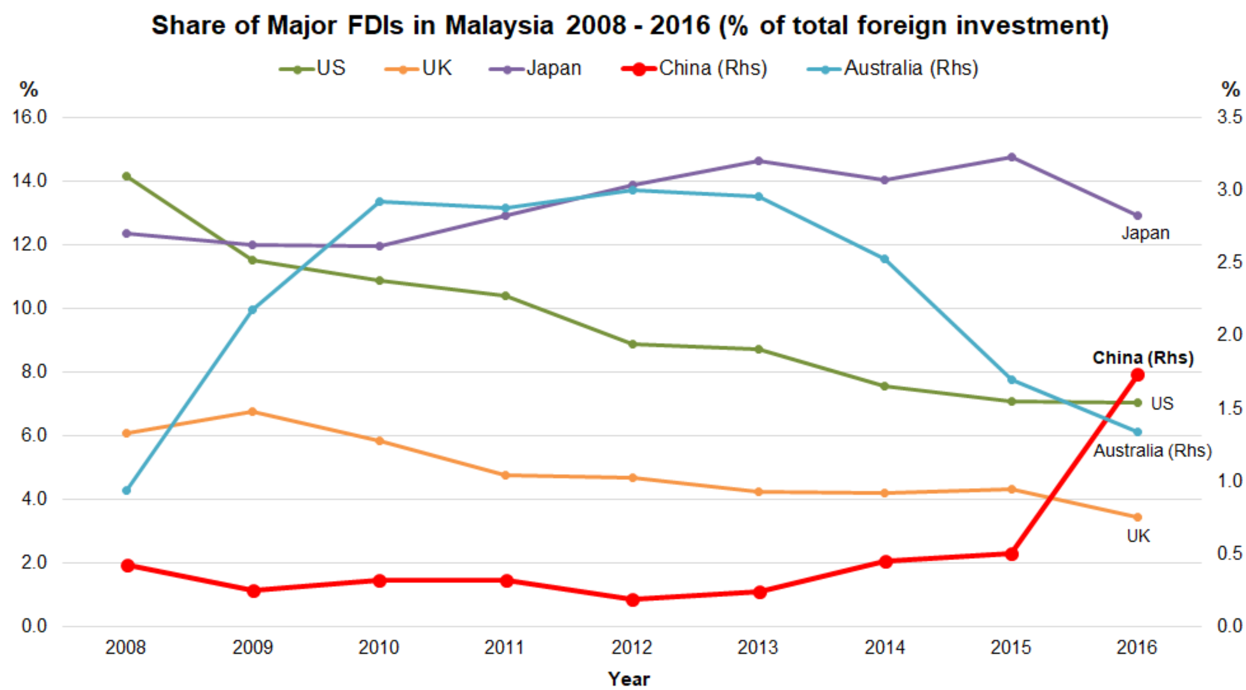
Chart 2 shows China’s accumulated investments in Malaysia standing at 2.77% of total foreign investments by third quarter of 2017. This is compared to an 8-year average of just 0.34% from 2008 to 2015. The spike in Chinese FDI coincided with the introduction of BRI in 2013, as explained earlier, but the total FDI stock is still miniscule compared to other countries (see Chart 3).

But nevertheless, we have reasons to believe that growth in Chinese FDI will be exponential from hereon as shown in China’s FDI inflow where it accelerated by nearly four times within just two years (2014-2016). If the massive value of projects signed between the Chinese and Malaysian companies as highlighted previously were materialised, China’s FDI stock will be growing at an even higher trajectory, thereby ‘re-basing’ the average upwards moving forward.[16]

Therefore, the “new normal” in the investments relationship between the two countries deserves a re-thinking and also a richer discussion on what this new development may mean to the future of the Malaysian economy.

[16] Former China ambassador in Malaysia, Dr. Huang Huikang, had earlier claimed that China had topped the list as the largest FDI country in Malaysia, surpassing US, Japan and Singapore. He is believed to have taken net FDI flow as a reference. See 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/ (accessed 28 Jan 2018)

Chart 3: Share of Major FDI Countries in Malaysia, 2008-2016, % of total foreign investment



Source: DOSM

> **"By comparing China's size of accumulated investments with other major countries, we are of the view that there has been a disproportionate level of concerns displayed by the public about Chinese investments."**

Chart 3 compares the downward trend in FDI stock by major countries into Malaysia with China's rising position. In 2016, although China has surpassed Australia (see Rhs) in FDI stock since mid-2013, China's investment position (1.73%) is dwarfed by other countries such as Japan (13%) and US (7%). It is also important to note here that Singapore (not shown in this chart) continues to lead in inward FDI flow, contributing to one-fifth of Malaysia's total foreign investment.

By comparing China's size of accumulated investments with other major countries, we are of the view that there has been a disproportionate level of concerns displayed by the public about Chinese investments. It is also interesting to note that the relative popularity with FDI from the US and Japan without also having their indirect "influence" or soft power being put to scrutiny, at least not to a degree that is commensurate with the size of their accumulated investments.

Section 2 – China's Greenfield Investments

Manufacturing Sector

According to the Malaysia Investment Performance Report 2016, the total approved investments in the manufacturing sector was worth RM58.5bil, with 733 projects approved and 64,120 jobs created. Out of the total amount, the combined foreign investments into the sector was registered at RM27.4bil (or 47% of total), with China being the biggest investor with investments worth RM4.7bil (or 8% of total). Combining China with Netherlands (RM3.2bil), Germany (RM2.6bil), UK (RM2.6bil), and South Korea (RM2.2bil), these countries altogether would contribute more than half of the total foreign FDI into approved Malaysian manufacturing investments.[17] In fact, the size of manufacturing FDI into Malaysia from China was twice that of ASEAN. In terms of subsectors, China's investments into the Malaysian manufacturing were concentrated in steel, non-metallic mineral and solar industries.[18]

Table 2: China's accumulated Greenfield Sectoral FDI into BRI countries from 2003-2015, (Millions of USD)

"How does China's focus in manufacturing investment contribute to Malaysia's services-oriented economy?"

Sectors	ASEAN	South Asia	West Asia	CIS[19]	Central and Eastern Europe	Central Asia	Total
Manufacturing	436.5	164.8	165.5	156.7	75.4	46.9	1064.8
Electricity	129.6	175.7	20.1	11.5	12.9	8.9	358.7
Mining	55.3	35.4	79.3	5.1	0.0	16.0	196.0
Construction	55.7	8.7	3.9	28.4	3.8	0.8	103.6
Logistics	33.8	5.6	3.5	2.0	4.4	26.9	76.4

Source: FDI Intelligence Database

As shown in Table 2 above, China's investment strategy in ASEAN countries lies with manufacturing, construction, and logistics given the region's abundant natural resources and young labour, as well as a favourable policy environment. The concentration has been markedly different in South Asia and West Asia where Chinese investments are predominantly in electricity and mining respectively. But how does China's focus in manufacturing investment contribute to Malaysia's services-oriented economy?

[17] MIDA: Malaysia Investment Performance 2016 Slides (slide 19). Based on observation, the ranking of the top FDI countries changes by the years. However, China is expected to remain in the top 10 biggest investors in Malaysia's manufacturing sector.

[18] MIDA: Malaysia Sustains Investment Growth Momentum. Available: http://www.mida.gov.my/home/3439/news/malaysia-sustains-investment-growth-momentum/ (accessed 3 January 2018)

[19] CIS: Commonwealth of Independent States

There are some success stories from the recent influx of Chinese greenfield investment. First, Malaysia has now become the world's third largest solar photovoltaic cell manufacturer after China and Taiwan, following the Chinese investments of more than RM1.5bil into the industry and another RM650mil from renewable energy projects in 2016. Apart from manufacturing, these investments have also contributed to building a complete solar ecosystem comprising of more than 200 companies from upstream to downstream activities, and from producing wafers and cells, to inverters and system integrators.[20]

"How does China's focus in manufacturing investment contribute to Malaysia's services-oriented economy?"

Second, the influx of Chinese investment has also transformed the glass manufacturing sector in Malaysia. Prior to 2016, Malaysia had always been a net importer of glass with annual spending of RM1.5bil in the global market. After billions of ringgit worth of investments by China's Kibing Glass Group and Xinyi Glass Holdings Ltd, not mentioning the benefits of a transfer of technology and managerial resources[21], Malaysia is now a net exporter to developed economies such as the United Arab Emirates, Singapore, Switzerland, Japan and United States.[22] So, in 2016, it was reported that RM1.9bil worth of glass and glassware products were manufactured for exports, contributing to more than a third of the share of Malaysia's total manufactured exports in the non-metallic mineral industry.[23]

The positive relationship between exports and productivity is worth highlighting, especially the adoption of international best practices in manufacturing as demonstrated by the Chinese greenfield investment cases above.[24] But it may be too early to draw a more general conclusion on the contribution of Chinese investments to the Malaysian economy given that the surge in investments has only been a recent phenomenon. Therefore, future research may include the study on Chinese greenfield investments and the link to sectoral competitiveness.

[20] See http://www.thesundaily.my/news/2193974 (accessed 3 January 2018)
[21] See 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/ (accessed 3 January 2018)
[22] World Bank Group: World Integrated Trade Solution (WITS). Available: https://wits.worldbank.org/CountryProfile/en/Country/MYS/Year/LTST/TradeFlow/Export/Partner/by-country/Product/68-71_StoneGlas (accessed 3 January 2018)
[23] MIDA: Non-Metallic Mineral Industry. Available: http://www.mida.gov.my/home/non-metallic-mineral-industry/posts/ (accessed 3 January 2018)
[24] Dowling J.M. & Valenzuela M.R. *Economic Development in Asia*: *International Trade and Investment*. (Singapore: Cengage Learning Asia Pte Ltd, 2017), 146.

Section 2 – China's Greenfield Investments
Constructions

Construction is the second largest Chinese greenfield investments into ASEAN, and particularly in Malaysia. China's concentration in the financing, material supplying, and actual construction work is consistent with its agenda to enhance infrastructure connectivity along the 65 countries identified as strategic partners in the BRI. According to the American Enterprise Institute, in 2016, China's outward FDI into BRI countries was at USD78.1bil, of which USD47.5bil (or 60%) was channelled into constructions.[25]

On August 2017, Mr. Najib launched the construction of East Coast Rail Link (ECRL) with China Communications Construction Company (CCCC) appointed as the main contractor of the mega-project. The RM55bil rail line will ultimately link Port Klang in the west coast of Peninsular Malaysia to Kuantan Port on the east, before connecting to the north-eastern corner of Malaysia.[26]

"China's concentration in the financing, material supplying, and actual construction work is consistent with its agenda to enhance infrastructure connectivity along BRI countries."

The ECRL is expected to strengthen Malaysia's trade route advantage in the strategic Strait of Malacca, serving as the gateway between Southeast Asia and South Asia, the Middle East, and also Africa.[27] Furthermore, by easing the logistics for external trade with the help of improved connectivity, Malaysia will be more capable too in drawing in higher volume of foreign investment inflows.[28] Sectoral spill-overs are also made possible with enhanced connectivity, such as the tourism sector in the east coast and hence indirectly uplifting the economic welfare of the households in those areas.

Other mega-projects which involve Chinese investments and construction works include the Kuala Lumpur-Singapore High Speed Rail (HSR), Mass Rapid Transit 3 (Circle Line), Gemas-Johor Bahru Electrified Double Tracking Railway, Penang Port Expansion, Kuantan Port Expansion, Kuala Linggi International Port in Malacca, Melaka Gateway Project, Carey Island, and Bagan Datoh Port in Perak, totalling RM370bil over the next ten years.[29]

Different views abound on the implications of Chinese investments into mega-projects in Malaysia. First, on the potential cost involved, there are arguments for choosing China's construction companies given their higher efficiency and productivity levels. For instance, the former Chinese ambassador Mr. Huang Huikang compared the relatively shorter time span needed for ECRL to a similar project in Switzerland. Also, the mega-projects were intended to be jointly completed with a target of 30-40% of the total project value awarded to local contractors. The Malaysian government stated further that these public works were awarded to create a win-win situation for both countries, and reassured the public that they will not kick-out the locals' "rice bowls".[30]

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[25] American Enterprise Institute statistics
[26] ECRL is primarily a domestic investment with some funding from China. See http://www.freemalaysiatoday.com/category/nation/2017/12/18/ecrl-a-domestic-investment-says-academic/ (accessed 4 Jan 2018)
[27] Peter Hays, a London based analyst, specializes in trade and regulation in the Asia Pacific region. Available: https://globalriskinsights.com/2017/09/impact-chinese-investments-malaysia/ (accessed 4 January 2018)
[28] Yeah Kim Leng, an Economics Professor in Sunway University. Available: http://www.xinhuanet.com/english/2018-01/03/c_136869258.htm (accessed 4 January 2018)
[29] See https://www.themalaysianinsight.com/s/12213/ (accessed 4 January 2018)
[30] See 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/ (accessed 4 January 2018)

Besides, there are also concerns about the financing aspect of these infrastructure projects, especially if the soft loans obtained were eventually added onto the burden of the future generations given the long horizon of interest payment. An opposite view to that concern will be that these FDIs promote development and growth to the Malaysian economy, especially with the expected benefits of local firms absorbing the transfer of technology know-how. In the long run, the enhanced capacity and expertise in the Malaysian industrial sector can open up new market opportunities and compete globally in the higher value-added product space, thereby partially addressing the issue of "premature deindustrialisation".[31]

[31] See https://www.themalaysianinsight.com/s/12213/ (accessed 4 January 2018)

Services Sector

Growing dominance in the services sector as a share of Malaysia's economic expansion is consistent with the experiences of other countries on achieving the developed nation or high-income economy status. Significant sub-sectors within services are wholesale and retail trade, and also the information and communications industry. The services sector is expected to grow in importance as the key economic driver of the future given the strong emphasis stated in the government's ambitious TN50, a 30-year transformation roadmap, for a developed nationhood by 2050.

In 2016, Malaysia's approved investments in the service sector was worth RM141.2bil, with 4,199 projects implemented and 88,108 jobs created. A whopping 80% of the total approved investments in the service sector (or RM112.9bil) was actually contributed by domestic investors. Despite having a smaller share, foreign investments in the service sector had actually registered an increase of 128% from 2015 (or RM12.4bil).[32]

"Chinese firms appear to be more comfortable acquiring assets in Western economies because the business environment in those countries is systematically more open, certain and secure in terms of legal protection to ownership rights."

Given Malaysia's strategic focus and faster investment growth by foreigners in the services sector, why is it the case that China remains more interested to invest in Malaysia's manufacturing sector than services?

China has demonstrated huge interest in the services sector of Western advanced economies. In 2016, China's global M&A investment stood at USD221.7bil, with 42% and 33% of the investments going into Europe and North America respectively.[33] The bulk of the 622 M&A deals inked in 2016 was concentrated in the service sector, mainly in financial services technology, media and telecommunication, energy and public utilities.[34]

Chinese enterprises have been looking for M&A investment opportunities in the service sector in the West despite the potential challenges of geography, linguistic and culture. Given the Western economies' relative advancement in services, Chinese investors have been more inclined to undertake M&A investments, as means to accelerate the transfer of technology and know-how, rather than greenfield investments. Also, Chinese firms appear to be more comfortable acquiring assets in Western economies because the business environment in those countries is systematically more open, certain and secure in terms of legal protection to ownership rights.[35]

Apart from the pull-factors explaining growing Chinese thirst into services sectors of the West, we must not overlook the fact that China is also working to transform itself away from an extractive, factor-driven manufacturing powerhouse into a highly innovative, services-oriented economy. In 2016, China's services sector made up more than 50% of the country's GDP (or USD5.6tril), more than the share

[32] MIDA: Malaysia Investment Performance 2016 Slides (slide 35)
[33] EY-China Overseas Investment Network
[34] *Ibid* and http://res.hurun.net/Upload/file/20171017/201710171545252993124.pdf (accessed 23 January 2018)
[35] See http://www.scmp.com/comment/insight-opinion/article/1944491/why-china-investing-heavily-europe (accessed 8 January 2018)

"…China's glaring absence in Malaysia's service sector may suggest gaps in the latter's relative competitiveness level, at a time when China's FDI is rising globally, especially in the services sector."

of manufacturing. In the same year, the Chinese government had set up an USD4.4bil fund to encourage high value-added service exports, thus reinforcing its commitment towards services sector reform.[36] The eventual goal for China is for its services to take up 70-80% of the country's GDP, which is the average for advanced economies.

Despite public concerns about the growing size of Chinese investments in Malaysia, and the potential risks that this may bring to the stability of the economy, we are of the view that the nature of Chinese investments is in fact more critical to the development of the Malaysian economy. Putting it differently, the absence of Chinese investments in Malaysia's services is a larger cause of concerns.

China's FDI concentration in Malaysia's non-services sectors, while consistent with the overall pattern within the ASEAN region, may suggest a certain degree of "marriage of convenience" due to Malaysia's strategic location along the BRI routes. While both countries share similar emphasis on creating a services-oriented economy that is on par with advanced nations by 2050, China's glaring absence in Malaysia's service sector may suggest gaps in the latter's relative competitiveness level, at a time when China's FDI is rising globally, especially in the services sector.

[36] See https://www.forbes.com/sites/sarahsu/2017/02/21/china-takes-another-step-towards-a-service-economy/#3e5448a628c1 (accessed 10 January 2018)

Section 3 – China's Merger & Acquisition (M&A) Investments

China's Foreign M&A Investment Patterns

Would greenfield investments be more preferable compared to M&A? Public perception of foreign investors scooping up national assets via M&A has always been negative, considering the potential losses of employment and technological edge in foreign hands, not mentioning the emotional losses if the assets sold were national champions or symbols of national pride.

As described earlier, China remains cautious of potential backlashes with countries along the BRI routes due to M&A, and hence its larger share of greenfield investments in those countries. Furthermore, China prioritises the long-term economic gains from the successful realisation of BRI, and hence positions itself as a dominant player in providing infrastructure financing and engineering skills to those BRI countries. But on the other hand, as China seeks to develop its indigenous capacity to become an advanced services-oriented economy, it has demonstrated larger appetite in acquiring services firms, mainly from advanced Western economies as well as Hong Kong, Singapore, and South Korea.[37]

"According to a study by Crowe Horwath, M&A transactions in 2017 declined from 2016, which is consistent with a decreasing trend for the past five years."

Should we be worried about the extent of foreign M&A activities in Malaysia? According to a study by Crowe Horwath, an accounting firm, there were only 78 M&A transactions worth RM13.8bil in 2017, a marked declined from 236 M&A transactions worth RM34.3bil in 2016, which is consistent with a decreasing trend for the past five years.[38] Based on the data from Crowe Horwath's report and UNCTAD, it is calculated that more than half of the M&A transactions recorded in 2017 were undertaken between domestic companies. Further studies may be needed to investigate the reasons behind the falling trend in M&A, and to understand if there is a general lack of attractiveness in Malaysia's assets in the eyes of foreign investors.

Nevertheless, there were some high-profile M&A deals struck between Chinese and Malaysian companies that may have given the impression of Chinese firms scooping up assets that are strategically important to Malaysia, such as China's Zhejiang Geely Holdings Group's purchase of 49.9% and 51% of Proton and Lotus shares respectively.[39] There is also suspicion of a Chinese bail-out that is politically motivated such as the RM10bil acquisition on 1MDB's Edra Global Energy Berhad by China General Nuclear Power Corporation.[40] In our view, while there are valid reasons to scrutinise M&A deals involving foreign firms, it is also pertinent for us to find out if there is a discernible pattern in these Chinese M&A deals, as we have done for greenfield investments in the earlier sections.

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37 See http://res.hurun.net/Upload/file/20171017/201710171545252993124.pdf (accessed 23 January 2018)
38 Chiu, H. Y. (2017) Merger & Acquisition Trends in Malaysia. See full report at http://www.crowehorwath.net/uploadedFiles/MY/insights/Merger%20and%20Acquisition%20Trends%20in%20Malaysia.pdf (accessed 23 January 2018)
39 *Ibid.*
40 For press release, see http://1mdb.com.my/press-release/edra-successful-completion-of-the-share-sale-purchase-agreement (accessed 23 January 2018)
For news article, see https://www.thestar.com.my/business/business-news/2016/03/23/1mdb-says-sale-of-edra-to-china-group-completed/ (accessed 23 January 2018)

"…we do not see a pattern such as that in the Western advanced economies where China's M&A deal is concentrated in key services and technology sectors."

Compared to greenfield investments, M&A investments by Chinese companies are considerably lower in Malaysia, or in ASEAN more generally. Given China's 2050 vision to achieve a services-oriented economy on par with advanced countries, the influx of Chinese investments into Malaysian manufacturing and construction companies are not consistent with Beijing's policy direction. More importantly, we do not see a pattern such as that in the Western advanced economies where China's M&A deal is concentrated in key services and technology sectors.[41]

This dichotomy reinforces our earlier suspicion if Malaysian assets are indeed incompatible with China's thirst for technology and knowledge transfer, and therefore highlighting the greater need to boost Malaysia's capacity for innovation, and not to be unduly fearful of a rising trend in Chinese investments. On the other hand, since strategic companies in the ASEAN region are usually state-owned or closely linked to the government, an overly aggressive M&A by China will create backlashes that may jeopardise its realisation of BRI policies.

[41] See https://www.cnbc.com/2017/11/12/chinese-ma-china-outbound-mergers-and-acquisitions-to-rise-in-2018.html (accessed 12 January 2018)

Section 4 – Conclusion

Moving Forward

A recurrent theme in this paper is the search for discernible patterns in China's investments in Malaysia, and to understand how these investments matter to China in the greater scheme of things as much as how they would impact Malaysia. While we recognise the importance of safeguarding national interests when approving a foreign investment, we would take the stand of promoting instead the scrutiny of the nature and quality of these investments, rather than discriminating against the country of origin of these FDIs.

The recent influx of China's greenfield investments into the Malaysian manufacturing and construction sectors have been accompanied with some success stories in technological upgrading and therefore the creation of new markets for domestic firms. However, it is important to note that it is still too early for us to conclude if these successes are replicated systematically in the two industries, and more so towards the entire economy.

On the other hand, we highlight the glaring absence of Chinese investments in Malaysia's services-sector given that both countries aim to become a services-oriented economy that is on par with advanced nations by 2050. We then study the motivations behind China's relatively extensive M&A deals in selected sectors in Western advanced economies, and to attribute the different investment focus for Malaysia and ASEAN to their strategic locations as part of the BRI. This dichotomy may suggest greater loss of investment opportunities moving forward if Malaysia's innovation and technological capacity is not significantly improved and made compatible to China's ongoing push for high-quality, indigenous innovation-led growth strategy.

"A strong domestic investment position is a sign of economic strength, and this is a key "pull" factor for foreign investments."

While this paper is primarily interested in the patterns of China's FDI in Malaysia, it is important to note that domestic investments are still larger in size than foreign investments. A strong domestic investment position is a sign of economic strength, and this is a key "pull" factor for foreign investments.[42] Other "pull" factors will include the government's commitment to maintaining fiscal discipline and also policy continuity, such as the government's attitude towards cross-border trade and finance, tax, and legal protection to ownership rights and intellectual property. The government should also encourage more greenfield FDIs in order to create new market opportunities and foster the transfer of technology and expertise.

Lastly, this paper is also intended to serve as a primer for future research undertakings on the issues of Chinese investments and its implications to Malaysia. Among the topics that are relevant may include the implications of a potential China's financial contagion on Malaysia's industry sectors, managing negative externalities like occupational safety and pollution, and the linkages between mainland China and Hong Kong FDI into Malaysia.

[42] Calderón, César; Loayza, Norman; Servén, Luis. 2004. *Greenfield Foreign Direct Investment and Mergers and Acquisitions : Feedback and Macroeconomic Effects*. Policy Research Working Paper; No. 3192. World Bank, Washington, DC. © World Bank. https://openknowledge.worldbank.org/bitstream/handle/10986/13941/325780wps3192.pdf?sequence=1&isAllowed=y License: CC BY 3.0 IGO.

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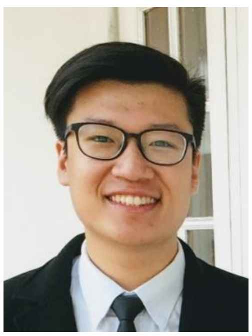

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