A New Colonialism? Chinese Foreign Direct Investment in Malaysian Infrastructure

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A NEW COLONIALISM?  
CHINESE FOREIGN DIRECT INVESTMENT  
in Malaysian Infrastructure  

Phillip Hernandez  

Throughout the last decade, Malaysia has witnessed, first hand, the significant inroads that the People’s Republic of China has made in extending its influence throughout the Eastern Hemisphere. Malaysia has been deemed a pivotal location for the receipt of Chinese investment funds, especially in massive infrastructure mega projects. This article discusses China’s investment influence on Malaysia and the associated ramifications while identifying three main overarching themes of Chinese investment that revolve around the topic of debt sustainability.

Introduction

Infrastructure is 1 of 17 sustainable development goals proposed by the United Nations and is a key consideration for developing countries seeking sustainable growth. The advancement of infrastructure can propel a nation to developed status and result in numerous spillover effects on its economy. More specifically, greater availability and quality of infrastructure in a developing country will foster economic growth via the attraction of capital inflows from foreign investors who view sound infrastructure as a desirable attribute in the investment decision-making process. Foreign direct investment (FDI), which may come from individuals as well as public enterprises, private corporations, or governments, aims to establish a long-term and substantial level of influence on an enterprise or project in a foreign host country. FDI has been historically implemented as a key instrument in driving economic development (Duce).

With the South China Sea accounting for about a third of international trade, Southeast Asia quickly became a corridor for the resurgence of FDI post the 2008 global financial crisis. As a result, direct investors in world powers, such as the United States of America, Japan, and, in particular, the People’s Republic of China, have sought investment opportunities in the development of rapidly growing Southeast Asian economies. In 2013, China, using its leverage in the region, introduced a Belt and Road Initiative (BRI), composed of about 65 countries, to enhance connectivity between Eurasian countries via land and maritime routes (Cai).

Malaysia, a BRI participant and the third ranked country in Southeast Asia by gross domestic product (GDP) per capita, has grown at steady annual GDP growth rates between 4% and 7% per year since 2010. In addition to its strong growth profile, Malaysia’s strategic location along the Strait of Malacca has made it a lucrative investment target for Chinese
BRI investors. In fact, China was Malaysia's top source of FDI in 2017, accounting for approximately 7% of total inward FDI and clinching the lion’s share of construction FDI (Shukry and Ho). Notably, recent BRI projects are showcasing the inroads China is making in the Malaysian infrastructure sector.

China's most significant construction investments in Malaysia have been in transportation systems, such as railway networks and ports. Examples of Chinese-funded mega projects in Malaysia include the Penang Second Bridge, the Malacca Gateway, and the East Coast Rail Link (ECRL). The economy of Malaysia appears to be highly dependent on Chinese investment, which is at an all-time high with 12 recent Chinese-funded infrastructure projects across Malaysia, valued at an estimated RM242 billion (Todd and Slattery). With bilateral trade partnerships and mega projects between China and Southeast Asian nations becoming increasingly prevalent, the nature of China's business dealings in Malaysia has received increased press coverage. The large influx of Chinese investment has raised warning signals regarding China's underlying investment rationale. Critics have suggested that Chinese investors are extending unsustainable long-term loans for infrastructure projects in developing countries such as Malaysia. While the lucrative terms and conditions surrounding Chinese FDI contracts are often tough to turn down, data suggest that Chinese-funded projects in Malaysia may not be win-win arrangements as the country copes with increased debt levels, evaluating new project quality and practicality, and maintaining autonomy from China’s massive sphere of influence (Todd and Slattery).

In this article I discuss China's investment influence on Malaysia and the associated ramifications, including concerns regarding a possible new colonialism centered around Chinese investment. I identify three main overarching themes—(1) debt traps, (2) transparency, and (3) financing—that revolve around the topic of debt sustainability. I also provide insights into the perceived superiority of Chinese construction and whether it is genuinely needed. Lastly, I propose some prescriptive guidelines if infrastructure investment projects are to be undertaken.

A New Colonialism

As the most economically, strategically, and politically prominent country within Asia, China has established a regional sphere of influence and has recently designated Southeast Asia as a target for prospective BRI projects. A potential risk for sovereign nations is Chinese domination. Because of the rapid influx of investment, Southeast Asian countries should heed China’s previous controversial business practices in other countries used to spread its influence.

Malaysia should take note of China's seizure of ownership of foreign infrastructure if the debtor country cannot comply with repayment terms. Perhaps the most glaring example is the case of Sri Lanka. The country has $55 billion in foreign debt, 10% of which is owed to Chinese lenders, and is operating at a 77% debt-to-GDP ratio. With little room to take on more debt and struggling to make repayments, in 2017, Sri Lanka ratified an agreement with a Chinese state-owned enterprise (SOE) to write off $1.1 billion worth of debt in exchange for a 99-year lease of their Hambantota Port (Macan-Markar). This transaction essentially provides China unfettered access to port facilities near one of its key Asian competitors, India. Malaysia may face similar consequences as the economies of China and Malaysia become more heavily interconnected. A potential global recession or an extraordinary domestic economic event may lead to the relinquishment of pivotal Malaysian infrastructure assets and gateways. The sequence of events in Sri Lanka has caused other BRI partners, including Pakistan, Malaysia, Myanmar, Bangladesh, and Sierra Leone, to re-evaluate investments that may be disguised as debt-trap diplomacy (Chandran).

A 2019 Association of Southeast Asian Nations (ASEAN) study concluded that most Southeast Asian nations are growing wary of China’s investment behavior in the region as developing countries take on more debt. More than 1,000 respondents from multiple sectors of society in all ten ASEAN member states, including 146 respondents from Malaysia, participated in the survey. In response to the query, “What is your view of BRI proposals in your country?” a resounding 84.2% of surveyed Malaysians responded with, “My government should be
cautious to avoid getting into unsustainable financial debts with China” (Tang et al., p. 20). Similarly, 70% of all ASEAN respondents shared the same sentiment. Meanwhile, a mere 8.6% of the Malaysian survey respondents believed that the BRI benefits outweighed the potential economic and political fallout. Further, 5.8% of respondents believed that Malaysia should completely avoid participating in BRI projects. Indeed, the strong rhetoric of Prime Minister Mahathir Mohamad has headlined the mass media and policy discussion spheres, causing doubt to creep into the minds of Malaysians as they step back and consider the potential negative ramifications of Chinese investment. Not surprisingly, Malaysia ranked highest among the ten ASEAN countries in terms of exercising caution towards Chinese investment as the survey was administered during talks to renegotiate the terms surrounding ECRL (Tang et al., p. 20).

Debt Sustainability

Debt Trap

Under the BRI, China has expressed its intentions to invest trillions of dollars into the infrastructure of developing countries, but the question remains, At what financial cost to the recipients? The exact amount of debt owed to China is undisclosed, but China is a top contributor to Malaysia’s inward FDI and has financed several mega infrastructure projects in recent years. According to stress tests conducted by the International Monetary Fund (IMF), external debt would remain manageable under a variety of shocks. However, Malaysia’s debt levels hovered at just above median peer levels before the approval of two projects, which prompted conversation regarding the possibility of a credit-rating downgrade (“Malaysia…”).

Soon after Mahathir was sworn in as Malaysia’s seventh Prime Minister in May of 2018, he brought to national attention the immediate review of the ECRL. Agreed to under the previous administration by former Prime Minister Najib Razak, the ECRL was Chinese funded with a RM66 billion project cost. At the end of a 5-day visit to China in August 2018, Mahathir stated: “It’s all about borrowing too much money, which we cannot afford and cannot repay because we don’t need these projects in Malaysia” (Beech). The borrowing to which Mahathir referred is the approximately RM1 trillion total external debt that the country has accumulated, representing an estimated 62.5% of the country’s GDP in 2018 (“Malaysia…”).

After months of negotiations, in what could be viewed as either a victory or a concession, Mahathir ultimately reached a new deal to resume construction of the ECRL but at nearly two-thirds of the previous cost. The original RM66 billion project cost was negotiated down to RM44 billion ($10.7 billion). Mahathir’s office was quoted: “This reduction will surely benefit Malaysia and lighten the burden on the country’s financial position” (Sipalan et al.). Although Mahathir may have succeeded in reducing the overall cost of the ECRL, details of the terms were not available, and the impending RM22 billion worth of compensation and penalty charges may have twisted his arm (“RM22 billion…”). Nevertheless, while project renegotiations are a step in the right direction for Malaysia, the financial burden on the country remains ambiguous.

Nations with developing economies require a balance between early investment in infrastructure to support future economic growth and stable revenue generation to be able to service the resulting debt. Without adequate oversight, a self-fulfilling debt prophecy can emerge if a highly leveraged country initially struggles to make debt repayments, thus leading to a higher cost of capital as future investors seek appropriate compensation for the risks they are taking on (Nicolini). In other words, Malaysia may find itself having to pay a premium on future projects if its debt-to-GDP ratio vastly increases. Fortunately, Malaysia has surpassed the early stages of development and can exercise investment discretion as the country undergoes rapid economic development.

Transparency

The lack of public transparency surrounding the financing of Chinese BRI loans is indicative of a nation that seeks to
acquire advantages when negotiating with sovereign governments. Apart from infrequent official media announcements of new BRI projects that may reveal top line costs, Chinese creditors do not publish cross-border financing agreements or terms for their BRI projects nor does a centralized public database exist for such information. Additionally, finding BRI project details published by the debtor nation is unlikely. China’s main funding sources for 2016 BRI projects, including loans or equity investments, are China’s four main state-owned commercial banks (Bank of China, China Construction Bank, Agricultural Bank of China, and Industrial and Commercial Bank of China), the China Development Bank, and the Export-Import Bank of China, accounting for 51.4%, 37.7%, and 8.2% of total funding, respectively (Wildau and Ma). Unlike China’s three main BRI funding sources, multilateral lending institutions, such as the World Bank, the Asian Development Bank, the Asian Infrastructure Investment Bank, and most bilateral development finance institutions, publish the terms of loans to governments for all to see. Because of the lack of transparency and access to BRI loan data, financing terms are not widely available to be analyzed and compared. Currently, there are insufficient data available for analysts to calculate the amount of debt a country like Malaysia owes to China, and some nations potentially are receiving more favorable terms than others. With China becoming a bigger player in the developmental assistance of other nations, it should comply with worldwide common practices of lending transparency facilitated via multilateral agreements. The lack of transparency should, at the very least, raise doubts about the financial viability of the transactions and, indeed, the projects themselves.

Twenty-two of the world’s largest creditor nations, including Japan, Germany, and the United Kingdom, are permanent members of the Paris Club, an informal group of nations with a common objective of developing solutions to aid debtor nations struggling to service their debt. The organization is grounded on a multilateral approach to debt relief with observers that include the IMF, the World Bank, and many other international institutions. China, the world’s third largest international creditor, however, has often favored bilateral methods to solving default matters and has chosen to be only an ad hoc participant in the Paris Club (Hurley et al., p. 22). Therefore, China does not have to adhere to the Paris Club principles of solidarity, consensus, and, most importantly, information sharing. Without multilateral agreements, China deals exclusively with the debtor country to resolve its debt circumstances, and, although there are public data provided by the IMF regarding Chinese debt relief actions, for the most part, Chinese creditors work with their debtors on a case-by-case basis. Unlike the permanent members of the Paris Club, Chinese creditors are not obliged to reveal information regarding the management of credit restructurings or negotiations.

**Financing**

Although there is an established relationship between China and Malaysia, the financing terms on project loans provided by Chinese creditors distribute the majority of the financial risk onto Malaysia and, at times, favor Chinese over Malaysian firms. Malaysia’s construction sector continues to grow at a healthy rate, despite a large percentage of contracts granted to Chinese organizations. Widely criticized as unfair to local and non-Chinese foreign investors, China’s SOEs offer extremely favorable pricing and financing options in exchange for Malaysian construction contracts. Recently, Chinese SOEs have taken advantage of Chinese state funding by offering lucrative loan terms, such as longer grace and repayment periods, that are below market interest rates (Massa, p. 11). Considering that a majority of Chinese contractors employed in Malaysia are SOEs, Malaysia is familiar with the terms and has at times prioritized Chinese contractors, such as the direct negotiation with China Communications Construction Company (CCCC) for the ECRL project. Massive SOEs, such as CCCC, China Harbour Engineering Corporation, and China Railway Construction Corporation, acquire financing via state-owned banks. Advantageous export credit insurance is also provided by the state-owned China Export & Credit Insurance
Corporation (Massa, p. 4). Ultimately, because Malaysia runs a budget deficit, its main source of current and future funding must come from private or foreign funds, and Chinese lenders possess the financing to gain a competitive advantage over local and non-Chinese foreign lenders.

Chinese contractors are able to attain such favorable financing in part because China is not a member of the Organisation for Economic Co-operation and Development (OECD) and therefore is not forced to follow OECD guidelines. The guidelines would have influenced the quantity of Chinese aid allowed, credit practices and repayment terms, and the exchange of information and would have imposed social, environmental, and governance standards on Chinese financing activities. OECD member nations are limited on the conditions and terms surrounding export credit financing in order to provide a fair playing field where the quality and price of service are favored over preferential financing terms. Since Chinese firms are able to achieve such preferential financing, they are able to tolerate low margins and beat out Malaysian contractors that cannot guarantee such terms (Massa, p. 17).

Malaysia does welcome construction tenders from all countries, including China, and, in most cases, the government negotiates clauses requiring foreign contractors to subcontract local contractors for 30% of the project. However, 30% is still a minority, and Chinese contractors have been known to exclusively award subcontracts to other Chinese corporations. The reality is that Chinese corporations have the capacity to take on various sizeable projects, and when they must subcontract, they more often than not contract other Chinese companies with whom they are familiar because of similar working practices and costs. The losers in this scenario are local and other foreign contractors (Todd and Slattery). Although the terms provided by Chinese financing are attractive, Malaysia may be doing a disservice to its own local construction enterprises and forgoing potentially higher-quality projects by settling for the lowest bidder.

### Is Chinese Infrastructure Quality Superior?

China’s BRI serves as a tool to generate more business for Chinese engineering and construction companies at a time when “over half the infrastructure investments in China made in the last three decades have been [net present value] negative” (Ansar et al., p. 377). (Net present value refers to the current value of all future cash flows generated by a certain project.) According to Ansar and colleagues, “China’s track record in delivering infrastructure is no better than that of rich democracies” (p. 360). In fact, there are media reports describing Chinese infrastructure investments in Africa as subpar in quality. Analysis of the outcome of infrastructure projects completed by Chinese firms within China itself reveals that investment in infrastructure has actually deteriorated economic value in China “due to poor management of risks that impact cost, time, and benefits.” (Ansar et al., p. 377). As a result, China’s own crumbling infrastructure has become a priority concern for the government.

In summary, there is no significant empirical evidence suggesting a difference in the performance of Chinese firms compared to OECD country firms between 2000 and 2013 (Farrell, p. 7). An ASEAN survey indicated that 28.7% of Malaysians believe that it is actually “too early to analyze impacts of BRI projects due to lack of information” (Tang et al., p. 19). From a project management standpoint, China may offer lower tender rates than other countries for projects, but evidence suggests that the work itself is not necessarily of better quality, with some associated evidence of inferior quality.

### White Elephant Projects

White elephant projects are those that typically arise from corrupt or opaque approval systems in which the high capital cost of a project outweighs the long-term usefulness or value of the project. The rhetoric surrounding white elephant projects has escalated since the removal of the Najib-led government and the election of current Prime Minister Mahathir. For instance, Pacific Asia economists such as
Alex Holmes have suggested that the current infrastructure system in Malaysia is satisfactory for a developed economy and that recent investment influxes into port infrastructure may lead to oversupply and inflation (White). Malaysia must be cautious when entertaining expensive foreign-funded projects that come with dubious economic value and that may prove to be underutilized in the future. Mahathir has criticized, postponed, or reevaluated potential white elephant projects such as the high-speed rail (HSR) to Singapore and the ECRL.

In late May of 2018 following the general election, Mahathir began to ratchet up the criticism of high-priced rail projects in Malaysia as he publicly doubted their economic viability. In his view, the proposed HSR running between Singapore and Malaysia would not be beneficial to Malaysia because it will cost a huge sum of money and save passengers only approximately 1 hour in travel time (Bland and Mallet). The backlash from halting the project was mixed, but Mahathir insists on ensuring the future financial stability of Malaysia. In an interview with The New York Times, Mahathir also claimed that he had evidence that the ECRL could have been built by a local company for about half of the RM55 billion ($13.4 billion) sum his predecessor agreed to pay China-owned CCCC (Beech). Clearly, Mahathir has been critical of dubious investments agreed to under the previous administration for projects where he does not quite see the need. There is no hard evidence to back the Prime Minister’s claim, and he ultimately agreed to a final project cost of RM44 billion ($10.7 billion). However, the lack of public feasibility studies and limited disclosure on financing terms on those China-related projects is worrisome and cause for concern, perhaps justifying Mahathir’s views.

Widespread criticism of steeply priced infrastructure projects in Malaysia in the early half of 2018 coincided with a massive ongoing investigation into malfeasance at Malaysia’s state-owned investment fund, 1Malaysia Development Berhad (1MDB), a fund that was intended to attract foreign investment and came under scrutiny for at least RM16.45 billion ($4 billion) in irregular transactions. Several infrastructure projects taken on during Najib’s administration may have been linked to the 1MDB scandal according to Malaysian Minister of Finance Lim Guan Eng. For example, the ECRL was said to have an exorbitant price tag despite favorable comparisons made by Najib concerning the higher costs of other railways. In reality, the economics of railway projects should be evaluated independently and should not be compared directly due to differences in geography, technology, and construction time frame. Proponents of the ECRL claim that the railway system will “upgrade east-west connectivity, help boost economic development along the east coast and improve the well-being of residents in Pahang, Terengganu and Kelantan” (Foon). However, the HSR and ECRL will only enhance, not pioneer, this connectivity, and, according to a survey conducted by the Malaysian National News Agency, Bernama, many road users would prefer upgrades to the existing roads instead of the ECRL (Latib). Additionally, because of the lack of transparency, logistics analysts note that no Chinese firm has agreed to support the railroad and that freight costs will likely deter any substitution effects, unless government subsidies are provided (Yean).

In order to avoid building so-called bridges to nowhere, Malaysia should implement a mandatory procedure grounded on a transparent appraisal and approval system. Implementing a robust procurement process will ensure that every proposed project passes through a system of checks and balances whereby the project in question, especially those contracted at a state level, will have to align with Malaysia’s overarching developmental goals. This will prevent one-off type projects that are not consistent with the country’s holistic development plan. Further, such a process will help in adopting financing that will support the time sensitivity of projects and ensure that programs to guarantee technology transfer, local employment, and so forth are set in place.

Conclusion

As the first ASEAN country to establish diplomatic relations with China, Malaysia has had a history of strongly rooted economic and political ties with that country. Over
many decades, the bilateral relationship has contributed to the strengthening of trade and investment, either through direct investment or via joint venture collaborations. Until recently, Malaysia could have been considered a success story of an Asian democratic nation with a rapidly growing economy, despite Chinese political and economic influence. To be clear, Chinese investment in Malaysia is not entirely detrimental, and Malaysia should not be entirely opposed to it. Malaysia could benefit from a sustainable and transparent two-way investment relationship with China.

There are three main factors that Malaysia’s Prime Minister should address before moving forward with Chinese investment dealings while maintaining cordial ties. First, current dubious investment projects should be halted and comprehensive evaluations, from both financial and feasibility perspectives, should take place. Second, full transparency and accountability standards should be followed by nations seeking to invest in Malaysia and by the Malaysian ministry responsible for sponsoring the project. This will allow for an impartial procurement process where all parties involved are fully aware of the details of the transaction. Third, the implementation of statewide governance and regulatory criteria will serve as a tool to eliminate the possibility of white elephant projects and ensure the development of economically viable projects that will deliver dividends to Chinese and Malaysian investors and to Malaysian communities. Ultimately, the Mahathir administration will have a fine line to walk, but, with sustainable investment standards set in place and proper evaluations of project practicality, Malaysia can realize sustained growth with minimized risk.
References


