

ISSN 0219-3213

2014 #01

Trends in  
Southeast Asia

CHINA'S ECONOMIC ENGAGEMENT  
WITH SOUTHEAST ASIA: MALAYSIA

JOHN LEE



ISEAS Publishing

INSTITUTE OF SOUTHEAST ASIAN STUDIES

# Trends in Southeast Asia

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Published by: ISEAS Publishing  
Institute of Southeast Asian Studies  
30 Heng Mui Keng Terrace  
Pasir Panjang, Singapore 119614  
publish@iseas.edu.sg <http://bookshop.iseas.edu.sg>

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### **ISEAS Library Cataloguing-in-Publication Data**

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Lee, John.

China's economic engagement with Southeast Asia : Malaysia.

(Trends in Southeast Asia, 0219-3213 ; TRS 1/14)

1. Malaysia—Foreign economic relations—China.
2. China—Foreign economic relations—Malaysia.
3. Malaysia—Foreign relations—China.
4. China—Foreign relations—Malaysia.
5. Malaysia—Foreign relations—United States.
6. United States—Foreign relations—Malaysia.

I. Title.

II. Series: Trends in Southeast Asia ; TRS 1/14.

DS501 I59T no. 1(2014)

2014

ISBN 978-981-4519-71-7 (soft cover)

ISBN 978-981-4519-72-4 (e-book, PDF)

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Typeset by Superskill Graphics Pte Ltd

Printed in Singapore by Mainland Press Pte Ltd

# FOREWORD

The economic, political, strategic and cultural dynamism in Southeast Asia has gained added relevance in recent years with the spectacular rise of giant economies in East and South Asia. This has drawn greater attention to the region and to the enhanced role it now plays in international relations and global economics.

The sustained effort made by Southeast Asian nations since 1967 towards a peaceful and gradual integration of their economies has had indubitable success, and perhaps as a consequence of this, most of these countries are undergoing deep political and social changes domestically and are constructing innovative solutions to meet new international challenges. Big Power tensions continue to be played out in the neighbourhood despite the tradition of neutrality exercised by the Association of Southeast Asian Nations (ASEAN).

The **Trends in Southeast Asia** series acts as a platform for serious analyses by selected authors who are experts in their fields. It is aimed at encouraging policy makers and scholars to contemplate the diversity and dynamism of this exciting region.

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# China's Economic Engagement with Southeast Asia: Malaysia

By John Lee

## EXECUTIVE SUMMARY

- Malaysia has one of the closest and seemingly warmest diplomatic relationships with China of all Southeast Asia countries. It was the first member of ASEAN to formally recognise the People's Republic of China, which became Malaysia's largest trading partner in 2009. With the relationship elevated to a 'comprehensive strategic partnership' in 2013, and due to the economic importance of China to Malaysia and the region, there is speculation that Kuala Lumpur is gradually but ineluctably 'tilting' towards Beijing strategically and away from traditional security partners.
- However, the deepening economic relationship between the two countries is largely driven by a general deepening of economic regionalisation and integration throughout the Asia-Pacific — whilst the Malaysian and Chinese economies are both complementary and competitive vis-à-vis each other at the same time. In reality, China is just one of several important partners for Malaysia in this regional network and is far from being the *dominant* economic partner.
- Malaysia is carefully crafting the image of a 'neutral broker' even as it follows the strategic trend of many maritime states in Southeast Asia by hedging against China through reaffirming and strengthening military relations with the U.S. and other regional states. Moreover, in a strategic environment in which powerful countries such as the U.S. and Japan are seeking to retain influence over security partners and reaffirm old friendships, the bargaining position of smaller maritime powers such as Malaysia is likely to remain strong.
- Moreover, ostensible neutrality also suits domestic political and regime interests within the country. Many groups and individuals in

the dominant United Malays National Organisation (UMNO) party are reluctant to appear too close to the U.S. Additionally, many of the pro-business ethnic Chinese community would be critical of any unnecessary deterioration in the Sino-Malaysian relationship.

- These external and domestic factors provide strong motivation and incentive for Kuala Lumpur to stick with its current approach to China: forging ahead with a ‘comprehensive strategic relationship’ whilst in reality making itself a ‘small target’ when it comes to political disagreements with Beijing, and quietly reaffirming and strengthening military relations with the U.S. at the same time.

*\*This is the third in a series on the theme of “China’s economic engagement with Southeast Asia”, and follows analyses on Thailand and Indonesia, both also written by John Lee.*

# China's Economic Engagement with Southeast Asia: Malaysia

By John Lee<sup>1</sup>

## INTRODUCTION

Just prior to Chinese President Xi Jinping's visit to Malaysia in October 2013, China's Ambassador to Malaysia, Chai Xi, proclaimed that "Sino-Malaysia relations have embarked on a track of comprehensive, steady and fast development in recent years," and that the bilateral relationship is "taking the lead compared with China's relations with other ASEAN countries."<sup>2</sup> The latter sentiment was repeated by President Xi during his meeting with Malaysian Prime Minister Najib Razak, suggesting that the Sino-Malaysia relationship serve as "a fine example in the region."<sup>3</sup>

In 1974, Malaysia became the first country in ASEAN to formally recognise the People's Republic of China and such glowing statements on the continuing warm bilateral relationship appear to be supported by recent trends and developments. China emerged as Malaysia's largest trading partner in 2009 and retains that position today, with two-way trade rising at an average of 15.7 per cent per annum in 2002-2012.

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<sup>2</sup> "Interview: Xi's visit to lift China-Malaysia ties to higher level: Chinese ambassador," *Xinhua*, October 1, 2013 <[http://news.xinhuanet.com/english/china/2013-10/01/c\\_132766418.htm](http://news.xinhuanet.com/english/china/2013-10/01/c_132766418.htm)> accessed January 7, 2014.

<sup>3</sup> "China, Malaysia agree to lift ties to comprehensive strategic partnership," *Xinhua*, October 4, 2013 <[http://news.xinhuanet.com/english/china/2013-10/04/c\\_132772213.htm](http://news.xinhuanet.com/english/china/2013-10/04/c_132772213.htm)> accessed January 7, 2014.

The two-way figure was almost US\$95 billion in 2012, and is likely to exceed US\$100 billion mark when 2013 statistics are released.<sup>4</sup> Significantly, Malaysia is China's largest trading partner amongst the ASEAN countries and both countries explicitly plan to increase trade past the US\$160 billion mark by 2017.

During Xi's October 2013 visit, the leaders also agreed that the relationship be elevated to a 'comprehensive strategic partnership'. In doing so, Malaysia and China will increase communication on key economic and strategic issues, expand economic and trade cooperation, and enhance party-to-party exchanges on political governance and economic management. Moreover, Malaysian Defence Minister Hishammuddin Hussein announced several weeks later that the two countries will hold their first ever joint military exercises in 2014, building upon the *2005 Memorandum of Understanding on Defence Cooperation*.<sup>5</sup> The minister also invited his Chinese counterpart, General Chang Wanquan, to visit the Malaysian naval base of Mawilla 2 on the island of Borneo and to establish 'direct contact' with the Chinese fleet in the South China Sea – despite an outstanding maritime dispute over the sovereignty of parts of the South China Sea with China (and other countries.)

Unlike the governments in Hanoi and Manila, Kuala Lumpur's apparent reluctance to confront Beijing over the latter's growing assertiveness of claims in the South China Sea is inviting speculation that Malaysia is 'tilting' towards China.<sup>6</sup> One illustration is the naval exercise by the People's Liberation Army Navy (PLAN) off the disputed

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<sup>4</sup> Yantoultra Ngui, "China elevates Malaysia ties, aims to triple trade by 2017," *Reuters*, October 4, 2013 <<http://www.reuters.com/article/2013/10/04/us-malaysia-china-idUSBRE99304020131004>> accessed January 7, 2014.

<sup>5</sup> "China, Malaysia to Hold Joint Military Drills," *Defence News*, October 30, 2013 <<http://www.defensenews.com/article/20131030/DEFREG03/310300020/>> accessed January 7, 2014.

<sup>6</sup> For example, see "Malaysia Tilts Towards China," *Asia Sentinel*, July 10, 2012 <<http://www.asiasentinel.com/politics/malaysia-tilts-towards-china/>>; Aparupa Bhattacharjee, "China-Malaysia: Is the tilt real?," *Institute of Peace and Conflict Studies #4141*, October 15, 2013 <<http://www.ipcs.org/article/china/china-malaysia-is-the-tilt-real-4141.html>> both accessed January 7, 2014.

region of James Shoal (Zhengmu Reef to the Chinese and Beting Serupai to Malaysians) in March 2013. Although 1,800 kilometres from the Chinese mainland and only 80 kilometres away from the Malaysian coast the PLAN exercise, which involved one of China's latest amphibious landing ships, was greeted publicly with silence by Kuala Lumpur even as a Malaysian naval offshore patrol vessel monitored the exercised and asked the PLAN to leave the area.<sup>7</sup>

More generally, and although retaining close military ties with the United States, Kuala Lumpur's reluctance to jeopardise a perceived 'special relationship'<sup>8</sup> with China is widely understood to be driven by the economic benefits that sustained good relations with Beijing (and avoidance of controversy) will bring to Malaysia. This is consistent with a dominant contemporary narrative that domestic political dysfunction and fiscal problems in the United States are only increasing the influence of a steadily growing China throughout Southeast Asia. Indeed, official statements by Kuala Lumpur about the Sino-Malaysian bilateral relationship now and into the future are replete with comments about the enormous benefits of China's continued rise to Malaysia's economic future. As the narrative goes, while continued American engagement provides *reassurance* and *stability*, the current and future relationship with China brings *opportunity* and *prosperity*.

There is some truth to the claim that China, already Asia's largest economy, is changing and shaping the strategic and political decisions of major Southeast Asian capitals. But as previous contributions by this author in the current series have pointed out, booming trade and other economic numbers with China in themselves offer only limited clues to the future of the bilateral relationship between China on the one hand, and smaller Southeast Asian countries on the other; and that official

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<sup>7</sup> See Shahrman Lockman, "Why Malaysia isn't afraid of China (for now)," *ASPI Strategist*, April 24, 2013 <<http://www.aspistrategist.org.au/why-malaysia-isnt-afraid-of-chin><http://www.ipcs.org/article/china/china-malaysia-is-the-tilt-real-4141.html> for now/> accessed January 7, 2014.

<sup>8</sup> See Tang Siew Mun, "Malaysia can play honest broker," *New Straits Times*, October 2, 2013 <<http://www.nst.com.my/mobile/opinion/columnist/malaysia-can-play-honest-broker-1.366424>> accessed January 7, 2014.

statements about ever deepening bilateral relations and mutual trust need to be critically and closely examined.<sup>9</sup>

This paper will argue that depictions of a Malaysian ‘tilt’ towards China as being brought about by deepening *economic dependency* on China’s rise fail to capture the reality or complexity of Kuala Lumpur’s strategic and political approach towards Beijing. China has emerged as an important economic partner for Malaysia, and will likely become even more so in the future. Even so, the deepening economic relationship between the two countries is largely driven by a similar and general deepening of economic regionalisation and integration throughout the Asia-Pacific – whilst the Malaysian and Chinese economies are both complementary and competitive vis-à-vis each other at the same time. Although China is emerging as a central hub of manufacturing assembly and production, economic opportunity (and resulting strategic and political leverage) in the region remains dispersed, and contemporary economic developments and trends are not creating powerful economic tools for Beijing to seduce or else compel Kuala Lumpur to gradually bend to its strategic and political will. In reality, China is just one of several important partners for Malaysia in this regional network and is far from being the *dominant* economic partner.

Instead, Malaysia’s reluctance to raise controversial or awkward issues with China is better explained by Kuala Lumpur’s long-standing approach of trying to be many things to many countries, whilst adopting the diplomatic posture of being a ‘small target’ to avoid overt disagreements with other Asian great powers. This has characterised Malaysia’s approach to China more than to any other country over the past two decades. For example, Kuala Lumpur has generally left discussion of difficult issues (such as China’s claims and recent behaviour in the

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<sup>9</sup> See John Lee, “China’s Economic Engagement with Southeast Asia: Thailand,” *Trends in Southeast Asia* #1, November 4, 2013 <[http://www.iseas.edu.sg/documents/publication/Trends\\_2013-1.pdf](http://www.iseas.edu.sg/documents/publication/Trends_2013-1.pdf)>; “China’s Economic Engagement with Southeast Asia: Malaysia,” *Trends in Southeast Asia* #3, December 29, 2013 <[http://www.iseas.edu.sg/documents/publication/Trends\\_2013-3.pdf](http://www.iseas.edu.sg/documents/publication/Trends_2013-3.pdf)> both accessed January 7, 2013; “China’s Economic Engagement with Southeast Asia: Myanmar,” [forthcoming in 2014].

South China Sea) to other countries more willing to incur Beijing's anger in raising these publicly, to larger powers such as the U.S., or else offer only quiet support for including these items on the agenda of multilateral forums in the region.

In doing so, it has carefully crafted the image of a neutral broker even as it follows the strategic trend of many maritime states in Southeast Asia by hedging against China through reaffirming and strengthening military relations with the U.S. The ostensibly neutral stance will remain as long as China lacks the capacity to meaningfully 'punish' or exclusively 'seduce' a relatively open economy such as Malaysia to its side, which is the case now and in the foreseeable future. Moreover, in a strategic environment in which powerful countries such as the U.S. and Japan are seeking to retain influence over security partners and reaffirm old friendships, the bargaining position of smaller maritime powers such as Malaysia remains strong.

Ostensible neutrality also suits domestic political and regime interests within the country. Many Islamic identifying groups and individuals from the dominant United Malays National Organisation (UMNO) party within the governing Barisan Nasional (BN) coalition are reluctant to appear to be too close to the U.S. Additionally, many of the pro-business ethnic Chinese community have forged strong business interests in China (as they have done throughout the rest of the ASEAN+3 economic region) and would be critical of any potential loss of commercial opportunity resulting from any political deterioration in the Sino-Malaysian relationship.

These external and domestic factors provide strong motivation and incentive for Kuala Lumpur to stick with its current approach to China: forging ahead with a 'comprehensive strategic relationship' with China, whilst in reality making itself a 'small target' when it comes to political disagreements with Beijing, and quietly reaffirming and strengthening military relations with the U.S. at the same time. Whether such an approach can continue to be successful depends on whether regional great powers such as the U.S. and China will persist with their softly-softly approach to wooing Malaysia. But the point is that the bilateral economic relationship is only one, and by no means the decisive or main reason behind Malaysia's reluctance to rock the boat on any issue with China.

## MANOEUVRING BETWEEN THE U.S. AND CHINA

For over two decades, Malaysia's longest-standing Prime Minister Mahathir Mohammad (1981-2003) crafted a three-pillar strategy for Malaysia to 'punch above its weight' and better secure its interests in the region. The first was through entrenching strong bilateral relationships with traditional security and economic partners such as the U.S. and Japan, in addition to a strong economic and diplomatic relationship with a rising China. The second was to use regional multilateral forums to engage and bind larger powers to agreed rules of engagement, hence enhancing the leverage of smaller Southeast Asia states; in addition to attempts to extend Malaysian influence within these forums.<sup>10</sup> The third pillar was to enhance Malaysian regional and global influence by exercising leadership in non-traditional groupings. This included Malaysian promotion of South-South cooperation, relating to economic and technical cooperation amongst developing nations, and its standing as one of the leaders within the 57 member-state Organisation of the Islamic Conference (OIC) which Malaysia chaired from 2003-2007. In particular, Malaysia receives deserved credit for its role in the development of a global Islamic finance industry (as well as key concepts associated with 'Islamic finance'), a sector that grew 38.5 per cent per annum in size from 2004 to 2011 and was a US\$1.6 trillion global industry at the end of 2012.<sup>11</sup>

Malaysia's ability to ultimately enhance its standing and relevance to the U.S. and China – despite an occasionally rocky diplomatic relationship with the former – is of high relevance for this paper because enduring strategic mindsets and approaches are critical to understanding how economic developments will or will not change Malaysian strategic

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<sup>10</sup> See John Lee, "Malaysia's two-step hedging strategy: Bilateral and regional activism," *ASPI Strategic Insight No. 24*, April 2006 <<https://www.aspi.org.au/media-centre/press-releases/malaysias-two-step-hedging-strategy-bilateral-and-regional-activism>> accessed January 8, 2014.

<sup>11</sup> Islamic Financial Services Board, *Islamic Financial Services Industry Stability Report 2013* <[http://ifsb.org/docs/IFSB%20-%20IFSI%20Stability%20Report%20TEXT%20FINAL%20\(OUTPUT\).pdf](http://ifsb.org/docs/IFSB%20-%20IFSI%20Stability%20Report%20TEXT%20FINAL%20(OUTPUT).pdf)> accessed January 8, 2014.

and political relations with China in the future. Much of the difficulty in understanding the Malaysian approach is that Kuala Lumpur's rhetoric is often inconsistent with its actual motivations and behaviour. Even so, peering beneath the surface reveals a remarkable consistency in the way Malaysia has managed its relations with the U.S. and China, and positioned itself between these two great powers.

*(a) U.S.-Malaysia relations – an enduring and ‘unsung success story’*

Mahathir and his successors have all profoundly understood the benefits of an engaged U.S. in Asia and the importance of the U.S.-Malaysia bilateral relationship. But during periods in Mahathir's tenure, at least, this has not always been obvious. For example, and in the process of enhancing his and the UMNO party's Islamic credentials to the OIC (as well as his own political domestic credentials to a domestic Islamic audience), Mahathir's diplomacy often deviated from the script, launching several provocative, unnecessary and indulgent public attacks on American foreign policy and values.

For example, Malaysia did what would have been unthinkable during the Cold War in repeatedly scolding the U.S. for 'interference' and 'imperialism' when Washington criticised the arrest of then Deputy Prime Minister Anwar Ibrahim in 1998 and subsequently supported the *reformasi* movement's demands for greater civil liberties and improved government transparency and accountability.<sup>12</sup> As a self-appointed spokesperson for the Islamic world, Mahathir suggested that the U.S.-led invasion of Iraq in 2003 was driven by "racism", a statement that severely harmed the bilateral relationship according to former American Ambassador to Malaysia Marie T. Huhtala.<sup>13</sup> Mahathir was (and continues

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<sup>12</sup> See Chen May Yee, "Gore's Remarks Could Cause Backlash Against Malaysia's Reform Movement," *Wall Street Journal*, November 18, 1998 <<http://online.wsj.com/article/SB911327500797080500.html>> accessed January 8, 2014.

<sup>13</sup> See Mark Baker, "US warns of fallout from Mahathir 'War on Islam' comment," *Sydney Morning Herald*, May 30, 2003 <<http://www.smh.com.au/articles/2003/05/29/1054177672355.html>> accessed January 8, 2014.

to be) a leading participant in the “Asian Values” debate in the first decade of this century, arguing that American and European criticism of his policies and practices was an imposition of Western cultural and moral ‘imperialism’ on Asian societies and governments.<sup>14</sup>

Many commentators persuasively argue that such public rhetoric was driven less by the international and foreign policy implications of U.S. actions and is more about how U.S. policy and actions might adversely affect the authority and power bases of ruling elites within Malaysia. For example, the ‘Asian’ versus ‘Western’ values debate – compounded by a post-Cold War American foreign policy that pushed for the global advance of political and economic liberalism – was seen by many UMNO leaders as a source of challenge to their domestic standing and rule. As one commentator puts it, “Malaysia’s tense relations with the U.S. ... were largely due to the latter’s liberal institutionalist grand strategy when the spread of liberal democracy, human rights and open markets was a stated foreign policy goal,”<sup>15</sup> and this directly threatened Malaysia’s authoritarian and interventionist political-economy.<sup>16</sup>

Whatever the reason for Mahathir’s diplomacy, Malaysian defence cooperation with the U.S. remained strong even during the worrying diplomatic lows reached in the late-1990s and which persisted during the first decade of this century. Kuala Lumpur steadfastly offered Washington military access to its airfields and ports; U.S. naval ships visited Malaysian ports frequently; and training exercises continued between the navies, armies and air forces of both countries. Malaysia

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<sup>14</sup> See “World Could Learn From Asian Values: Mahathir,” *Nikkei*, May 25, 2012 <<http://e.nikkei.com/e/for/forum/foa/2012/Nni20120525D25SS621.htm>> accessed January 8, 2014.

<sup>15</sup> Helen E.S. Nesadurai, “Malaysia and the United States: Rejecting Dominance, Embracing Engagement,” *IDSS Working Paper Series no. 72*, December 2004, p. 3 <[http://mercury.ethz.ch/serviceengine/Files/ISN/27198/ipublication\\_document\\_singledocument/4c2a10f9-e657-4c1d-a391-c7c85997f482/en/WP72.pdf](http://mercury.ethz.ch/serviceengine/Files/ISN/27198/ipublication_document_singledocument/4c2a10f9-e657-4c1d-a391-c7c85997f482/en/WP72.pdf)> accessed January 8, 2014.

<sup>16</sup> See Kuik Cheng-Chwee, “Malaysia’s U.S. Policy Under Najib: Ambivalence No More?”, *RSIS Working Paper No. 250*, November 5, 2012 <<http://www.rsis.edu.sg/publications/WorkingPapers/WP250.pdf>> accessed January 8, 2014.

remained one of the few bases for the American military for jungle-warfare training, and Malaysian military personnel continued to benefit from U.S. sponsored training programmes in America. As then Defence Minister and current Prime Minister Najib Razak put it in 2002, the strategic and military partnership between the two countries was an “unsung success story” over the difficult diplomatic years.<sup>17</sup>

Upon assuming the leadership after Mahathir in 2003, Abdullah Badawi immediately toned down Malaysian rhetoric against American policies and proclaimed the bilateral relationship to be at its “best ever” in June 2004.<sup>18</sup> In 2008, and as evidence of the enduring strength of the security relationship, the U.S. authorised around US\$270 million worth of arms to be sold to Malaysia, more than to any other state in Southeast Asia.<sup>19</sup> In 2010, and as part of a ‘new chapter’ in U.S.-Malaysian relations,<sup>20</sup> then American Secretary of State Hillary Clinton praised Malaysia as a “thought leader” in the Islamic world, and as an example of a successful, pluralistic and moderate Muslim nation. Malaysian initiatives to promote Islamic finance and also the ‘Sisters of Islam’ initiative which seeks to promote women in Muslim societies were also lauded.<sup>21</sup>

In fact, Malaysian substantial policy towards the U.S. under leaders Abdullah and Najib was a continuation of the Mahathir years, even if the

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<sup>17</sup> The Honourable Najib bin Tun Abdul Razak, “U.S.-Malaysia Defence Cooperation: A solid Success Story,” *The Heritage Foundation Lecture #742 on Asia*, May 3, 2002 <<http://www.heritage.org/research/lecture/us-malaysia-defense-cooperation>> accessed January 8, 2014.

<sup>18</sup> “US-M’sia Ties Best Ever, says Abdullah,” *Malaysian National News Agency*, June 21, 2004.

<sup>19</sup> See Joshua R. Johnson, “Cooperation and Pragmatism: Malaysian Foreign Policy under Najib,” *Asia Pacific Bulletin No. 63*, June 3, 2010 <[http://www.eastwestcenter.org/sites/default/files/private/apb063\\_1.pdf](http://www.eastwestcenter.org/sites/default/files/private/apb063_1.pdf)> accessed January 8, 2014.

<sup>20</sup> See “Spring of change for U.S.-Malaysia relations,” *The Star*, April 18, 2010 <<http://www.thestar.com.my/story.aspx/?sec=nation&file=%2f2010%2f4%2f18%2fnation%2f20100418144447>> accessed January 8, 2014.

<sup>21</sup> See “Malaysian can be Muslim thought leader: Hillary Clinton,” *Jakarta Globe*, November 2, 2010 <<http://www.thejakartaglobe.com/archive/malaysia-can-be-muslim-thought-leader-hillary-clinton/>> accessed January 8, 2014.

diplomatic language issued by Kuala Lumpur softened. It is worth noting that during the period of diplomatic spats under the Mahathir years, the Malaysian prime minister enthusiastically endorsed President George W. Bush's 'War on Terror' following the terrorist attacks on September 11, 2001 (even if he criticised American military actions in Afghanistan, and subsequently in Iraq)<sup>22</sup> and jumped at the chance to accept an invitation to visit the U.S. in May 2002. Malaysia was once again considered an important security partner to the U.S., this time in the era of the 'War on Terror', with Mahathir agreeing to an anti-terrorism accord and to the setting up of a Counter Terrorism Centre in Malaysia in cooperation with the U.S., while Malaysia was explicitly upheld by America as an exemplar of a modern and moderate Muslim country.<sup>23</sup>

The point is that an enduring Malaysian recognition of the importance of its strategic and military relationship with the U.S., and the more general strategic role played by the U.S. in the region has long withstood occasional bouts of diplomatic hostility and words between the two countries over the last two decades. Additionally, Mahathir was (and continues to be) behind such diplomatic provocations and hostilities in what appear to be periodical attempts to appeal to domestic Islamic audiences, while his successors have eschewed such confrontational diplomacy in favour of support for American policies, or else kept silent. A consistent theme is that Malaysia has continually exploited its membership and championing of initiatives such as the Non-Aligned Movement, the OIC and South-South cooperation in order to appeal to non-Western states and governments. But Kuala Lumpur has nevertheless worked quietly with Washington in terms of military and intelligence cooperation, whilst cultivating a non-aligned image by avoiding any high-profile alliance or security relationship.

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<sup>22</sup> See Mark Landler, "War on terror Fuels Political Feuds in Malaysia," *New York Times*, October 19, 2001 <<http://www.nytimes.com/2001/10/19/world/war-on-terror-fuels-political-feuds-in-malaysia.html>> accessed January 8, 2014.

<sup>23</sup> See Joseph Liow, "Malaysia's Opposition to the Iraq War: A Matter of Principle or Expediency?", *IDSS Commentaries 15/2003*, April 11, 2003 <<http://www.rsis.edu.sg/publications/Perspective/IDSS152003.pdf>> accessed January 8, 2014.

As the next section will argue, reaffirming an already strong relationship with the U.S. offers Malaysia several possibilities to manage and hedge against the rise of China.

*(b) Malaysia's approach to China – conflict avoidance and hedging*

If words with the U.S. have at times been hostile, the opposite can be said about Malaysian diplomacy with China over the past decade and a half. In 2014, the two countries will celebrate forty 40 years of diplomatic relations, after Prime Minister Tun Abdul Razak Hussein, the father of Malaysia's current leader, reversed the non-recognition policy of predecessor Tunku Abdul Rahman Putra in 1974. Although formal recognition allowed the resumption of normal diplomatic interaction between Malaysia and China, it was only from the late 1980s onwards that significant milestones in the bilateral relationship were achieved.

A landmark year was 1988. Malaysia abolished a 5 per cent administrative charge and removed other restrictions placed on Malaysian firms seeking to import Chinese products. Multiple exit visas for businesspeople seeking to visit China were relaxed for many of the mainly ethnic Chinese Malaysians seeking to do business in China. A Sino-Malaysian Trade Agreement was signed that year in which both sides agreed to give preferential treatment to custom tariffs on imported goods. An Investment Guarantee Agreement and an accord on the establishment of a Sino-Malaysian Economic and Trade Joint Committee were also concluded.

Further milestones were reached during the middle and latter parts of the Mahathir era. In May 1999, Malaysia and China signed a 12-point agreement in Beijing called the *Framework for Future Bilateral Cooperation*. This agreement was to facilitate 'all directional relationship and good neighbourliness, friendship and cooperation based on mutual trust and support.' The agreement was to cover defence and security matters in addition to economic and other forms of cooperation. The long-standing leader's bet on China's rise paid off. Bilateral trade between the countries grew rapidly, from US\$1.33 billion in 1991 to US\$4.26 billion in 1998. In 2002, Malaysia overtook Singapore as China's largest trading

partner in ASEAN. By the time Mahathir left office in 2003, bilateral trade had grown to US\$20.13 billion.<sup>24</sup>

The public rhetoric during the Mahathir years also set the foundations for the style of Malaysian diplomacy towards China in the current era. Throughout the 1990s, Mahathir stated several times that Southeast Asia had little to fear from a wealthy and strong China, that “Beijing had not, historically exhibited colonizing ambitions,” and that a prosperous China will become an engine of growth for Asia and the world. As the economic relationship between Malaysia and China deepened, Mahathir consistently made public statements that China was not a military or political threat to Malaysia, or Asia. During a time when China’s escalation of a dispute with the Philippines over the Spratly Islands and behaviour during the missile crisis in the Taiwan Straits during the mid-1990s were still very much in the minds of concerned Southeast Asian states, Mahathir nevertheless criticised proponents of the ‘China threat’ thesis as espousing “bad and dangerous” ideas,<sup>25</sup> and reiterated the argument that China’s rise presented enormous economic opportunities to Malaysia and the region.<sup>26</sup>

Even if Mahathir tended to overshoot when it came to the thesis on China’s peaceful rise, his successors have nevertheless refrained from publicly supporting any version of the ‘China threat’ thesis.<sup>27</sup> As Najib put it in 2010 in a speech at the Council on Foreign Relations in New York, “Malaysia does not see China as indulging in power projection but as wanting to engage with major powers to achieve a balance in the

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<sup>24</sup> Data from Malaysia External Trade Development Corporation.

<sup>25</sup> See Herbert Yee and Ian Storey (eds.), *The China Threat: Perceptions, Myths and Reality* (New York, NY: Routledge Curzon, 2002.)

<sup>26</sup> See Poon Kim Shee, “The Political Economy of Mahathir’s China Policy: Economic Cooperation, Political and Strategic Ambivalence,” *Ritsumeikan Annual Review of International Studies* Vol. 3, 2004, pp. 59-79.

<sup>27</sup> See Cheng-Chwee Kuik, “Making Sense of Malaysia’s China Policy: Asymmetry, proximity, and Elite’s Domestic Authority,” *The Chinese Journal of International Politics*, 2013, pp. 1-39.

region.”<sup>28</sup> More than this, Najib has expressed a personal commitment to further the bilateral relationship, telling his counterpart President Xi Jinping in 2013 that “I am pleased as a leader of government and at a personal level that what was started in 1974 (through formal recognition of the PRC) by my late father has today blossomed into a very important relationship between the two countries” and that the prime minister was keen to “see cooperation between the two countries transcend to all levels of society.”<sup>29</sup>

In return, Beijing’s choice of words in describing its relationship with Kuala Lumpur is arguably the warmest of any offered to Southeast Asian countries. For example, then Chinese Premier Wen Jiabao described Malaysia as a “good brother and close neighbour” during Najib’s trip to Beijing in April 2011. Making special mention of Malaysia being the first ASEAN member state to recognise the PRC, Wen declared that “We’ve never forgotten these historical episodes between our two countries” and that while “both China and Malaysia have some disputes over the relevant islands and reefs in the South China Sea, the disputes have not impeded our efforts to have peaceful coexistence between us.”<sup>30</sup> These sentiments were reaffirmed by current President Xi Jinping during his visit to Kuala Lumpur in October 2013 when the decision to upgrade ties to form a ‘comprehensive strategic partnership’ was announced.<sup>31</sup>

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<sup>28</sup> A Conversation with Dato’ Sri Mohd Najib Tun Razak, Prime Minister, Malaysia, Council on Foreign Relations, September 28, 2010 <<http://www.cfr.org/malaysia/conversation-dato-sri-mohd-najib-tun-razak-prime-minister-malaysia/p23049>> accessed January 10, 2014.

<sup>29</sup> “Interview: Malaysia keen to enhance ties with China: PM,” *Xinhua*, October 4, 2013 <<http://english.people.com.cn/90883/8416801.html>> accessed January 9, 2014.

<sup>30</sup> Najib Razak, “Wen Jiabao Hails Malaysia As Good Brother & Close Neighbour,” *Bernama*, April 26, 2011 <[http://www.1malaysia.com.my/news\\_archive/wen-jiabao-hails-malaysia-as-good-brother-close-neighbour/](http://www.1malaysia.com.my/news_archive/wen-jiabao-hails-malaysia-as-good-brother-close-neighbour/)> accessed January 9, 2014.

<sup>31</sup> “China, Malaysia agree to lift ties to comprehensive strategic partnership,” *Xinhua*, October 4, 2013 <[http://news.xinhuanet.com/english/china/2013-10/04/c\\_132772213.htm](http://news.xinhuanet.com/english/china/2013-10/04/c_132772213.htm)> accessed January 9, 2014.

It is significant that both Abdullah and Najib chose China as the first country outside ASEAN to visit upon assuming office in 2003 and 2009 respectively. The decades of Malaysian friendship and perhaps diplomatic deference to China have paid dividends. For example, a US\$25 billion contract to supply over two million metric tons of liquefied natural gas annually to China for 25 years was signed in 2006. A US\$800 million loan facility to build a bridge in Abdullah's home state of Penang at an interest rate of 3 per cent over 20 years was announced in 2007, reportedly the largest and most favourable loan facility China has ever offered for a single project in a foreign country.<sup>32</sup>

Even when it comes to the South China Sea disputes, Chinese anger is directed towards Vietnam and the Philippines rather than Malaysia. For example, and just one month after assuming the leadership in April 2009, Najib, along with Vietnam, made a joint submission to the United Nations Convention on the Law of the Sea (UNCLOS) reasserting its sovereignty in territories also claimed by China. In protesting to the United Nations Secretary-General, Beijing argued that the Joint-Submission "seriously infringed upon China's sovereignty, sovereign rights and jurisdiction," and that China had "indisputable sovereignty" over what was effectively 80 per cent of the South China Sea.<sup>33</sup> Beijing also responded by submitted its 'nine-dotted line' claim over the majority of the South China Sea several days later.<sup>34</sup> Yet, when Najib visited China in June 2009, Beijing diplomatically stated that the two countries had sensibly agreed to solve any dispute through "friendly negotiation",<sup>35</sup> and focused instead on the many positives in the bilateral relationship.

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<sup>32</sup> See Mazwin Nik Anis, "Penang Bridge Loan Deal Signed," *The Star*, July 14, 2007 <<http://www.thestar.com.my/story.aspx?file=%2f2007%2f7%2f14%2fnation%2f18302147&sec=nation>> accessed January 9, 2014.

<sup>33</sup> See Paragraph 3 of Letter CML/17/2009 from Permanent Mission of China to the UN Secretary-General, 7 May, 2009.

<sup>34</sup> See Robert C. Beckman and Tara Davenport, "CLCS Submissions and Claims in the South China Sea," *The South China Sea: Cooperation for Security and Development Workshop*, November 10-12, 2010 <<http://cil.nus.edu.sg/wp/wp-content/uploads/2009/09/Beckman-Davenport-CLCS-HCMC-10-12Nov2010-1.pdf>> accessed January 9, 2014.

<sup>35</sup> See "Malaysia PM wants friendly talks," *China Daily*, June 4, 2009 <<http://english.sina.com/china/p/2009/0603/245811.html>> accessed January 9, 2014.

Indeed, a ‘Joint Action Plan on Strategic Cooperation’, which covered 13 key areas for future cooperation on political, economic and cultural issues, was announced.<sup>36</sup> One can hardly imagine Beijing pursuing the same softly-softly diplomatic approach with Manila or Hanoi in the midst of tension over South China Sea sovereignty issues.

Despite the diplomatic warmth offered to China over a sustained period of time, one should remember that Kuala Lumpur’s approach “is by no means a reflection of our fatalism or adopting a subservient position towards China’s rise” as Najib put it in 2006 while serving as Deputy Prime Minister.<sup>37</sup> When taken in isolation, recent developments in the Sino-Malaysian strategic relationship – such as the joint military drills which will take place this year – can give the misleading impression that the Malaysian ‘tilt’ towards China is well advanced and irresistible. But when considered alongside the advances in the U.S.-Malaysian strategic relationship, the true extent of Kuala Lumpur’s wariness of China, and hedging strategy against its largest trading partner becomes apparent.

The strategic and military cooperation that continued between the U.S. and China despite the diplomatic difficulties during the Mahathir years has already been mentioned. This cooperation has endured and been significantly advanced, even if such developments do not attract the same headlines as less substantial forms of strategic and military cooperation with Beijing.

For example, Abdullah renewed the Acquisition and Cross-Servicing Agreement with the U.S. in 2005 which allows the two armed forces to share logistics and supplies for the next 10 years. In 2011, Najib upgraded Malaysia’s status in the U.S.-led Cobra Gold military exercises – the longest running American-led military exercises in the Pacific – from ‘observer’ to ‘participant’. The fact that the exercises bring together personnel from Thailand, Japan, South Korea and Singapore (in addition to Indonesia and Malaysia) to enhance tactical partnership and

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<sup>36</sup> See “China and Malaysia to upgrade cooperation,” *Xinhua*, June 5, 2009 <<http://www.globaltimes.cn/china/top-photo/2009-06/434670.html>> accessed January 9, 2014.

<sup>37</sup> Najib Razak, Deputy Prime Minister of Malaysia, “Strategic Outlook for East Asia: A Malaysian Perspective,” Keynote Address to the Malaysian and East Asia International Conference, Kuala Lumpur, March 9, 2006.

interoperability is highly significant.<sup>38</sup> In August 2013, U.S. Secretary of Defence Chuck Hagel reaffirmed that the “U.S. is committed to continuing to assist Malaysia’s military, as it increases its capability in areas like humanitarian assistance, disaster relief, peace keeping, maritime security and counter-terrorism,” and that America was due to conduct more than 75 military exchanges and visits with Malaysian counterparts throughout 2013.<sup>39</sup> Navies from the two countries have conducted the Cooperation Afloat Readiness and Training (CARAT) exercises since 1996, which aim to improve Malaysia’s disaster relief and maritime security capabilities from both land and sea. Held in Kuantan, CARAT 2011 was the first exercise that saw an American attack submarine participating.<sup>40</sup> Another example is the long-running Keris Strike exercises which seek to further enhance military-to-military operability between the two armed forces.<sup>41</sup> In responding to China’s increased assertiveness to claims in the South China Sea since 2009, American naval visits to Malaysian ports have increased from single digit instances prior to 2009 to well over 30 in more recent years.<sup>42</sup>

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<sup>38</sup> See Donna Miles, “Cobra Gold 2012 to Promote Partnership , Interoperability,” *American Foreign Press Service*, January 13, 2012 <<http://www.defense.gov/News/NewsArticle.aspx?ID=66803>>; Donna Miles, “Exercise Cobra Gold 2013 Kicks Off in Thailand,” *American Foreign Press Service*, February 11, 2013 <<http://www.defense.gov/news/newsarticle.aspx?id=119256>> both accessed January 9, 2014.

<sup>39</sup> See Cheryl Pellerin, “Hagel Underscores Commitment to Partnership With Malaysia,” *American Foreign Press Service*, August 25, 2013 <<http://www.defense.gov/news/newsarticle.aspx?id=120670>> accessed January 9, 2014.

<sup>40</sup> See Mike Morley, “Submarine Participation the Highlight of 17th U.S.-Malaysia CARAT Exercise,” US Pacific Command, June 8, 2011 <<http://www.c7f.navy.mil/news/2011/06-June/005.htm>> accessed January 9, 2014.

<sup>41</sup> See Murray Hiebert, Elina Noor, Gregory Poling and Tham Siew Yean, *From Strength to Empowerment: The Next Generation of U.S.-Malaysia Relations* (Washington DC: CSIS May 2012) <[http://csis.org/files/publication/120515\\_Hiebert\\_StrengthEmpowerment\\_Web.pdf](http://csis.org/files/publication/120515_Hiebert_StrengthEmpowerment_Web.pdf)> accessed January 9, 2014.

<sup>42</sup> See Remarks by Andrew J. Shapiro, Assistant Secretary, Bureau of Political-Military Affairs, Malaysian Armed Forces Defence College, Kuala Lumpur, February 15, 2012 <<http://www.state.gov/t/pm/rls/rm/184846.htm>> accessed January 9, 2014.

The point is that the strategic, military and intelligence relationship with the U.S. is far more extensive and meaningful than with China. That Kuala Lumpur does this quietly stems from a domestically driven political sensitivity towards appearing too close to the U.S. Additionally, downplaying both its strategic and military cooperation with the U.S., and emphasizing publicly its opposition to the ‘China threat’ thesis allows Kuala Lumpur to ‘have its cake and eat it too’: strategically hedging against future Chinese assertiveness whilst avoiding being targeted by Beijing over Kuala Lumpur’s claims in the South China Sea and pursuing a closer strategic and military relationship with Washington.

*(c) Malaysia’s approach to China – hedging through multilateralism*

Making itself a ‘small target’ and promoting itself as a friend and ‘honest broker’ vis-à-vis China have allowed Malaysia to pursue a highly creative multilateral approach in furthering its, and the region’s, interests in terms of managing China’s rise. Indeed, the real innovation in Malaysian policy vis-à-vis China over the past two decades has been the revival of multilateralism as a counter-dominance strategy.

When China embarked on its so-called charm offensive from the late 1990s onwards, ASEAN members disagreed as to the extent of the threat that a rising China posed. Besides improving bilateral relations, it was thought that deeper Chinese commitment to ASEAN processes would render it more sensitive to the concerns of smaller Southeast Asian states such as Malaysia, and perhaps even help ‘socialise’ China.<sup>43</sup>

To achieve this, and wanting to deal multilaterally and not just bilaterally with China, Malaysia took a leading role in selling China’s self-proclaimed ‘peaceful rise’ to the region. This was needed to assure

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<sup>43</sup> See Alice Ba, “Who’s socializing whom? Complex engagement in Sino-ASEAN relations,” *The Pacific Review* 19:2, 2006, pp. 157-179 <<http://www.udel.edu/poscir/faculty/ABa/BaWhosSocializing.pdf>>; Amitav Acharya, “Seeking security in the dragon’s shadow: China and Southeast Asia in the emerging Asian order.” *RSIS Working Papers* 44(3), 2003 <[http://dr.ntu.edu.sg/bitstream/handle/10220/4446/RSIS-WORKPAPER\\_52.pdf?sequence=1](http://dr.ntu.edu.sg/bitstream/handle/10220/4446/RSIS-WORKPAPER_52.pdf?sequence=1)> both accessed January 10, 2014.

other member states that China's future intentions and behaviour were not pre-determined but could be shaped for the better. Championing China's 'peaceful rise' would also help persuade Beijing that it had influential friends amongst ASEAN member states. Additionally, and in order to persuade China to fully commit to ASEAN processes, Kuala Lumpur was keen to ensure that ASEAN-led forums would not be used by the U.S. to promote a form of multilateral 'containment' of China. Defining the logic of Chinese participation as one of encouraging and shaping its 'peaceful rise', rather than constraining Chinese assertiveness, was critical to this endeavour.<sup>44</sup>

Whether such an approach has been successful in actually shaping Chinese intentions or only influencing Beijing's behaviour superficially is a question for another time.<sup>45</sup> Either way, it is undeniable that the endeavour to encourage China to engage fully with ASEAN processes has been largely successful. It is also clear that Malaysia continues to pursue the same essential game-plan in placing some reliance on ASEAN mechanisms to help restrain Chinese behaviour in the region, building a 'special' and 'comprehensive relationship with Beijing, and continuing to publicly play down the inevitability of a 'China threat' whilst reaffirming and strengthening old strategic and security ties.

For example, in his 2010 remarks to the Council on Foreign Relations in New York, Najib in response to a question about increased Chinese assertiveness in Southeast Asia responded that Malaysia continues to "believe that China would not want to destabilise the region" and that there remain "mechanisms for us to undertake conflict resolutions with China."<sup>46</sup> Such mechanisms, as he explained subsequently, means "a

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<sup>44</sup> See John Lee, "Malaysia's two-step hedging strategy: Bilateral and regional activism".

<sup>45</sup> See D.M. Jones and M Smith, "Making process, not progress: ASEAN and the evolving East Asian regional order," *International Security* 32(1) 2007, pp. 148-84.

<sup>46</sup> A Conversation with Dato' Sri Mohd Najib Tun Razak, Prime Minister, Malaysia, Council on Foreign Relations.

multilateralism that can rise to the task ahead.”<sup>47</sup> Najib has also reaffirmed a preference that disputes over sovereignty of parts of the South China Sea be managed multilaterally rather than bilaterally where “ASEAN will work together as one.”<sup>48</sup> Hence, the emasculating failure of the ASEAN Foreign Minister’s Meeting to issue a joint communique in July 2012 over ASEAN member states disagreeing on whether the South China Sea ought to have been mentioned<sup>49</sup> was deemed in private by Malaysia as “totally unacceptable.”<sup>50</sup> In public, Kuala Lumpur frequently proclaims that through its special and comprehensive relationship with Beijing, Malaysia stands ready to advance the development of Sino-ASEAN relations and cooperation as it has done for a long time.<sup>51</sup> As far as the South China Sea disputes are concerned, Kuala Lumpur is seeking to use its special relationship to resurrect the idea of a binding Code of Conduct in the South China Sea between all claimants, especially China.<sup>52</sup>

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<sup>47</sup> Dato’ Sri Mohd Najib Tun Razak, Keynote Address at the 10th IISS Asian Security Summit, The Shangri-La Dialogue, Singapore, June 3, 2011 <<http://www.iiss.org/en/publications/conference%20proceedings/sections/shangri-la-aa36/the-shangri-la-dialogue-2011-fa85/sld11-04-keynote-address-45f9>> accessed January 10, 2014.

<sup>48</sup> See Reiji Yoshida, “Malaysia’s Najib, Abe discuss China air zone,” *Japan Times*, December 13, 2013 <<http://www.japantimes.co.jp/news/2013/12/12/national/malaysias-najib-abe-discuss-china-air-zone/#.Us9QHvQW2a8>> accessed January 10, 2014.

<sup>49</sup> See Luke Hunt, “ASEAN Summit Fallout Continues,” *The Diplomat*, July 20, 2012 <<http://thediplomat.com/2012/07/asean-summit-fallout-continues-on/>> accessed January 10, 2014.

<sup>50</sup> See Carlyle Thayer, “ASEAN’s Code of Conduct in the South China Sea: A Litmus Test for Community Building?” *The Asia-Pacific Journal* 10:34, August 20, 2012 <[http://www.japanfocus.org/-Carlyle\\_A\\_-Thayer/3813](http://www.japanfocus.org/-Carlyle_A_-Thayer/3813)> accessed January 10, 2014.

<sup>51</sup> See “Xi’s visit ushers in new era in China-Malaysia ties,” *Xinhua*, October 5, 2013 <[http://news.xinhuanet.com/english/china/2013-10/05/c\\_132774143.htm](http://news.xinhuanet.com/english/china/2013-10/05/c_132774143.htm)> accessed January 10, 2014.

<sup>52</sup> See “KL commends Beijing over South China Sea,” *The Star*, October 10, 2013 <<http://www.thestar.com.my/News/Nation/2013/10/10/KL-commends-Beijing-over-South-China-Sea-Chinas-commitment-to-resolve-disputes-peacefully-a-step.aspx/>> accessed January 10, 2014.

Even so, the pragmatic element in Malaysian strategic and security thinking remains unabated – evidenced by the hedging policy of upgrading military-to-military ties with the U.S. at a time when Chinese assertiveness over maritime claims grow. It is worth noting that such a hedge is one against not just Chinese assertiveness but the failure of an ASEAN-led capacity to respond effectively to Chinese assertiveness.

## **AN EVOLVING ENVIRONMENT**

Malaysia's 'unsung success story' of security hedging with the U.S. and 'best friend' diplomatic routine with China has served the relatively small country well – it has a prominent voice in Washington and Beijing even if there is some ambiguity about its actual influence in these capitals. Even so, Malaysia's relations with both are frequently characterised as the 'best ever' and filled with even greater 'promise'.

Such an approach was formulated at a time when America had uncontested strategic primacy in the region, was only momentarily challenged by Japan in terms of economic leadership, and China was still a much smaller economic player. Given that Japan was, and remains a willing pillar of the American system of alliances in Asia, the economic rise of Japan did not fundamentally challenge the regional strategic order even if memories of Japanese aggression during World War II revived some apprehensions.

China is the first economic power to rise up outside the America-led hub-and-spokes strategic system. It is now the second largest economy in the world and the largest in Asia. It has also emerged as the largest trading partner for a number of regional countries, including Malaysia. Forged during a less 'complicated' time, there are legitimate questions being asked about whether Malaysia can continue to conduct its relations with Washington and Beijing as it has done for almost two decades, or whether economic forces and reality will gradually draw Kuala Lumpur towards Beijing in political and strategic terms.

The sections below offer an analysis and assessment of the economic relationship between Malaysia and China, and whether China's economic size and relevance is indeed exerting a political and strategic influence over Malaysia that will place increasing and perhaps irresistible pressures

on the relatively small country to change or abandon its hedging strategy against China.

The paper concludes that whilst economic opportunities presented by China will cause Malaysia to persist with its non-confrontational rhetoric vis-à-vis China, such economic opportunities are neither large nor compelling enough to force Kuala Lumpur to abandon its current hedging strategy against China. Indeed, a large part of Malaysia's economic future remains tied to consumption in the advanced, industrialised economies, while there are important aspects to the Sino-Malaysian economic relationship, which are both competitive as well as being mutually beneficial.

Additionally, given the complex and regionally integrated nature of economies in the Asia-Pacific, translating bilateral economic interactions with one country into strategic leverage over that country is extremely difficult if not impossible. In the case of Malaysia, its relatively open economy leaves it vulnerable to the impersonal and ruthless forces of market competition, but it also means that Malaysia is far from being over-reliant on China for economic growth and continued prosperity.

## **SINO-MALAYSIAN TRADE**

In 2009, China surpassed Singapore as Malaysia's largest trading partner, registering RM\$128.38 billion in two-way trade.<sup>53</sup> The fact that two-way trade increased from RM\$4.44 billion in 1992, to RM\$23.83 billion in 2000, and then to RM\$117.94 billion in 2007 is clear evidence of China's rapidly increasing importance to Malaysia.<sup>54</sup> In October 2013, Malaysia and China announced a bilateral trade target of US\$160 billion or RM511 billion for 2017,<sup>55</sup> having reached RM\$166.8 billion in 2011, and RM\$180.61 billion in 2012.

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<sup>53</sup> Ministry of International Trade and Industry Malaysia (MITI) figures.

<sup>54</sup> MITI figures.

<sup>55</sup> Zuhri Azam Ahmad, Yuen Meikeng, Cecilia Kwok and Isabella Lai, "Malaysia and China set trade target of RM511bil," *The Star*, October 5, 2013 <<http://www.thestar.com.my/News/Nation/2013/10/05/Msia-and-China-set-trade-target-of-RM511bil-Xi-and-Najib-also-agree-to-form-strategic-partnership.aspx/>> accessed January 14, 2014.

The increase in two-way trade is also predictably reflected in the increasing importance of China as a trading partner when considered as a percentage of Malaysia's total trade.

Trade volume between the two countries has grown forty-fold over a twenty-year period from 1992 to 2012. The description that Sino-Malaysian ties are at their 'best ever' and approaching 'historical highs' is largely due to trade figures such as these.<sup>56</sup> Yet, closer analysis of the nature and structure of the trade relationship reveals that there are strong elements of competition, as well as win-win complementarity between the two countries. Moreover, private firms with little regard for or interest in national objectives are driving the trade relationship, suggesting that using trade as a tool for strategic or political leverage will be difficult if not impossible. Finally, Sino-Malaysian trade is very much part of a regional production network, meaning that Beijing has little capacity to control or disrupt this network for non-economic gain. These observations and arguments are presented below.

Traditional trade theory assumes that countries export products and services that best suit that country's particular advantages in offering

***Table 1: Malaysian two-way trade with major partners as a proportion of total trade (%)***

	<b>1992</b>	<b>2000</b>	<b>2005</b>	<b>2011</b>	<b>2012</b>
<b><i>China</i></b>	12.16	13.48	18.77	13.1	13.8
<b><i>Singapore</i></b>	19.42	16.54	13.85	12.6	13.44
<b><i>Japan</i></b>	19.64	16.69	16.69	11.7	11.12
<b><i>U.S.</i></b>	17.21	18.74	18.74	18.3	8.4
<b><i>Thailand</i></b>	13.07	13.72	15.32	15.1	15.66

*Source: MITI figures and author's calculations.*

<sup>56</sup> For example, see "Malaysia and China in vital phases of development," *The Star*, June 2, 2013 <<http://www.thestar.com.my/News/Nation/2012/10/03/Envoy-Malaysia-and-China-in-vital-phases-of-development.aspx/>> accessed January 14, 2014.

these, and that all inputs into these products and services are indigenous to that exporting country. In this way, countries can export what they are well placed to produce and import what other countries are better placed to produce, hence generating a genuine win-win economic relationship for both countries. In contrast, intra-firm and/or processing trade involves goods and even services being produced in more than one country. As trade experts have noted, recent liberalisation in trade and capital mobility have changed trading patterns dramatically, transformed the implications and meaning of trade statistics, and defined and affected bilateral trade balances, especially in the Asia Pacific.<sup>57</sup> What the implications of Sino-Malaysian trade statistics might be is an important question for this paper.

Official Chinese figures suggest that processing trade constitutes around one third of the country's total trade.<sup>58</sup> Prior to the global financial crisis of 2000-2008, processing trade constituted approximately half of all China's trade, before declining steeply as regional and global trade dramatically slowed. Even so, and with Western global end consumer markets recovering, some experts and studies suggest that processing trade is currently above 40 per cent of all trade.<sup>59</sup>

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<sup>57</sup> See Yuqing Xing, "Processing Trade, Exchange Rates and China's Bilateral Trade Balances," *GRIPS Discussion Paper 10-30*, January 2011 <[http://r-center.grips.ac.jp/gallery/docs/Process\\_Trade\\_XYQ\\_110106.pdf](http://r-center.grips.ac.jp/gallery/docs/Process_Trade_XYQ_110106.pdf)>; Kalina Manova and Zhihong Yu, "Firms and Credit Constraints along the Global Value Chain: Processing Trade in China," *NBER Working Paper No. 18561*, October 2013 <<http://www.stanford.edu/~manova/TR.pdf>>; both accessed January 14, 2013.

<sup>58</sup> See Jamil Anderlini and Lucy Hornby, "China overtakes US as world's largest goods trader," *Financial Times*, January 10, 2014 <<http://www.ft.com/cms/s/0/7c2dbd70-79a6-11e3-b381-00144feabdc0.html#axzz2qLZ0PiaS>>; Xu Hongcai, "Changing trade structure," *China Daily*, January 28, 2013 /, [http://usa.chinadaily.com.cn/business/2013-01/28/content\\_16180661.htm](http://usa.chinadaily.com.cn/business/2013-01/28/content_16180661.htm)> both accessed January 14, 2014.

<sup>59</sup> See Miaojie Yu and Wei Tian, "China's Processing Trade: a firm level analysis," in Huw McKay and Ligang Sing (eds.), *Rebalancing and Sustaining Growth in China* (Canberra: ANU Press, 2012), pp. 111-148 <<http://press.anu.edu.au/wp-content/uploads/2012/06/ch061.pdf>>; Alyson Ma, Ari Van Assche and Chang Hong, "Global Production Networks and China's Processing Trade,"

Moreover, processing exports from China to East and Southeast Asian economies are three times higher than to other regions, while processing imports from East and Southeast Asian economies into China are more than 11 times higher than to other regions.<sup>60</sup> This means that the proportion of processing trade between China and economies such as Malaysia is certain to be significantly higher than the estimated 50 per cent figure given for processing trade as a proportion of overall trade. Additionally, foreign invested or owned firms produce more than half of China's exports.<sup>61</sup> This makes the point that foreign private sector commercial entities and interests constitute a significant proportion of the export sector in China, and certainly dominate the country's processing export sectors. Such entities locate production and assembly processes in China because of low labour costs (which are rising rapidly) and tax and other incentives offered by the Chinese government.<sup>62</sup>

This is important because foreign commercial entities locate operations in China for purely commercial reasons. Chinese political officials would find it extremely difficult to force or persuade these foreign entities and interests to do their political bidding, for example, by issuing directives to China-based export manufacturing companies to boycott certain countries for political or strategic reasons. Seeking only economic efficiencies and commercial gain, such firms or investors would eventually abandon basing current or future operations in export manufacturing areas such as Shenzhen, Pudong and Suzhou.

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Paper presented at 'China, Japan and the United States: A Deeper Integration' Conference, Tokyo, May 27-28, 2009 <<http://neumann.hec.ca/pages/ari.van-assche/papers/Hong-Ma-Van%20Assche-ADBI-090816.pdf>>; "Background Note On Processing Trade And China's External Imbalances," UNCTAD contribution to the G20 Framework Working Group, August 12, 2011 <[http://unctad.org/en/docs/webgds2011\\_g20d03\\_en.pdf](http://unctad.org/en/docs/webgds2011_g20d03_en.pdf)> all accessed January 14, 2014.

<sup>60</sup> See Yuqing Xing, "Processing Trade, Exchange Rates and China's Bilateral Trade Balances", p. 3.

<sup>61</sup> See Yuqing Xing, "Processing Trade, Exchange Rates and China's Bilateral Trade Balances", p. 1.

<sup>62</sup> See Miaojie Yu and Wei Tian, "China's Processing Trade: a firm level analysis".

When one examines the structure of trade between Malaysia and China, the above observations are highly relevant.

In 2012, exports to China accounted for 12.6 per cent of Malaysian exports, second only to Singapore which accounted for 13.6 per cent. In the same year, China held its place as the leading import source country for Malaysia, at 15.1 per cent of imports, with Singapore second at 13.3 per cent.

Let's look at what Malaysia exports to and imports from China. There is often an assumption that wholly produced commodities such as palm oil and rubber are significant export products to China. Indeed, exports of palm oil to China in 2012 amounted to RM10.68 billion, constituting about 10.7 per cent of all exports to China. Exports of crude rubber in the same year amounted to RM3.05 billion, constituting about 3.4 per cent of all exports to China.<sup>63</sup>

However, while commodities constituted over 85 per cent of the country's exports in the early 1960s, they now constitute less than one-fifth of exports.<sup>64</sup> More than 70 per cent of exports to China are

***Table 2: Sources of imports and destination of exports for Malaysia (by percentage)***

	Share of total exports (2012)	Share of total imports (2012)	Share of total exports (2011)	Share of total imports (2011)
<b>China</b>	12.6	15.1	13.1	13.2
<b>Singapore</b>	13.6	13.3	12.7	12.8
<b>Japan</b>	11.8	10.3	11.5	11.4
<b>U.S.</b>	8.7	8.1	18.4	9.6
<b>Thailand</b>	5.4	6	15.1	6.1

*Source: MITI and Department of Statistics Malaysia figures.*

<sup>63</sup> Department of Statistics Malaysia figures.

<sup>64</sup> Department of Statistics Malaysia figures.

manufactured goods, with goods in the ‘electrical and electronics’ (E&E) sectors dominating such export of manufactured goods and accounting for 46 per cent of all exports to China in 2012. The main E&E exports were semiconductor devices, which accounted for 64.4 per cent of total E&E exports to China. Other important E&E exports to China were hybrid and electronic integrated circuits. This compares to 2012 Malaysian exports to all countries in which E&E products constituted 32.9 per cent of all exports, suggesting that E&E sectors dominate Malaysian exports to China. Indeed, on 2012 figures, China is the largest export market for Malaysia’s E&E sector, receiving 17.6 per cent of all Malaysia’s E&E exports, leading the U.S. which receives 14.2 per cent and Singapore which receives 14 per cent.<sup>65</sup> Figures for 2011 and 2010 are similar to the 2012 figures.<sup>66</sup>

The structure of imports from China to Malaysia is remarkably similar. Manufactured parts and goods constituted 95.2 per cent of total imports from China, compared to manufactured goods from all countries constituting 78 per cent of all imports from all countries combined. This emphasises China’s enhanced importance as an exporter of manufactured goods to Malaysia. In terms of Chinese manufactured goods imported into Malaysia, E&E products are the leading category at 37.8 per cent of all manufactured goods in 2012 and 40 per cent in 2011, followed by machinery, appliances and parts.<sup>67</sup> For Malaysian E&E imports, China was the leading supplier with 24 per cent of all such imports in 2012, followed by Singapore and the U.S. with 12.5 per cent respectively. In 2012 and 2011, China also was the leading export country of machinery and appliances parts to Malaysia, making up 20 per cent of Malaysian imports in that sector in 2012 and 18.9 per cent in 2011.<sup>68</sup>

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<sup>65</sup> Department of Statistics Malaysia figures.

<sup>66</sup> Department of Statistics Malaysia and Malaysian External Trade Development Corporation figures.

<sup>67</sup> See “Trade Performance for the Year in 2012 and Month of December,” Department of Statistics Malaysia <[http://www.statistics.gov.my/portal/images/stories/files/LatestReleases/trade/bi/Dec12/Pre\\_External\\_Trade\\_Dec12BI.pdf](http://www.statistics.gov.my/portal/images/stories/files/LatestReleases/trade/bi/Dec12/Pre_External_Trade_Dec12BI.pdf)> accessed January 15, 2014.

<sup>68</sup> Department of Statistics Malaysia figures.

## IMPLICATIONS OF THE PROCESSING-TRADE STRUCTURE

The Sino-Malaysian trade relationship is remarkably similar when it comes to structure and product category, and is dominated by exports and imports of manufacturing products and parts, especially in the E&E, machinery and appliances categories. This immediately challenges the prospect that ‘ordinary’ trade – where both countries export products that are wholly produced from domestic inputs, and import products wholly produced in a foreign country – is the dominant characteristic of the bilateral trade relationship. Such a processing-dominant trade structure has a number of implications relevant to this paper.

First, it is clear that export-manufacturers view the ASEAN+3 economic region as a vast production chain with little discrimination as to where they locate production processes beyond commercial motivations of (capital and labour) cost and reliability. In this sense, one needs to understand the role ASEAN+3 economies continue to play in export-manufacturing, with a large proportion of products destined for the vast and still dominant consumption markets in the U.S. and the European Union. This is evident in figures showing that while ASEAN-China trade had grown in high double digit rates per annum for the previous ten years, trade between China and ASEAN immediately contracted by 7.8 per cent in that year when the 2009 global financial crisis plunged the Western markets into recession.<sup>69</sup> This is reflected in Sino-Malaysian trade which actually declined 1.7 per cent in 2009 from the previous year, having grown at a remarkable 21.7 per cent per annum (compounded) in the 10 years before.<sup>70</sup> Admittedly, the decline in Sino-Malaysian trade was significantly lower than the decline in Malaysian trade with other countries in 2008-2009. For example, the decrease in two-way trade with Singapore, Japan, the U.S. and Thailand was 15.7 per cent, 21.5 per cent, 20.6 per cent, and 9.8 per cent respectively.<sup>71</sup> Exports to China actually

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<sup>69</sup> China Customs figures.

<sup>70</sup> Department of Statistics Malaysia figures.

<sup>71</sup> Malaysian External Trade Development Corporation figures.

increased 6 per cent in that time period, even as imports from China declined 9.3 per cent.

That the decline in trade with China was significantly less than the overall decline in Malaysian trade with all countries suggest that Malaysia continues to be a valued niche player in sub-categories of manufactured goods and parts (especially semiconductors within the E&E category which contributes about 30 per cent of Malaysia's total manufacturing sector output)<sup>72</sup> for China-based manufactured firms. Hence, Malaysian exports of manufactured goods to China rose slightly during the difficult 2009 period, even as exports of such goods to other countries declined. This also reaffirms China's importance as a central hub of export manufacturing amongst the ASEAN+3 economies.

However, the fact that Chinese exports to Malaysia declined suggest that manufactured parts imported from China and 'processed' in Malaysia which are then shipped out again are still largely destined for Western consumer markets. In other words, although increased demand from Chinese end consumers will make up some of the slack in the event of recession in the industrialised economies, the consumption capacity of Western consumers (and not Chinese consumers) remain the primary and dominant driver of ASEAN+3, and in particular Sino-Malaysian trade.

This is clear from figures which show that Sino-Malaysian trade only recovered to 'normal' boom-time levels when the economies of the U.S. and also the E.U. emerged out of recession. For example, in 2008-2009, Chinese imports to the U.S. declined by about US\$41 billion or 12.2 per cent – triggering the significant decline in trading levels between the ASEAN+3 economies. In 2009-2010 and 2010-2011, Chinese imports to the U.S. increased by about US\$69 billion or 23.3 per cent, and US\$35 billion or 9.6 per cent respectively.<sup>73</sup> Over the same time period, two-way Sino-Malaysian trade increased by RM18.64 billion or 14.5 per cent

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<sup>72</sup> See Fauzi Hussin and Chee Wuan Ching, "The Contribution of Economic Sectors to Economic Growth: The Cases of Malaysia and China," *International Journal of Academic Research in Economics and Management Sciences* 2:2, March 2013, pp. 36-48 at pp. 36-7.

<sup>73</sup> U.S. Census figures.

(2009-2010), and RM20 billion or 13.7 per cent (2010-2011). Similarly, Malaysian trade with other ASEAN countries increased RM53 billion or 21 per cent (2009-2010) and RM25.3 billion or 8.3 per cent (2010-2011), having dramatically declined RM45.7 billion or 15.4 per cent in 2008-2009.<sup>74</sup>

This is compelling evidence that Western industrialised economies (rather than end consumer markets in China) have a greater role in driving trade between the ASEAN+3 countries, and Sino-Malaysian trade in particular. After all, China's GDP still grew 8.7 per cent in 2009,<sup>75</sup> yet the dominant variable when it came to trade between ASEAN+3 countries was still the struggling economies of the U.S. and E.U.

Second, when it comes to sectors such as E&E and information communications technology (ICT) – sub-sectors that dominate Sino-Malaysian trade – foreign invested or owned firms account for more than 80 per cent of China's exports.<sup>76</sup> This is important because foreign invested and owned firms are far less likely to tolerate 'political interference' from Beijing, and any such attempt by Beijing would eventually cause foreign entities to divest out of China and/or resist pouring new capital to fund manufacturing plants in the country. Besides the resulting loss of jobs in an export manufacturing sector that employs tens of millions of people,<sup>77</sup> a loss of interest in China by foreign entities would jeopardise China's capacity to 'import' innovation, and research and development (R&D) through attracting foreign capital and firms setting up export-manufacturing firms in the country.<sup>78</sup>

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<sup>74</sup> Department of Statistics Malaysia figures.

<sup>75</sup> China National Bureau of Statistics figures.

<sup>76</sup> See Yuqing Xing, "China's High-tech Exports: Myth or Reality," *GRIPS Discussion Paper 11-05*, June 2011 <<http://r-center.grips.ac.jp/gallery/docs/11-05.pdf>> accessed January 14, 2014.

<sup>77</sup> See Kai Guo and Papa N'Diaye, "Is China's Export Orientated Growth Sustainable?," *IMF Working Paper WP/09/171*, August 2009 <<http://www.imf.org/external/pubs/ft/wp/2009/wp09172.pdf>> accessed January 16, 2014.

<sup>78</sup> See Ling Feng, Zhiyuan Li and Deborah L. Swenson, "The Connection Between Imported Intermediate Inputs and Exports: Evidence from Chinese Firms," *National Bureau of Economic Research Working Paper 18260*, July 2012

Third, while China's rise has offered benefits for regional economies, there are also strong elements of competition between the two economies, which in important respects are deepening. On the one hand, China's economic rise and integration into ASEAN+3 production chains have made the whole ASEAN+3 region even more attractive to foreign firms and capital seeking manufacturing options. Additionally, although the size and ease with which regional firms can tap into a growing Chinese consumer market is often overstated, the Chinese domestic consumption market is nevertheless growing rapidly and will provide significant opportunities for regional economies.

Even so, all countries are jostling with each other to attract foreign direct investment (FDI) dedicated to setting up manufacturing hubs in their country, which will in turn offer benefits such as increased employment and technological transfers – major reasons why China chose the so-called 'East Asian export-manufacturing' route in the first place. (This will be look at shortly.) At the turn of this century, China's emergence as a major export-orientated manufacturing hub for processing trade was widely seen as beneficial for ASEAN's more advanced economies such as Malaysia and Singapore.<sup>79</sup> Such arguments are generally predicted on the assumption that more advanced ASEAN countries such as Malaysia can exploit the lower wages by shifting lower-skilled and lower value

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<[http://www.nber.org/papers/w18260.pdf?new\\_window=1](http://www.nber.org/papers/w18260.pdf?new_window=1)>; Guillaume Gaulier, Francoise Lemoine and Deniz Unal-Kesenci, "China's Integration in East Asia: Production Sharing, FDI & High-Tech Trade," *CEPII Working Paper 2005-09*, June 2009 <[http://cepii.com/PDF\\_PUB/wp/2005/wp2005-09.pdf](http://cepii.com/PDF_PUB/wp/2005/wp2005-09.pdf)> ; Hans Kundnani and Jonas Parello-Plesner, "China and Germany: Why the Emerging Special Relationship?", *European Council on Foreign Relations Policy Brief ECFR/55*, May 2012 <[http://ecfr.eu/page/-/ECFR55\\_CHINA\\_GERMANY\\_BRIEF\\_AW.pdf](http://ecfr.eu/page/-/ECFR55_CHINA_GERMANY_BRIEF_AW.pdf)> all accessed January 16, 2014.

<sup>79</sup> For example, see W Hai, "China's WTO membership: Significance and implications," *China Center for Economic Research Working Paper No. E2000007*, September 9, 2000 <<http://time.dufe.edu.cn/jjwengcong/e2000007.doc>>; T.H. Chan and C.W. Hooy, "China-Malaysia Trading and Exchange Rate: Complementary or Conflicting Features?," *MPRA Paper No. 25546*, October 1, 2010 <[http://mpra.ub.uni-muenchen.de/25546/1/MPRA\\_paper\\_25546.pdf](http://mpra.ub.uni-muenchen.de/25546/1/MPRA_paper_25546.pdf)> both accessed January 16, 2014.

added processes to countries such as China, creating a win-win dynamic for both. Indeed, this appears to accurately characterise much of China's trade with advanced neighbouring economies such as Japan, South Korea, Taiwan and Singapore.

Yet, the dynamic for Malaysia is changing since China is itself moving up the value-chain in the production process, whilst holding its market share growth in the low-tech final assembly process at the same time.<sup>80</sup> China has significantly broadened its manufacturing production, management and technological processes, and skill base through massive foreign and indigenous investment<sup>81</sup> and the 'learning' that comes from doing so.<sup>82</sup> This is consistent with other surveys that show China being able to absorb a wide range of industrial technologies far better than other emerging market economies such as Malaysia have done over the previous two decades.<sup>83</sup> In terms of specific sectors, one study shows that while China-based manufacturing firms have lost their comparative advantage in low-skilled and value-added categories such as basic metal and plastic products, it is rapidly gaining a competitive advantage in

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<sup>80</sup> See Tze-Haw Chan, Hooi Hooi Lean and Chee-Wooi Hooy, "A Macro Assessment of China Effects on Malaysian Exports and Trade Balances," *MPRA Paper No. 48801*, August 2, 2013, p. 20 <<http://mpra.ub.uni-muenchen.de/48801/>> accessed January 19, 2014.

<sup>81</sup> See Robert Koopman, Zhi Wang, and Shang-Jin Wei, "A World Factory in Global Production Chains: Estimating Imported Value Added in Chinese Exports" *CEPR Discussion Papers 7430*, 2009 <<http://www.cepr.org/pubs/dps/DP7430#>> accessed January 16, 2014.

<sup>82</sup> See Steve D. Levitt, John A. List and Chad Syverson, "Toward an Understanding of Learning by Doing: Evidence from an Automobile Assembly Plant," Department of Economics paper, University of Chicago, April 2013 <<http://faculty.chicagobooth.edu/chad.syverson/research/learningbydoing.pdf>> accessed January 16, 2014.

<sup>83</sup> See Chen Fanyu, Leow Ken Wei, Ng Choon Preng, Tunesh Lingam and Vivien Wong Zi Wen, "The Effect of China's Foreign Direct Investment (FDI) on the Malaysian Economic Performance," Faculty of Business and Finance, Universiti Tunku Abdul Rahman, March 2011 <<http://eprints.utar.edu.my/283/1/FE-2011-0806807.pdf>> accessed January 23, 2014.

telecommunications and electronic products and more advanced office equipment.<sup>84</sup> More general, studies suggest that China's export success and capacity to move rapidly up the value chain is based on the country's ability to "master and accumulate new and more complex capabilities" and that this is primarily reflected in the "diversification and sophistication of its export basket."<sup>85</sup>

The increased sophistication of its production base and processes is consistent with Beijing's hopes of capturing more value-add in the manufacturing process. This is reflected in a higher share of high-tech and sophisticated parts and products produced indigenously, rather than imported from middle- and high-income trading partners. Importantly, an increasing number of studies are finding that the sophistication of Chinese parts and products have become comparable to countries such as Malaysia and Thailand.<sup>86</sup> This is consistent with a number of earlier warnings that China was unlikely to stand still in the value chain and would increasingly challenge advantages that drew export manufacturers and brands to base production and processing operations in Malaysia.<sup>87</sup>

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<sup>84</sup> Jesus Felipe, Abdon Arnelyn and Kumar Utsav, "Development and Accumulation of New Capabilities: The Index of Opportunities," *VOXEU*, July 22, 2010 <<http://www.voxeu.org/article/new-measure-national-opportunities-development>> accessed January 16, 2014.

<sup>85</sup> Jesus Felipe, Abdon Arnelyn, Norio Usui and Kumar Utsav, "Why China Has Succeeded – And Why It Will Continue To Do so," *Levi Economics Institute Working Paper No. 611*, August 2010 <<http://www.levyinstitute.org/publications/?docid=1292>> accessed January 16, 2014.

<sup>86</sup> See "China's growth Through Technological Convergence and Innovation" in *China: 2030* (Washington DC: World Bank, March 2013) <<http://www.worldbank.org/content/dam/Worldbank/document/SR2--161-228.pdf>> accessed January 16, 2014, pp. 161-228.

<sup>87</sup> See R Jenkins, "Measuring the Competitive Threat from China," *UNU-WIDER Research Paper No. 2008/11*, February 2008 <[http://www.wider.unu.edu/publications/working-papers/research-papers/2008/en\\_GB/rp2008-11/\\_files/78941357991723260/default/rp2008-11.pdf](http://www.wider.unu.edu/publications/working-papers/research-papers/2008/en_GB/rp2008-11/_files/78941357991723260/default/rp2008-11.pdf)> accessed January 16, 2014; D Greenway, A Mahabir and C Milner, "Has China displaced other Asian countries' exports?", *China Economic Review* 19(2) June 2008, pp. 152-169.

Although public official statements and many articles tend to emphasise the complementary nature of Sino-Malaysian trade, and the ‘complementary versus competitive’ argument in Sino-Malaysian trade is ongoing,<sup>88</sup> there is strong evidence that some previous Malaysian export strengths have been eroded by China’s rise. In looking at Malaysia’s top 10 exports to its two most important industrialised markets (the U.S. and Japan) in 1991-2007, the author found that in two categories where Malaysia decreased its market share (integrated digital circuits and transmit receivers for radio and televisions,) China increased its market share vis-à-vis the two advanced economies. Even in categories where Malaysia increased its market share, these product categories were still considered ‘partially threatened’ as China increase in market share in those product categories (vis-à-vis the U.S. and Japan) was larger. More generally, and in the E&E sectors that are so important to Malaysian exporters, China had a growing if not larger market share of exports to the U.S. and Japan in all of these categories.<sup>89</sup> While China was expanding market share for all technology products, the most rapid gains were being made in high-tech E&E products,<sup>90</sup> possibly posing a threat to Malaysia’s long-standing advantages in these categories.<sup>91</sup>

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<sup>88</sup> For an argument that trade with China complements the Malaysian economy, see Tze-Haw Chan and Chee-Wooi Hooy, “Malaysia-China Trade and Macroeconomic Linkages In The Globalization Era: A VECX Modelling,” International Conference on Globalisation Trends and Cycles: The Asian Experience, University of Nottingham, January 12-13, 2011 <<http://www.nottingham.ac.uk/gep/documents/conferences/2011/malyasia-conf-january/hooy-chee-wooi.pdf>> accessed January 16, 2014.

<sup>89</sup> Shahid Yusuf and Kaoru Nabeshima, *Tiger Economies Under Threat: A Comparative Analysis of Malaysia’s Industrial Prospects and Policy Options* (Washington DC: World Bank 2009), pp. 51-60.

<sup>90</sup> *Ibid.*, p. 60.

<sup>91</sup> Such an argument was considered several years ago by Jane T. Haltmaier, Shaghil Ahmed, Brahim Coulibaly, Ross Knippenberg, Sylvain Leduc, Mario Marazzi, and Beth Anne Wilson, “The Role of China in Asia: Engine, Conduit or Steamroller?”, *Board of Governors of the Federal Reserve System International Finance Discussion Papers Number 904*, September 2007 <<http://www.federalreserve.gov/pubs/ifdp/2007/904/ifdp904.pdf>> accessed January 17, 2014.

Using related reasoning, Malaysia's vulnerability is also heightened by the fact that the process and product innovation it once enjoyed in the manufacture of medium- and high-tech E&E parts and products was generally 'imported' into the country by foreign firms.<sup>92</sup> Even now, inputs for manufacturing are largely imported and not produced domestically. For sub-categories in the E&E sector where it continues to be successful in export, 'local' content and innovation are still relatively low.<sup>93</sup> Dependent on foreign firms for innovation and efficiency, Malaysia has become highly vulnerable to other countries that can offer similar manufacturing and assembly environments at better economic scale and cost.

Indeed, China's virtual duty-free regime for attracting processing imports in order to increase its market-share in the processing trade vis-à-vis other medium- and low-income ASEAN economies has been an enormous success. In 1993, processing imports entering China was valued at US\$36.4 billion, rising to US\$417 billion by 2010.<sup>94</sup> The top four sources of Chinese processing imports are Taiwan, Japan, South Korea and the U.S.<sup>95</sup> – all advanced economies using China-based firms to add further value and assembly medium- and high-tech products. The top nine most important destinations for Chinese processing exports – accounting for about 71 per cent of all processed Chinese exports – are all advanced, consumer economies: U.S., Japan, South Korea, Germany, Netherlands, Singapore, U.K., Taiwan and France.<sup>96</sup> Worrying for Malaysia is that

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<sup>92</sup> See Tze-Haw Chan and Chee-Wooi Hooy, "Malaysia-China Trade and Macroeconomic Linkages In The Globalization Era: A VECX Modelling".

<sup>93</sup> See M. Affendy Arip, Lau Sim Yee and Madono Satoru, "An Analysis of Intra-Industry Trade between Japan, Malaysia and China," *International Journal of Institutions and Economies* 3:1, April 2011, pp. 1-30 <<http://ijie.um.edu.my/RePEc/umk/journl/v3i1/Fulltext1.pdf>> accessed January 17, 2014.

<sup>94</sup> See Yuqing Xing, "Joining Global Production Networks: China's Processing Trade and High-Tech Exports," Presentation to Asian Development Bank Institute, December 11, 2013 <[http://www.adbi.org/files/2013.11.12.cpp.sess2.1.xing\\_global.production.networks.prc.pdf](http://www.adbi.org/files/2013.11.12.cpp.sess2.1.xing_global.production.networks.prc.pdf)> accessed January 17, 2014.

<sup>95</sup> Ibid.

<sup>96</sup> Ibid.

in 2006, China emerged as the largest exporter of finished high-tech goods, rising from US\$10 billion (6.8 per cent of manufacturing exports) in 1995 to US\$492 billion (31.2 per cent of manufacturing exports) in 2010.<sup>97</sup> Under the Chinese Customs' classification, 'Computer and Communication Technology' constituted 72.3 per cent of these exports, with 'Electronics' a further 15.7 per cent. Overall, high-tech exports constitute about 80 per cent of China's processing exports.<sup>98</sup>

Remember that importing high-tech parts and products, adding value to and assembling finished products, and exporting them to advanced consumer economies was, and remains, critical for a middle-income economy like Malaysia to generate export-orientated jobs and accelerate technology- and innovation-transfer from advanced economy firms to the domestic economy. In fact, Malaysia's export-dependent model has been attributed as a key factor in the country's impressive record of poverty alleviation<sup>99</sup> and job creation<sup>100</sup> in the 1970s, 80s and 90s.

Note that China cannot be held fully responsible for firms shifting higher value-add production and assembly to China, and away from ASEAN countries. The evidence presented here arguably says more about the need for Malaysia to place more emphasis on innovation, R&D, and productivity growth to overcome its disadvantages from lack of scale (compared to China) than it does about China emerging as an 'economic threat' to Malaysia *per se*. According to 2011 figures, affiliated

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<sup>97</sup> See Yuqing Xing, "China's high-tech exports: myth and reality," *GRIPS Discussion Paper 11-05*, June 2011 <<http://r-center.grips.ac.jp/gallery/docs/11-05.pdf>> accessed January 17, 2014.

<sup>98</sup> See Yuqing Xing, "Joining Global Production Networks: China's Processing Trade and High-Tech Exports".

<sup>99</sup> See P Athukorala, "Growth, Employment and Equity in Malaysia," in K. Sharma (ed.), *Trade Policy, Growth and Poverty in Asian Developing Countries* (London: Routledge 2003).

<sup>100</sup> See C. O. Fong and K. C. Lim, "Investment incentives and trends of manufacturing investments in Malaysia," *The Developing Economies* 22(4) 1984, pp. 396-419 <<http://onlinelibrary.wiley.com/doi/10.1111/j.1746-1049.1984.tb01165.x/pdf>> accessed January 20, 2014.

companies of multinational enterprises account for over 60 per cent of Malaysia's manufacturing output and over 80 per cent of manufacturing exports (or 65 per cent of total exports.)<sup>101</sup> These foreign firms will make their own decisions on where to base manufacturing plants and processes according to commercial considerations. If Malaysia does not improve its indigenous capacity and business environment in these areas, then someone else will 'eat Malaysia's lunch' even if China does not. But the point remains that the economic interests of the two countries are not always aligned despite burgeoning two-way trade numbers.<sup>102</sup>

## REGIONAL COMPETITION FOR CAPITAL

The importance of FDI to Malaysia's economic development is demonstrated by the fact that it was ranked second in Southeast Asia in terms of share of FDI for the region in the 1970s, 1980s and 1990s, before falling to third this century.

These figures immediately show that Malaysia has relied on a relatively open FDI regime to attract much needed outside capital and expertise, and continues to do so. Indeed, foreign investment was behind

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<sup>101</sup> See Prema-chandra Athukorala and Swarnim Wagle, "Foreign Direct Investment in Southeast Asia: Is Malaysia Falling Behind?", *Journal of Southeast Asian Economies* 28:2 August 2011, pp. 115-133 at p. 115 <[http://muse.jhu.edu/journals/asean\\_economic\\_bulletin/v028/28.2.athukorala.html](http://muse.jhu.edu/journals/asean_economic_bulletin/v028/28.2.athukorala.html)> accessed January 20, 2014.

<sup>102</sup> Note that Malaysia only de-pegged the ringgit from the U.S. dollar after China allowed the yuan to appreciate significantly against the U.S. dollar in July 2005. This is evidence that Malaysia sees itself in a somewhat competitive relationship with China in export-manufacturing, and was not prepared to allow an artificially low yuan undermine the attractiveness of Malaysia as an export-manufacturing economy. The same dynamic applies currently. Even though there is a debate as to the degree to which the yuan is undervalued against the U.S. dollar, the export-manufacturing industries of both Malaysia and China depend heavily on American domestic consumption. This means that China's managed currency peg against a U.S.-dominated 'basket of currencies' will continue to undermine the competitiveness of Malaysia's export-manufacturing sectors to some extent.

**Table 3: Shares of total FDI inflows in Southeast Asia (percentage)**

	1970-79	1980-89	1990-99	2000-11
<b>Brunei</b>	1	0	1	2
<b>Cambodia</b>	0	0	0	1
<b>Indonesia</b>	36	8	10	6
<b>Laos</b>	0	0	0	0
<i>Malaysia</i>	25	26	23	11
<b>Myanmar</b>	0	0	2	1
<b>Philippines</b>	6	7	6	4
<b>Singapore</b>	24	48	38	58
<b>Thailand</b>	7	11	15	17
<b>Timor-Leste</b>	n/a	n/a	n/a	0
<b>Vietnam</b>	0	0	6	9

*Source: United Nations Conference on Trade and Development figures.*

61.7 per cent of all investment projects in 2010, 61 per cent in 2011 and 50.7 per cent in 2012.<sup>103</sup>

Let's now look at the economic sectors attracting FDI into Malaysia. In the 1970s and 1980s, large E&E foreign firms such as Intel, Motorola, Hewlett Packard, Texas Instruments and Hitachi dominated FDI into the country. These giants viewed Malaysia as an attractive low-cost, but relatively high-skilled base for manufacturing. More recently, the sectors attracting FDI has diversified. For the decade 2000-2009, US\$42 billion of cumulative net FDI inflows was recorded. Manufacturing accounted for 41 per cent, services 37 per cent, and the oil and gas sectors 17 per cent.<sup>104</sup>

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<sup>103</sup> Malaysian Investment Development Authority figures.

<sup>104</sup> Bank Negara Malaysia figures.

Even so, the continued importance of manufacturing, and the E&E sector in particular, should not be understated. In 2011, there were 92 investments for projects of RM100 million or larger, totalling RM46 billion or 83.6 per cent of total investments approved. RM18.7 billion or 40.7 per cent were in the E&E sector alone. In terms of all 2011 investments approved, the E&E sector received RM20.1 billion, with the basic metals sector a distant second with RM9.9 billion in investments.<sup>105</sup>

As the figures for 2011 cited earlier indicates, multinational enterprises account for over 60 per cent of Malaysia's manufacturing output and over 80 per cent of manufacturing exports (or 65 per cent of total exports) – indicating clear reliance on outside firms and FDI for the country's economic development, and to drive the export-manufacturing model of growth. Indeed, of the RM56.1 billion worth of investment in 2011, RM24.7 billion or 44 per cent was in export-orientated projects.<sup>106</sup> Foreign investments in these export-orientated projects amounted to RM20.1 billion or 81 per cent of all export-orientated investment.<sup>107</sup>

In 2012, of the RM41 billion in total investment, RM\$15.2 billion or 37 per cent went into export-orientated projects.<sup>108</sup> Although we do have 2012 figures for the proportion of export-orientated projects that are funded by foreign investment, we do know that RM20.8 billion of foreign investment (50.6 per cent of all 2012 investment) went into manufacturing projects for that year.<sup>109</sup> When we see that 67 per cent of all Malaysian exports by value are manufactured goods,<sup>110</sup> and 81.2 per cent of all investment in the export-orientated E&E manufacturing sub-category were by foreign entities in 2012,<sup>111</sup> we can be reasonably sure

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<sup>105</sup> Malaysian Investment Development Authority figures.

<sup>106</sup> 'Export orientated' projects are defined as projects involving export of at least 80 per cent of output.

<sup>107</sup> Malaysian Investment Development Authority figures.

<sup>108</sup> Malaysian Investment Development Authority figures.

<sup>109</sup> The Bank Negara Malaysia figure is higher at 58.2 per cent.

<sup>110</sup> Malaysian External Trade Development Corporation figures.

<sup>111</sup> Malaysian Investment Development Authority figures.

that foreign firms once again dominated Malaysian manufacturing output and export-orientated manufacturing output in particular, like they did in previous years.

In summary, Malaysia is still largely dependent on exports for growth (as well as technology, innovation and productivity advances) and its foreign investor dominated export-sector is in turn heavily dependent on FDI (in addition to strong global consumer demand in primarily industrialised economies rather than large developing economies such as China as the earlier section argued). Not surprisingly, about 47.5 per cent of all FDI stock at the end of 2011 is in the export-orientated dominated manufacturing sector.<sup>112</sup> These correlations and connections are clearly demonstrated in Table 4 below.

The upshot is that FDI into Malaysia is largely destined for the export-manufacturing sectors. And if Malaysia is competing with other ASEAN+3 countries to host export-manufacturing processes and plants,

***Table 4: Correlation between Export Volume, FDI and GDP Growth in Malaysia***

	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
<b>Exports in RM billions (% growth from previous year)</b>	605.1 (2.74)	663.5 (9.65)	553.3 (-16.62)	639.43 (15.6)	694.55 (8.62)	702.19 (17.41)
<b>FDI in RM billion (% growth from previous year)</b>	29.07 (34.82)	24.1 (-17.1)	5.04 (-79.1)	29.32 (481.75)	32.93 (12.31)	27.13 (-17.41)
<b>GDP Growth (%)</b>	6.3	4.8	-1.5	7.4	5.1	5.6

*Source: Malaysian External Trade Development Corporation; United Nations World Investment Report; World Bank Department of Statistics; Author's Calculations.*

<sup>112</sup> Bank Negara Malaysia figures.

then it is also competing with ASEAN+3 countries for FDI and the attention of multinational firms. As mentioned, Malaysia is heavily reliant on FDI and foreign expertise and innovation, given the relative lack of domestic contribution in terms of capital and capability, especially in the manufacturing sectors.

It is in this context that trends in FDI are worrying for the country, and also suggestive that China's economic rise, and the latter's emergence as a hub of export-manufacturing, is increasingly becoming a mixed blessing for the country.

These figures are suggestive of a number of things.

For a start, when compared to other ASEAN countries, Malaysia is receiving a smaller share of FDI and has never recaptured the relative heights that it reached in the 1990s – suffering the ills of countries such as Thailand which were once far more prominent in export-manufacturing at a time when China was less integrated into regional production chains.<sup>113</sup>

**Table 5: FDI by percentage of all FDI in ASEAN-6 countries**

	1985-89	1990-96	1997-99	2000-04	2007	2008	2009	2010	2011	2012
<b>Indonesia</b>	9.1	13.7	3.1	-4.7	9.4	19.7	13.3	17.3	18.4	18.7
<i>Malaysia</i>	16.4	26.6	15.1	11.9	11.5	15.5	3.8	11.9	11.7	9.5
<b>Philippines</b>	9.2	5.8	5.0	4.2	3.9	3.3	5.3	2.2	1.7	2.6
<b>Singapore</b>	49.8	34.7	44.1	57.9	48.4	23.1	45.7	50.3	53.6	53.2
<b>Thailand</b>	15.2	11.1	20.4	18.7	15.4	18.1	16.2	7.6	7.5	8.1
<b>Vietnam</b>	0.1	5.5	6.8	5.6	9.1	17	12.1	10.6	7.1	7.9

Source: UN World Investment Reports; Author's Calculations.

<sup>113</sup> See John Lee, *China's Economic Engagement with Southeast Asia: Thailand* (Singapore: ISEAS Trends in Southeast Asia Series #1, 2013) <[http://www.iseas.edu.sg/documents/publication/Trends\\_2013-1.pdf](http://www.iseas.edu.sg/documents/publication/Trends_2013-1.pdf)> accessed January 22, 2014.

Moreover, it is true that Table 6 seems to back up the argument that China’s economic rise has not come at the expense of ASEAN economies, but has improved the attractiveness of the whole region for manufacturing firms – evidenced by the rise of FDI in both China and ASEAN. Even so, and as argued earlier, Malaysia’s lack of indigenous value-add to the manufacturing process renders it vulnerable to competition from countries moving up the value-add manufacturing chain such as China, wearing away the advantages a middle-income Malaysia held in the 1990s.

Additionally, it is also apparent that levels of FDI entering ASEAN are far more volatile than levels of FDI entering China. Since much of the FDI is destined for the export-manufacturing sectors, the implication is that a global decline in demand for exports is likely to have more severe consequences for ASEAN, rather than the Chinese economy. This suggests that China’s economic scale offers it advantages not available to ASEAN manufacturing hubs, while China’s capacity to move up the value chain of production (from low-value to middle-value added) is entrenching it as a preferred value-add manufacturing hub compared with middle-income ASEAN competitors such as Malaysia.<sup>114</sup> This Chinese

**Table 6: Growth in FDI – ASEAN versus China**

	2006	2007	2008	2009	2010	2011	2012
<b>China - US\$ billion (% per annum growth)</b>	72.715 (0.4)	83.521 (14.9)	108.312 (29.7)	95 (-12.3)	114.734 (20.77)	123.985 (8.1)	121.08 (-2.3)
<b>ASEAN – US\$ billion (% per annum growth)</b>	56.701 (39.2)	85.640 (51)	50.543 (-41)	47.81 (-5.4)	97.893 (104.7)	109.044 (11.4)	111.336 (2.1)

Source: UN World Investment Reports; Author’s Calculations.

<sup>114</sup> See Prema-chandra Athukorala and Swarnim Wagle, “Foreign Direct Investment in Southeast Asia: Is Malaysia Falling Behind?”.

‘preferred status’ to multinational manufacturing firms offer China some protection during periods of global downturn – important when there are dramatic decreases in FDI into the region which tend to occur during a downturn in industrialised economies. In contrast, middle-income ASEAN manufacturing hubs such as Malaysia and Thailand are far less resilient to global economic headwinds. For example, in 2008-2009 FDI into Malaysia declined by 79.1 per cent and by 42.6 per cent in Thailand. This compares to a decline of only 12.3 per cent in China.

Indeed, Malaysia’s declining competitiveness in the export-orientated sectors – especially vis-à-vis China – is demonstrated by a number of indices. During periods of ‘normal’ levels of FDI inflows defined as those prior to 2009, export-orientated capacity utilisation rates have hovered around 75-80 per cent of full capacity. During the first quarter of 2009, export-orientated capacity utilisation dropped to around 60 per cent,<sup>115</sup> suggesting that Malaysia is losing, or has lost its position as a ‘preferred’ middle-income export manufacturing hub. Even post-2009, Malaysia has lost its relative position in the regional export of E&E parts and products. In E&E export levels (with January 2008 taken as a base of 100,) Malaysia declined to about 66 in January 2009, before recovering to about 110 in early 2010. As of early 2012, it is back down to levels of below 90. In contrast, China declined to about the same level as Malaysia in January 2009, but reached to about 120 in January 2010, and to about 160 in late 2010.<sup>116</sup>

## CHINESE FDI IN MALAYSIA

In 2007-2008 and 2008-2009 when FDI into Malaysia declined 17.1 per cent and 79.1 per cent respectively, Malaysia was forced to diversify its FDI sources and seek investment from firms based in countries such as China. In January 2010, State Grid Corporation of China and 1Malaysia

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<sup>115</sup> See *Malaysian Economic Monitor: Brain Drain* (Washington DC: World Bank April 2011), p. 14 <[http://siteresources.worldbank.org/INTMALAYSIA/Resources/324392-1303882224029/malaysia\\_ec\\_monitor\\_apr2011\\_full.pdf](http://siteresources.worldbank.org/INTMALAYSIA/Resources/324392-1303882224029/malaysia_ec_monitor_apr2011_full.pdf)> accessed January 22, 2014.

<sup>116</sup> *Ibid.*, p. 14.

Development signed a number of “multibillion dollar” agreements to develop the Sarawak Corridor of Renewable Energy, generating up to US\$11 billion of economic value according to the Malaysia press release.<sup>117</sup> Another announcement was China Harbour Engineering Co investment in the RM4.5 billion Penang Bridge project, completed at the end of 2013.<sup>118</sup> A more recent announcement is the joint-establishment of the Malaysia-China Kuantan Industrial Park (and Qinzhou Industrial Park) to further boost bilateral trade and investment.<sup>119</sup>

Despite these high profile examples of Chinese investment particularly during difficult economic times, Malaysia is far from being overly reliant on Chinese FDI, with China not even counted amongst the top five investors in 2008-2012, as Table 7 shows.

As of the end of 2012, cumulative Chinese FDI in Malaysia stands at US\$6.3 billion or RM20.05 billion, a mere 4.8 per cent of total Malaysian FDI stock.<sup>120</sup> Bank Negara figures in 2011 suggest that Chinese FDI stock in Malaysia was even lower, at RM1.126 billion, or 0.3 per cent of all FDI stock in the country – only the 14<sup>th</sup> largest investor country in Malaysia.<sup>121</sup> Even if we accept the higher figure, the stock of Chinese

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<sup>117</sup> See Hamisah Hamid, “Malaysia, China giant pump billions into Sarawak corridor,” *Business Times*, January 12, 2010 <<http://www.1mdb.com.my/danabelia/news-1/1malaysia-china-giant-pump-billions-sarawak-corridor>> accessed January 23, 2014.

<sup>118</sup> See Josephine Jalleh, “All abuzz over Penang’s new bridge,” *The Star*, November 17, 2013 <<http://www.thestar.com.my/News/Nation/2013/11/17/All-abuzz-over-Penangs-new-bridge.aspx/>> accessed January 23, 2014.

<sup>119</sup> See Ahmad Fairuz Othman and M. Hamzah Jamaludin, “Malaysia-China jointly launch Kuantan Industrial Park,” *New Straits Times*, February 5, 2013 <<http://www.nst.com.my/latest/malaysia-china-jointly-launch-kuantan-industrial-park-1.213392>> accessed January 24, 2014.

<sup>120</sup> Figure of total Chinese FDI stock from Yuen Meikeng and Isabella Lai, “Najib hoping for more FDI from China for mutual benefit,” *The Star*, October 4, 2013 <<http://www.thestar.com.my/News/Nation/2013/10/04/China-more-FDI-najib.aspx/>> accessed January 23, 2014. Total FDI stock in Malaysia figures from *UN World Investment Report 2013*: <<http://unctad.org/en/pages/PublicationWebflyer.aspx?publicationid=588>> accessed January 23, 2014.

<sup>121</sup> Bank Negara Malaysia figures.

**Table 7: Top 5 investors in Malaysia by country, 2008-2012**

<b>2012 – Top 5</b>	<b>Value of foreign investments (RM billions)*</b>
Singapore	14.9
Japan	11.3
USA	9.5
Hong Kong	7.6
Netherlands	5.7
<b>2011 - Top 5</b>	<b>Value of foreign investments (RM billions)</b>
Japan	10.1
South Korea	5.2
USA	2.5
Singapore	2.5
Saudi Arabia	2.2
<b>2010 - Top 5</b>	<b>Value of foreign investments (RM billions)</b>
USA	11.7
Japan	4
Hong Kong	2.8
Singapore	2.1
Germany	1.9
<b>2009 - Top 5</b>	<b>Value of foreign investments (RM billions)</b>
Japan	7
Hong Kong	5.3
USA	2.3
Singapore	2
Taiwan	0.716
<b>2008 - Top 5</b>	<b>Value of foreign investments (RM billions)</b>
Australia	13.1
USA	8.7
Japan	6.5
Germany	4.4
Spain	4.2

*Source: Malaysia Investment Development Authority; Bank Negara Malaysia; CIMB Research*

*\*2012 Figures are based on CIMB estimates and are unconfirmed.*

FDI in Malaysia as of the end of 2012 equates to about 11.5 per cent of all Malaysian FDI stock originating from Asia. To state the relative insignificance of Chinese FDI in Malaysia in another way, total Chinese FDI stock at the end of 2012 is a mere 1.24 per cent of total Chinese FDI stock for all countries at the end of 2012.<sup>122</sup> This indicates that Malaysia is not a major FDI player for China, suggesting that the political and strategic consequences of Chinese FDI in Malaysia are minimal. Even when we consider cross-border mergers-and-acquisitions (M&A) involving Malaysian firms as targets (which sometimes do not show up in FDI figures, the M&A activity of Chinese firms in Malaysia do not even make the top ten rankings from 2001-11.<sup>123</sup>

In fact, the problem for Malaysia is its record of net FDI outflows since 2007, indicating a relative lack of confidence and/or opportunity for Malaysia based firms in the country compared to other economies. This is shown in Table 8 below. In such a competitive regional environment for capital, especially vis-à-vis the manufacturing sectors, such an unenviable record is unique amongst the ASEAN-6 economies. All this is

**Table 8: Malaysian FDI inflows and outflows – 2006-12**  
(US\$ billions)

	2006	2007	2008	2009	2010	2011	2012
<b>FDI Inflows</b>	6.08	8.695	7.172	1.453	9.06	12.198	10.074
<b>FDI Outflows</b>	6.021	11.314	14.965	7.784	13.399	15.249	17.115
<b>Net FDI</b>	0.059	-2.619	-7.793	-6.331	-4.339	-3.051	-7.041

Source: UN World Investment Reports.

<sup>122</sup> Calculated from UN World Investment Report figures.

<sup>123</sup> See *OECD Investment Policy Reviews: Malaysia 2013* (Paris: OECD 2013), p. 47 <<http://www.oecd-ilibrary.org/docserver/download/2013031ec007.pdf?expires=1390527281&id=id&accname=ocid195150&checksum=25E7243F6B23ABFC4A4C9D203FE00605>> accessed January 24, 2014.

further reaffirmation that while economic regionalism, and the deepening of regional production chains in particular, has been a boon for the Asia-Pacific, China's move up the manufacturing value chain is a competitive challenge to middle-income ASEAN countries such as Malaysia.

Moreover, in relative terms, China is far from being a dominant source of opportunity for Malaysian-based firms. In 2001-2011, China was ranked sixth in terms of cross-border M&A transactions involving Malaysian firms as acquirers, driven largely by Malaysian manufacturing firms seeking to acquire Chinese-based manufacturing firms to promote greater vertical integration of the manufacturing process.

Even then, Chinese firms acquired by Malaysian firms via M&As amounted to only US\$3.213 billion, or 5.8 per cent of all such acquisitions in 2001-11. While the average size of an acquisition by a Malaysian firm through an M&A was US\$40.5 million for all firms, the average size of a Malaysian M&A acquisition of a Chinese firm was US\$20.34 million. This suggests that such Malaysian acquisitions of Chinese firms tend to be smaller commercial plays, compared to the average size of an acquisition in advanced economies such as Singapore and the U.K. (ranked one and fourth respectively in terms of cross-border M&A transaction countries involving Malaysian firms as acquirers) which has an average acquisition size of US\$53 million and US\$105 million respectively.<sup>124</sup>

In terms of stock of Malaysian FDI abroad, China is not even ranked in the top 10 countries.<sup>125</sup> China's Statistical Bulletin indicates that US\$5.6 billion of cumulative FDI has entered from Malaysia as of the end of 2010, while Bank Negara Malaysia has a figure of US\$1.9 billion worth of FDI stock entering China.<sup>126</sup> If we accept the Chinese Statistical Bulletin figure, this represented about 5.8 per cent of Malaysia's outward FDI

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<sup>124</sup> Figures from OECD.

<sup>125</sup> Bank Negara Malaysia figures.

<sup>126</sup> See Khor Yu Leng, "The Significance of China-Malaysia Industrial Parks," *ISEAS Perspective* #37, 2013, June 17, 2013 <[http://www.iseas.edu.sg/documents/publication/iseas\\_perspective\\_2013\\_37\\_the\\_significance\\_of\\_china\\_malaysia\\_industrial\\_parks.pdf](http://www.iseas.edu.sg/documents/publication/iseas_perspective_2013_37_the_significance_of_china_malaysia_industrial_parks.pdf)> accessed January 24, 2014.

stock at the end of 2010, while the Bank Negara figure represented 1.96 per cent of Malaysia's outward FDI stock in the same time period.<sup>127</sup>

In looking to the future, Malaysia's New Economic Model plan to become a 'high-income' country by 2020 includes looking beyond manufacturing with an emphasis on developing and exporting value-added services to the region. Part of the plan is to position Malaysia as an attractive regional location for global firms to bring in FDI in order to base their operational headquarters and other aspects of the business in the country. There has been some success in attracting multinationals to the country in this context. But it is noteworthy that the vast majority of these firms are giants from advanced industrialised countries, rather than from China.

For example, a survey of the leading multinationals with significant operational bases in Malaysia shows that they are overwhelmingly from the U.S., U.K., Germany, Switzerland, France, Netherlands, Sweden and Norway.<sup>128</sup> The point is that firms and capital from advanced economies, rather than from China will be the more important contributors to the success of forward-looking plans such as the New Economic Model.

## CONCLUSION

Using economics to extract political and strategic leverage and concessions is far more difficult than many commentators imagine.<sup>129</sup> In the case of Sino-Malaysian relations, this paper has argued that China's capacity to exploit the economic relationship to exercise meaningful or

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<sup>127</sup> Author's calculations based on UN World Investment Report figures.

<sup>128</sup> See PwC, *Malaysia in Focus 2012* <<http://www.pwc.com/asia-practice/south-east/assets/publications/Malaysia-in-Focus-2012.pdf>> accessed January 26, 2014.

<sup>129</sup> On a commentary that China can use its trade relationship to extract political concession vis-à-vis Australia, see Hugh White, "China will inflict pain if Abbott blunders on," *Sydney Morning Herald*, December 24, 2013 <<http://www.smh.com.au/comment/china-will-inflict-pain-if-abbott-blunders-on-20131223-2zueu.html>> accessed January 25, 2014.

decisive influence over the political and strategic decisions of Malaysia is severely limited. Broadly speaking, this is the case for a number of reasons.

First, while economic opportunities presented by China's rise are considerable now and will be more so in the future, such opportunities are neither large nor compelling enough to force Kuala Lumpur to abandon its long-standing strategic hedging strategy against Beijing. In fact, there is a strong case to be made that Malaysia's export-orientated and open economy remains tied to the enormous consumer markets in North America and the European Union, and is less reliant on the Chinese consumer than is often believed.

Second, the complex and integrated nature of the ASEAN-6 and East Asian economies means that translating bilateral economic interactions with one country, into strategic leverage over that country is extremely difficult if not impossible. Just as Malaysia's relatively open economy leaves it vulnerable to the ruthless forces of market completion, it also means that the Malaysian economy and Malaysian firms are not over-reliant China for their current or future prosperity.

Third, while China's economic rise and integration with the other ASEAN+3 economies have brought benefits to the region as a whole, weaknesses in the Malaysian economy combined with China's move up the manufacturing value-chain means that there are strong elements of competition between the two economies. This is played out in terms of lowering the relative competitiveness and attractiveness of Malaysia as a hub of higher value-add manufacturing and assembly, and as a destination for FDI. China's economic rise is not the straightforward win-win for Malaysia, despite the persistently positive diplomatic rhetoric between the two capitals.

Fourth, and despite China's emergence as Malaysia's largest trading partner, the two economies are not intrinsically tied more to each other than to other regional economies. This is evident in the extraordinarily low inward and outward FDI numbers between Malaysia and China compared to Malaysia's investment relationship with a number of other regional and global economies.

Fifth, and in looking at reporting of the bilateral economic relationship generally, one should not be surprised or alarmed by the far more

noticeable Chinese economic presence in Malaysian society. A Chinese presence is particularly apparent in residential real estate sectors.

With respect to real estate, the evidence is that Chinese residential properties tend to be private citizens, and that these Chinese citizens are increasingly interested in so-called ‘second-tier’ markets such as Edinburgh, Sydney, Melbourne, Miami and Malaysia given the high prices in ‘first tier’ markets such as New York, London, and Los Angeles.<sup>130</sup> It is estimated that prices for similar homes in similar urban locations in Kuala Lumpur are twenty times cheaper than what they might be in cities such as Hong Kong.<sup>131</sup> Besides seeking real estate bargains, it is well known that Chinese citizens buy houses in countries and cities where Chinese people visit as tourists, or have their student-children as buyers to gain exposure to those countries. In other words, Chinese people buy real estate where Chinese people go as one article puts it.<sup>132</sup> Chinese interest in Malaysian real estate is hardly unique in this respect.

The point is that there is little economic leverage to be extracted from Chinese real estate buying in Malaysia or elsewhere. For a start, Chinese buyers are overwhelmingly private citizens even if Chinese firms buying and developing greenfield projects include Chinese SOEs. When it comes to greenfield developments, it is more a matter of Chinese developers seeking greater diversification in their portfolios, and selling properties to Chinese buyers eager to themselves diversify their assets outside China. Indeed, overseas real estate buying reflects the desperation

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<sup>130</sup> See *Asia-Pacific Emerging Trends in Real Estate 2014* (Washington DC: PwC and the Urban Land Institute, 2013) <<http://www.pwc.in/assets/pdfs/publications/2013/emerging-trends-in-real-estate.pdf>> accessed February 28, 2014.

<sup>131</sup> See Zurairi Ar, “Chinese flocking to Malaysia for bargain homes,” *Malay Mail*, November 11, 2013 <<http://www.themalaymailonline.com/malaysia/article/chinese-flocking-to-malaysia-for-bargain-homes>> accessed February 28, 2014.

<sup>132</sup> See “Real estate companies go where Chinese people go,” *People’s Daily*, October 30, 2013 <[http://usa.chinadaily.com.cn/business/2013-10/30/content\\_17069756.htm](http://usa.chinadaily.com.cn/business/2013-10/30/content_17069756.htm)> accessed February 28, 2014.

of some Chinese citizens to take assets out of the country.<sup>133</sup> In summary, Chinese buying of Malaysian real estate is not coordinated by the state but driven by private citizen motivations of wealth generation<sup>134</sup> and/or preservation.<sup>135</sup>

Finally, and in looking to the future, we should note that deeper Chinese regional economic integration, for example through Chinese membership of a Trans-Pacific Partnership (TPP) agreement does not significantly change the analysis of contemporary affairs presented in this paper. In fact, full Chinese membership and participation in the TPP would actually lower any capacity of Beijing to use economics to extract strategic or political concessions. This is the case since the TPP will challenge many aspects of China's authoritarian political-economy, thereby weakening the possible economic tools at the CCP's disposal. For example, the TPP demands equal treatment for foreign and domestic firms which would weaken the economic standing of China's highly protected and privileged SOEs. All firms in a TPP member's jurisdictions

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<sup>133</sup> See John Lee, "Capital flight is China's house of cards," *Business Spectator*, February 12, 2014 <<https://www.businessspectator.com.au/article/2014/2/12/china/capital-flight-chinas-house-cards>> accessed February 28, 2014.

<sup>134</sup> See "The Chinese are coming," *Star Property feature article*, July 12, 2013 <<http://www.starproperty.my/index.php/articles/property-news/the-chinese-are-coming/>> accessed February 28, 2014.

<sup>135</sup> Note that similar arguments apply to the estimated 10,000 Chinese students studying in Malaysian institutions as at early 2013. This compares to an estimate of 400,000 Chinese students abroad in all institutions throughout the world. This means that Malaysia attracts only about 2.5 per cent of the Chinese market. More important, the motivations for why students leave the country are entirely private: either to secure a better education or else migrate to that country. See Wang Qingfeng, "China Becomes World's Top Source of Overseas Students," *Caixin Online*, September 25, 2012 <<http://english.caixin.com/2012-09-25/100441943.html>>; Sarah Cluster, "China-Malaysia recognition increases mobility," *The PIE News*, January 21, 2013 <<http://thepienews.com/news/china-malaysia-mutual-recognition-inceases-mobility/>>; "Why Are Overseas Chinese Students Not Returning to China?," *ChinaSmack*, November 7, 2013 <<http://www.chinasmack.com/2013/stories/why-are-overseas-chinese-students-not-returning-to-china.html>> all accessed February 28, 2014.

would need to meet higher standards of transparency and commercial accountability. Market forces, rather than government bodies, would be given the power to allocate resources, capital and economic opportunity.<sup>136</sup> All this points to the weakening of the state or regime in economic affairs even as trade and investment increases between TPP member states.

Possibilities such as a viable TPP aside, the reasons elaborated upon earlier in the paper cast serious doubt on the proposition that economic dependency on China is forcing Malaysia to pursue a softer and more compliant political and strategic posture vis-à-vis Beijing. Instead, Kuala Lumpur's superficially soft and warm rhetoric towards Beijing is better explained by its political strategy of making itself into a 'small target' for great Asian powers such as China. As the first part of the paper argues, and even in the midst of a rapidly rising China that is significantly larger now than it was twenty years ago, Kuala Lumpur's game plan is essentially unchanged from a couple of decades ago: on the one hand, avoid overt disagreement on difficult issues with China and allow other capitals to confront Beijing about disturbing aspects of the latter's behaviour; and on the other, ensure that the strategic and military relationship with the U.S. remains strong.

Such a 'dual approach' makes sense for Kuala Lumpur while the U.S. and China remain content that Malaysia be allowed to do this. The cost to Malaysia is minimal or zero, while the benefits are obvious. Should either great power capital become impatient with Kuala Lumpur's free-riding and conflict avoidance approach, then its hitherto successful cost-free strategy will become less feasible. But for the moment and in the foreseeable future, China lacks the economic leverage to force Malaysia to alter or abandon its game-plan.

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<sup>136</sup> See Hu Shuli, "China should join the Trans-Pacific Partnership talks," *South China Morning Post*, November 20, 2013 <<http://www.scmp.com/comment/insight-opinion/article/1361170/china-should-join-trans-pacific-partnership-talks>>; Sophie Song, "Trans-Pacific Partnership (TPP) Trade Agreement Will Force China's Hand in Domestic Economic Reforms," *International Business Times*, November 1, 2013 <<http://www.ibtimes.com/trans-pacific-partnership-tpp-trade-agreement-will-force-chinas-hand-domestic-economic-reforms>> both accessed February 14, 2014.



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ISBN 978-981-4519-71-7



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