



A STUDY OF CHINESE CAPITAL FLOWS TO SIX COUNTRIES

Mitigating Governance Risks From Investment in Southeast Asia

**CENTER FOR INTERNATIONAL
PRIVATE ENTERPRISE**

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TABLE OF CONTENTS

Forward & Introduction	2
CHAPTER 1	
Chinese Investment in Southeast Asia: Making Sense of the Data	6
CHAPTER 2	
Restoring Trust in the Bri: The State of Chinese Investment in Malaysia	40
CHAPTER 3	
Chinese FDI in the Philippines: An Examination of Online Gambling and Energy	69
CHAPTER 4	
Chinese Investments in Cambodia: Minding the Governance and Economic Gaps	83
CHAPTER 5	
Chinese Investment in Vietnam	105
CHAPTER 6	
Chinese Investment in Myanmar	132
CHAPTER 7	
The Outcome of China's Investment in Indonesia: Lessons from the Nickel Industry	144
CHAPTER 8	
Identifying Governance Gaps in Fintech: Country Examples and Indonesia Case Study	169
Conclusion	197

FORWARD & INTRODUCTION

Forward

CIPE works at the intersection of economic development, democracy and human rights, a unique position from which to address governance challenges posed by high-risk capital flows. In recent years, CIPE and its partners have witnessed an alarming trend: large amounts of capital invested by authoritarian regimes flowing through opaque channels into emerging markets. In these markets where governance is already weak and corruption is already rampant, high risk capital creates political and economic distortions which often do more harm than good in the recipient country. CIPE coined

the term corrosive capital to describe state-backed financing that lacks transparency and accountability flowing from authoritarian states into new and fragile democracies.

CIPE's approach to combatting the effects of corrosive capital centers on identifying specific governance gaps in countries where democratic processes are at risk. Then, working with local partners, we design and implement projects that help close these gaps, fostering collaboration and information sharing among civil society, the private sector, and lawmakers. Because the adverse governance impacts in countries that receive this capital are well-documented and the global flows of such capital are growing

exponentially, CIPE is currently expanding both its policy research and programming on corrosive capital.

This report is unique in a number of ways: (1) it presents invaluable local perspectives on how Chinese investments are being documented, perceived, and implemented in countries around the world; (2) it identifies governance gaps which permit capital inflows to exploit or exacerbate weakness in young democracies; and (3) it provides recommendations for local stakeholders to address these gaps and make the most of Chinese investments. This publication is a demonstration of CIPE's commitment to the principles of local ownership, inclusion, learning & innovation, and accountability which are essential for emerging economies to enjoy sustainable and inclusive growth.

The report represents a group effort by CIPE and its partners. The effort grew out of a long-running dialogue on Chinese investment in Southeast Asia. CIPE partners cited a lack of data and consistency in the existing literature on the governance effects of Chinese state-backed debt and investment in emerging Asian markets. This report aims to fill that information gap and illuminate the governance distortions engendered by corrosive capital.

The first step in this effort was a set of deep-dive country-specific assessments. CIPE

partnered with five think tanks and three independent researchers based in Southeast Asia to systematically study the issues. In addition, CIPE commissioned the Rhodium Group to collaborate with our partners in the development of a comprehensive dataset to track Chinese direct investments flowing into Southeast Asia.

It is CIPE's hope that this publication equips donors, implementers, policymakers, and advocates with information that makes their work more effective at managing the risks of corrosive capital. By mitigating the risks of corrosive capital, the targeted investments of CIPE's ongoing program can achieve a larger scale and aggregate impact on the resilience of markets and democracies in the face of capital flows from nondemocratic countries.



Andrew Wilson

**EXECUTIVE DIRECTOR
CENTER FOR INTERNATIONAL
PRIVATE ENTERPRISE**

Introduction

Chinese outward investments have increased substantially in recent years, especially after 2013's introduction of its Belt and Road Initiative (BRI). BRI is the most ambitious infrastructure investment effort in recent history. The effect of BRI in Southeast Asia has been a tremendous volume of capital rushing in over a very short period of time. Chinese capital (including foreign direct investment, aid, and commercial loans) offers many benefits. It contributes to economic growth, job opportunities, and better-connected infrastructure networks in local economies. However, a growing volume of evidence indicates that many forms of capital emanating from authoritarian nations have a corrosive effect on democratic institutions and private enterprise in recipient countries.

The genesis of this publication was a CIPE forum in December 2017 at which CIPE's Southeast Asian partners expressed the urgent need to fill the information gap of the impact of corrosive capital on governance distortions. Local researchers and analysts across the region have identified an absence of evidence in the existing body of work on Chinese investment projects and the impact on the local economies and communities. Additionally, researchers and scholars sought greater clarity on specific gaps in governance through which Chinese capital can flow.

This report analyzes the patterns, trends, and characteristics of Chinese investments in Southeast Asia. Against the backdrop of the rising flood of Chinese investment across the region, the report highlights common issues and shared governance risks across countries, and identifies questions requiring further study. The sizable economic interests and political intricacies of China and BRI make this research sensitive in some countries; as result, some information has been redacted from the final report.

Countering corrosive capital requires working closely with local partners in vulnerable countries. In each case, the specific governance gaps which place democratic institutions at risk must be identified. In cooperation with local partners, CIPE can then design and implement local projects to help close those gaps and reinforce democratic institutions by fostering collaboration and information sharing among civil society, the private sector, and lawmakers.

Objectives, Scope & Methodology of the Report

This report aims to answer an important policy question: How can Southeast Asian economies benefit from the Chinese investment while mitigating the associated risks? This report will provide authoritative

and up-to-date data on Chinese regional FDI and loans in chapter 1; the following seven chapters document different forms of Chinese capital flows and identify governance gaps in six countries. Chapter 2 presents the case of Malaysia which highlights issues of opaque procurement practices associated with Chinese mega projects, as well as the need to improve corporate governance of state-owned enterprises to avoid conflict of interest. In chapter 3, Chinese investments are involved in controversial price fixing in the Indonesian extractives industry. Chapter 4 demonstrates the development of evolved oversight mechanisms to screen infrastructure projects in Myanmar. In Chapter 5, Cambodia provides an illustration of what can happen in a small to mid-sized country that becomes overly dependent on Chinese investment. In Chapter 6, the authors raise environmental concerns in Vietnam. Chapter 7 discusses regulatory capture issues in the Philippines using the online gambling industry as an example. Looking into the fast-growing

Fintech industry, chapter 8 showcases risky investments and the data abuse problem in Indonesia. In all the case studies, authors examine the macro-level impact of Chinese investment, identify governance gaps, assess its initial impact. They then develop policy recommendations for key stakeholders such as businesses, governments, civil society organizations and international organizations to address these challenges and develop a streamlined, transparent, foreign investment monitoring and management process.

The scope of this report is primarily Foreign Direct Investment (FDI) from the People's Republic of China. During the research process, some authors discovered that domestic controversy centered primarily on Chinese commercial loans funding large infrastructure projects. The capital discussed in this report therefore encompasses all investments from China. Some authors focus on FDI while others place greater emphasis on other official financing such as aid and loans.

CHAPTER 1**CHINESE INVESTMENT IN SOUTHEAST ASIA: MAKING SENSE OF THE DATA**

THILO HANEMANN (RHODIUM GROUP), & STANLEY SEIDEN (CIPE CONSULTANT)

Introduction

China's outbound foreign direct investment (OFDI) and other capital flows have grown rapidly in the past decade, requiring recipient countries to assess the benefits and risks from these investments.

FDI is generally recognized as beneficial to local economies because it brings new jobs, tax revenue and knowledge spillovers from worker training, technology transfers and R&D activities. At the same time, there are several widely recognized potential negative impacts that foreign investment can have on local economies and communities. These include: national security risks tied to foreign

ownership of or proximity to sensitive assets; distortions to a host country's trade patterns and balance; decreases in competition and consumer welfare if mergers are anti-competitive; market distortions caused by subsidies and mercantilist behavior on the part of the source country; and corruption and corrosion of local institutions.

Researchers' understanding and analysis of these impacts are complicated by incomplete and widely diverging data on Chinese outbound investment. Official government statistics on global capital flows suffer from several shortcomings, which are further amplified in the case of China due to deficiencies in the Chinese statistical system,

capital controls that incentivize firms to not disclose their investments, and other factors. The data situation is particularly problematic for smaller developing countries with weak regulatory institutions and the lack of financial disclosure requirements.

The data situation for Chinese investment in Southeast Asia exemplifies these problems. We know that Chinese companies have rapidly expanded their footprint in Southeast Asian economies since the early 2000s, and anecdotal evidence and data suggest that investments specifically targeted infrastructure, real estate, and basic materials. However, official datasets remain incomplete; they are often inconsistent with each other; they conflict with on-the-ground evidence; and the quality of national data across the region varies starkly. It is therefore important for researchers to consider and critically evaluate existing official datasets and augment official statistics with alternative “bottom-up” datasets that are based on identifying and aggregating individual investment transactions.

The individual contributions to this volume follow this general approach: they combine official data with alternative datasets and case studies. This chapter provides an overview of Chinese capital inflows including

FDI, aid, and loans in Southeast Asia based on the available datasets. The first section defines foreign direct investment and describes the challenges for measuring FDI in general and outbound FDI from China in particular. Section 2 then summarizes official data as well as transactions-based data for Chinese FDI in six Southeast Asian nations: Cambodia, Indonesia, Malaysia, Myanmar, the Philippines, and Vietnam. Section 3 describes Chinese development loans and foreign aid in Southeast Asia.

Cataloguing Chinese Outbound Capital Flows

In national accounting statistics, cross-border investment flows are commonly separated into five categories: direct investment, portfolio investment, derivatives, other investment, and reserves (Table 1, PG. 8-9).¹

All these channels have become important for Chinese activity in Southeast Asia and have been taken into account by the researchers working on this volume. This chapter will address the first two channels presented above: direct investment and other investment. Foreign direct investment contributes the largest volume of flows compared to the other four channels of

1 See the IMF’s Balance of Payments and International Investment Position Manual (IMF 2007); the IMF definitions also are used by other international organizations such as the OECD and UNCTAD.

Chinese outbound flows. FDI also involves foreign investors directly taking ownership of local assets and thus exerting influence over the operations of companies in the local economy. Finally, FDI relationships are usually “sticky”, which means that investors take a long-term interest in the local

economy, as opposed to just short-term capital flows for speculative gains. Other investment, analyzed in section three of this chapter, includes Chinese development loans and aid, one of the fastest-growing types of Chinese capital flows to the region.

TABLE 1: Typology of Cross-Border Capital Flows

DEFINITION	EXAMPLE
<p>Direct investment entails cross-border capital flows from a resident entity that achieve significant influence over the management of an invested entity and a long-term investment relationship in another economy.² The common threshold for a direct investment is 10% of voting shares. In addition to capital contribution, direct investors usually provide expertise, innovation, technology, management and marketing, which may benefit the target entity or economy. Within this report, direct investment will usually be referred to as “foreign direct investment,” FDI.</p>	<ul style="list-style-type: none"> Guangzhou Yuetai Group acquires real estate assets in Cambodia China Steel Corporation builds a factory in Indonesia A Chinese national sets up a company in Malaysia
<p>Other investment entails all flows that do not fall under the previous categories, such as foreign bank deposits, currency holdings, cross border loans, insurance, pension or trade credits. Under standard national accounting frameworks, “other investment” is a category used to contain all investments that do not conform to the other four categories of cross-border capital flows. “Other investment” takes on greater significance, however, in the context of Chinese flows to Southeast Asia, where development loans from state-owned enterprises or state-affiliated entities contribute large shares of total cross-border flows.</p>	<ul style="list-style-type: none"> The Export-Import Bank of China provides a loan for the second Penang bridge project in Malaysia

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2 See the IMF’s Balance of Payments and International Investment Position Manual (IMF 2007)

Chinese FDI in Southeast Asia

CHALLENGES WITH FDI DATA

A range of different measures and sources are available for tracking global FDI flows. Most countries compile balance of payments

(BOP) statistics that include information on annual inflows and outflows for each type of cross-border investment and related income flows. The corresponding numbers for the inward and outward stock of each category, which is the accumulated flows adjusted for exchange rate and valuation changes,

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DEFINITION	EXAMPLE
Portfolio investment entails a typically shorter-term investment in liquid securities which constitutes no control or ownership, for example, holdings of equity shares with less than 10% of voting rights, or corporate debt instruments. Portfolio investment involves debt or equity securities, other than those included in direct investment or reserve assets. A company's residual value is acknowledged through equity securities. Debt securities are a negotiable instrument for the evidence of debt, and they include bills, bonds, certificates of deposit, or preferred stock.	<ul style="list-style-type: none"> Chinese bank purchases shares in Singapore-listed companies Shanghai-based VC firm Gobi Ventures provides VC financing to Malaysian startup Carsome
Derivatives refer to financial instruments such as swaps, futures, and options, which are only contractually related to the underlying value of real assets such as firms or commodities. The specific financial risks including interest rate risk, foreign exchange risk, equity and commodity price risk, credit risks can be traded in financial markets separately.	<ul style="list-style-type: none"> Chinese bank purchases currency hedging contracts in Singapore
Reserve assets refer to reserves held by governments in the form of gold, foreign exchange, or special drawing rights at the IMF. Reserves are external assets which are readily available to monetary authorities to manage and control balance of payments, or to intervene in currency exchange rate, and other purposes.	<ul style="list-style-type: none"> PBOC purchasing government bonds issued by Indonesian government

SOURCE: Author's Compilation

are recorded in countries' international investment position (IIP) statistics. The IMF uses these figures reported by its member states to compile global financial statistics. In addition to such national accounting statistics that capture aggregate flows with the rest of the world based on IMF standard definitions, many countries publish additional datasets that provide a more disaggregated view of their investment relationship with other economies. Several international organizations, such as the United Nations Conference on Trade and Development (UNCTAD) or the Organization for Economic Cooperation and Development (OECD), also collect data on FDI and other cross border investment flows.

Problems with the validity and accuracy of official FDI statistics have been the subject of broad academic debate. One of the most important problems is that the collection and calculation of FDI statistics rely on the efforts of national statistical agencies, which have very different capabilities and resources. Several specific problems have increased the challenges in collecting FDI data in recent years: First, the use of holding companies and offshore vehicles has increased tremendously in recent years, and the extent of "round-tripping" (where companies route funds to themselves through countries or regions with generous tax policies and other incentives) and "trans-shipping" (where

companies channel funds into a country to take advantage of favorable tax policies only to re-invest it to a third country) flows is hard to identify. Official statistics often only record direct flows, which can lead to gross under- or over-measurement of a country's foreign investment volume. Second, FDI data by definition should be recorded in market value, but because of the difficulty of obtaining such data on all assets, official data is often recorded in book or historical value, leading to measurement errors. Third, FDI by definition covers all investments with a 10% or higher share in voting rights, but it is often difficult to determine this threshold due to "indirect" holdings.

The result is that international FDI statistics are usually published with a delay of 1.5 years or more; that data from home and host countries are inconsistent with each other; and that there are systemic distortions due to the existence of tax havens. This makes a holistic real-time assessment of global FDI flows virtually impossible and requires analysts to find ways of working around existing gaps and distortions.

SPECIFIC ISSUES WITH ANALYZING CHINESE OUTBOUND FDI

The task of getting reliable data on FDI flows to and from emerging economies is further complicated by lack of resources and

experience in collecting such statistics. Many emerging-economy statistical offices do not have the necessary personnel or adequate training for collecting detailed and accurate data on FDI flows and the operations of transnational enterprises. Moreover, in emerging economies firms have an even greater incentive to use offshore holding companies due to the lack of an adequate financial and legal environment at home and existing capital controls. The case of Chinese FDI statistics illustrates some of these issues.

In China, FDI statistics are compiled by two agencies. The State Administration of Foreign Exchange (SAFE), the foreign exchange regulator of the People's Bank of China (PBOC), is responsible for collecting and publishing FDI data for China's Balance of Payments and International Investment Position. These statistics only provide aggregate numbers for outward FDI, and do not contain any detailed breakdowns by country or industry. Such details are available through the Ministry of Commerce (MOFCOM). MOFCOM collects FDI data following relevant Chinese procedures, and publishes results in annual statistical bulletin releases, which provide FDI flows and stocks in current cost terms, including breakdowns by industry and geographic distribution.

The first difficulty lies in understanding the respective roles of the two agencies and reconciling differences between MOFCOM

and SAFE data. The roles of MOFCOM and SAFE vary for inward FDI and outward FDI data compilations. For inward FDI, MOFCOM is responsible for collecting non-financial-companies inward FDI data through its mandatory approval and registration system and SAFE is responsible for collecting financial-companies inward FDI through its Foreign Asset Liabilities and Revenues & Losses reporting system. For outward FDI, data primarily comes from MOFCOM's non-financial-companies outward FDI reporting system, which is supplemented with financial company data and disinvestment data from SAFE. Despite improvements in collaboration between MOFCOM and SAFE, the dual-agency system continues to complicate FDI data and metadata transparency and reliability. The two agencies separately publish quarterly and annual data on their respective parts, and sometimes on estimated overall FDI data. Generally, MOFCOM and SAFE FDI stock data sync up with a nine-month delay in an annual OFDI statistics bulletin report, but discrepancies persist in FDI flows data. The discrepancies and time-lapse issue make official Chinese data confusing to use for foreign policy makers who are unfamiliar with the Chinese system and revision schedule.

A second problem with Chinese FDI statistics is that existing capital controls and burdensome regulatory requirements incentivize firms to mis-report capital

outflows. The Ministry of Commerce and SAFE collect data based on information submitted by firms in mandatory collection processes. Even though information submission is in theory “mandatory,” accurate reporting wholly depends on compliance of individual companies and those firms have incentives to under-report or not report because of China’s strict capital control and outward foreign investment review system.

Lastly, the lack of a sufficient legal and financial system at home also complicates data collection on Chinese outward FDI, as firms almost always rely on offshore entities to structure their overseas investment. The extensive use of special purpose entities in offshore financial centers does impact the aggregate number of OFDI (through round-tripping), but most importantly distorts data on the geographic distribution of Chinese OFDI and the targeted industries. According to MOFCOM data, more than 75% of China’s 2017 outbound FDI stock was registered in either Hong Kong or tax havens such as the Cayman Islands or Bermuda.

AVAILABLE DATASETS

Data on Chinese FDI in Southeast Asia are available from government agencies in China and Southeast Asian countries, regional organizations and private data providers. This

section provides an overview of available official datasets from the ASEAN Secretariat and the Chinese Ministry of Commerce, to showcase the similarities and differences between the official datasets.

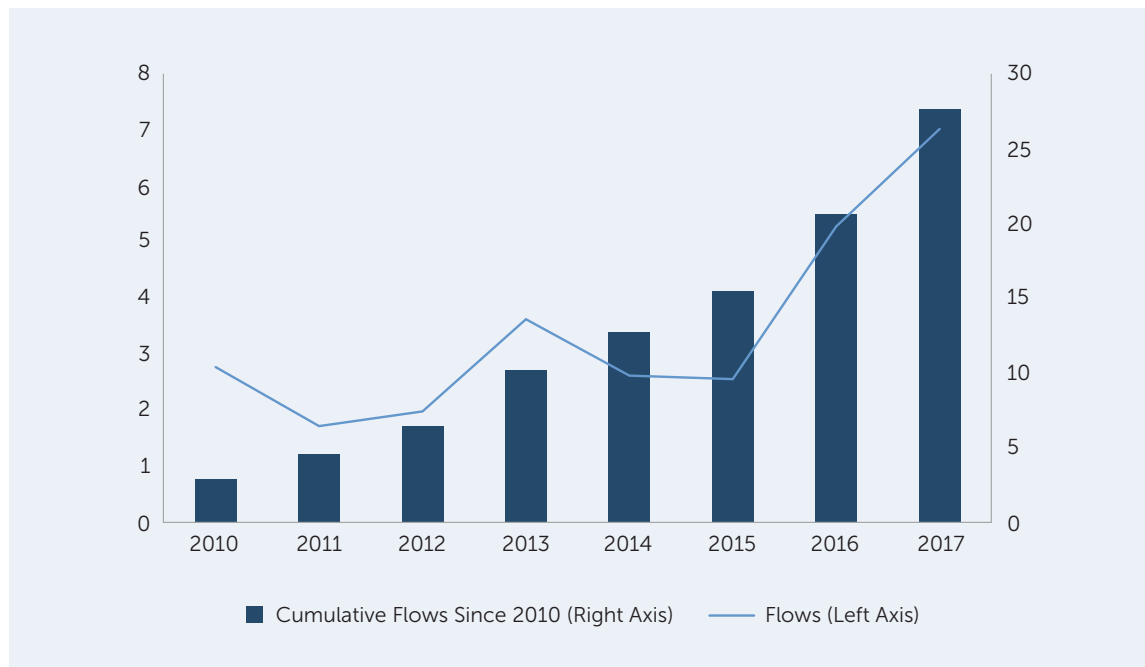
ASEAN statistics

The statistics division (ASEANstat) of the ASEAN Secretariat provides macroeconomic data, flows of foreign direct investment, and other indicators in a compiled portal. The system collects national statistics, which are compiled based on principles of the System of National Accounts.

According to ASEANstat data, there has been an increase of Chinese investment from 2010 to 2017 into the eight Southeast Asian countries covered in this study. Annual investment flows grew from \$2.8 billion in 2010 to \$3.7 billion in 2012, slightly dipping to below \$2.6 billion in 2014-2015, before climbing back up to over \$7 billion per year in 2017 (Figure 1, PG. 13). In total, ASEAN official data show a total of \$28 billion cumulative Chinese FDI flows in the eight Southeast Asian countries from 2010 to 2017.

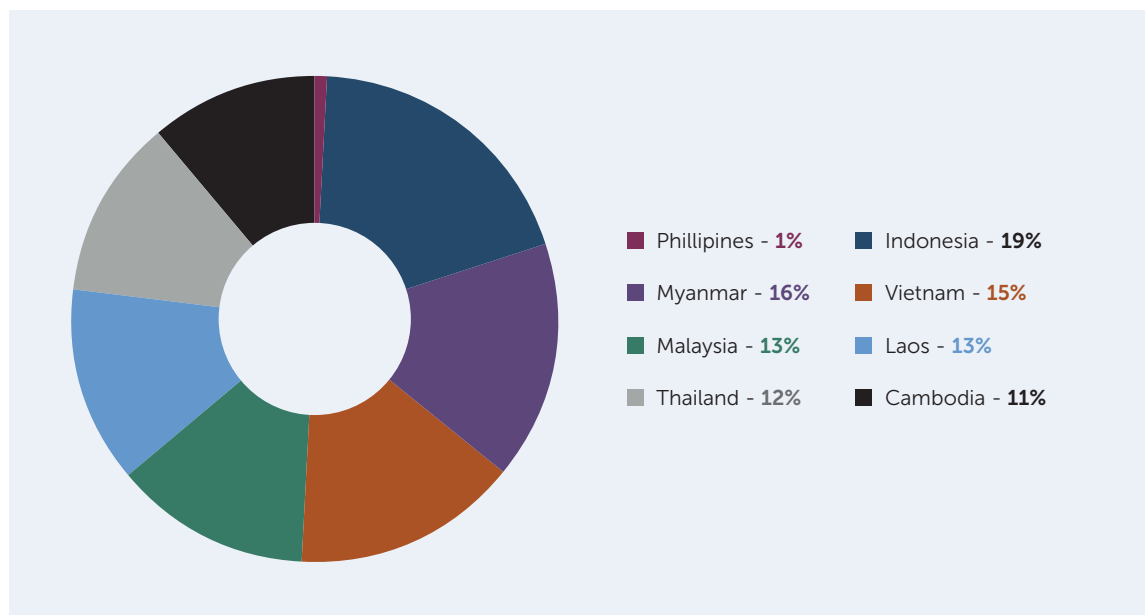
Figure 2 (PG. 13) and 3 (PG. 14-15) show a further breakdown of annual Chinese investment flows by country: Indonesia was the largest recipient among the eight countries from 2010-2017 (\$5.2 billion), followed by Myanmar (\$4.3 billion), Vietnam (\$4 billion), and Malaysia (\$3.7 billion).

FIGURE 1: ASEAN Statistics: Annual Flows and Cumulative Flows of Chinese Investment in Southeast Asia*, 2010-2017 (USD Billion)



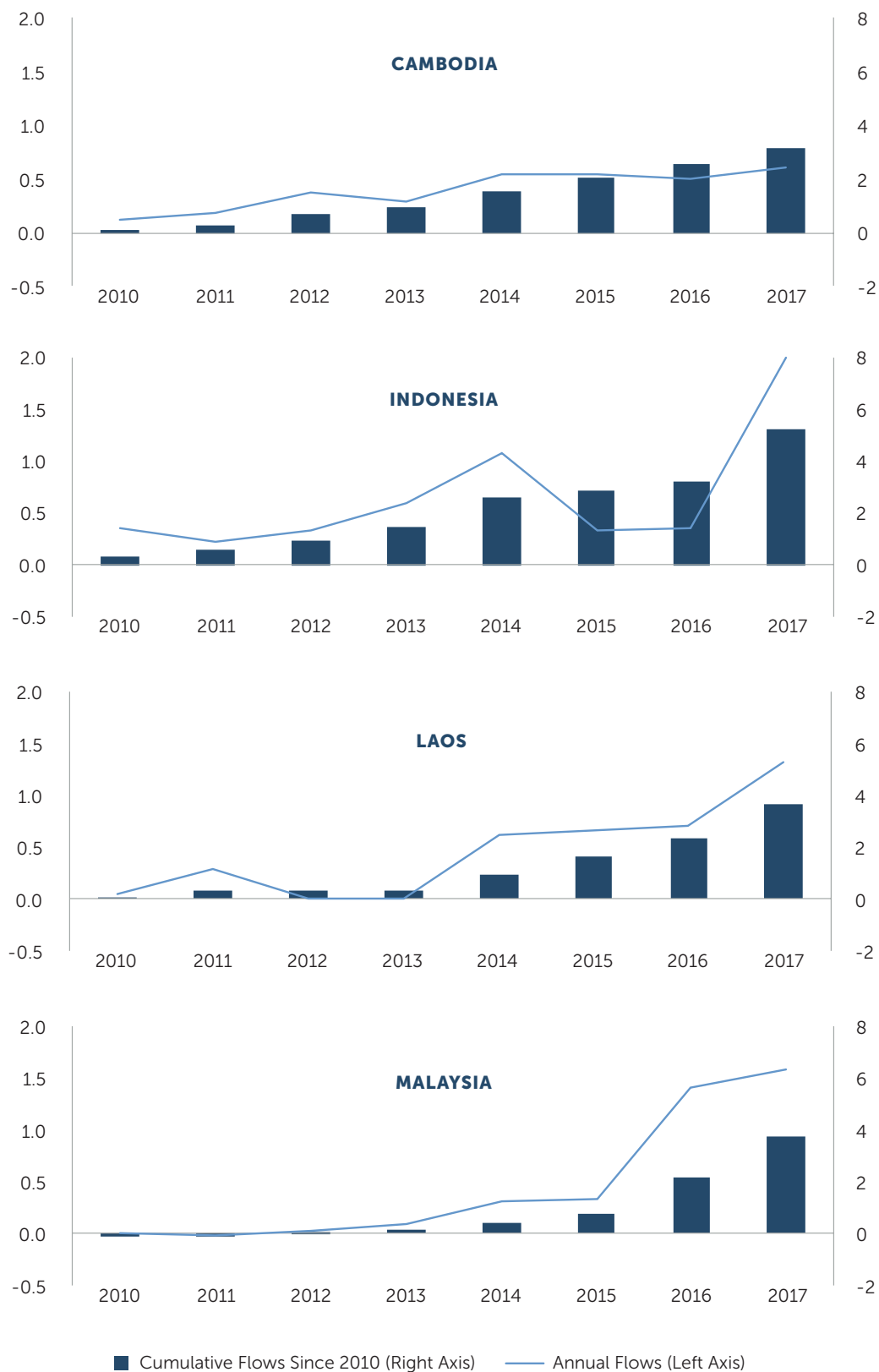
SOURCE: ASEANstat. *Data include the eight countries covered in this study: Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Thailand, and Vietnam

FIGURE 2: ASEAN Statistics: Chinese Investment in Southeast Asia by Country*, Cumulative Flows 2010-2017 (Percent)



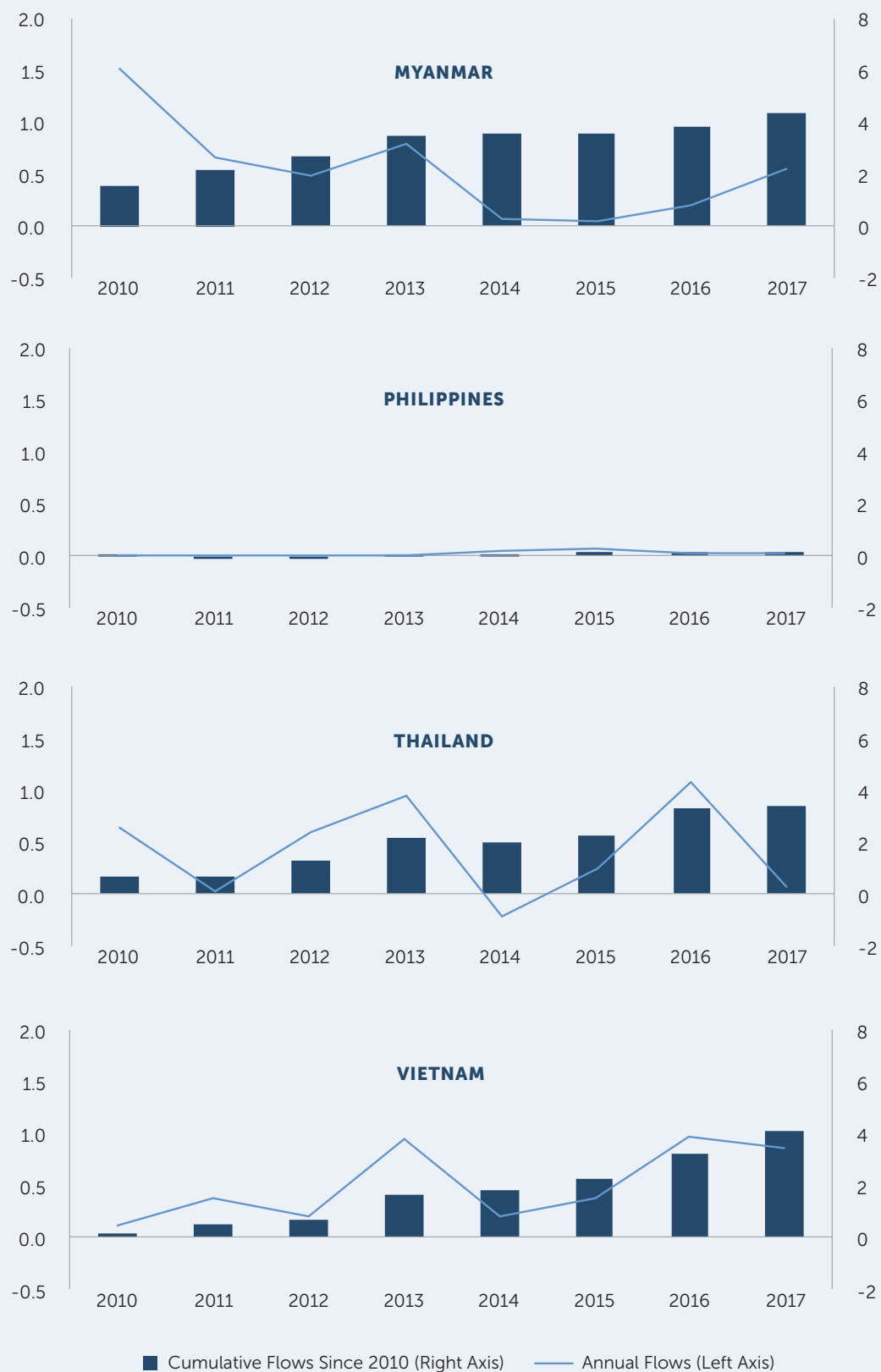
SOURCE: ASEANstat. *Data includes the eight countries covered in this study: Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Thailand & Vietnam

FIGURE 3: ASEAN Statistics: Annual Flows and Cumulative Flows of Chinese Investment in Southeast Asia by Country*, 2010-2017 (USD Billion)



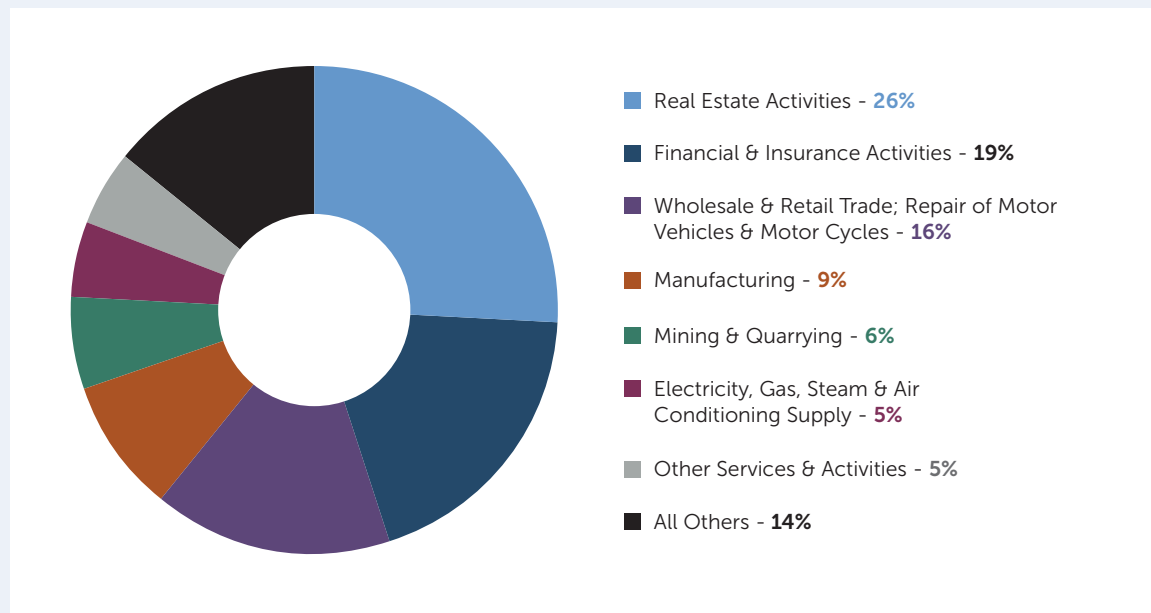
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SOURCE: ASEANstat. *Data include the eight countries covered in this study: Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Thailand, and Vietnam.

FIGURE 4: ASEAN Statistics: Chinese Investment in All ASEAN Countries by Industry*, Cumulative Flows 2012-2017 (Percent)



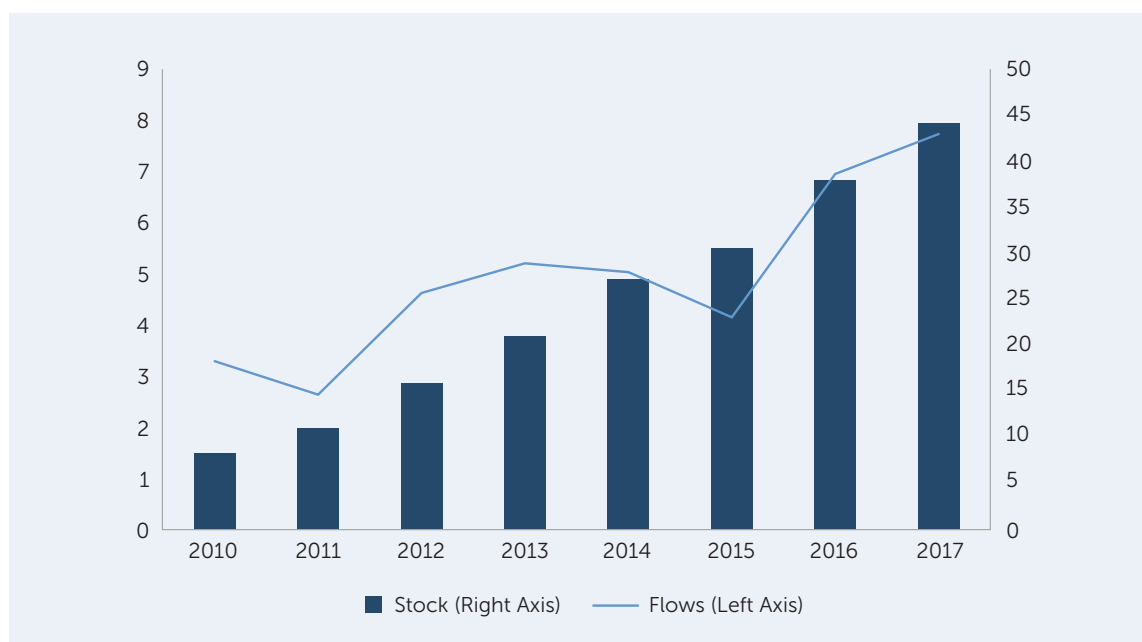
SOURCE: ASEANstat. *Data include all ASEAN countries: Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Vietnam, Philippines, Singapore, and Thailand.

ASEAN official data show that Chinese investments in all ASEAN countries target a variety of industries (Figure 4, PG. 16). From 2012-2017, real estate was the top recipient sector for Chinese investment (26% of total), followed by financial and insurance activities (19%) and wholesale and retail trade; repair of motor vehicles and motorcycles (16%).

Chinese Statistics

The Chinese Ministry of Commerce is the primary agency governing trade and FDI relationships and maintains datasets on monthly and annual FDI flows to and from China. MOFCOM collects more detailed

indicators including industries, and target countries, and publishes data on non-financial FDI on a monthly basis, based on administrative approval and registration records from China's record system, as well as periodic company surveys. Non-financial FDI refers to direct investment by companies other than banking, securities, insurance, and other financial institutions. These monthly data records are then combined with data on financial FDI collected by SAFE and published in the form of an annual statistical bulletin on outward FDI, which is the Statistical Bulletin of China's Outward Direct Investment. (MOFCOM, 2017)

FIGURE 5: MOFCOM Statistics: Flows and Stock of Chinese Investment in Southeast Asia*, 2010-2017 (USD Billion)

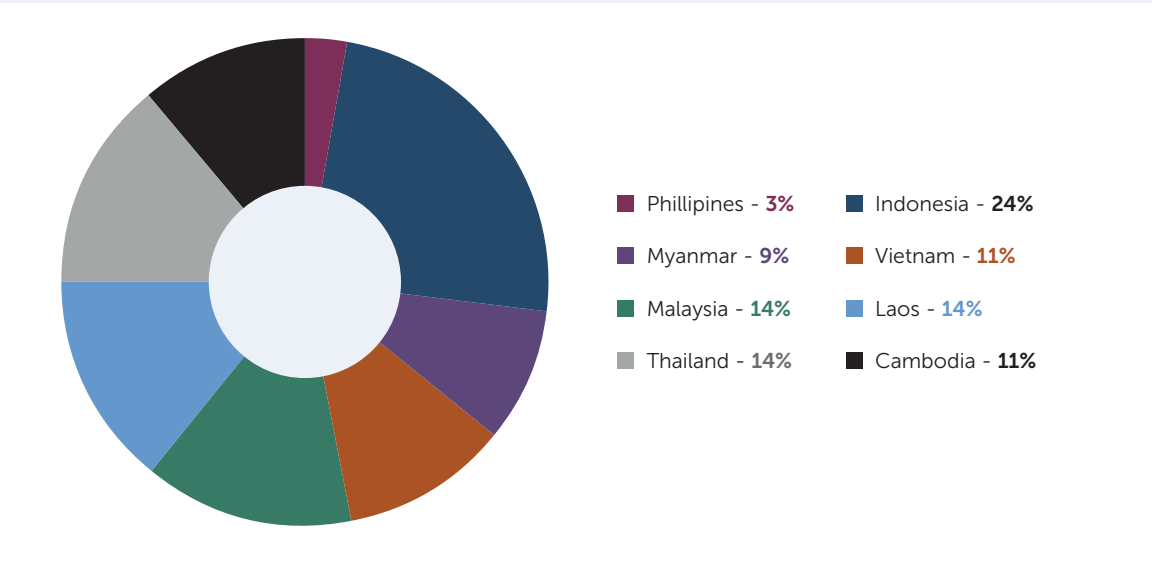
SOURCE: Ministry of Commerce (MOFCOM). *Data include the eight countries covered in this study: Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Thailand, and Vietnam.

MOFCOM statistics show a similar growth trend for Chinese investment in the eight Southeast Asian countries covered in this study, but slightly higher levels of annual investment flows (Figure 5, PG. 17). According to MOFCOM statistics, annual Chinese direct investment flows in the eight Southeast Asian countries grew from \$3.3 billion in 2008 to over \$5 billion in 2013, and jumped up to an average of \$7.3 billion in 2016-2017 (compared to \$6.1 billion in 2016-2017 in the ASEAN statistics). In 2017, the stock of Chinese investment in the eight countries was \$44 billion (compared to \$28 billion in the ASEAN official statistics).

Similar to the ASEAN statistics, MOFCOM data also show that Indonesia is the biggest recipient for Chinese direct investment among the eight countries (Figure 6, PG. 18 and 7, PG. 18-20). In total, Indonesia received \$9.6 billion cumulative Chinese investment from 2010-2017, followed by Malaysia and Thailand.

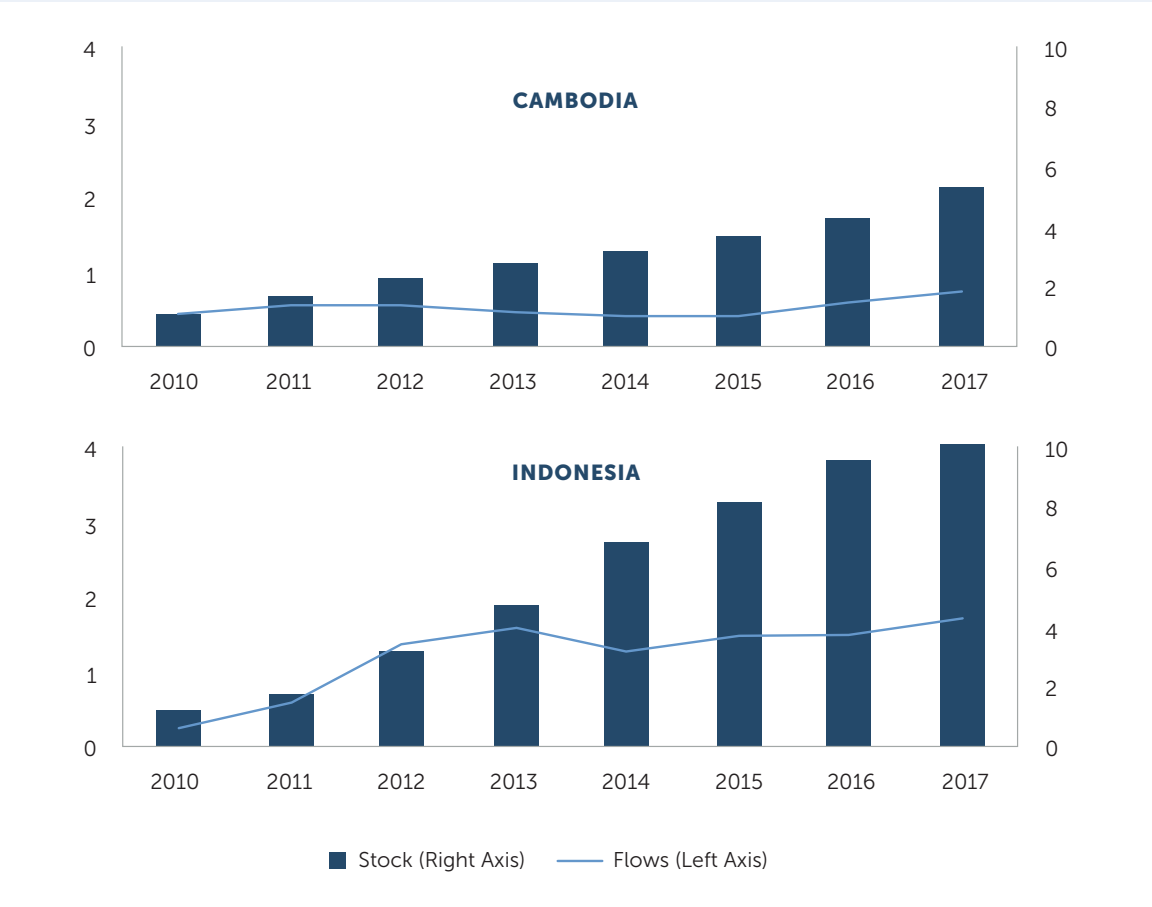
MOFCOM statistics present a quite different breakdown of target industries for Chinese investment in all ASEAN countries (Figure 8, PG. 20). From 2010-2017, the biggest recipient sector for Chinese investment was manufacturing (compared to real estate in

FIGURE 6: MOFCOM Statistics, Chinese Investment in Southeast Asia by Country*, Cumulative Flows 2010-2017 (Percent)



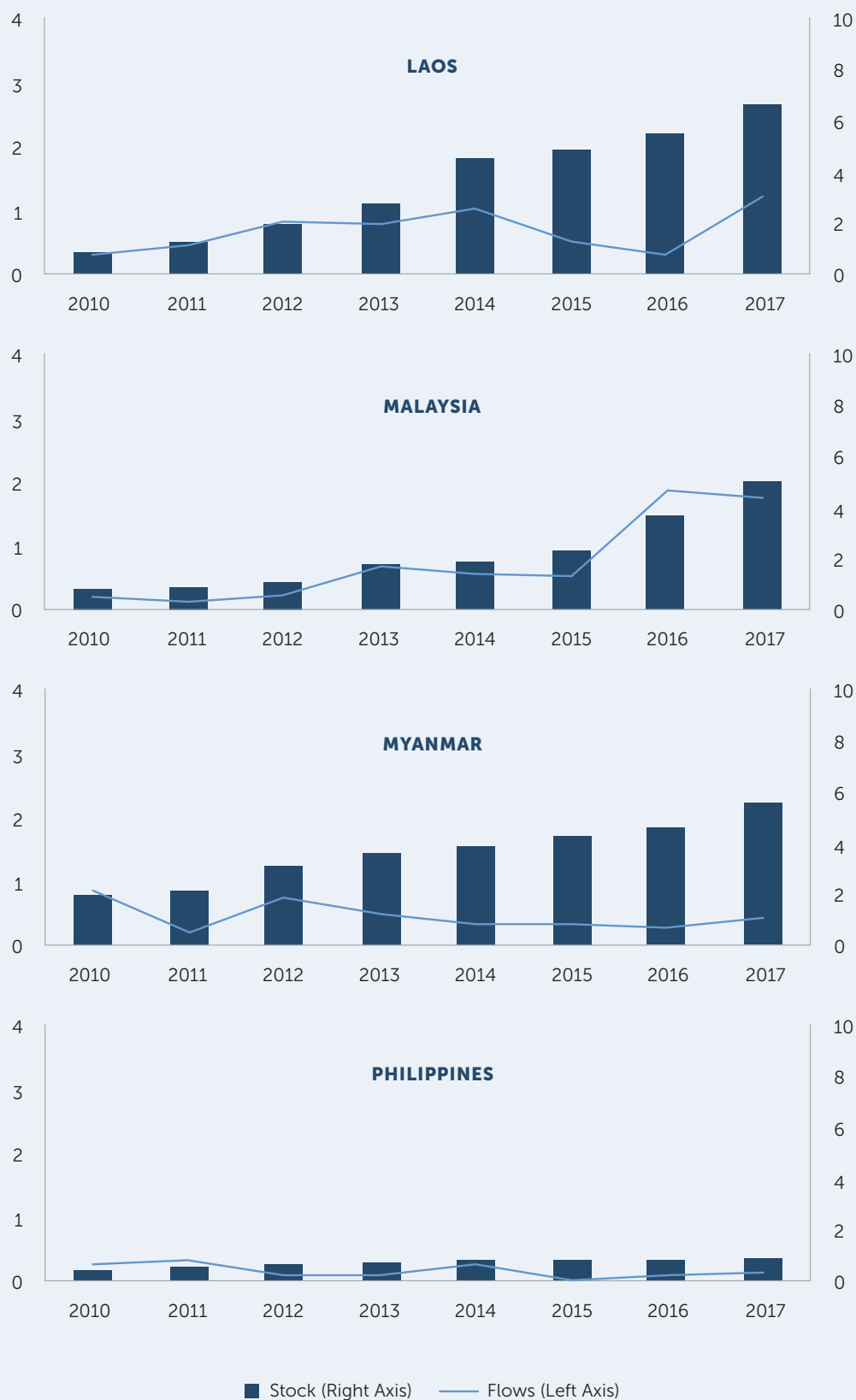
SOURCE: Ministry of Commerce (MOFCOM) *Data include the eight countries covered in this study: Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Thailand, and Vietnam.

FIGURE 7: MOFCOM Statistics: Flows and Stock of Chinese investment in Southeast Asia by Country*, 2010-2017 (USD Billion)



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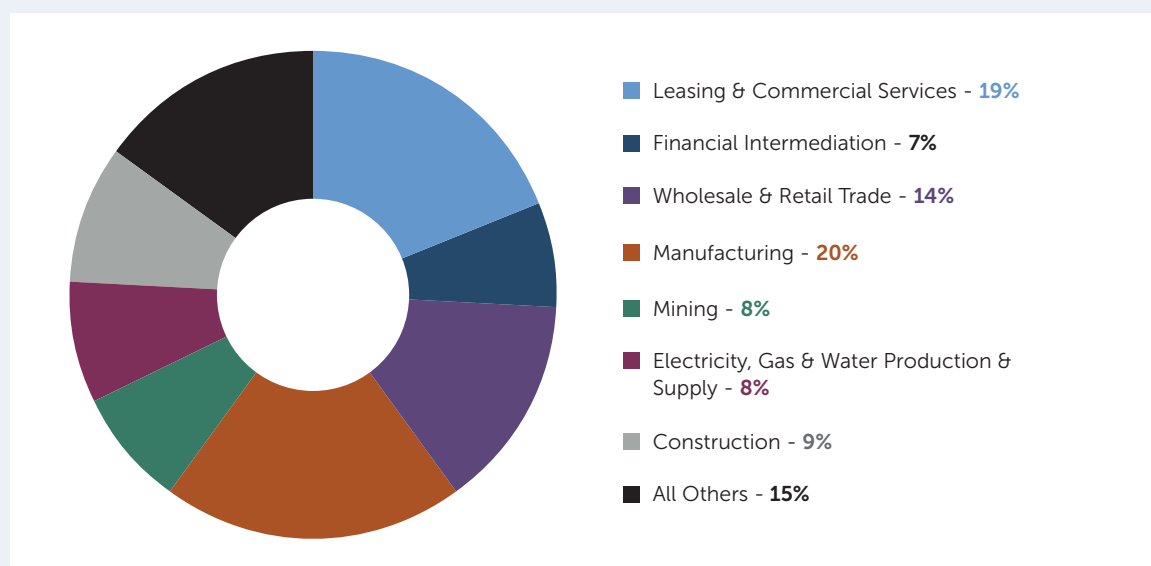
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SOURCE: Ministry of Commerce (MOFCOM) *Data include the eight countries covered in this study: Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Thailand, and Vietnam.

FIGURE 8: MOFCOM Statistic, Chinese Investments in All ASEAN Countries by Industry*, Cumulative Flows 2010-2017 (Percent)



SOURCE: Ministry of Commerce (MOFCOM) *Data include all ASEAN countries: Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Vietnam, Philippines, Singapore, and Thailand.

the ASEAN official statistics). This is followed by leasing and commercial services and wholesale and retail (similar to in the ASEAN official statistics). Real estate activities, the largest recipient sector in ASEANstat data, has a small presence in the MOFCOM breakdown.

Transactions Data

The previous section has shown that the scope, timelines, and quality of official data can vary substantially. Official data from both the Chinese side and the recipient country are not sufficient for an in-depth, real-time analysis of Chinese investment patterns. This is particularly true for policy research, which requires timely information to be supplied to decision makers.

Researchers have therefore come up with alternative approaches to assess the scope and direction of Chinese overseas investment. One approach that researchers rely on is widely available data on mergers and acquisitions (M&A) to assess trends in Chinese overseas investment. In recent years, several think tanks, academic institutions and private sector firms have compiled databases with more comprehensive coverage based on a bottom-up approach of collecting data on individual transactions: the Heritage Foundation's China Global Investment Tracker tracks China's global

non-bond investments more than \$100 million; Rhodium Group (RHG) maintains various datasets that capture Chinese FDI transactions in various economies based on media reports, professional deal databases and regulatory filings; several professional service providers offer insights on Chinese outbound M&A patterns specifically.³

Such alternative datasets are not comparable to those compiled using the traditional balance of payments method, but they do avoid some of the existing problems – namely issues with time lags and pass-through locations – and permit a real-time assessment of investment trends.

The following section is based on a transactions database on Chinese FDI transactions in Southeast Asia compiled by Rhodium Group. The dataset is compiled from collecting and aggregating data based on individual transactions, including acquisitions, greenfield projects, and expansions. The dataset provides an aggregated headline figure for each country as well as various metrics of interest such as industry and investor type breakdowns.⁴

Annual Flows and Stock

The Rhodium Group data sample includes a total of 313 transactions by PRC-based

3 For example, see the Heritage Foundation's China Global Investment Tracker at <http://www.aei.org/china-global-investment-tracker/>, and Rhodium Group's US-China Investment Hub at <https://www.us-china-investment.org/>

4 For a full explanation of methodology, please see <https://rhg.com/research/china-investment-monitor-methodology-update/>

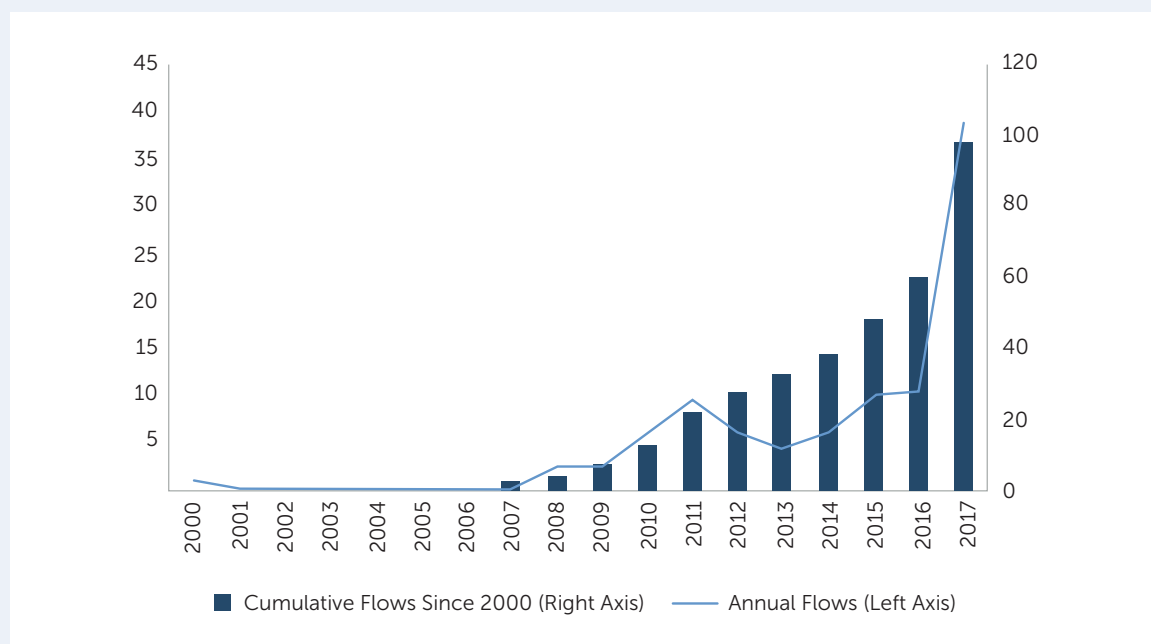
companies in the eight Southeast Asian nations covered in this study between 2000 and 2017. Together these transactions are worth \$98 billion.

This transactions dataset shows a similar increase of Chinese FDI in Southeast Asia as official data, but at higher investment levels: annual investment grew from less than \$2 billion before 2008, to more than \$6 billion in 2010 and more than \$10 billion in 2015. In 2017 annual investment jumped to nearly \$40 billion (compared to less than \$10 billion in official statistics in 2017).

The higher investment levels are partially a function of the recording methodology of the dataset, which includes the full

announced value of greenfield projects at project commencement date. Recording the full value of these projects (rather than incrementally along with the progress of construction) contributes to a more volatile trend and higher value that compared to official statistics. The jump in the recent years can be mostly attributed to several announced multi-billion-dollar real estate projects in Malaysia and Indonesia. For example, the jump in the 2017 flows figure is due to one mega deal (Country Garden's Forest City project in Malaysia for over \$33 billion). While the total value for this project is over \$30 billion, this is spread over 20 years of construction. If we were to record the actual amount invested in the project

FIGURE 9: Transactions Data, Annual Chinese FDI Transactions and Cumulative Flows in Southeast Asia, 2000-2017 (Completed Acquisitions and Announced Greenfield Projects; USD Billion)



SOURCE: Rhodium Group

in 2017, we would most likely see a decline in total Chinese investment in Southeast Asia from 2016 to 2017, which is in line with global trends (Figure 9, PG. 22).

Entry Mode

Out of the \$98 billion FDI transactions from Chinese investors 2000-2017, the majority was attributable to greenfield investment projects (\$83 billion). There was only a limited number of greenfield projects before 2010, when annual project values remained at less than \$2 billion, and Chinese FDI entered the region mostly through M&A. Since 2010, greenfield projects have become the main channel of Chinese FDI, and the annual value of greenfield investment reached over \$8 billion in 2011. Annual greenfield investment

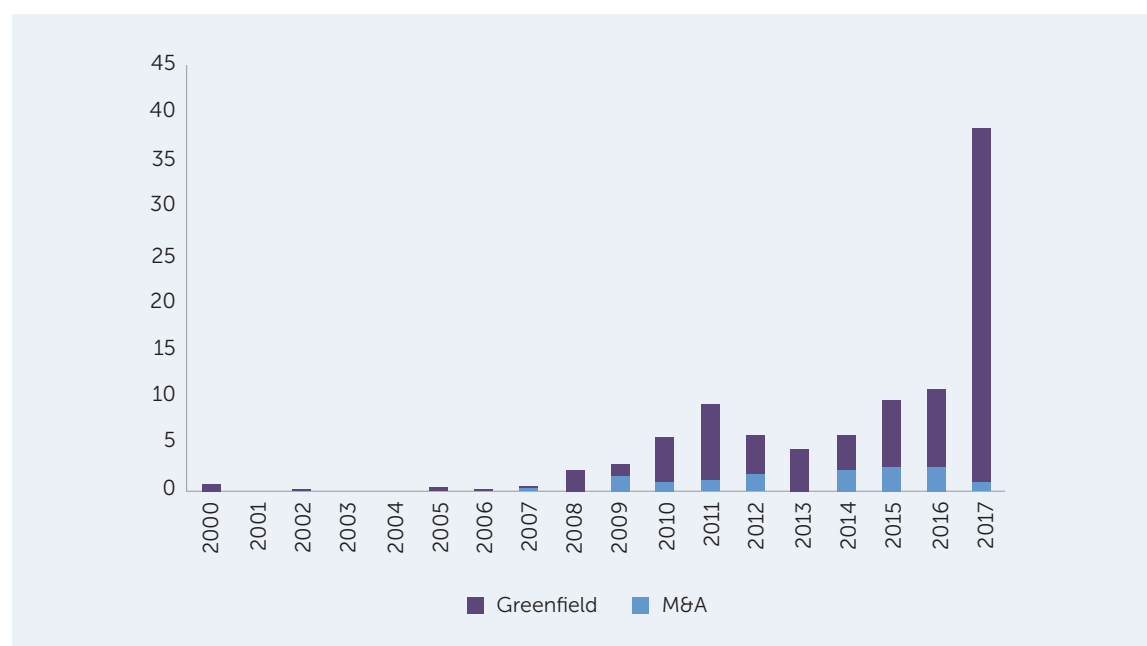
values dropped between 2012-2014 but grew again since 2015. Greenfield investment value skyrocketed in 2017, but mostly because of a singular large greenfield project (Country Garden's Forest City project, which will take multiple years to complete and might not happen at the initially announced scope). The annual value of M&A deals fluctuated between \$1 billion and \$3 billion between 2010-2017 (Figure 10, PG. 23).

Geographic Distribution

Transactions data mirror official data in that there is a huge gap between the largest and smallest recipients of Chinese investment.

Malaysia was the largest recipient of Chinese investment (\$48 billion), followed by Indonesia (\$20 billion) and Thailand (\$8

FIGURE 10: Transactions Data, Annual Chinese FDI Transactions in Southeast Asia by Entry Mode, 2000-2017 (Completed Acquisitions and Announced Greenfield Projects; USD Billion)



SOURCE: Rhodium Group

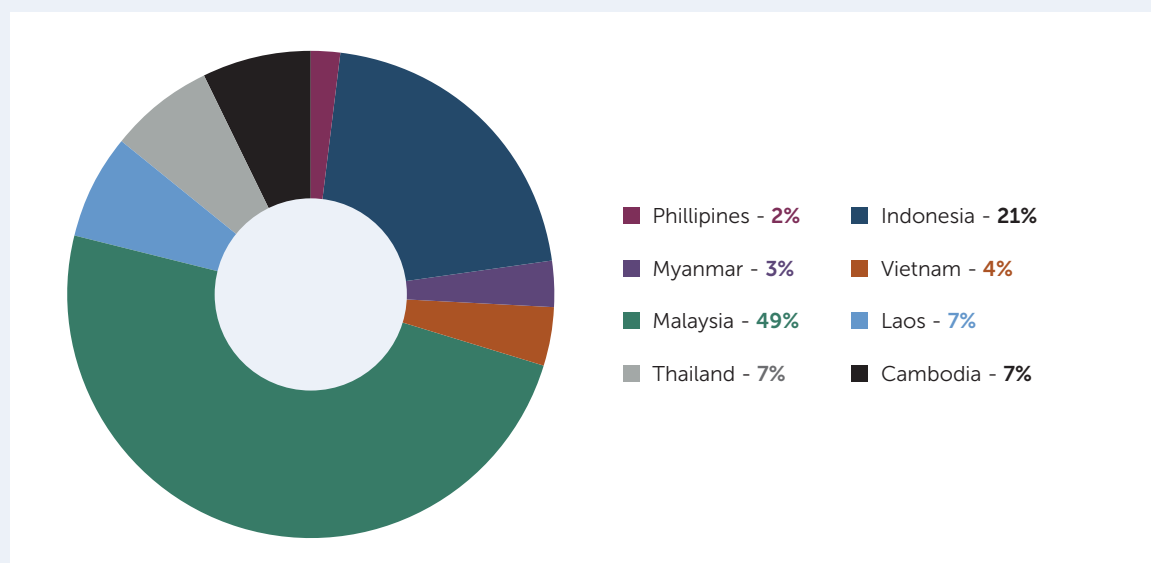
billion). The top three recipients took up more than 75% of the total Chinese FDI in Southeast Asia. At the low end, Vietnam, Myanmar and the Philippines respectively received \$4 billion, \$3 billion and \$2 billion of Chinese FDI.

Among the top recipients, greenfield project investment was the driving force. Greenfield

projects counted for more than 70% of Chinese FDI in both Malaysia and Indonesia.

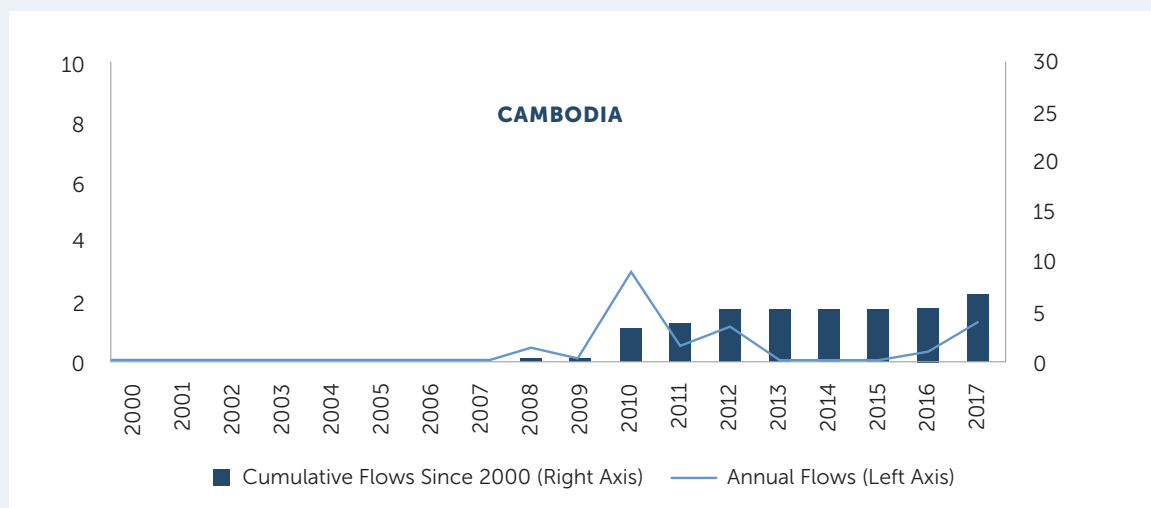
Compared to official data, transactions data show a relatively bigger role for Malaysia and Indonesia. This is due to large greenfield real estate developments in those countries (Figure 11, PG. 24 and 12, PG. 24-27).

FIGURE 11: Transactions Data, Chinese FDI Transactions in Southeast Asia by Country, 2000-2017 (Percent)



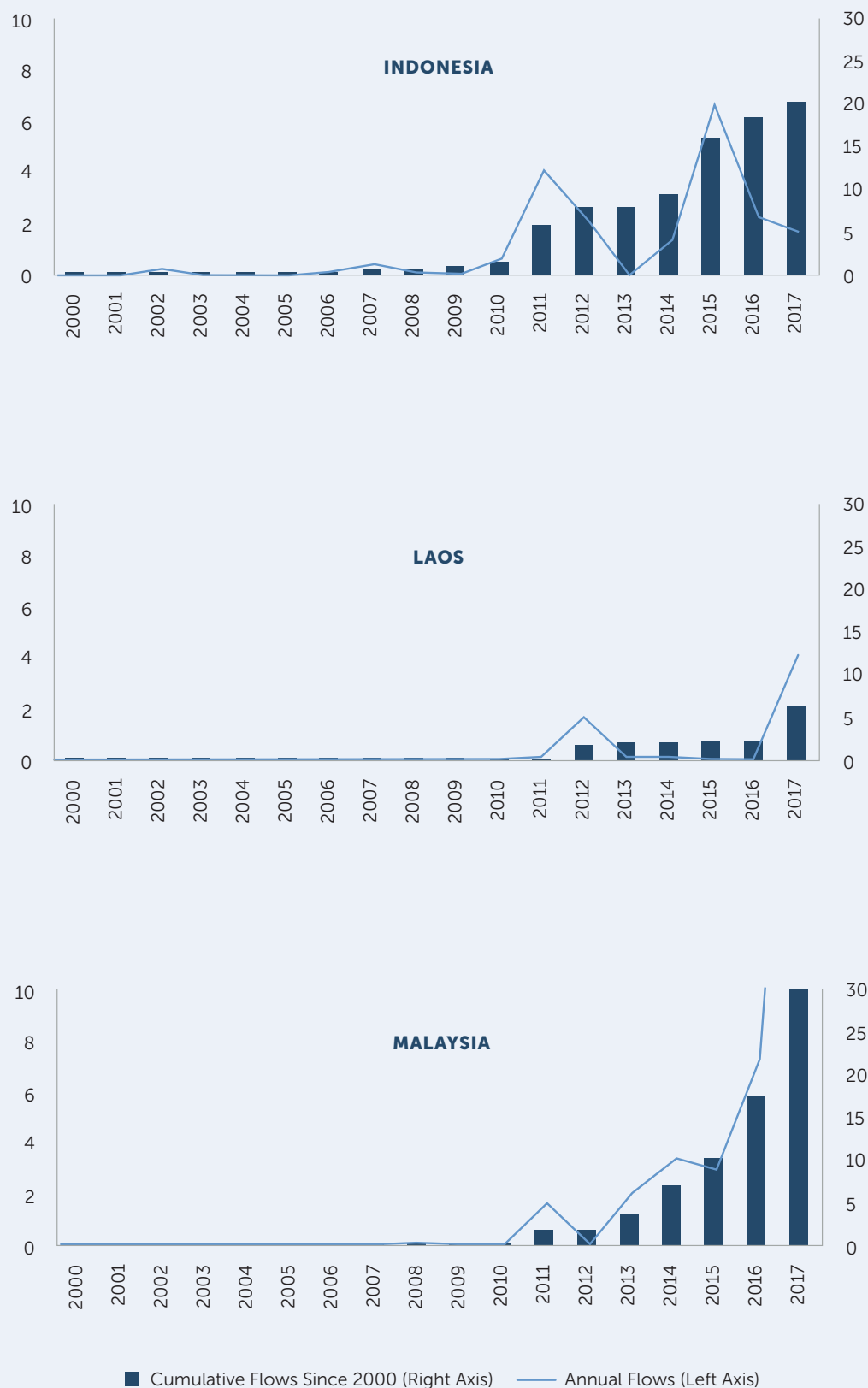
SOURCE: Rhodium Group

FIGURE 12: Transactions Data, Annual Chinese FDI Transactions and Cumulative Flows in Southeast Asia by Country, 2000-2017 (USD Billion)



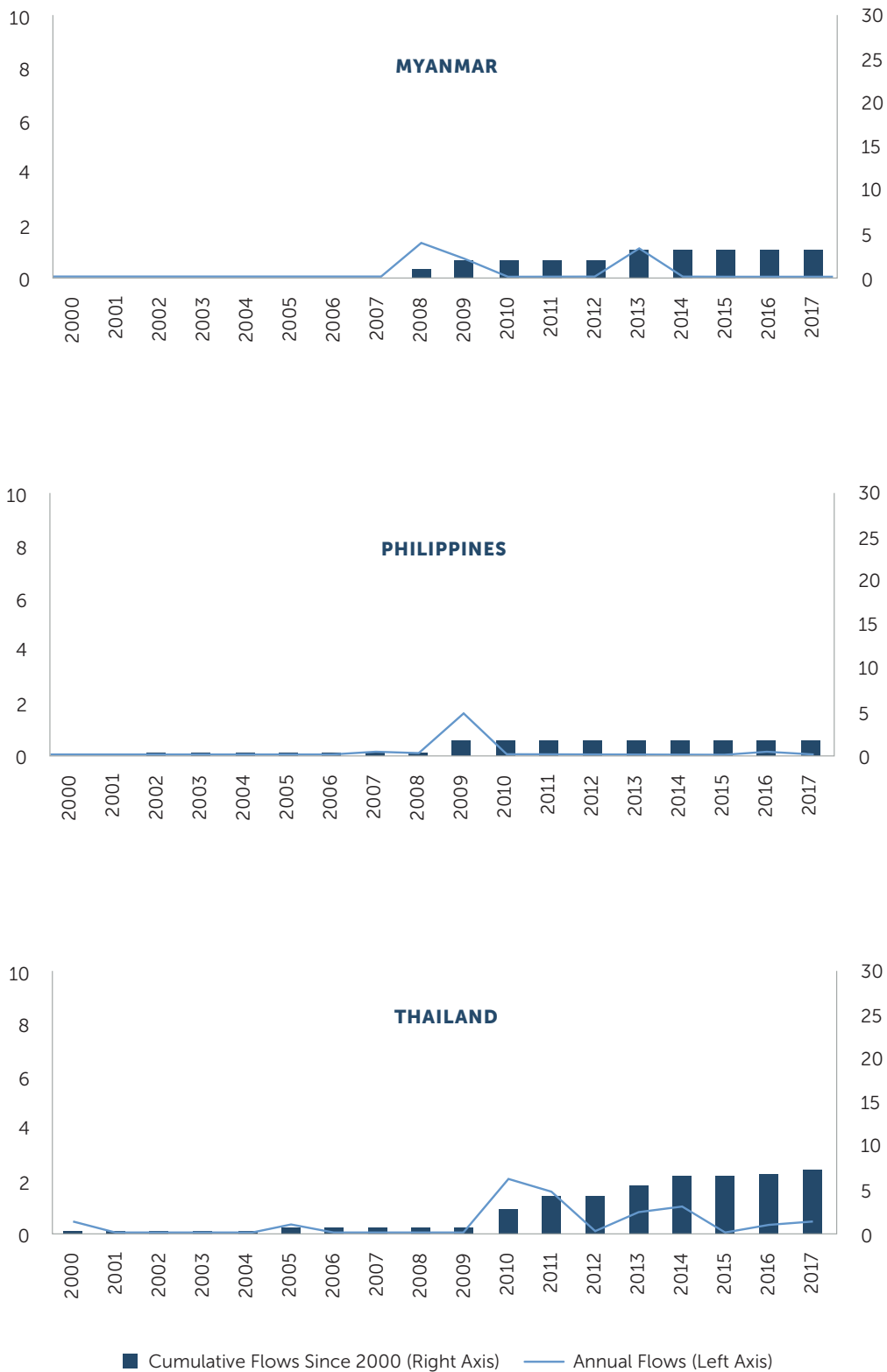
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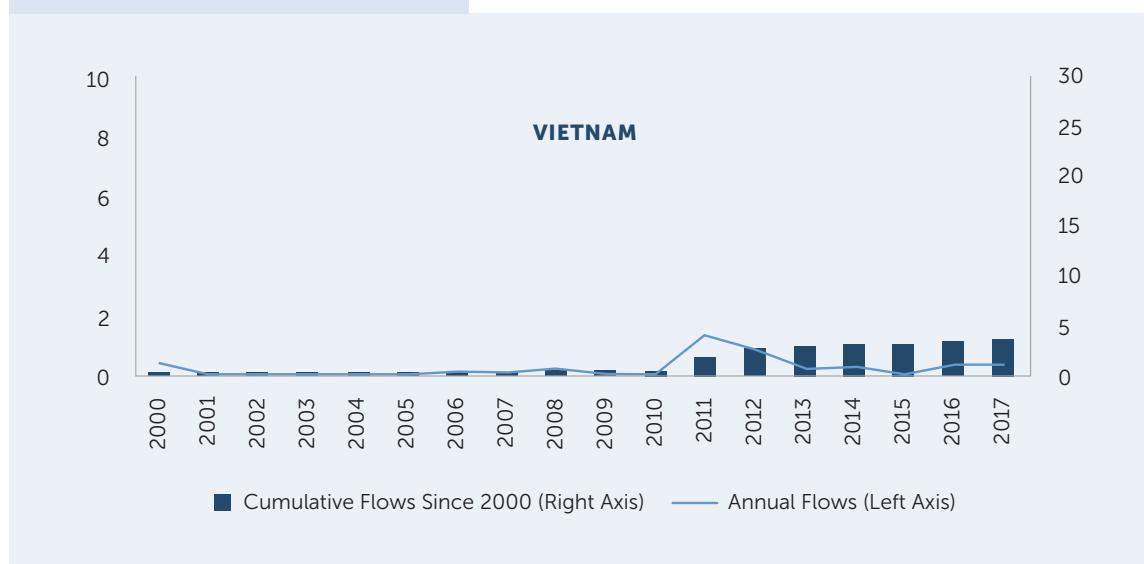
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SOURCE: Rhodium Group

Industry Distribution

Transactions data show that Chinese companies invested in a diverse range of industries in Southeast Asia. The top two sectors are real estate and hospitality and transport and infrastructure (together they make up 67% of the total investment in the dataset). These are followed by basic materials (16%) and energy (10%).

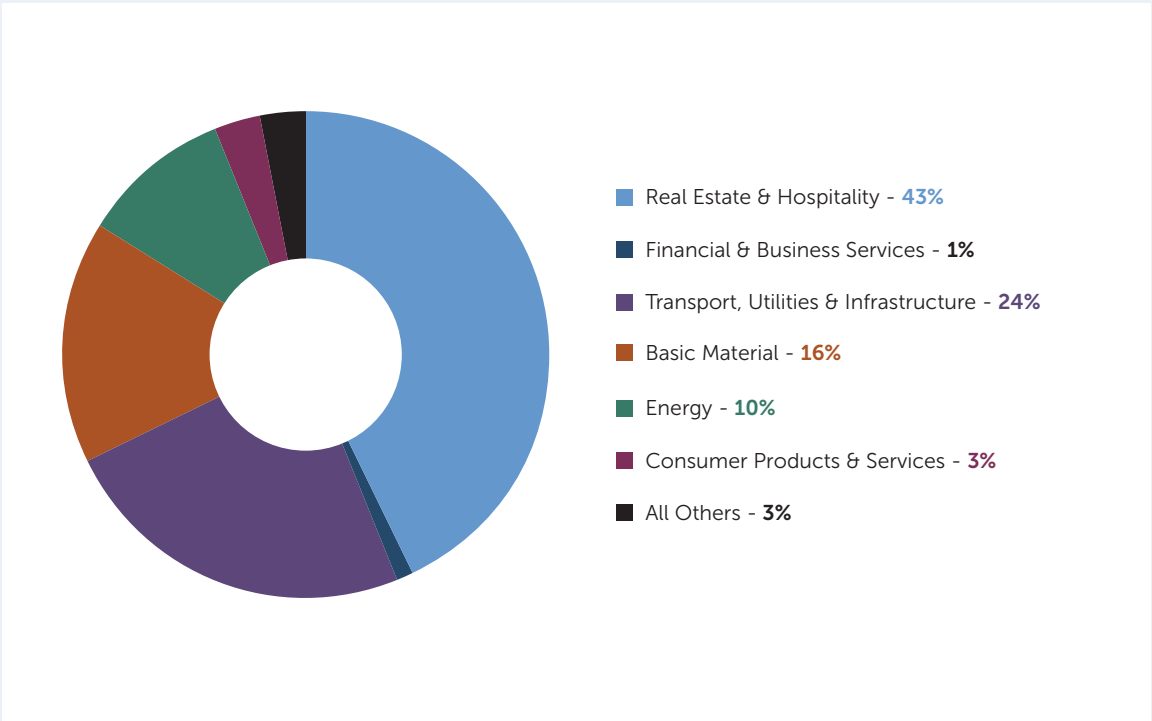
Investments in real estate and hospitality and transport and infrastructure industries are capital-intensive, thus mega greenfield projects counted for more than 80% of the total investment in the top two industries. Top investors in these two sectors are Country Garden, Greenland Group, China Minsheng Investment and China Huaneng. One caveat for these industries is that they mostly consist

of large, greenfield constructions that last many years. Investment value for these projects are already logged in full at project commencement day, even though the project construction will last for many more years (Figure 13, PG. 28).

Investors

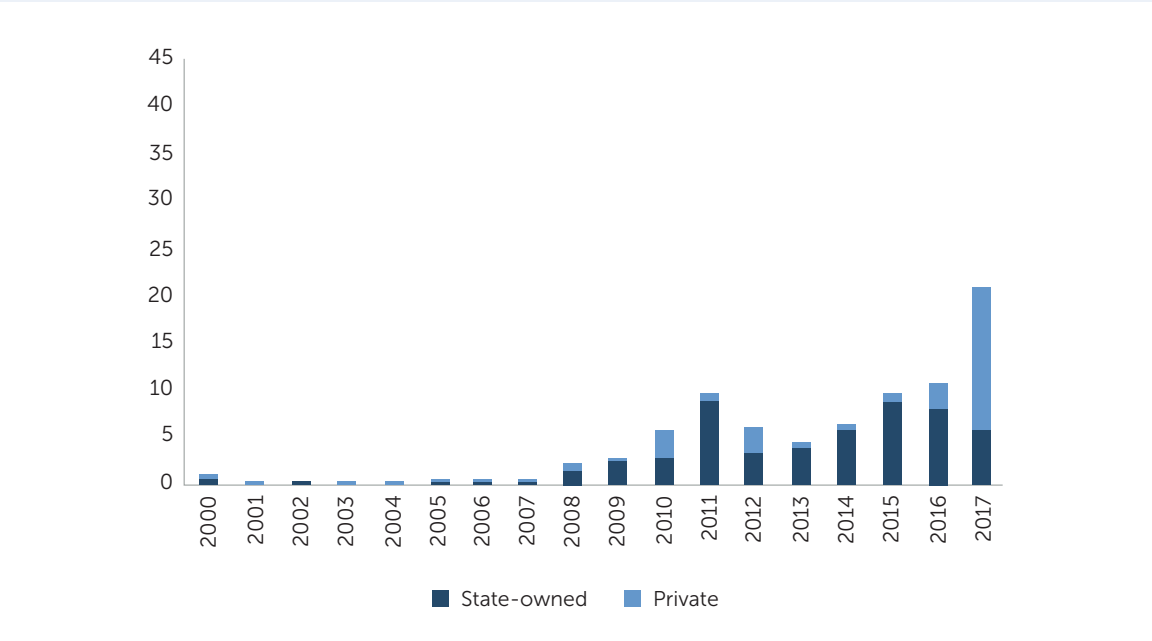
Chinese investment in Southeast Asia predominantly came from state-owned investors for 2000-2016. During this period, investment from state-owned investors made up 78% of the total by value, and investment from private investors only made up 22%. The most prominent state-owned investors include China General Nuclear Power, China Huaneng Group, Greenland Group, and PetroChina. In 2017, Country Garden (a private investor) started its \$33

FIGURE 13: Industry breakdown of Chinese FDI in Southeast Asia, 2000-2017 (Percent)



SOURCE: Rhodium Group

FIGURE 14: Chinese FDI in Southeast Asia by Investor Ownership, 2000-2017 (USD Billion)



SOURCE: Rhodium Group

billion Forest City project in Malaysia, which dramatically pushed up the share of private company investment. As discussed, this deal is currently over-represented as the full value is all logged in 2017 (Figure 14, PG. 28).

Chinese Development Flows to Southeast Asia

INTRODUCTION TO CHINESE DEVELOPMENT FLOWS

Chinese development flows to Southeast Asia have undergone rapid growth in the past two decades, similar to that of other outbound Chinese capital. Unlike FDI flows, Chinese development flows primarily take the form of loans, extended most often by state-affiliated banks or state-owned enterprises to local businesses in the recipient country. In addition to the repayable nature of these flows, development flows are further distinguished from typical FDI by their origin: development finance generally originates from the official sector or entities directly linked to the official sector, and the related flows themselves are in some way tied to state policy. The fact that some Chinese development flows are defined internally or externally as “foreign aid” further complicates effective analysis.

As will be described below, Chinese development flows defy simple classification. While foreign loans extended by private

banks are typically be categorized in national accounting frameworks as “other investment,” China’s largest banks are state-owned, rather than private. The Export-Import Bank of China (“Exim Bank”), which is directly responsible for most official development assistance, is administered directly by China’s State Council. Development assistance provided by most Western countries is classified as “overseas development assistance” (ODA) and measured as such, but Chinese development loans frequently fail to meet necessary ODA criteria, as well.

Despite these classification challenges, Chinese development flows remain a crucial topic of study. Chinese development loans to Southeast Asia have undergone rapid growth in the past two decades, similar to that of other outbound Chinese capital. By volume, China is already among the top providers of overseas development credit. Much of Chinese development lending targets large-scale infrastructure projects, and development agreements frequently involve large quantities of Chinese labor and technology. As a result, these flows have critical implications for national security, technical capacity, and infrastructure autonomy for recipient countries. In some Southeast Asian countries, excessive reliance on Chinese development lending has raised concerns over falling into Chinese debt traps. For its part, China has

faced criticism over its unique approach to development assistance, and in particular for its disregard for shared standards of development assistance endorsed by the OECD. Second, China's non-compliance with international development assistance standards, together with the strong state affiliation of China's banking and commercial sectors, creates challenges in classifying Chinese development assistance under established frameworks.

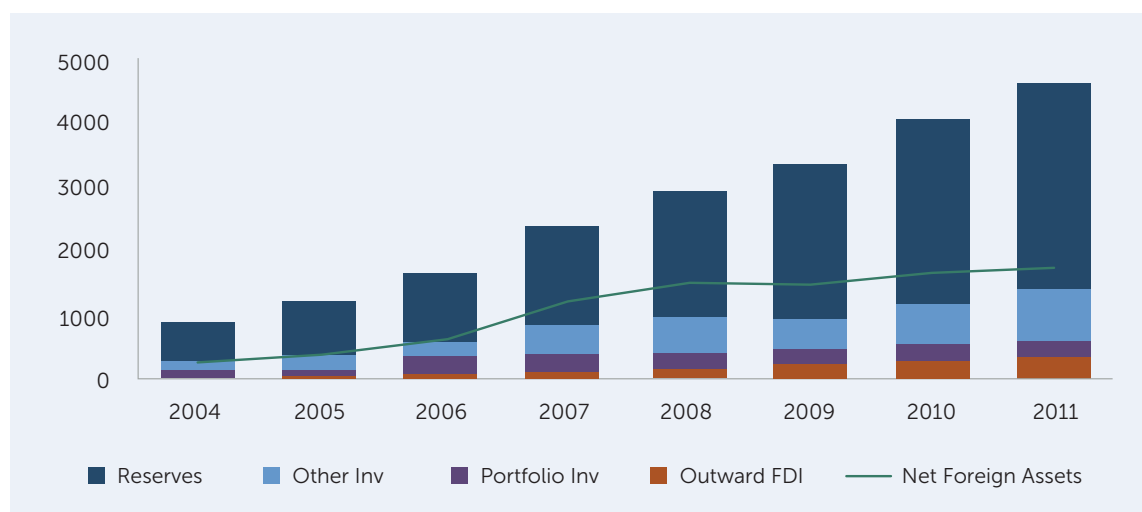
TYPOLOGY OF CHINESE DEVELOPMENT FLOWS

Researchers attempting to track and analyze Chinese development flows face numerous challenges. Despite the significant size and impact of China's development assistance worldwide, these flows are rarely captured in macroeconomic analysis of Chinese cross-border capital flows, which rarely distinguish development loans from the super-category of "other investment" (Figure 15, PG. 31).

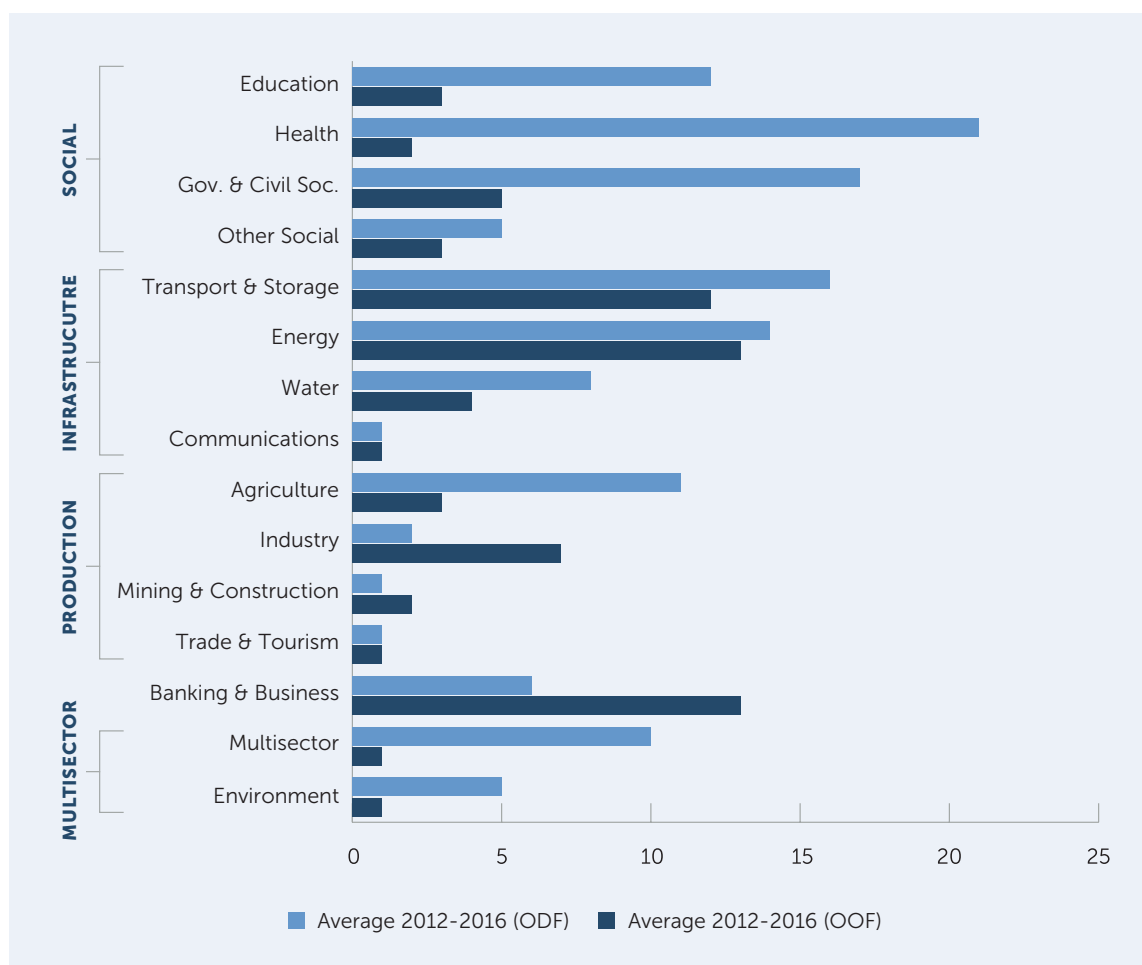
Where capital flow accounting fails, the OECD provides a more useful framework of analysis. The OECD has established the presiding system for classifying international development investment, defining all such investment as falling into two classes: official development assistance (ODA) and other official flows (OOF). Official development assistance refers to official sector resource

flows "with economic development as the main objective" and provided "at concessional financial terms." Official development assistance can, and often does, consist of a combination of loans and grants. While ODA can in some cases appear very similar to foreign direct investment, the primary distinction lies in the fact that ODA must, by definition, originate from the "official sector," while FDI can originate from any resident entity in the investing country. Official development assistance also differs from typical FDI in the concessionality of ODA loans, which are often extended at sub-market interest rates or with generous grace periods on repayment.

Per OECD terminology, official sector flows to ODA-recipient countries that do not meet the criteria of official development assistance are "other official flows" (OOF). Specifically, other official flows are those whose primary objective is not development, or which do not meet required concessionality levels. In the context of contemporary official sector flows to developing countries, OOF comprises only a fraction of ODA, though relative quantities do vary by donor, recipient, and sector. Because official sector outflows from most OECD states are for the purpose of development assistance, and because these states have collectively established standards for this assistance, most official sector flows from OECD members qualify as ODA (Figure

FIGURE 15: Chinese International Investment Position, 2004 – 2011 (USD Billion)

SOURCE: Building a Global Portfolio: What China Owns Abroad, Rhodium group, <https://rhg.com/research/building-a-global-portfolio-what-china-owns-abroad/>

FIGURE 16: Concessional and non-concessional ODF by Individual Allocable Sector and by Type of Official Flow, Average 2012-2016 constant prices (USD Billion Commitments)

SOURCE: International development statistics (database), (OECD, 2018[2]) <http://www.oecd.org/dac/financing-sustainable-development/development-finance-data/idsonline.htm>.

16, PG. 31). For Chinese official sector flows, the opposite is true.

Whereas ODA provided by OECD members is often described as “foreign aid” in common parlance, China has also resisted this terminology. Most development assistance that could be considered Chinese foreign aid still originates China’s Ministry of Commerce, in coordination with the Ministries of Finance and Foreign Affairs. Also distinct from much OECD ODA, a large portion of China’s development flows target infrastructure projects, and the recipients of development flows are frequently foreign state-owned enterprises. Through both official policy and public statements, China has encouraged a perception that Chinese development loans avoid political conditions typical of development assistance from developed, Western states. Indeed, China even forgoes the terminology of “donors” and “aid,” often preferring to refer to itself as a “partner” in overseas development projects. Since 2010, much of China’s foreign assistance has been conducted under a “South-South” cooperation initiative, a framework China continues to use today (Table 2, PG. 33).

So long as China chooses to forgo global standards in terminology or methodology regarding development assistance, international organizations face challenges in classifying and categorizing related financial flows. While most analysis

concludes that China engages in low levels of ODA relative to OOF due to the nature of Chinese loans, this classification may fail to adequately characterize the nature of Chinese official development finance. While other official flows are distinguished from official development assistance by degree of concessionality, Chinese aid is often highly concessional. As later chapters in this report will reveal, China frequently secures foreign tenders by undercutting other lenders with extremely low loan repayment rates and other favorable terms.

Other unorthodox loan terms, however, are also used to justify the classification of Chinese aid as OOF, rather than ODA. Chinese official development finance frequently blends commercial and natural-resource-backed loans, which some deem exploitative or otherwise insufficiently concessional to qualify financing as ODA. Finally, China also frequently defers to publish official statistics about the finances of its overseas investment projects, confounding efforts to comprehensively analyze and categorize this funding in OECD frameworks. The Chinese State Council’s two Foreign Aid White Papers, published in 2011 and 2014, provide rare glimpses into China’s foreign development agenda, but these documents provide minimal information on project financing or lending terms.

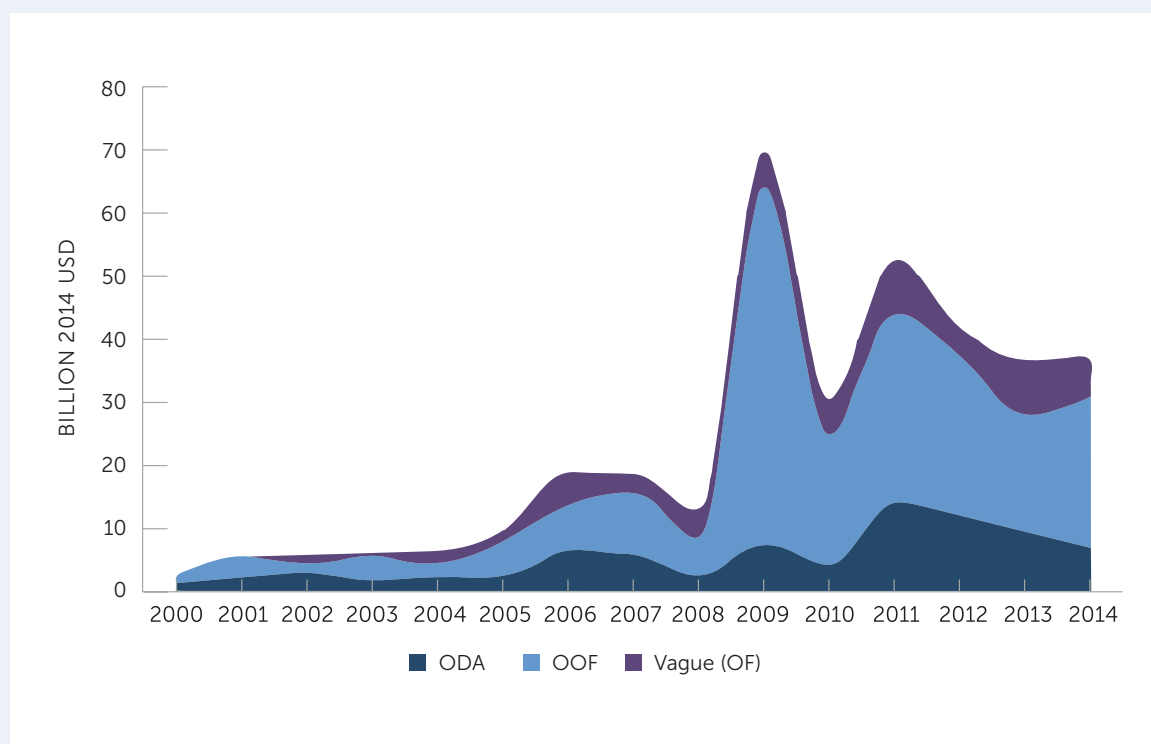
TABLE 2: Comparison of Capital Flow Classifications: OECD and China

	OFFICIAL FLOWS	CROSS-BORDER CAPITAL FLOWS
OECD COUNTRY	<p>Official Development Assistance</p> <ul style="list-style-type: none"> • OECD-defined, official sector flows meeting specific concessionality criteria <p>Other Official Flows</p> <ul style="list-style-type: none"> • Official sector flows that fail to meet OECD criteria for ODA 	<p>Other Investment</p> <ul style="list-style-type: none"> • Public or private loans not originating in the official sector, extended to foreign recipients • Non-loan other investment (trade credits, foreign bank deposits) <p>Foreign Direct Investment</p> <ul style="list-style-type: none"> • Long-term, cross-border capital investments <p>Portfolio Investment/Derivatives/Reserve Assets</p> <ul style="list-style-type: none"> • Various (see Table 1 above)
CHINA	<p>Official Development Assistance</p> <ul style="list-style-type: none"> • Relative to Western countries, a smaller amount of Chinese official sector flows are considered ODA <p>Other Official Flows</p> <ul style="list-style-type: none"> • Most Chinese official sector flows are classified as OOF under the OECD framework. • Other official flows and other investment can be difficult to distinguish 	<p>Other Investment</p> <ul style="list-style-type: none"> • Due to the highly centralized structure of China's government and economy, most large-scale foreign loans originate from the official sector • Other official flows and other investment can be difficult to distinguish <p>Foreign Direct Investment</p> <ul style="list-style-type: none"> • Long-term, cross-border capital investments <p>Portfolio Investment/Derivatives/Reserve Assets</p> <ul style="list-style-type: none"> • Various (see Table 1 above)

TRENDS IN CHINESE DEVELOPMENT ASSISTANCE

Attempts to overcome these obstacles have met with some success. AidData, a research laboratory at William and Mary University's Global Research Institute, has aggregated years of records of Chinese development projects around the world. Their research provides numerous insights into Chinese

development investment, including estimates of financing stock (between 2000 and 2014, China invested \$81.1 billion of ODA and \$216.3 billion of OOF, relative to US investment of \$366.4 billion ODA and \$28.1 billion OOF); growth trends (Chinese official flows totaled approximately \$37 billion in 2014, compared to \$3 billion in 2000); as well as sectorial and regional focuses. Due to the challenges in collecting and analyzing

FIGURE 17: Chinese Official Finance, 2000 – 2014

SOURCE: AidData, <https://www.aiddata.org/china-official-finance>

information about official flows, however, data about official sector flows tend to lag behind similar FDI data. AidData's data, for example, cover only a 15-year period from 2000 to 2014, though data availability is limited in some regions at certain periods within this timeframe (Figure 17, PG. 34).

Chinese official flows to Southeast Asia have followed a growth trend similar to both those of Chinese FDI to the region as well as Chinese official flows to the rest of the world. Between 2000 and 2012, China delivered \$5 billion in ODA and \$28.6 billion in OOF to Southeast Asia. Cambodia was the

primary recipient of ODA (\$2.7 billion) over this 13-year period, well ahead of secondary recipient Myanmar (\$760 million). Over the same period, Laos received the largest quantity of OOF (\$11.3 billion), followed by Indonesia (\$6.5) (Table 3, PG. 35).

According to AidData's analysis, energy generation and supply received the largest share of Chinese ODA (39.6%) and the second largest share of OOF (42.1%) to Southeast Asia over this period. The leading sector for Chinese OOF was transport and storage (44%), which comprised the third largest recipient of ODA (16.2%). These proportions

TABLE 3: Chinese ODF to Southeast Asia

	ODA-LIKE FLOWS		OOF-LIKE FLOWS	
COUNTRY	US\$ MIL	%	US\$ MIL	%
Cambodia	2660.3	53.1	3583.9	12.5
Myanmar	756.1	15.1	1058.6	3.7
Laos	574.9	11.5	11258.4	39.3
Indonesia	403.2	8.0	6512.0	22.8
Vietnam	349.6	7.0	3673.5	12.8
Philippines	253.3	5.1	1227.3	4.3
Thailand	14.0	0.3	1.2	0.0
Malaysia	0.4	0.0	1302.0	4.5
TOTAL	4011.7	100.0	28617.0	100.0

SOURCE: AidData

TABLE 4: Chinese ODF to Southeast Asia by Sector

	ODA-LIKE FLOWS		OOF-LIKE FLOWS	
SECTOR	US\$ MIL	%	US\$ MIL	%
Energy Generation & Supply	1984.4	39.7	12056/0	42.1
Action Relating to Debt	949.0	18.9	N/A	N/A
Transport & Storage	811.0	16.2	12581.3	44.0
Agriculture, Forestry & Fishing	413.7	8.3	355.8	1.2

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	ODA-LIKE FLOWS		OOF-LIKE FLOWS	
SECTOR	US\$ MIL	%	US\$ MIL	%
Industry, Mining & Construction	255.5	5.1	1474.9	5.2
Government & Civil Society	248.1	4.9	77.3	0.3
Communications	97.1	1.9	1229.1	4.3
Emergency Response	91.8	1.8	N/A	N/A
General Budget Support	68.7	1.4	N/A	N/a
Unallocated/Unspecified	N/A	N/A	87.7	0.3
Other Social Infrastructure	N/A	N/a	189.2	0.7
Other Mutlisector	27.7	0.6	393.8	1.4
Others	64.9	1.3	17.5	0.1
TOTAL	5011.7	100.0	28617.0	100.0

SOURCE: AidData

are consistent with China's global official sector flows worldwide, which also focus predominantly on these two sectors (37.8% for energy generation and supply; 25.1% for transport and storage). AidData does not designate a sub-sector for general infrastructure development, but the Table 3 sectors of energy generation and supply, transport and storage, communications,

water supply and sanitation, and other social infrastructure can all be considered to comprise an infrastructure supersector (Table 4, PG. 35-36).

Summary of Findings

This overview chapter has described various types of Chinese outbound capital flows

and then discussed two types of capital flows in greater detail: direct investment and development loans and aid.

For Chinese FDI in Southeast Asia we find:

- **FDI HAS GROWN RAPIDLY BUT OTHER FLOWS ARE CATCHING UP:** FDI is

historically the most important type of Chinese presence in Southeast Asia but China's outbound presence has become more diverse in the past five years. Lending and government aid have grown rapidly across the region, especially from policy banks and large state-owned commercial banks. Private Chinese investors have also rushed into Southeast Asia's technology scene and we observe a big increase in venture capital and other private equity investment. These flows often complement each other so it is important to consider FDI plus other types of capital flows.

- **DATASETS SHOW DIFFERENT FOOTPRINTS OF CHINESE FDI IN THE REGION:** Our analysis show

that different data sources could vary significantly in definition and coverage. Serious researchers must consider all angles while conducting research.

- **THERE IS LIKELY INFORMAL ACTIVITY HAPPENING THAT OFFICIAL AND TRANSACTIONS DATASETS DO NOT COVER:** As discussed, one particular

distortion in Chinese outbound FDI statistics is extensive "informal activity" through special purpose entities in offshore financial centers (such as Hong Kong) and other channels that allow investors to bypass official approval and capital control. This issue is likely amplified in Southeast Asia due to its geographic proximity to China and large ethnic Chinese population.

- **CHINESE INVESTMENT HAS GROWN RAPIDLY SINCE THE MID-2000S:** While

all three data sources show an increase of Chinese investment into Southeast Asia in the past decade, transactions data shows more volatility than official Chinese data. Notably, there was a dip in annual investment flows around 2012-2014, which is also present in official data. This dip is partially attributable to lower activity in the energy and materials sectors during those years. This is in contrast with the rest of the world, which generally saw steady increase of Chinese investment through this time.

- **COUNTRY MIX:** Transactions data show that Malaysia and Indonesia are the biggest recipients of Chinese FDI, followed by Thailand, Cambodia, and Laos. Vietnam, Myanmar and the Philippines received relatively lower levels of Chinese investment. Greenfield investment is the main driver of Chinese

investment in top recipient countries.

This is in contrast to Chinese investment in advanced economies where the majority of investment comes from acquisitions.

- **INDUSTRY DISTRIBUTION:**

Transactions data show that the industry distribution of Chinese direct investment in Southeast Asia is visibly concentrated in real estate and hospitality, transportation and infrastructure, basic materials and energy. This is different from the breakdowns in official data: while ASEANstat data also show real estate as the top sector, other top sectors from ASEANstat and MOFCOM are financial services and wholesale and retail. This is also quite different from the rest of the world: in comparison, the industry distribution of Chinese direct investment in the US and Europe are more diverse and focused on technology and services sectors.

- **INVESTOR OWNERSHIP:** Chinese investment in Southeast Asia predominantly came from state-owned investors (78% of total 2000-2016). In comparison, in the US and Europe, Chinese investment in the early 2000's was more dominated by state-owned companies, but in recent years the share of private investors rose sharply. This trend is not yet as clear in

Southeast Asia, besides private company Country Garden's outsized greenfield investment project.

For Chinese development loans and foreign aid in Southeast Asia we find:

- China's approach to development finance (aid) is to tie aid, direct investment, and trade to achieve win-win conditions for both China and recipient countries. Most Chinese aid projects are implemented by the Ministry of Commerce, in coordination with the Ministries of Finance and Foreign Affairs. Little official data exists documenting the specific mechanisms of Chinese aid.
- A large portion of Chinese aid has consistently gone to infrastructure projects, and foreign state-owned enterprises are common recipients of aid flows. In its public pronouncements on aid and foreign relations, China claims to adhere to five principles of peaceful co-existence and eight principles of aid. Both through its espoused principles and in public statements, China has encouraged a perception that Chinese development loans avoid political conditions typical of development assistance from developed, Western states. Indeed, China rarely uses the donor/aid terminology common among other states. Instead, China frequently refers to itself as a "partner"

in overseas development projects. Since 2010, much of China's foreign assistance has been conducted under a "South-South" cooperation initiative, a framework China continues to use today.

- Chinese official flows to Southeast Asia have followed a growth trend similar to both those of Chinese FDI to the region as well as Chinese official flows to the

rest of the world. Between 2000 and 2012, China delivered \$5 billion in ODA and \$28.6 billion in OOF to Southeast Asia. Cambodia was the primary recipient of ODA (\$2.7 billion) over this 13-year period, well ahead of secondary recipient Myanmar (\$760 million). Over the same period, Laos received the largest quantity of OOF (\$11.3 billion), followed by Indonesia (\$6.5).

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CHAPTER 2

RESTORING TRUST IN THE BRI: THE STATE OF CHINESE INVESTMENT IN MALAYSIA

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ECONOMIC AFFAIRS [IDEAS])

Executive Summary

Chinese investment in Malaysia has significantly increased since 2013, coinciding with the launch of the Belt and Road Initiative (BRI). This includes Chinese participation in large-scale infrastructure and real estate “megaprojects,” which are characterized by significant levels of state involvement on the part of both China and Malaysia. Due to systemic weaknesses in Malaysia’s public procurement system and the poor governance of government-linked companies (GLCs), there is a risk that this influx of new investment will exacerbate preexisting problems with long-term

implications for Malaysia. Indeed, these risks have materialized in a number of cases, most notably in the corruption scandal associated with former Prime Minister Najib Abdul Razak and 1Malaysia Development Berhad (1MDB). In order to maximize the benefits and mitigate the risks of the BRI moving forward, the Malaysian government should prioritize structural institutional reform to address systemic weaknesses in public procurement and the governance of GLCs. More widely, the Malaysian government should prioritize private sector- led investment from China, which can support development of local industry and for which there is a demonstrated need or market demand.

Introduction

Malaysia, with its strategic location as an intermediary for trade between China and the West, has attracted significant investment from China in recent years. The economic relations between Malaysia and China have historically been very robust, with China consistently being Malaysia's top trade partner over the past decade, primarily due to the close proximity and long-standing relationship between the two nations. Malaysia's net Foreign Direct Investment (FDI) flow with China has grown from a mere MYR25 million in 2011 to MYR6.9 billion in 2017, a more than 276-fold increase in just six years.

This increase in the net FDI flow has been compounded by the ambitious Belt and Road Initiative (BRI). Since its introduction in 2013, the BRI has garnered more than USD1 trillion of investments into the numerous infrastructure projects in its 126 partner countries. For emerging economies like Malaysia, China's initiative to build a more interconnected land and maritime trade route can fill investment gaps for infrastructure projects. These infrastructure developments have the potential to stimulate economic growth via capital injections, job creation, and increased access to international markets.

However, globally there has been criticism of the various projects under BRI. Despite positive economic relations between

Malaysia and China, these concerns have also manifested in Malaysia as large infrastructure megaprojects have been accused of facilitating corruption and rent-seeking behavior among political leaders. May 2018 witnessed an historic general election in Malaysia, resulting in the first change of government since its independence. After the victory of the Pakatan Harapan Coalition, several megaprojects under the BRI were suspended, either temporarily or indefinitely, as they were deemed to be economically unviable or had been subject to corruption. Since the election, the new government has sought to renegotiate these projects to secure better terms for Malaysia, with some success. However, institutional reforms to address the systematic weaknesses in governance have been lacking.

In this chapter, we consider the recent growth of Chinese investment in Malaysia under the BRI and the concerns surrounding major BRI projects, and suggest how these concerns might be addressed by strengthening governance in Malaysia.

Chinese Investment in Malaysia

Chinese investment in Malaysia has grown significantly in recent years. Before 2013, Chinese investment in Malaysia was relatively low, although there were notable cases of significant investments, including

Huawei and ZTE's entry into Malaysia's telecommunications sector in 2001 and 2004, respectively, and automobile producer Chery's investment in 2008 (Tham, 2018).

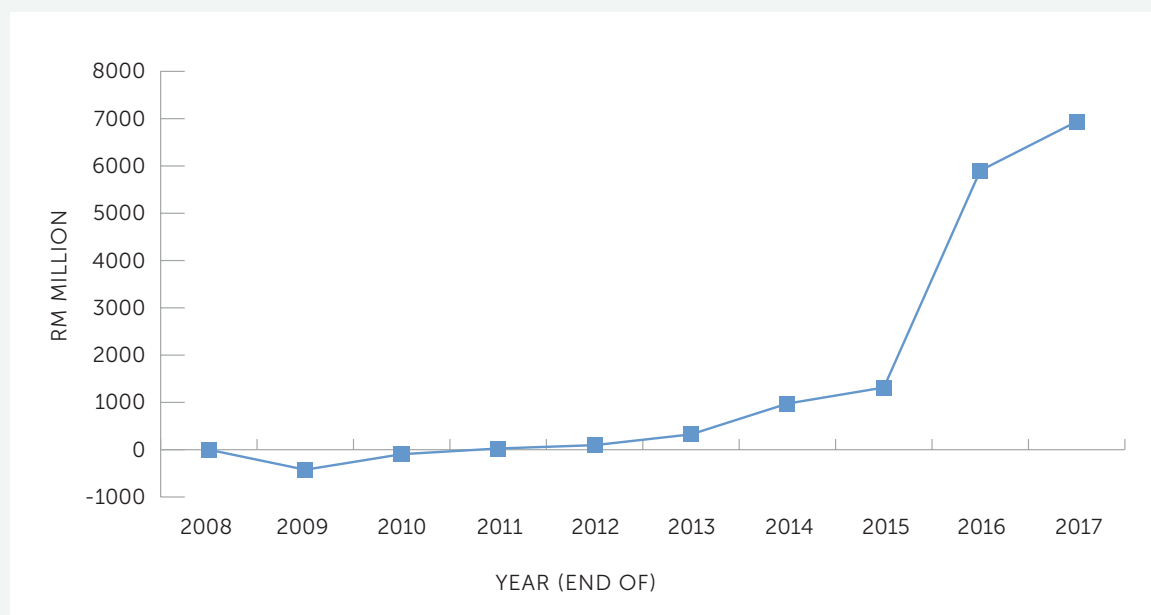
The scale of Chinese investment in Malaysia increased significantly in 2013, following the announcement of the BRI (Chart 1, PG. 42).

Despite this significant recent growth in investment, China still has some way to go to match the total investment stock of Malaysia's largest investors, including Japan and the EU (Chart 2, PG. 43), although some of the investment recorded from Hong Kong and Singapore may in fact ultimately be Chinese in origin.

Using data prepared for this report by the Rhodium Group, we can scrutinize the investment pattern from China in more detail. In the first instance, considering acquisitions and greenfield investments, we can see that the overall profile of Chinese investment is – unsurprisingly – similar to what is reported by the Department of Statistics Malaysia (DOSM) (Chart 3, PG. 43).

Further disaggregating the Chinese investment, we can see that its nature as well as scale have changed since 2013. Chart 4 (PG. 44) provides the sectoral composition of investment. Historically, Chinese investment has centered on manufacturing, but post-2013, investment in other areas

CHART 1: Net Foreign Direct Investment from China to Malaysia, 2008-2017



SOURCES: Bank Negara Malaysia and department of statistics Malaysia (2019)

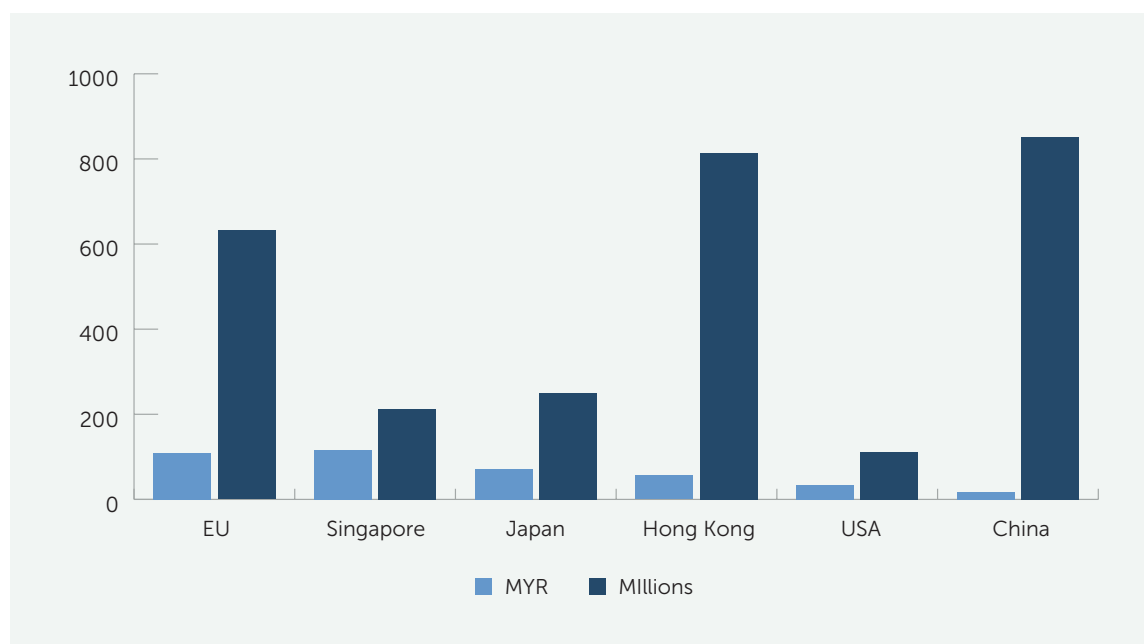
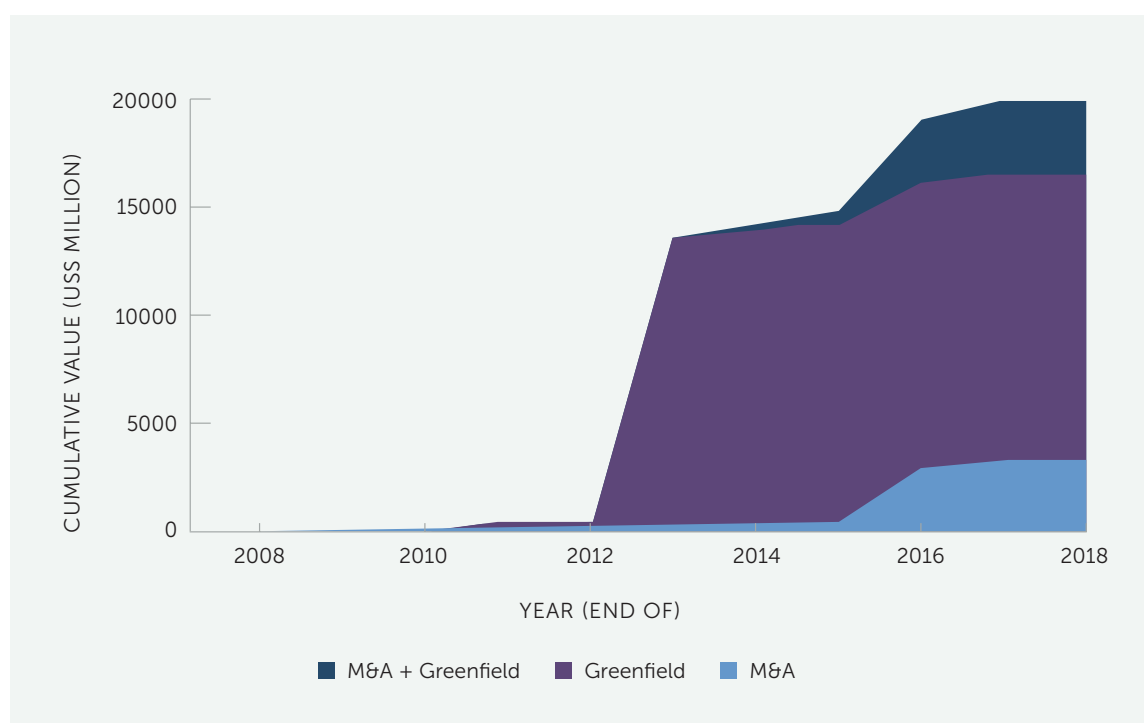
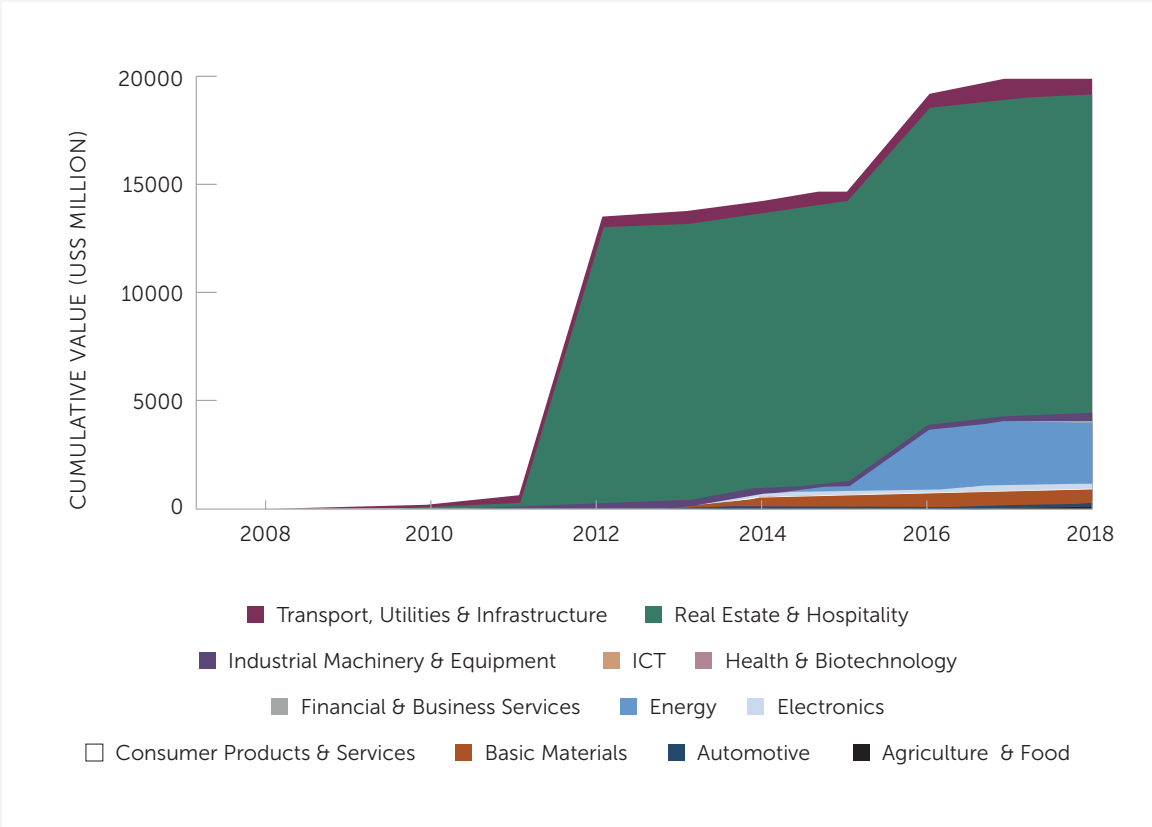
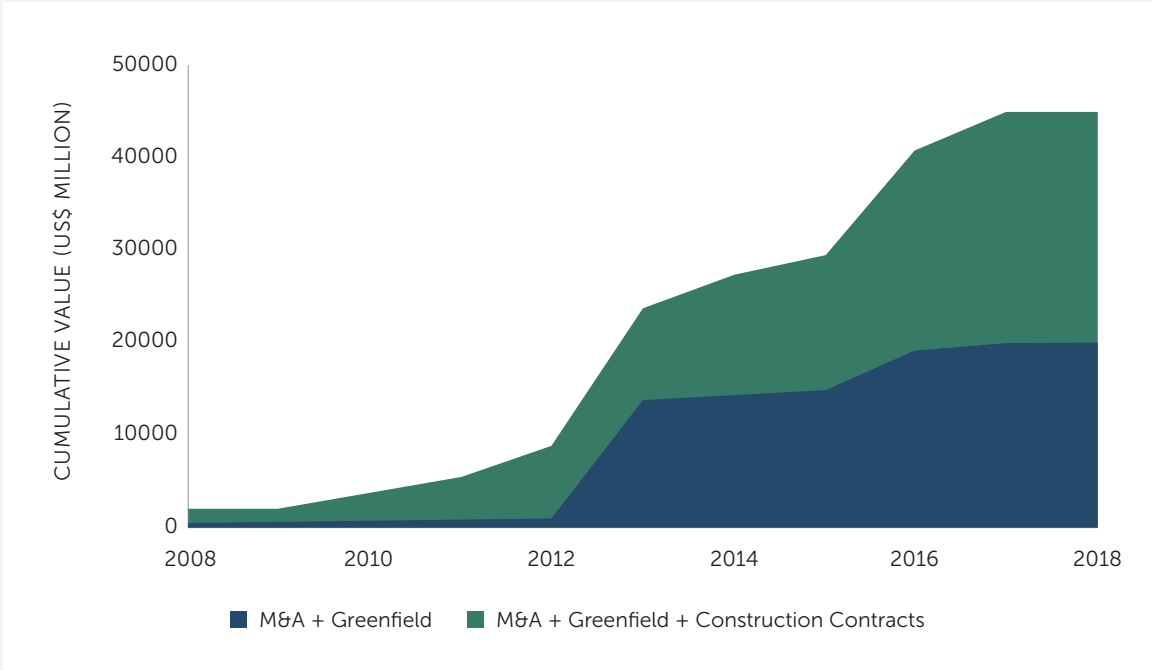
CHART 2: Foreign Direct Investment Position in Malaysia by Country, Q4 2017 (MYR, millions)**SOURCE:** Department of Statistics, Malaysia (2019)**CHART 3:** Chinese Acquisitions and Greenfield Investments in Malaysia, 2008-2017**SOURCE:** Author's compilation based on RHG data

CHART 4: Chinese Investment in Malaysia by Sector, 2008-2017



SOURCE: Author's compilation based on RHG data

CHART 5: Chinese Investment and Construction Contracts in Malaysia, 2008-2017



SOURCE: Author's compilation based on Rhodium Group data, American Enterprise Institute (AEI) China Global Investment Tracker Defining the BRI

has increased, particularly in the real estate and hospitality sectors. The spike in real estate investment in Chart 4 is driven by the very large Forest City Project, which has a Gross Development Value of MYR420 billion.

Chinese Contractors

The charts above focus on investments from China. Over the same time period, the presence of Chinese contractors in the construction sector has also dramatically increased. Indeed, in public discourse, the distinction between Chinese “investment” and Chinese contractors is often lost. Chart 5 (PG. 44) demonstrates significant growth in the volume of contracts awarded to Chinese contractors. The growth in contracts is greater than the increase in investment. This is very instructive in understanding some of the concern about the benefit to Malaysia from the increased presence of Chinese firms, as we discuss further below.

Charts 1 through 5 all highlight increases in the economic presence of Chinese firms (including both investments and contracts) post-2013, coinciding with the launch of the BRI in November 2013. However, there is no settled definition of which projects can be categorized as “BRI” projects, and which represent “business-as-usual” investments and contracts. The 14 Memorandums of Understanding (MoUs) signed between the Chinese government and the former Malaysian government in 2016 are often referred to in the context of the BRI and

include controversial “megaprojects” such as the East Coast Railway Link (ECRL) and the Melaka Gateway development. Broader definitions of BRI refer to investments (or contracts) which involve Chinese and Malaysian state-owned enterprises (SOEs) or government-to-government agreements, or which can be construed as being “strategic” and typically translating into investments in infrastructure. Indeed, some analysts have argued that all Chinese investment post-2013 can be considered part of the BRI, given that it is such a broad concept. The Malaysian government has established a Belt and Road Secretariat in the Ministry of International Trade and Industry (MITI) which is developing a list of officially designated BRI projects, but this list has not been made public.

There exists no clear definition of the BRI as distinct from Chinese investment more broadly. For the purposes of this chapter, we will focus on the “megaprojects” most often associated with the BRI in Malaysia and linked to the MoUs signed between the Malaysian and Chinese governments, a non-exhaustive list of which is provided in Table 1 (PG. 46-47). We have deliberately included a range of projects, including both transportation infrastructure and real estate development, to reflect the diversity of the BRI.

Various concerns have been raised regarding increased Chinese investment, particularly focused on the large-scale projects such as

TABLE 1: Examples of BRI Projects in Malaysia and Current Status

PROJECT	DESCRIPTION	CHINESE ENTITY	STATUS
Tun Razak Exchange (TRX)	Mixed Development in Kuala Lumpur (KL)	China State Construction Engineering Corporation	Ongoing
East Coast Rail Link (ECRL)	Transportation Infrastructure	China Communications and Construction Company	Suspended (May '18); restarted (Apr. '19)
Malaysia China Kuantan Industrial Park (MCKIP)	Industrial Park	Guangxi Beibu Gulf International Port Group	Completed
Penang Road & Undersea Tunnel	Transportation Infrastructure	China Railway Construction Corporation & China Harbor and Engineering Corporation	Ongoing; corruption investigation
Forest City	Mixed Development	Country Garden Holdings	Ongoing
Gemas to Johor Bahru Electrified Double Tracking Rail	Transportation Infrastructure	China Communications Construction Corporation, China Railway Engineering Corporation and China Railway Construction Company	Ongoing
Multi-Product Pipeline (MPP) and Trans-Sabah Gas Pipeline (TSGP)	Energy Infrastructure	China Petroleum Pipeline	Canceled (May '18)
Bandar Malaysia	Mixed Development in KL	China Railway Engineering Corporation	Suspended (May '17); restarted (Apr. '19)

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PROJECT	DESCRIPTION	CHINESE ENTITY	STATUS
Melaka Gateway	Mixed Development in Melaka	PowerChina International, Shenzhen Yantian Port Group and Rizhao Port Group	Ongoing

SOURCE: IDEAS (2017) Governance Concerns with BRI Projects

those in Table 1. Indeed, the issue of Chinese investment played an important role in the 14th General Election in May 2018. The ruling coalition, Barisan Nasional (BN), was unseated for the first time since Malaysia's independence by the opposition coalition, Pakatan Harapan (PH), which campaigned on a platform opposing certain China-linked projects, and which upon winning office canceled several major projects.

The projects listed in Table 1 include a mix of public procurement projects, such as the East Coast Rail Line, and greenfield investments, such as the Malaysia China Kuantan Industrial Park. Governance concerns arise in both types of projects. In general, these are pre-existing weaknesses in governance in Malaysia, but they could be exacerbated by this influx of large-scale investments, particularly those that do not impose strict governance standards.

Governance Challenges in Public Procurement Projects

There are a range of challenges relating to public procurement projects in Malaysia.

David Jones (2018) concludes that

[d]espite the advances in public procurement through E-procurement, greater accountability, clearer and more coherent rules, and attempts to tackle corruption, several weaknesses remain, many highlighted by the [Auditor General]. These include inadequate pre-planning, poor drafting of scope and specifications, and poor selection of suppliers, contractors and consultants, as well as weak supervision of projects by procuring entities and consultants.

Echoing these sentiments, Yap Swee Sung (2018) notes that

Malaysia continues to suffer from problems of wastage, over-pricing, cost overruns, delays, and sub-standard quality in the final delivery of goods, services, and works in public procurement. While some of these problems may be attributed to administrative inefficiency, inexperience, or human error in the procurement process, in many cases, they also stem from intentional manipulation and fraud in addition to existing practices of nepotism, cronyism, and corruption at the expense of taxpayers.

Many of these challenges are present in the case of BRI procurement projects. In order to assess the extent of these challenges, we refer to international best practices in governance of public procurement. In 2016, the Organisation for Economic Co-operation and Development (OECD) published a checklist for supporting the implementation of the OECD Recommendation of the Council of Public Procurement, which includes various requirements for transparency and public accountability. The Construction Sector Transparency Initiative (CoST) requires procuring entities to ensure that information about the purpose, scope, costs and execution of publicly financed construction projects is open and accessible to the public, and that it is disclosed in a timely manner. The information is intended

to be sufficient to inform stakeholders about relevant aspects of the project in an understandable and useful way. Drawing on these international guidelines and analysis of Malaysia's public procurement weaknesses, we have identified the following "key tests" of good governance to apply to the BRI procurement projects:

1. Whether the contract award was subject to **open tender**, rather than direct negotiation. Under Malaysia's own procurement rules (found in Malaysia Treasury Circular PK 2), open tender is the required method for goods, services and works over MYR500,000.
2. Whether a comprehensive **cost-benefit analysis** has been undertaken and is publicly available. The elements included in the Cost-Benefit Analysis should include a thorough needs assessment for the project, the projected feasibility and economic impact, and the long-term sustainability from a public finance perspective.
3. Whether a comprehensive **environmental impact assessment (EIA)** has been undertaken to evaluate the likely environmental impacts of the project or development, taking into account inter-related socio-economic, cultural and human-health impacts, both beneficial and adverse.

4. Whether the **contract details** are available for independent or public scrutiny, in order to assess value for money, conformity with the cost-benefit analysis, etc.
 5. Whether the details of **funding sources** for the project have been fully disclosed, including any public financial liabilities undertaken or private financing involved. Crucially, this must include the extent of public financial liability in the form of loans guaranteed by the government.
 6. Whether the details of **sub-contractors** have been made publicly available to assess the level of local participation on public works.
 7. Whether the project has been subject to a robust **external audit**
- to assess performance and ensure compliance with the government's own procurement policy.
- In terms of the requirement for transparency and making information available in an understandable and useful way, we interpret this to mean at minimum that the information above is available for public viewing online. Table 2 (PG. 49-50) provides an assessment of these tests for three ongoing BRI procurement projects from the list of projects from Table 1. First is the East Coast Rail Line (ECRL), a railway intended to connect the East Coast Economic Region (ECER) states of Pahang, Terengganu and Kelantan to one another and to Peninsular Malaysia's West Coast and Central Region. The assessment below relates to the renegotiated terms of the ECRL announced

TABLE 2: Assessment of BRI Procurement Projects in Malaysia

GOOD GOVERNANCE TEST	EAST COAST RAIL LINE	PENANG ROAD & UNDERSEA TUNNEL	GEMAS TO JOHOR BAHRU ELECTRIFIED DOUBLE TRACKING RAIL
Open Tender	No	Yes	Yes
Cost-Benefit Analysis	Feasibility studies have been conducted but are not publicly available	Feasibility studies are still pending completion	No publicly available studies found

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GOOD GOVERNANCE TEST	EAST COAST RAIL LINE	PENANG ROAD & UNDERSEA TUNNEL	GEMAS TO JOHOR BAHRU ELECTRIFIED DOUBLE TRACKING RAIL
EIA	The EIA for the revised specification is pending	The EIA has been undertaken and approved but is not publicly available	Not found
Contract Details	Details not publicly available	Details not publicly available	Details not publicly available
Funding Sources	Federal procurement project with loan financing from EXIM Bank for which some details are available	State procurement project. Funding is reported to include land reclamation and loan financing from China; full details are not publicly available	Federal procurement project
Sub-Contractors	The full list of sub-contractors has not been made available	The full list of sub-contractors has not been made available	The full list of sub-contractors has not been made available
External Audit	The project has not been subject to an external audit	The project was investigated for corruption and subsequently cleared	The project has not been subject to an external audit

in April 2019. The main contractor for the project is the China Communications and Construction Company (CCCC), and the project is partly financed by the EXIM Bank of China. Second is the Penang Undersea Road and Tunnel, which will connect Butterworth, Seberang Perai in the east to George Town, Penang Island in the west. The project is being undertaken by a Malaysian consortium in partnership with the China Railway Construction Corporation (CRCC). Finally, we have the Gemas to Johor Bahru Electrified Double Tracking Rail project, being undertaken by a Chinese consortium consisting of CCCC, CRCC and the China Railway Engineering Corporation (CREC).

From Table 2, it is clear that the projects in question fail to meet several of the key tests for good governance of public procurement and that there is a general lack of transparency. It is important to note that these problems are not limited to BRI procurement projects and are present across the Malaysian public procurement system. However, given the scale of the BRI, it is vital that public procurement policies and practices are robust enough to mitigate the risk of corruption and abuse. In the case of ECRL, there is clear evidence that the process was abused, as discussed in more detail below. The Penang Undersea Tunnel

was investigated by the Malaysian Anti-Corruption Commission (MACC), although it has been cleared. The need for good governance in public procurement is also wider than reducing corruption – it is also about ensuring that public works represent value for money for the taxpayer.

Governance of Projects Involving Government-Linked Companies

Those BRI projects which are not examples of public procurement can loosely be considered as private investments. However, on closer inspection it is clear that there is significant public involvement on both the Chinese and Malaysian side via state-owned enterprises (SOEs) and government-linked companies (GLCs).¹

The Malaysian government maintains a significant footprint in the economy through GLCs. This can include significant shareholdings in publicly-listed companies (PLCs) and through wholly-owned unlisted entities, both at the federal and state level (Gomez, 2018). The strong presence of GLCs in Malaysia has raised several concerns due to the risks of patronage and corruption, given the lack of transparency and clear governance frameworks. Of course, this

1 In Malaysia, the term GLC is more commonly used than SOE.

is not true of all GLCs, and many are run professionally in pursuit of laudable social aims. Nonetheless, the requirement for transparency and public scrutiny is heightened when GLCs are involved in major projects, given their close relationship with the government.

In order to assess the weaknesses in governance which occur when the participation of GLCs is high, we can again turn to international best practices, in this case the management and transparency guidelines for SOEs. The 2015 OECD Guidelines on Corporate Governance of State-Owned Enterprises establishes clear guidelines for the disclosure and transparency of SOEs. These include requirements to publicly disclose and make easily available the following information:

- Enterprise financial and operating results, including where relevant the costs and funding arrangements pertaining to public policy objectives;
- The remuneration of board members and key executives;
- Board member qualifications and selection process, including board diversity policies, roles on other company boards, and independence;
- Any material transactions with the state and other related entities; and

- Any financial assistance, including guarantees, received from the state, and commitments made on behalf of the SOE, including contractual commitments and liabilities arising from public-private partnerships.

Separately, under the guidelines relating to the responsibilities of the boards of SOEs, the OECD advises that “[m]echanisms should be implemented to avoid conflicts of interest preventing board members from objectively carrying out their board duties and to limit political interference in board processes.” In the case of the BRI projects with significant GLC participation, it is clear that these standards for good governance are not being met. Figure 1 (PG. 53) illustrates the corporate structure of the Malaysia China Kuantan Industrial Park (MCKIP).

MCKIP is not a public procurement project. The development is jointly owned by a Chinese investment vehicle (Guangxi Beibu Gulf International Port Group) and a Malaysian consortium (Kuantan Pahang Holding Sendirian Berhad [Sdn Bhd]). Two of the Malaysian consortium parties (Sime Darby and IJM) are private Malaysian firms listed on the Kuala Lumpur Composite Index (KLCI), but with substantial shareholdings by government-linked investment companies (GLICs), which are in turn owned by the federal government. The third and fourth Malaysian partners Perbadanan Kemajuan

FIGURE 1: Ownership Structure of Malaysia China Kuantan Industrial Park (MCKIP)

SOURCE: Suruhanjaya Syarikat Malaysia (2019)

Negeri Pahang (PKNP) and Perbadanan Setiausaha Kerajaan Pahang (PSK) are both enterprises wholly owned by the Pahang state government. From this, it is clear that the Malaysian government's participation in

this project is in fact quite high, despite it not being a public procurement project.

Given the strategic nature of the project, it can be argued that the high government

presence is justified. Furthermore, in the case of MCKIP, no specific allegations of corruption have been made. However, the challenge here is the general lack of transparency, particularly given the interests of publicly-owned entities and the potential financial liabilities that arise from this, which will ultimately fall on the taxpayer. In 2013, the then-prime minister announced a series of investments, including the Framework Agreement on Financing Cooperation, between China Development Bank Corporation and the master developer of MCKIP. The exact details of this framework are not publicly available, but reporting from the time claims that the agreement included MYR2.5 billion to be invested by the master developer (East Coast Economic Region, 2013). However, what is not clear is whether PKNP or PSK – part owners of the master developer – provided any investment and if so, on what terms. According to the Federal government's accounts, MYR120 million in loan guarantees are currently provided to PKNP (Penyata Kewangan Kerajaan Persekutuan, 2017). It is not clear whether these loans are linked to MCKIP or other projects. Although PKNP has a website, it does not publish annual reports or financial statements accessible to the public. Such information does not seem to be publicly available in the case of PSK either. Therefore, the participation of PKNP and PSK in MCKIP fails to meet the tests of good

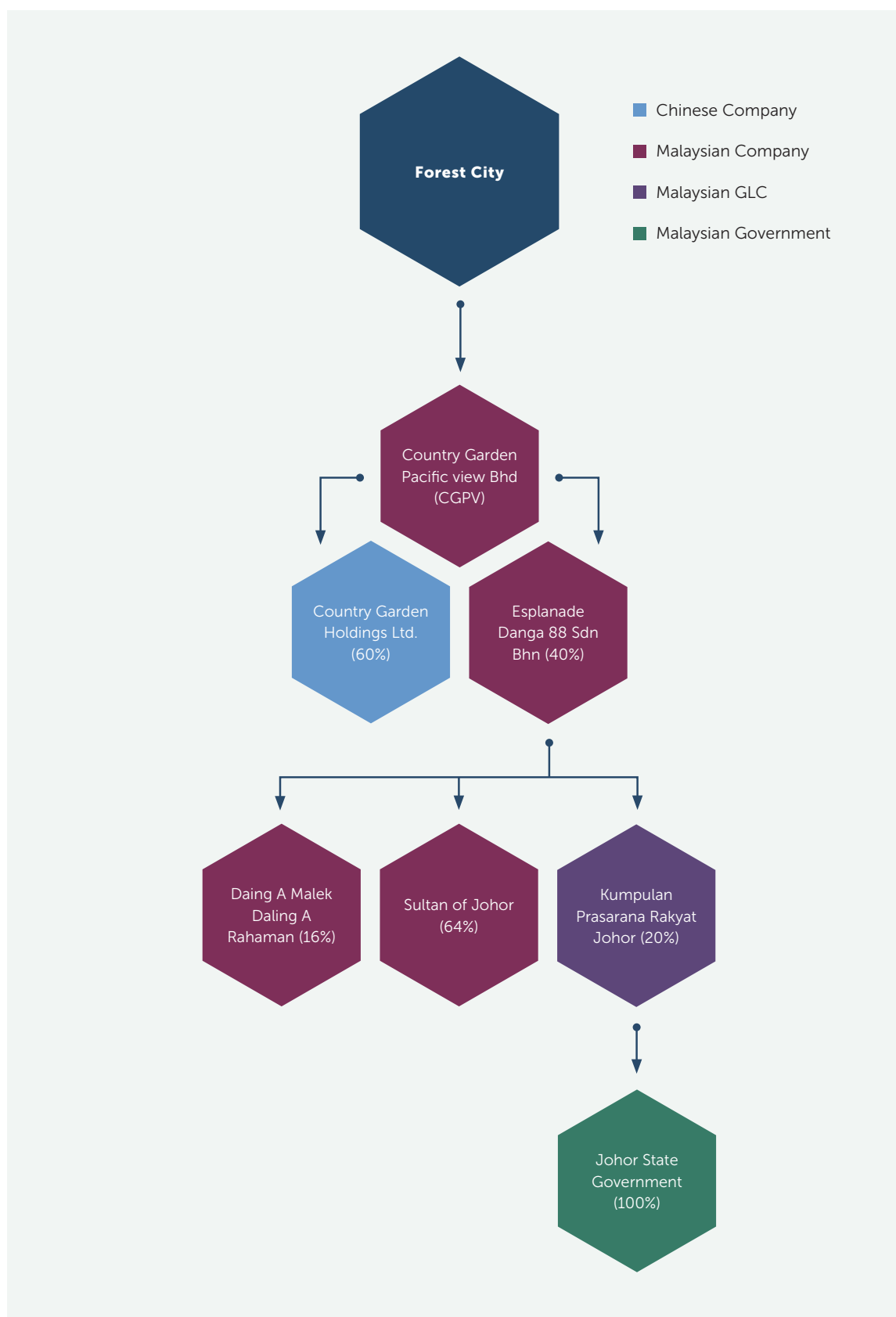
governance and transparency identified above, specifically in relation to the financial activities of publicly-owned enterprises.

A separate issue is that of conflict of interest.

PKNP is an example of a State Economic Development Corporation (SEDC), a type of entity that is present in all of Malaysia's states. The boards of the SEDCs typically include politicians, specifically the chief minister for that state, and potentially other politicians too. The Chief Minister of Pahang is a director of PKNP along with several other senior bureaucrats from the Pahang state government. Given that the Chief Minister is an elected politician, the question of a conflict of interest arises..

The fact that the Pahang state government, through PKNP and PSK, is effectively in a commercial arrangement with both local and international private enterprises could also affect the disposition of the government towards other private actors. The board composition of these entities would not seem to meet the OECD standards required to avoid conflict of interest. We have also not been able to identify any publicly available information on the remuneration of board directors, which further undermines the transparency and good governance of these enterprises.

Another example is provided in Figure 2 (PG. 55), which illustrates the ownership structure of the Forest City development,

FIGURE 2: Ownership Structure of Forest City

SOURCES: forestcitycgpv.com (2019) and Suruhanjaya Syarikat Malaysia (2019)

including the involvement of the Johor state government. Forest City is a large real estate development project in the state of Johor, close to Singapore.

In this case, concerns can again be raised over potential conflicts of interest given the involvement of publicly-owned enterprises. Kumpulan Prasarana Rakyat Johor (KPRJ) does not currently list board directors on its website, but company records filed with the Malaysian Companies Commission (Suruhanjaya Syarikat Malaysia) confirm that members of the Johor state government (both politicians and bureaucrats) are also directors of the company. The KPRJ website also does not feature any information on its involvement in the Forest City development and how this project meets its public policy objectives.

In the case of Forest City, there are not yet specific allegations of corruption. However, there have been concerns raised over the public interest of the project. For example, Rahman (2017) concludes that the project “is having a major impact on its neighboring community, Mukim Tanjung Kupang.”

The report adds that, “Negative effects include reduced fishing income, increased navigational dangers, more shallow and polluted waterways, noise and dust pollution, and dangers from speeding contractors’ and construction heavy vehicles.”

The government’s direct involvement in the project raises questions over its impartiality in ensuring that environmental standards are met. Concerns have also been raised about the wider benefits to the local community, specifically the provision for affordable housing within the development. Politicians, including the recent Prime Minister Tun Dr. Mahathir, have criticized the development for deliberately targeting foreign buyers and not prioritizing affordable housing (Ong, 2019). Given the involvement of publicly-owned entities, the question of the public interest of the project should have been more clearly established.

These examples demonstrate the potential problems that can arise due to the weaknesses in public procurement and governance of GLCs. These issues, however, are illustrated most starkly in the high-profile corruption scandal surrounding the GLC 1Malaysia Development Berhad (1MDB).

Corruption: BRI and 1MDB

The former prime minister of Malaysia has been accused of large-scale corruption through embezzlement of funds via the GLC 1Malaysia Development Berhad (1MDB), which is wholly owned by the Ministry of Finance and is linked to several BRI projects. In 2016, the Sarawak Report claimed to have seen documents that showed that the price

of the ECRL had been deliberately inflated in order to allow the agreement to include Chinese purchasing of 1MDB's debts. The report includes various photographs, which are claimed to be official documents, and the testimony of whistle-blowers. These claims were reinforced in 2019 when the *Wall Street Journal* reported also having seen the documents. They showed that the agreement to pursue both the ECRL and the Trans Sabah Gas Pipeline (TSGP) was linked to deals including the purchasing of 1MDB debt.

Partly in response to these allegations and following the general election in 2018, the new government suspended a number of BRI projects, including the Multi Product Pipeline (MPP), the TSGP and the ECRL. While the MPP and the TSGP were permanently canceled, the ECRL has been renegotiated and subsequently relaunched under the new government. The principal objective of the renegotiation was to reduce the cost of the project by narrowing its technical scope. The cost was reduced to MYR44 billion from MYR65.5 billion, resulting from changes in tunnel length and quantities, shorter and fewer elevated structures, and changes in ground treatment type (Malaysia Rail Link, 2019). The overall alignment length was reduced by 48 km and the number of stations was reduced from 26 to 20. Finally, the operation of the rail line will now be a

50:50 joint venture between Malaysia Rail Link (MRL) and CCCC, sharing any potential losses from the project. The project will continue to be financed through loans from China's EXIM Bank at an interest rate of 3.5% with a seven-year moratorium on repayments. On the basis of these revised terms, the government announced in April 2019 that the project would be restarted.

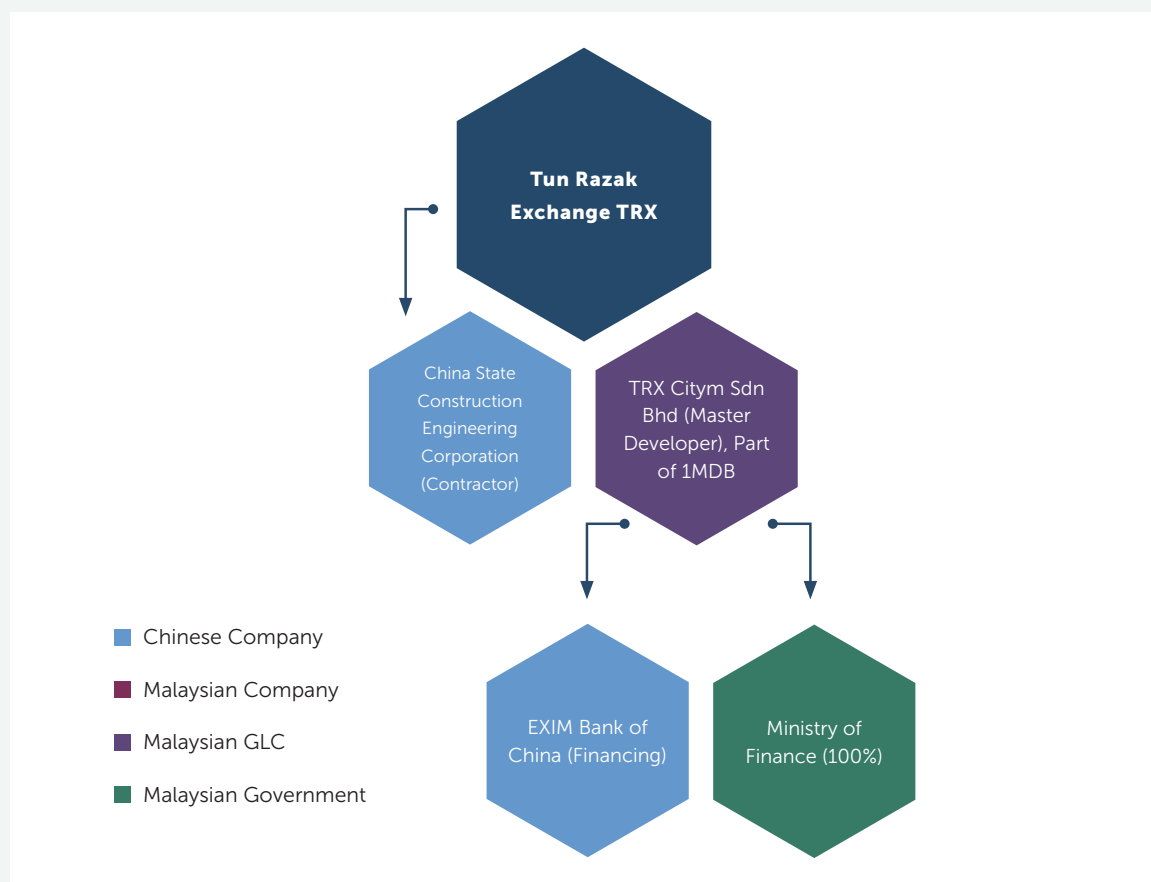
However, concerns with the project persist. As noted in Table 2, the procurement process is still lacking, including the absence of a publicly available feasibility study to demonstrate the value for money of the project. In 2016, the then-opposition MP Tony Pua referred to a feasibility study for the original ECRL project carried out by HSS Group which reportedly estimated the cost of the ECRL at MYR30 billion, when the price subsequently agreed upon with the contractor was more than MYR60 billion (Free Malaysia Today, 2016). In 2019, government adviser Tun Daim Zainuddin referred to a McKinsey study which apparently valued the original alignment at MYR47 billion (Free Malaysia Today, 2019). The lack of a common, objective evidence base undermines efforts to achieve consensus on the merits of a public work of this scale, even at the reduced price secured by the new government. Media reports refer to a feasibility report, but this has not been made widely available, stifling

the ability of civil society and the wider public to assess the underlying value for money of the project.

These concerns have been strengthened by recent revelations during the trial of the former prime minister on corruption charges. A witness statement given by the prime minister's former Special Officer Datuk Amhari Efendi Nazaruddin (2019) seems to confirm the previous allegations that negotiations over the MPP, TSGP and

ECRL explicitly included the acquisition of 1MDB's debts. This has led to renewed calls for the project to be canceled, despite the improved terms secured by the government. Indeed, the finance minister himself has recognized these concerns, but has cited wider considerations, including the importance of China as a trade partner and the cost of compensation if the government canceled the project. The government did cancel the other two projects implicated in the scandal – TSGP

FIGURE 3: Ownership Structure of Tun Razak Exchange (TRX)



SOURCE: trx.my (2019)

and MPP – but nonetheless remains in negotiation with China over the terms of these projects. According to the *New Straits Times* (Bernama, 2019), the project contractors were paid MYR8.3 billion, or 88% of the total contract value of MYR9.3 billion, even though only 13% of the projects were completed. The finance minister has recently confirmed that negotiations are ongoing, but the details cannot be disclosed owing to alleged political sensitivity (Edge Markets, 2019).

1MDB is also connected with other BRI projects. Figure 3 (PG. 58) illustrates the ownership structure for the Tun Razak Exchange, a commercial development in Kuala Lumpur. In this case, the Master Developer for the Tun Razak Exchange, TRX City Sdn Bhd, is wholly owned by the Federal Ministry of Finance. TRX City Sdn Bhd is a part of 1MDB. The development was part-financed by the EXIM Bank of China, and the China State Construction Engineering Corporation is the main contractor.

In 2018, Malaysian Finance Minister Lim Guan Eng disclosed that the federal government has, since 2012, guaranteed borrowings, extended advances, provided transfers to, and purchased land from TRX City Sdn Bhd amounting to MYR3.69 billion, of which the finance minister said MYR3.07 billion was misappropriated by 1MDB, mainly for 1MDB loan repayments. The finance minister

announced alongside this disclosure that the government would provide a further capital injection of MYR2.8 billion to prevent TRX City Sdn Bhd from declaring bankruptcy, and consequently the cancellation of the development – which would have resulted in MYR3.51 billion in compensation claims and a national embarrassment.

Public Financial Sustainability

These examples underline that when poorly governed public procurement and poorly governed GLCs are combined with large scale investment projects, such as those under the BRI, it creates significant risks which can ultimately fall to taxpayers. Specifically, we have identified three channels through which projects associated with BRI can become unsustainable from a public finance perspective:

- First, that public procurement projects are not subject to sufficient scrutiny or competition to demonstrate the underlying value for money or return on investment of the project, and can potentially lead to long-term financial costs for the taxpayer;
- Second, that the participation of GLCs can create a public financial liability, including through loans guaranteed by state and federal government; and

TABLE 3: Public Finance Exposure in BRI Projects in Malaysia

PROJECT	DESCRIPTION	PUBLIC FINANCE EXPOSURE	STATUS
Tun Razak Exchange (TRX)	Mixed Development in KL	Federal government, through participation of wholly-owned GLC; capital investment provided by the federal government. Linked to 1MDB	Ongoing
East Coast Rail Link (ECRL)	Transportation Infrastructure	Public procurement (federal); loan financing guaranteed by the federal government. Linked to 1MDB	Suspended (May '18); restarted (Apr. '19)
Malaysia China Kuantan Industrial Park (MCKIP)	Industrial Park	Pahang state government, through participation of wholly-owned GLC	Completed
Penang Road & Undersea Tunnel	Transportation Infrastructure	Public procurement (Penang)	Ongoing; corruption investigation
Forest City	Mixed Development in Johor	Johor state government, through participation of wholly-owned GLC	Ongoing
Gemas to Johor Bahru Electrified Double Tracking Rail	Transportation Infrastructure	Public procurement (federal)	Ongoing
Multi-Product Pipeline (MPP) and Trans-Sabah Gas Pipeline (TSGP)	Energy Infrastructure	Federal government, through participation of wholly-owned GLC; loan financing guaranteed by the federal government. Linked to 1MDB	Canceled (May '18)

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PROJECT	DESCRIPTION	PUBLIC FINANCE EXPOSURE	STATUS
Bandar Malaysia	Mixed Development in KL	Federal government, through participation of wholly-owned GLC	Suspended (May '17); restarted (Apr. '19)
Kuantan Port New Deep-Water Terminal	Transport Infrastructure	Capital investment provided by the federal government	Ongoing
Melaka Gateway	Mixed Development in Melaka	Public land reclamation included in the development	Ongoing

- Third, that weak governance both of public procurement and GLCs can result in corruption with a clear impact to public finances.

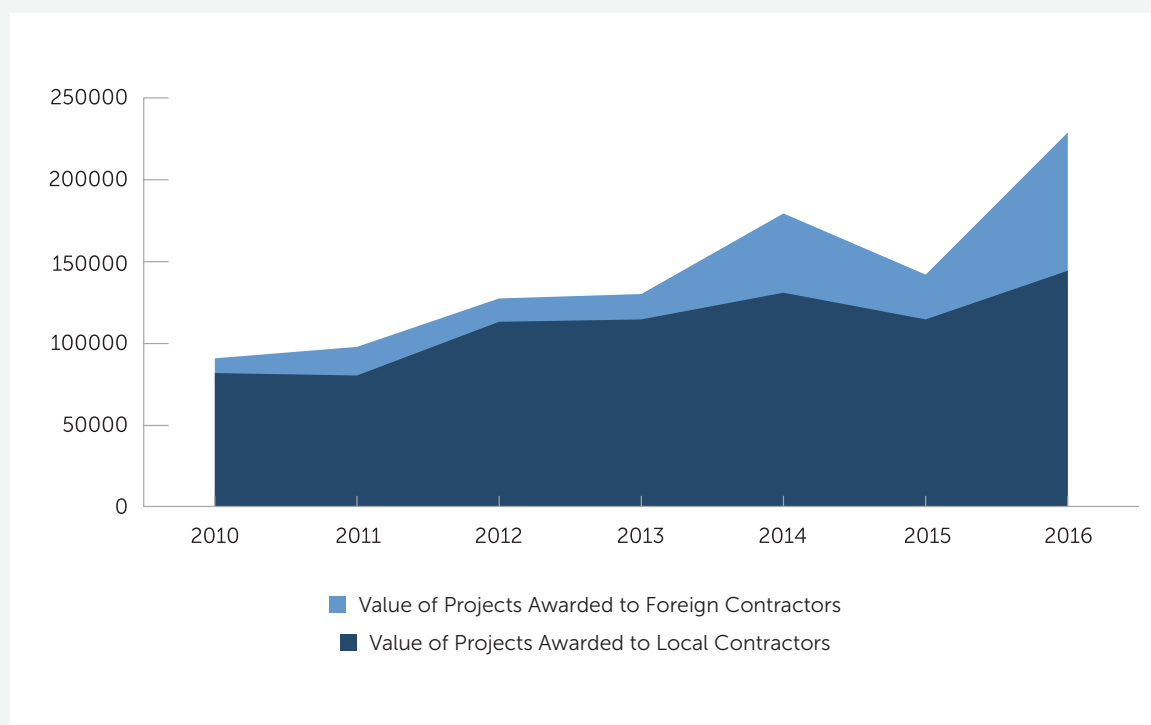
Returning to the projects listed in Table 1, we can see that public financial exposure through these channels is widely present (Table 3, PG. 60-61).

The World Bank has estimated that Malaysia, among other countries, is expected to increase its level of indebtedness as a result of BRI investment (Bandiera & Tsiropoulos, internal working paper, 2019). This underlines the importance of reform to ensure that public procurement is conducted on a value-for-money basis, with clear evidence of need; and that the

participation of GLCs is strictly monitored to ensure activities are in line with public policy objectives and conducive to public financial sustainability.

Impact on the Local Economy

Aside from the issues of governance related to public procurement and the participation of GLCs, significant attention has been given to whether or not BRI projects, such as those in listed in Table 1, have been positive for the development of the local economy. Specifically, there is a concern that the increased presence of Chinese contractors in the construction sector is “crowding out” local players. Chart 6 (PG. 62) compares the

CHART 6: Value of Projects Awarded to Local and Foreign Contractors

SOURCE: Construction Industry Development Board Malaysia (2017)

value of projects awarded to local and foreign contractors from 2010 to 2016 in Malaysia.

The percentage of contracts awarded to foreign contractors was around 12% until 2013, then grew significantly in subsequent years, reaching 37% in 2016. In terms of value, Chinese contractors represent the largest share, with 42% of the total value awarded to foreign contractors (Bandiera & Tsiropoulos, internal working paper, 2019). In other words, the growth in the value of contracts awarded to foreign contractors has not come at the expense of a decline

in the absolute value of contracts awarded to local contractors. The gains from the recent growth in total contracts awarded seems to have favored foreign contractors, in particular those from China.

This does not necessarily prove or disprove the claims of “crowding out.” In its 2017 report “China Contractors: Friend or Foe?” DBS Research argues that “[Chinese-led construction] projects are unlikely to take off without the associate funding and hence would still provide order book growth via subcontracting roles [for local

TABLE 4: Reasons Given for Not Using Local Firms

REASON	EXPLANATION
Skills	The necessary skills are not available among local firms and labor
Working Practices	Local firms and workers are not suited to the working practices of Chinese contractors
Cultural Preferences	Culinary preferences not available from local suppliers, for example
Language Barriers	Workers are required to operate in the same language or use equipment with associated language requirements (for example, manuals for equipment used in ECRL project were in Mandarin)
Insufficient Capacity of Local Suppliers	Scale of materials required necessitates importing rather than local supply
Comparative Challenges in Accessing Finance	Local firms struggle to access finance to compete

SOURCE: IDEAS (2018)

firms].” The report also notes that Chinese firms often enter the Malaysian market in a joint venture with a local firm, examples of which we have identified earlier. However, later in 2017 DBS Research updated its assessment, noting that the increased presence of Chinese firms was happening at a “heightened pace and has encroached into projects which were earmarked for local contractors.”

Identifying the impact on local industry more broadly (i.e. below the principal contractor level) is more difficult. Each of the projects

listed in Table 1 involves a range of different potential opportunities for sub-contractors and suppliers. In most cases, the government has set specific requirements for local content for 30% of the contract value. It is not possible to estimate the extent to which this condition has been met, given that we do not have access to the data on all the sub-contracts which have been awarded for any given project. It is certainly possible to identify cases where sub-contracts have been awarded and cases which suggest local firms have been overlooked (IDEAS, 2018). Table 4 (PG. 63) lists various factors

which have contributed to local firms not participating in Chinese-led projects.

The reasons listed in Table 4 include a number which can be considered legitimate business decisions. In the case of some reasons (including skills and capacity), whether or not these explanations can be justified might be contested. In the case of skills, this is particularly important as various studies have shown that the maximum benefits from FDI are derived from skill and technology transfers (Kubny and Voss, 2010). There have been several comments from industry bodies suggesting that local firms lack the necessary skills and the Malaysian government should therefore ensure Malaysian firms are positioned to participate in the more skill-intensive aspects of these projects.

Another important factor to highlight from Table 4 is the issue of financing. Chinese contractors are able to offer highly competitive financing arrangements and tolerate low margins. This is in part possible due to their support from the Chinese state. As DBS Research (2017) notes,

[Chinese contractors] enjoy strong support from the Chinese government via cheaper source of funding largely from mainland China lenders and the Export-Import Bank of China... They are also supported by the China Export and Credit Insurance Corporation

(SINOSURE) – China's policy-oriented insurance company that provides export credit insurance.

In contrast, local Malaysian small and medium-sized companies (SMEs) report challenges in securing access to credit and struggle to manage on the low margins that can emerge as a result of the highly competitive price structuring of projects by Chinese contractors.

In its 2011 study on Chinese export financing, the EU Parliament Policy Department noted that

[e]ven though there is no public information available on the financial terms offered by Chinese policy banks, anecdotal evidence shows that China usually offers more favorable financing terms than its Western competitors. For example, China's EXIM bank loans have longer grace and repayment terms as well as generally lower interest rates.

Moreover, China has not adopted the international OECD guidelines on export credit assistance, including maximum repayment terms, minimum interest payments and transparency. There is therefore a risk that this competitive financing provides Chinese firms an unfair advantage vis-à-vis local Malaysian firms.

Positive Impacts of Chinese Investments

The analysis in this chapter so far has focused on the infrastructure and real estate “megaprojects” associated with the BRI, and the risks associated with these projects. It is important to recognize that the BRI, and indeed Chinese investment in Malaysia more generally, goes beyond these projects. In particular, the manufacturing sector has exhibited greater presence of direct, Chinese firm-only investors and hence correspondingly less participation by Malaysian GLCs. Perhaps given the stronger effect of market competition and discipline on the profitability of these investments, it is possible to identify cases of Chinese manufacturing firms which have demonstrated contribution towards strengthening domestic manufacturing capacity. For example, in the solar panel industry. Malaysia has become the world’s third-largest solar photovoltaic cell (PV) manufacturer after China and Taiwan, following a MYR1.06 billion plant investment in 2016 by Longi Silicon Materials Corp, a major solar PV company from China. Apart from exports, these investments have also contributed to building a complete solar ecosystem comprising more than 200 companies from upstream to downstream activities, and from producing wafers and cells to inverters and system integrators.

Another example is the Malaysian glass manufacturing sector, which has been transformed by Chinese investment. Prior to 2016, Malaysia had always been a net importer of glass with annual spending of MYR1.5 billion in the global market. After billions of ringgit worth of investments by China’s Kibing Glass Group and Xinyi Glass Holdings Ltd., Malaysia has now become a net glass exporter to developed economies such as the United Arab Emirates, Singapore and the United States. Furthermore, in its 2016 report, the Malaysian Investment Development Authority (MIDA) also reported that MYR1.9 billion worth of glass and glassware products were manufactured for exports, contributing to more than a third of the share of Malaysia’s total manufactured exports in the non-metallic mineral industry.

These examples underline the benefits of FDI from China and the priority for Malaysian policymakers in ensuring that the benefits of the BRI can be maximized while mitigating the risks. This is also important from the perspective of Chinese policymakers and enterprises, as ultimately when these risks materialize the projects also suffer, thus reducing wider confidence in the BRI. In the case of Malaysia, in reaction to concerns about projects such as the ECRL, the overall number of projects has been reduced. The Chinese government has also indicated its desire to address these issues and to

promote good governance within the BRI. This is certainly a welcome move and is in the best long-term interests of the BRI itself.

Policy Recommendations

In light of the challenges highlighted in this chapter, CIPE proposes the following recommendations to ensure that the government of Malaysia can maximize the benefits and mitigate the risks from the BRI:

- To address the governance weaknesses in the public procurement system, the Malaysian government must include specific provisions in the forthcoming Government Procurement Act to ensure that:
 - detailed cost-benefit analyses are undertaken for major projects and that these are made public;
 - contract details are made available for public scrutiny;
 - a full list of sub-contractors engaged in a given project is made publicly available;
 - major projects are subject to mandatory audits; and
 - full details of financing arrangements for major projects are disclosed, including any publicly-backed debt guarantees.
- To address the governance weaknesses arising from the participation of government-linked companies (GLCs), it is vital that the Malaysian government ensure that:
 - All state-level development agencies should publish annual reports and detailed financial statements, detailing the participation of publicly owned entities in commercial enterprises. This must include disclosure of remuneration of company directors, any financial liabilities potentially borne by the taxpayer, and justification of the entities' activities against public policy objectives;
 - All GLCs have mechanisms in place to reduce conflicts of interest among directors, and concerted efforts to gradually reduce the commercial role of GLCs must become an imperative priority of the Malaysian government.
 - A dedicated Select Committee is established to facilitate greater parliamentary scrutiny of GLCs.
- Introducing freedom of information legislation is necessary for the Malaysian government to improve transparency and empower stakeholders to hold the government to account.

- To maximize the benefit for local industry, the government should ensure that local and foreign contractors can compete fairly on a level playing field by requiring foreign firms to abide by the OECD guidelines on export credit assistance.
- Malaysia's government should further ensure any local content requirements focus on promoting technology and knowledge transfer between foreign and Malaysian firms.

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CHAPTER 3

CHINESE FDI IN THE PHILIPPINES: AN EXAMINATION OF ONLINE GAMBLING AND ENERGY

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Executive Summary

This chapter assesses the potentially corrosive effects of private and state-backed Chinese foreign direct investment (FDI) on democratic governance in the Philippines. It examines the Philippine online gambling and energy industries, to serve as case studies of how inflows of Chinese FDI exacerbate governance gaps and loopholes in the Philippine regulatory oversight and policymaking processes.

In the gambling industry, the governance gaps center around the role of the Philippine Amusement and Gaming Corporation (PAGCOR), a Philippine government-

controlled monopoly with conflicting and contradictory roles as regulator, market participant, and revenue collector. These conflicts lead to governance gaps that are exploited by unaccountable state-backed money from Chinese investors.

In the energy industry, this review found that authorities routinely disregarded national security reviews concerning the role of the State Grid Corporation of China (SGCC), which has an ownership stake in the Philippines' sole energy distribution agency. In both of these industries, when huge amounts of money flow through governance gaps, the gaps widen, thereby exacerbating the adverse effects of such capital on the rule of law.

This study documents negative externalities associated with the governance gaps present in the Philippines' gambling and energy industries, such as black market activity and the illegal importation of laborers from China. This chapter concludes by identifying particular institutional responses that Philippine policymakers might consider in order to mitigate the corrosive effects of FDI on governance in select industries.

Background

Like many other countries, the Philippines encourages foreign direct investment (FDI) from any source. However, FDI in the Philippines has lagged behind other middle-income states. Unlike other developing countries, the Philippines prefers joint ventures or subcontracting agreements with foreign firms. Constitutional limits on foreign investment in certain sectors, including land, mass media, retail, and marine resources, impact the course of these investments (Camba, 2017a). Most other sectors limit FDI ownership to a 40% stake, favoring joint ventures between Filipino companies and the foreign firm. There are also sectors in which foreign investors are allowed to own 100% of the asset or firm within a limited period, such as the large-scale mining sector through the mineral process services agreement (MPSA) or business process outsourcing (BPO) (Camba, 2015).

Given these conditions, subcontracting agreements in construction, infrastructure, and other more advanced sectors are common among Filipino and foreign firms. However, the high cost of basic goods—energy, food, and transportation—and the government's preference for consortia under majority Filipino control deter foreign investors from pursuing projects in the Philippines. Conflict among political elites, regional political unrest, and criminal activity also increase the cost of investments.

Nonetheless, due to its young, English-literate labor force, the Philippines still attracts investments in key sectors. For instance, the Philippines is the call center capital of the world, and Japanese investors have continued to finance manufacturing projects in the Philippines for the past thirty years. Indeed, Japan and America are the biggest investors in the country, with Hong Kong and China not far behind. As seen in Table 1 (PG. 71), China has been catching up to American and Japanese levels of investment in recent years.

Investment in the Philippines is highly decentralized, and there are several different pathways to invest in the country. Most investment is made through the Department of Trade and Industry and the Philippine Board of Investments. In addition to these central bodies, there are seven major Investment Promotion Agencies (IPAs) that manage

TABLE 1: Average FDI Inflows in the Philippines (USD \$Millions)

SENDING STATE	1985-1990	1990-1997	1998-2005	2005-2016
USA	77.5	95.1	209	360
Japan	28.4	195	174	343
UK	104	66	77	56
Australia	38	6.6	2	27
South Korea	1.6	15.2	2	18
China & Hong Kong	N/A	N/A	63	218

SOURCE: Central Bank of the Philippines (2018)

the Philippines' Special Economic Zones, including export-processing zones, industrial parks and agro-industrial zones. In addition to the seven major IPAs, there are more than 40 smaller IPAs across the country that are directly accountable to local government units and able to negotiate, license, and distribute incentives to license foreign companies. Other government departments, such as the Department of Energy and Natural Resources, also have the power to license foreign investments in key sectors (Camba & Magat, 2019). This decentralized investment structure has contributed to the proliferation of online gambling companies based in the Philippines.

Under the Duterte administration, the Philippines has become the primary destination for Chinese online gambling investments because of cheap real estate, a booming service sector, and relative autonomy from Beijing (Camba, 2018). Online gambling began during Joseph Estrada's brief term as president, reemerged throughout the Aquino presidency, and has now resurged during the Duterte administration. Similar to BPOs, Chinese online gambling firms target an external market, which does not threaten Philippine businesses, and instead presents an additional opportunity for profit.

The online gambling sector is currently undergoing an economic boom, for three primary reasons (Camba, 2019). First, customers are located not only in China, but also in the “greater Chinese area” of Singapore, Hong Kong, and Taiwan. Some reports suggest that Chinese across the United States and Europe also avail themselves of these services, making it a mistake to attribute demand for online gambling to residents of China or Macau alone. A careful analysis of companies shows that the investors financing online gambling firms come from China, Macau, and Taiwan. The gambling firm workforce comprises labor from China, division heads from Malaysia or Indonesia, and management from Taiwan.

Second, all of the states of the greater Chinese area have experienced some degree of economic mobility and the emergence of wealthy consumer class.

Among these states, the PRC provides the most customers to online gambling firms due to its massive population and the ban on gambling in mainland China. Third, Hong Kong and Macau’s online gambling firms were increasingly pushed out by Beijing in 2016. Because online gambling has also served as a channel to launder

money out of China, leading to an outflow of U.S. dollars, Beijing has started to subject the industry to tighter regulations.

These three reasons coincided with a major change in Philippine regulations governing online gambling. This change principally affected the authority of the Philippine Amusement and Gaming Corporation (PAGCOR), a government-owned and controlled corporation (GOCC) holding authority over all gambling-related matters in the country. In the early 2000s, Philippine private company PhilWeb entered a 13-year contract with PAGCOR to sell gambling licenses outside of the Philippines’ special economic zones. With their monopoly over these licenses, PhilWeb could have pursued greater profit and industrial control. However, PhilWeb demonstrated an unwillingness to sell licenses to Chinese online gambling firms (Guinto, 2016).

The online gambling companies knew that there was money to be made once PhilWeb was out of the way (Lucas, 2018). These firms and their partners supported Duterte in the 2016 election and then used their political influence in the new administration to prevent the renewal of PhilWeb’s contract in September 2016.¹ After the end

1 Kim Wong, the Philippine Owner of the Oriental Group and the biggest online gambling firm in the country, is related to the Duterte government’s Secretary Vitaliano Aguirre (Punzalan 2017). Duterte has reached out to Charlie “Atong Ang,” one of the biggest online gaming owners in the Philippines, to clean up online gambling (Ranada 2018).

of PhilWeb's contract, PAGCOR acquired the authority to sell licenses, leading to an open market for online gambling firms and an increase of Chinese business activities and services in the sector (Cabalsi, 2016). In other words, the influx of Chinese online gambling investments would not have been possible under PhilWeb, due to PhilWeb's close links with the Aquino administration and the possibility of a long legal battle at the Supreme Court (Camba, 2018).

Governance Gaps

PAGCOR

The conflicting roles of the Philippine Amusement and Gaming Corporation (PAGCOR) as market regulator, market participant, and revenue collector create loopholes in Philippine regulations that are exploited by secretive foreign investors offering opaque financial backing. In general, the structure of the online gambling industry reinforces common problems with secrecy and opacity surrounding capital flows from China.

Online gambling firms use a special provision in Philippine law to invest in the country. Specifically, under Presidential Decree 1869 and Republic Act 9487, PAGCOR is empowered to bypass other agencies when it comes to regulatory checks (Office Gazette, 1983) revenue generation, and

state capacity. This undermines multiple state agencies in their attempts to properly conduct due diligence regarding foreign investment. The agencies that are bypassed include the Investment Promotion Authority (IPA), the Bureau of Internal Revenue (BIR), and the regulatory offices within the Department of Trade and Industry (DTI).

The Bureau of Internal Revenue (BIR), the Philippine agency in charge of taxation, does not interface directly with the online gambling firms (Ibarra, 2019). In the current system, online gambling firms pay PAGCOR an application fee of USD 50,000 for e-casinos and 40,000 for betting. Following approval, the firms pay a franchise fee ranging from USD 150,000 to 200,000 (Venzon, 2016). PAGCOR continues to collect revenue from these firms through a monthly levy of 5% of the firms' total profits. These revenue streams make PAGCOR the most profitable state enterprise in the Philippines.

The existing system lacks transparency and democratic oversight, making it impossible to know how much firms have earned and whether or not they are paying the correct amount of taxes. Under the current system, online gambling firms only need to report their earnings to PAGCOR by submitting a minimum number of documents before paying the yearly levies (Ibarra, 2019). This system makes it difficult to ascertain how PAGCOR judges the earnings of the online

gambling firms, thereby making tax evasion by firms more likely. While tax evasion is certainly not limited to the gambling industry, PAGCOR's role as both a GOCC and tax agency creates a particularly permissive environment for misconduct.

Another major issue is that the existing system for online gambling facilitates money laundering (Watts, 2019). Money laundering can occur in two ways. The first involves investment in an online gambling firm. Some of these investments are linked to Chinese businesses with known ties to the Chinese Communist Party (CCP) (Author Interview, 2018a). For these businesses, investing in foreign gambling firms provides a channel to move money outside of China (Author Interview, 2018b). Since online gambling is banned in China and Hong Kong, these firms have started to target the gambling sector of Southeast Asian states. The second form of laundering involves the use of auction houses in Metro Manila, where East Asian buyers take advantage of auctions to launder money into the country (Author Interview, 2018c).

In sum, the existing system makes PAGCOR the primary public entity that regulates, taxes, and monitors money laundering vis-à-vis online gambling firms. In other words, PAGCOR's primary function, that of generating revenue, directly contradicts these responsibilities, because the activities

of the online gambling firms can maximize tax and fee revenue. These problems directly corrode state institutions. In 2018, the BIR issued Revenue Memorandum Circular 78-2018, which mandates foreign and local online gambling firms register with the tax agency (Asia Gaming Brief, 2019). While this is a step in the right direction, the current system simply mandates the firms to "[register] with the revenue district office having jurisdiction over the place where the head office or branch is located" (Ramirez, 2019). The registration does not repeal the existing tax incentive and can be circumvented by giving power to the local BIR branches.

SECURITY CONCERNS IN ENERGY INDUSTRY ARE OVERLOOKED

The State Grid Corporation of China (SGCC), China's state-owned utility monopoly, is the largest utility company in the world and the second-largest corporation in the world in terms of revenue. SGCC is also a critical component of Beijing's Belt-and-Road Initiative, and its overseas purchases of energy infrastructure could reach USD 50 billion by 2020 (Tabeta, 2017). The worldwide portfolio of strategic assets that SGCC owns on behalf of the Chinese government includes a 40% stake in the National Grid Corporation of the Philippines (NGCP), the largest electricity provider in the Philippines

and one of the biggest benefactors of the Duterte administration.

In 2001, President Arroyo intended to privatize the National Transmission Corporation (Transco), opening the company to a bid (Gatdula, 2003). Eventually, the Monte Oro Grid Corporation (30%) and Calaca Bay's (30%) consortium with the State Grid Corporation of China (40%) won the bid. While numerous political elites attempted to hinder the awarding process because of China's political influence, the SGCC was able to successfully invest. President Benigno Aquino III's nationalistic policies resulted in new challenges. In 2013, Mar Roxas, Aquino's Interior Secretary and a member of the country's ruling elite, informed Beijing that there were security concerns regarding a foreign company's access to power grids.

In response to these concerns, the Aquino government did not renew the visas of 18 Chinese engineers for SGCC (Roberts, 2015). Ultimately, among the Chinese employees, only the board members were granted visa extensions (Xu, 2017). The SGCC proposed several projects, such as the extension of grids in Mindanao, the development of "smart" infrastructure in Luzon, and additional training for Filipino engineers in China. However, Aquino's officials blocked these ventures. In 2015, the Department of Energy and Natural Resources (DENR) imposed a security protocol on the SGCC,

expelling specialized power grid technicians, and turning over the control of key operations to Filipino staff members.

However, these safeguards were reversed shortly after President Duterte assumed office in 2016. Duterte promptly sacked Aquino's officials in the DENR, removing the constraints on SGCC's activities. Under the Duterte administration, the SGCC eventually flourished and acquired additional assets in the Philippines. For example, following Xi Jinping's November 2018 visit to Manila, the Philippine government awarded a contract to SGCC to extend telecommunications coverage using Huawei equipment.

Recent conversations in the Philippines have circled around three possible security implications posed by SGCC's high profile in the Philippines. First, even though the two Philippine companies own more shares of the consortium than the SGCC, the Chinese utility has more control over the decision-making process. Second, the technology used by SGCC include state-of-the-art undersea cables, towers, and transmission lines with technical specifications that surpass the knowledge and regulation capacity of current Philippine agencies (Bondoc, 2018). Third, there are concerns that the training of Filipino engineers has largely been dependent on the SGCC sponsorship of exchange programs with China, which could complicate effective

monitoring of foreign-trained engineers (Businessworld, 2017).

Potential Institutional Responses

REFORM PAGCOR'S POWER: EMPOWER THE DTI, BIR, AND DOJ

The current system generates two contradictions: gambling firms pay PAGCOR application and license fees before they apply to the Bureau of Investment (BOI) or the Investment Promotion Agencies (IPA). By the time the application gets to the BOI/ IPA, the firms already have the backing of PAGCOR, making it difficult for the BOI/ IPA to block the investments. Once the investments have been approved, a certain percentage of their earnings is remitted to PAGCOR, making the GOCC the most profitable state enterprise in the Philippines. As outlined above, the system bypasses either the BOI or the IPA, making it difficult to know whether or not these investments comply with rules and regulations. Furthermore, the current system makes it impossible know how much the firms earn and whether or not they are paying the appropriate amount of taxes.

A possible procedural change would be to require firms to apply directly to the DTI and the IPA concurrently. Only after approval by both agencies would firms be allowed to

apply or be referred to PAGCOR. Under this procedure, it would be possible to screen these investments, examine the amount of capital involved, the quantity of foreign labor required, and the potential impact on the local real estate market. In addition, the firms could also register with the Bureau of Internal Revenue (BIR) at this stage. Policy RMC 78-2018 was formulated in 2018 to require firms to register with BIR. In fact, the Duterte administration has used RMC 78-2018 to collect taxes from the local service providers of the online firms. However, the policy has insufficient teeth to enforce tax collection on foreign online firms who have invested in the Philippines.

As such, it is necessary to make firms accountable to the BIR rather than PAGCOR, which can be achieved by repealing PAGCOR's power to license rather than just repealing the tax regulation. Indeed, subjecting foreign online gambling firms to Philippine tax brackets, regulations, and exemptions is the most important policy move. If BIR is given power to tax gambling firms, the BIR can properly tabulate the amount of taxes that these firms should pay, rather than simply levying 5% of their profits. As such, the BIR could assess and collect taxes owed by these firms, as it does in almost every other industry in the Philippines. Another issue is that companies withhold taxation income from workers, making

it difficult for the government to tax the employees (Reyes, 2018). While the Philippines recently required firms to submit a list of their workers and pay for their taxes (O. de Vera, 2019), these processes require self-reporting and can be circumvented. As such, requiring the workers to register with the BIR should be a prerequisite before the firm can hire employees.

IMMIGRATION CONTROLS

While the Philippines recently made online firms register their workers with the Bureau of Immigration (BI) (Leyco, 2019), the process relies on self-reporting. In other words, it is still difficult to tell whether the firms use illegal workers or not. Black market organizations bypass immigration controls by using tourist companies to process the visits. Currently, companies submit information on tourists-turned-workers through advanced delegation processing (Author Interview, 2018a). However, these applications consist of 50-60 people per tourist trip, making it difficult for immigration officials to properly scrutinize each individual. As the BI processes these applications prior to their arrival in the country, Chinese tourists-turned-workers are able to easily move through immigration controls in various Philippine airports. An interview with a Chinese worker revealed that immigration controls outside the Ninoy Aquino International Airport are lax, largely

due to concerns among officials about scaring away Chinese tourists through implementation of a more rigorous security protocol.

Given this problem, several measures can be implemented. First, the “advanced delegation” application for tourist firms needs to be removed, but the visa-on-arrival system should be maintained, as it would continue to encourage Chinese tourists to visit the Philippines. However, immigration officials should be given more power to scrutinize these workers instead of processing the application ahead of time. Since officers are randomly assigned to Chinese tourists, it is easier to prevent collusion and also to catch those tourists-turned-workers. While the Department of Tourism and local governments might balk at these additional safeguards, the retention of the visa-on-arrival system can be a consolation. Furthermore, it is crucial to consider the potential implication of the illegal workers in the Philippine economy, which affects both the Chinese workers and Filipinos.

Second, the Philippine government needs to increase the budget of the BI and hire more immigration officers. In 2015, the Philippine executive and legislative branches allocated USD 17 million to the Bureau of Immigration. Budget limitations mean that BI staff will not receive pay raises, increasing the risk of black market organizations influencing BI officials.

While the Philippine congress and senate have made plans to increase BI's budget, these proposals have yet to be implemented.

SECURITY REVIEWS OF STATE-BACKED FOREIGN INVESTMENT INTO STRATEGIC SECTORS

The following solutions can also be pursued. First, the Philippine government should encourage other foreign investors to invest in Philippine energy grids in order to dilute the SGCC's stake and limit its influence. The Philippine government can acquire aid from Japan and other countries to expand energy infrastructure separate from the SGCC. Investment in alternative technology such as hydro and solar power plants can generate additional electricity for the Filipino population without the need for a supporting grid infrastructure, as some energy systems could have their own smaller distribution facilities.

Second, Filipino companies with outside experts should inspect the SGCC's security grids. Since SGCC manages technology that Filipino firms are not familiar with, using outside experts to determine possible problems is necessary. Similarly, as Huawei's investments in the Philippines seem to be proliferating, independent experts should inspect the telecommunications equipment to manage security risks. And finally, Filipino

engineers who have been trained in China should undergo background checks. Non-Chinese companies and countries should be encouraged to provide training for engineers outside the SGCC and China, mitigating the security risks posed by entrusting all technical training in an essential sector to a single foreign state.

INSTITUTING A CENTRALIZED FDI-REGISTRATION SYSTEM AND REGULATORY INSTITUTION

The current system is built around a decentralized investment structure. Investors can go through a number of government institutions to invest, particularly the BOI, the IPAs, local governments, or select state agencies (e.g. PAGCOR for gambling and DENR for mining). This system makes regulatory capture more likely because agreements between the foreign investor and the specific government institution can be made with little transparency. As a result, governance gaps are created due to the opacity of deals signed with foreign investors. A centralized FDI-registration system, following the example of several developed countries, could help to solve the problem of FDI transparency. For instance, The Committee on Foreign Investment in the United States (CFIUS) reviews the national security implications of all major investment deals. In the European Union, there is an

attempt to create a common regulatory framework to govern foreign investments. Indonesia used to have the Philippine model of a decentralized investment structure. In recent years, the Badan Koordinasi Penanaman Modal has become the sole agency to facilitate investments.

Conclusion

This chapter argues that Chinese FDI in online gambling has generated corrosive effects on Philippine institutions. Although increasing quantities of Chinese FDI have likely supported economic growth in the Philippines, Filipinos have also been negatively affected by related negative economic and societal externalities, such as PAGCOR's conflicts of interest, an influx of illegal workers, and rising real estate prices. In response, we suggest that the Philippine government repeal its existing law establishing PAGCOR as the primary regulator, tax collector, and watchdog of online gambling firms. A new law should be created, definitively placing PAGCOR's regulatory power in the hands of other, competing, Philippine agencies. Apart from suggesting policy responses to specific loopholes in laws and regulations, this article also recommends that the Philippines create an exclusive agency that deals with all Chinese FDI into the country, following the examples laid out by the United States

and the European Union. This report also examined Chinese investments in electricity grids, including the corrosive effects of some sectors and suggested policy responses.

Impact of money flowing (in secret) through these governance gaps:

- Government is denied revenue
- Public faith in public institutions can be harmed
- Informality and secrecy → human rights, other concerns (laborers)

It should be made clear that the author does not oppose Chinese FDI. Indeed, Chinese FDI in other parts of the Philippine economy has generated employment, grown revenue, and spurred a multiplier effect that strengthens the Philippine economy overall. Chinese FDI in the manufacturing sector, which could generate jobs for thousands of Filipinos, can help expand the Philippine economy and prevent xenophobic sentiments against Beijing. The Chinese government can consider the issues in the report, as their activities – no matter how well intentioned – can and will be problematic so long as these corrosive effects continue. Currently, very few Filipinos trust that China has good intentions for the Philippines. More productive and sincere engagements can prevent further deterioration of China's reputation as an economic partner.

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CHAPTER 4

CHINESE INVESTMENTS IN CAMBODIA: MINDING THE GOVERNANCE AND ECONOMIC GAPS

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Introduction

The flow of Chinese foreign direct investment (FDI) to Cambodia has significantly increased in the past few years, especially in the field of infrastructure development. Robust governance reforms and gradual economic diversification have enabled Cambodia to better attract investment from abroad. At the Government-Private Sector Forum held in Phnom Penh in March 2019, the government laid out new commitments and concrete reforms to reduce the cost of FDI-related production and logistics (Vannarith, 2019b). The Belt and Road Initiative (BRI) and Lancang-Mekong

Cooperation (LMC) further facilitated the flow of Chinese investment.

This chapter provides an overview of Cambodia's economic development, bilateral relations between Cambodia and China, and discusses the impacts and perceptions of Chinese investments in Cambodia. These key issues will be discussed through the lens of public procurement issues and a case study in Sihanoukville.

An Overview of Cambodia's Economic Development

Cambodia has experienced high economic performance over the past two decades, with

an average annual growth rate of 7.7%. In 2018, the growth rate remained at 7.5%. High growth has been primarily driven by rapid expansion of exports as well as robust internal demand, along with a surge in FDI (World Bank, 2019). The contribution of exports to Cambodia's GDP has gradually increased from 50.6% of GDP in 2017 to 53.5% in 2018 and an estimated 54.8% in 2019. Imports have similarly increased their share from 69.9% of GDP in 2017 to 76.3% in 2018 and estimated 76.7% in 2019. The main export products are garments (66.4%) and footwear (9.7%) (National Bank of Cambodia, 2019).

Cambodia has shown improvement in other indicators as well. The poverty rate fell from 53% in 2004 to 13.5% in 2014 and is expected to have dropped below 10% in 2019. Health and education have made remarkable progress despite certain issues that still require government attention (Sen, 2019). Foreign direct investment has increased over the years. FDI is estimated to have reached a record high of more than USD 3 billion, or 12.6% of GDP in 2018 (World Bank, 2018). Burgeoning exports and strong FDI inflows have contributed to further accumulation of gross international reserves, which in 2018 reached USD 10.1 billion (World Bank, 2019).

With its relatively young workforce: 70% of the total population under 35 years old, Cambodia has great potential to continue its climb up the development ladder.

Cambodia's development vision is to become a higher-middle-income country by 2030 and high-income country by 2050. The 2015-2025 Industrial Development Policy adopted in 2015 has become a roadmap for expanding industrialization's scale and scope in Cambodia. The policy aims to promote the country's industrial development to maintain high, sustainable, and inclusive economic growth through economic diversification, strengthened competitiveness, and greater productivity. However, the policy has not delivered expected results due to policy and coordination failures. For example, the policy has not provided a coordinated program of concrete, time-bound targets for investment projects in the various sectors and subsectors of Cambodia's economy (Kimlong, 2019b).

The Rectangular Development Strategy (2018-2023) is the core development policy of the country, focusing on four priority areas. First, *human resource development* focuses on improving the quality of education, science, and technology; providing vocational training; improving public healthcare and nutrition; and strengthening gender equality and social protection. Second, *economic diversification* focuses on improving logistics and enhancing transport, energy, and digital connectivity; developing key and new sources of economic growth; encouraging readiness for the transition

to a digital economy and the “industrial revolution 4.0;” and promoting financial and banking sector development. Third, *private sector development* concentrates on job market development, entrepreneurship, and SME development, and public-private partnerships. Fourth, *inclusive and sustainable development* focuses on agricultural and rural development; sustainable management of natural and cultural resources; management of urbanization; and promoting sustainability and adaptation to climate change.

Regional integration is one of the key components of Cambodia’s development strategy. The country has adopted a proactive regional integration scheme, which is chiefly shaped by economic pragmatism, referring to the alignment of foreign policy with economic interests (Vannarith, 2019a). Aiming to become a bridging state in ASEAN and the Mekong Region, Cambodia is advancing an inclusive, open, and rules-based multilateral system. Prime Minister Hun Sen stated in April 2019 that ASEAN has contributed to Cambodia’s economic development in many ways. ASEAN has become the third largest export market for Cambodian products, after the European Union and the United States. The share of Cambodia’s trade volume with other ASEAN Member States increased from a mere 4 percent in 1999 to more than 20 percent in 2018. ASEAN is also one of the top

investors in Cambodia. ASEAN member states accounted for 22% FDI inflows in 2017 and 25% in 2018 (Vireak, 2019b). Within ASEAN, Thailand, Vietnam and Malaysia are the three top investors in Cambodia (MFAIC).

After implementing an opening-up policy in the early 1990s and becoming a member of ASEAN in 1999, Cambodia adopted a free-market economy and took an active role in regional integration. Cambodia’s investment regime is relatively liberal and open compared with other ASEAN economies. Investment incentives are attractive to foreign investors, offering benefits such as 100 percent foreign ownership, corporate tax holidays of up to eight years, duty-free import of capital goods, and no restrictions on capital repatriation. Cambodia’s current Law on Investment specifies a number of incentives, especially tax incentives, for investors (CDC).

In addition, the Cambodian government has been improving its investment facilitation services. For example, the Government decided in 2005 to establish the Cambodian Special Economic Zone Board (CSEZB) under the Council for Development of Cambodia (CDC) to promote the special economic zone (SEZ) scheme in Cambodia. Administered by the CSEZB, the Special Economic Zone Administration is to be established in authorized SEZs and is expected to provide one-stop service to zone investors from the registration of investment projects to routine

export-import approvals (CDC). However, challenges and obstacles affecting foreign investment remain, particularly bureaucracy in business registration, inconsistency in policy coordination, and weak regulatory enforcement (Kimlong, 2019b).

Between 2015 and 2018, average annual foreign direct investment in Cambodia amounted to USD 5.2 billion, Special Economic Zone (SEZ) investment accounted for USD 331 million (15.8 percent). In 2018, total FDI capital totaled USD 6.45 billion, with investment primarily directed into infrastructure (USD 2.09 billion), industry (USD 1.38 billion), tourism (USD 816 million), services (USD 782 million), hotels (USD 692 million), and agriculture (USD 444 million). China has been a key investor in Cambodian SEZs overall.

Japan and South Korea have also invested in Cambodian infrastructure, but this has declined in recent years. In 2015, the difference between Chinese, Japanese and South Korean investment was stark. Chinese business had the largest influence in Cambodia with 1,055 companies having a presence in the country, followed by South Korea at 278 companies. Japan ranked third with 250 companies and comprised USD 56.7 million out of the total USD 4.6 billion FDI for that year (Kea, 2016) (Table 1, PG. 86 and Table 2, PG. 87).

An Overview of Sino-Cambodian Relations

Cambodia is generally perceived as the closest friend of China in Southeast Asia. There were three main critical development

TABLE 1: Investment Trends 2015-2018 (Million USD)

YEARS	TOTAL INVESTMENT	NON-SEZ INVESTMENT	SEZ INVESTMENT
2015	4,643.50	4,528.90	114.60
2016	3,609.55	3,326.30	283.25
2017	6,332.00	5,847.00	485.00
2018	6,451.52	6,009.46	442.06

SOURCE: Council for the Development of Cambodia

TABLE 2: Investments by Sector 2018 (Million USD)

SECTOR	INVESTMENT
Infrastructure	2,087.29
Industries	1,375.57
Tourism	816.79
Services	782.86
Hotel	692.02
Agriculture	444.18
Garment	223.93
Building Material	58.37
Energy	58.23
Bags	50.53
Shoes	40.97

SOURCE: Council for the Development of Cambodia

points in this relationship. China offered strong diplomatic and economic support to Cambodia in the aftermath of the violence in July 1997, to counter the pressures from the U.S. and other Western countries on Cambodia. In 2010, a comprehensive strategic partnership agreement was signed to advance the bilateral relationship in all

fields. In 2016, during President Xi Jinping's state visit to Cambodia, China called Cambodia an "ironclad friend." (FMPRC).

The bilateral relationship reached its peak in April 2019 when the two countries signed the Action Plan for Forging the Cambodia-China Community of Shared Future (2019-2023)

covering five key areas: political cooperation, security cooperation, economic cooperation, cultural and people-to-people cooperation, and multilateral cooperation. Under the pillar of economic cooperation, both sides agreed to continuously expand trade volume and realize the goal of USD 10 billion bilateral trade volume by 2023. Bilateral trade volume increased from USD 5.16 billion in 2016 to 6.6 billion in 2018 (Table 3, PG. 88). The main products that Cambodia exports to China are milled rice, cassava, pepper, cashew nuts, sugar, and apparel., The main products that Cambodia imported from China are mostly raw garment materials, machinery, vehicles, foodstuffs, electronics, medicines and cosmetics (Xinhua, 2019).

Both sides are committed to further raising the scale and level of Chinese investment in Cambodia, with a focus on enhancing investment cooperation in agriculture, industry (mainly textile, agro-industry, and

rice milling), infrastructure, construction, energy (mainly hydropower plants and coal energy), and tourism. Annual investment flows from China increased from USD 985 million in 2016 to USD 3.59 billion in 2018 (See Table 3). Over the 1994-2017 period, the total fixed investment from China was USD 12.6 billion, accounting for 20.2 percent of total investment in Cambodia. The Rhodium Group calculates that the cumulative gross value of Chinese FDI transactions through 2017 (including acquisitions and greenfield projects) in Cambodia is USD 7 billion. The top investment sectors are transport, utilities, infrastructure, real estate, and energy. In 2018 alone, China invested USD 2.69 billion in Cambodia. While it is not certain that China will continue to invest in the creation of dams in Cambodia, Chinese investment in hydropower plants is remarkable, accounting for USD 2.36 billion (Table 4, PG. 89). In fact, an estimated 80 percent of power produced in Cambodia comes from

TABLE 3: Trade and Investment (Million USD)

	2016	2017	2018
Bilateral Trade Volume	5,160	5,577	6,600
China’s Investment Capital	985	1,656	3,594

SOURCE: Ministry of Commerce and Council of Ministers of Cambodia

TABLE 4: Chinese Investment in Hydropower

NAME OF PROJECT (COMPLETED)	SIZE (MW)	INVESTMENT CAPITAL (MILLION USD)
Kirirom 1	12	26.00
Kirirom 3	18	47.10
Kamchay	194	280.54
Atay	120	199.97
Russey Om	338	485.76
Tatay	246	540.00
Lower Sesan 2	400	781.52
TOTAL	1,328	2,460.89

SOURCE: Ministry of Foreign Affairs and International Cooperation of Cambodia

projects undertaken by either state-owned or government-linked Chinese companies (Khmer Times, 2019a).

SIHANOUKVILLE CASE STUDY

The Sihanoukville Special Economic Zone (SSEZ) is a landmark project under the Belt and Road Initiative (BRI) and aims to create an ideal trading platform for export-oriented industries under the slogan “Investment in ASEAN, radiation to the world.” (SSEZ.com) Currently, the Sihanoukville Special

Economic Zone, an economic and trade cooperation zone constructed by Chinese and Cambodian companies, aims to attract 300 enterprises, which would employ about 100,000 workers. The zone currently has 161 companies, with registered capital of around USD 918 million and a labor force of 22,495, according to a statement released in January by the Council for the Development of Cambodia (Hong, 2019).

Both Cambodia and China agreed to jointly promote the implementation of major

investment projects such as the SSEZ, Phnom Penh-Sihanoukville Expressway, and Siem Reap Angkor International Airport. They will also provide more preferential policies for the development and operation of the SSEZ while supporting the SSEZ in completing the construction of its supporting industry chain. Both parties were committed to creating a better environment for the SSEZ and to encourage pragmatic cooperation between Cambodia and China. The Cambodian side also aspired to improve the investment environment to further facilitate Chinese enterprises' business in Cambodia.

In the Sihanoukville case, it can be argued that the negative impacts on the local community and the environment outweigh the benefits arising from the influx of Chinese investment projects in the area. Chinese nationals own more than 90% of businesses in Sihanoukville. Chinese investment projects and companies have few economic links and little technology and knowledge transfer with local Cambodian enterprises. Other negative impacts stemming from the influx of Chinese investment include increasing instability in Sihanoukville due to negative public perceptions of Chinese activities, increases in living costs, and environmental degradation.

BELT AND ROAD INITIATIVE IN CAMBODIA

The BRI is complementary to Cambodia's national development strategy of strengthening the country's economic competitiveness by diversifying sources of growth and expanding Cambodia's economic horizon. Cambodia-China cooperation under BRI focuses on seven areas, namely infrastructure, agriculture, capacity building, special economic zone development, culture and tourism, finance, and eco-environmental protection (Vannarith, 2017).

There are no standard criteria of what constitutes a BRI project in Cambodia. In many cases, the designation depends on a political decision (Table 5, PG. 91, for the major projects under the BRI in Cambodia). In March 2019, state-owned construction company China Road and Bridge Corporation committed to building Cambodia's first expressway connecting the capital of Phnom Penh to coastal Sihanoukville province. The 190-km expressway will cost USD 2 billion under a Build-Operate-Transfer (BOT) agreement. This is one of the key mega infrastructure projects under the BRI.

China is also one of Cambodia's key development partners. From 2013 to 2018, China provided a grant of 6.31 billion

Yuan (about USD 1 billion). In 2019, China pledged 4 billion Yuan (about USD 600 million) in a three-year project grant. In terms of concessional loans, China provided concessional loans of about USD 1.35 billion for the period 2016 to 2018. In terms of physical infrastructure development, China has built 29 roads with a total length of 2,900 km. China has also built 7 bridges with a total length of 6,824 km. In the 2016 to 2019 period, China has provided scholarships to 849 Cambodian students (MOFAIC). China also promised to import more rice from Cambodia, with the aim to import 400,000 tons per year and to support Cambodia in the face of the threat from the European Union to revoke Everything-but-Arms (EBA) preferential trade treatment from Cambodia (Al-Jazeera, 2019).

Enabling Factors for Chinese Investments to Cambodia

Chinese investments to Cambodia have been facilitated by deep mutual political trust, stable macroeconomic conditions, market access, low labor costs, and relatively easy access to land and other natural resources. The bilateral agreement on the protection and promotion of investment that came into force in August 1999 provided a legal framework to facilitate Chinese investment in Cambodia. Currently, the two countries are in the process of negotiating a bilateral free trade agreement that aims to further promote trade and investment. In 2010, China and Cambodia signed a landmark Comprehensive Strategic Partnership Agreement to advance their bilateral ties.

TABLE 5: Major BRI projects in Cambodia

NAME OF PROJECT	AMOUNT OF INVESTMENT
Sihanoukville Special Economic Zone	USD \$918 million (joint private investment by Chinese and Cambodian enterprises)
Phnom Penh-Sihanoukville Expressway	More than USD \$2 billion (public-private partnership)
New Siem Reap International Airport	USD \$1 billion (public-private partnership)
Lower Sesan 2 Dam	USD \$781.52 million (joint investment by a Chinese SOE and Cambodian enterprise)

This was the first strategic partnership agreement that Cambodia had ever signed with an external partner.

The establishment of the ASEAN-China Free Trade Agreement in 2010, the launching of the Belt and Road Initiative (BRI) in 2013, and the creation of the Lancang-Mekong Cooperation (LMC) in 2016 all contributed to building a suitable environment for regional integration as well as the enhancement of bilateral economic ties between China and Cambodia. These multilateral frameworks facilitated the inflow of Chinese investments to Cambodia, while strengthening regional connectivity (Kha, 2019).

In April 2019, the Ministry of Economy and Finance of Cambodia signed an MOU with the Bank of China on “Cooperation under the Rectangular Strategy and the Belt and Road Initiative” with the aim of promoting the BRI projects, especially those pertaining to infrastructure development, trade facilitation, and financial collaboration. The Bank of China agreed to assist the Ministry of Economy and Finance with attracting Chinese investment, hosting or organizing investment promotion activities, and providing favorable credit policies to key projects. Moreover, since early 2019, Cambodia has started using the Chinese Yuan, colloquially known as *renminbi*, as a floating currency, making

Cambodia one of the early supporters of the internationalization of *renminbi*.

The role of local Chinese ethnic communities is also important in drawing Chinese investors to Cambodia, in part because some local Chinese tycoons have strong political connections with local Cambodian political leaders. In a 2014 article on Chinese FDI in Cambodia, Daniel O’Neill correctly observes that, to avert risks, Chinese firms in Cambodia receive and secure political support from China (in the case of state-owned enterprises) and political connections and protection from local elites (O’Neill, 2014). Chinese investments in Cambodia are varied in terms of ownership type and asset specificity. China’s state-owned enterprises have focused on hydropower plant projects facilitated through grant aid or soft loans from the Chinese government to Cambodia. These projects frequently enjoy investment approval and political protection from the Cambodian government, and some of these projects have been criticized for their lack of transparency and accountability. China’s private firms, on the other hand, have concentrated their investments on the garment industry. Chinese firms investing in Cambodia’s land and resource sector have strong political connections with local political elites (O’Neill, 2014).

Local Perceptions Towards Chinese Investment

Chinese investments have had substantial impact on Cambodia, from political to socio-cultural, environmental, and socio-economic impacts. In the case of Chinese investments in Sihanoukville, the negative impacts on local community development and environment seem to outweigh the benefits arising from the influx of Chinese investment projects to the area. An increasing crime rate, booming gambling and sex industries, environmental degradation, inflation and rising cost of living, and social and cultural tensions between the Chinese and local community are some of the issues and concerns facing the local people (Sovinda, 2019).

There is a divergence of views among different actors and stakeholders in Cambodia regarding Chinese investment. The ruling elite are comfortable and quite confident that Chinese investment has helped to develop the national economy and strengthen regime legitimacy. This same elite, however, is also concerned about political and strategic implications from overreliance on China. Local business communities have different views. For example, it is primarily large corporations that have more opportunities and advantages to link up with Chinese companies, especially under joint venture frameworks. Local

small and medium size enterprises (SMEs) have much less to gain, and some are even marginalized due to their losses from competition with Chinese companies.

STATE ACTORS

China has played a critical role in developing the Cambodian economy, especially through the development of infrastructure, investment and job creation, and trade relations. China is most responsive to Cambodia's development needs in the context of infrastructural megaprojects. In the words of Cambodia's Secretary of State of the Ministry of Economy and Finance (Meng), "Without China, there would be no Cambodia today — one must learn to accept that. Why should we go to China for assistance? We don't want to favor China, but if they give us what we need, shouldn't we take it?" The Under-Secretary of State of the Ministry of Economy and Finance further wrote, "The prospect of shifting and relocating some of China's industries and production base to countries along the Belt and Road can only be promising for small economies like Cambodia" (Vanndy, 2019).

The Cambodian government has made efforts to attract more Chinese investment, especially through the reduction of production and logistics costs. Speaking at the Dinner Party of the Cambodia-China Business Forum on Cambodia in December

2016, Prime Minister Hun Sen said that the government would continue to improve the investment and business climate by improving logistics, providing stable and low-cost electricity, offering skills development for the work force, and reducing irregular fees (CNV).

Under mounting diplomatic and economic pressure from the US and the EU, Cambodia has sought assistance from China to mitigate the risks and hedge against the pressures from the West. Wang Huning, a Member of the Politburo Standing Committee of the CPC and Secretary of the Party's Secretariat, told Prime Minister Hun Sen in April 2019 that China would help Cambodia with all problems, including those arising from the withdrawal of EBA status by the EU (Niem Chheng, 2019b). The statement demonstrates China's firm commitment to assist Cambodia in all circumstances. An editorial in *Khmer Times* warned that, "the threat to revoke the EBA, which costs Cambodia up to USD 650 million dollars a year, would force Cambodia to fall completely into China's camp, and this might be an irreversible trend" (*Khmer Times*, 2019b).

With regard to the concern over the possible debt trap caused by the BRI projects, Cambodia is confident that it has managed its external debt prudently. According to the Debt Sustainability Analysis by the IMF,

Cambodia is at low risk of external debt distress (IMF, 2017). Prime Minister Hun Sen stated at the second Belt and Road Forum in April 2019 that, "BRI will [not] make some countries fall into a debt trap. Cambodia will negotiate and prepare projects in the interests of the nation and its people and not increase the financial burden and public debt. As a sovereign country, we have the right to make whatever choices we want and receive the loans necessary. We will implement these projects for national development based on self-reliance" (Niem Chheng, 2019a).

LOCAL PRIVATE SECTOR (SMALL BUSINESSES)

Chinese investment projects have few economic links with local enterprises and a low level of technology and knowledge transfer among local enterprises and workers. Some local small-businesses have even been marginalized and adversely affected because they could not compete with Chinese companies. Chinese firms have little interaction with local firms and do not contribute much to the capacity and skill development of the local workforce (Kubny, 2010). As a result, the spillover effect of Chinese investments on local SMEs has been limited.

Numerous news reports on Chinese investments in Sihanoukville illustrate that

small local businesses do not benefit from the influx of Chinese investments in the province. Local analyst Heng Pheakdey (2018) argues that, “Even though Chinese investment is bringing wealth to Cambodia, this wealth is mainly kept within Cambodia’s Chinese community. Chinese residents and visitors in Cambodia buy from Chinese businesses, eat in Chinese restaurants and stay in Chinese hotels. The trickle-down effect to local businesses is minimal.” A news report (Ng, 2018)quoted a local businessman as saying:

Hundreds of family-owned businesses have put up shutters in the past year. Many were evicted because the landlords preferred to lease properties to Chinese businessmen, who can afford to pay up to five times more. To make matters worse, local businesses have lost their traditional customer base: Western tourists who used to flock there for the sun, sand, and sea.

LOCAL COMMUNITY AND CIVIL SOCIETY

The local community and civil society have different views on the impacts of Chinese investments on their livelihood. Some welcome the presence of Chinese investments because they bring job opportunities and higher incomes. Some are concerned over the fact that their livelihood has been affected due to the climbing cost

of living, rising crime rate, and environmental degradation. Chinese investments in Cambodia lack strict social or environmental safeguards. With regard to Sihanoukville, local analyst Sim Vireak (2019) argues that “Unchecked development by Chinese investors has come at a cost, freezing out locals and changing the city’s character.” Scholar Kimkong Heng (2019) argues that, “The capital inflow and rising visitor numbers have been both beneficial and disruptive for Cambodia’s economic development and social cohesion.”

Rising crime is another concern for local people. In January 2018, local governor Yun Min warned that Chinese investments were bringing organized crime and instability to Sihanoukville. Governor Yun Min warned that the Chinese influx had “created opportunities for Chinese mafia to come and commit various crimes and kidnap Chinese investors, causing insecurity in the province.” China’s then-ambassador to Cambodia, Xiong Bo, also acknowledged the rising crime rate among Chinese living in Cambodia, including drug and sex trafficking as well as internet and telephone scams (Benjamin, 2019).

Social and cultural tensions between locals and Chinese immigrants have also been rising due to the lack of respect shown by some Chinese toward Khmer culture and values. Misspelling of Khmer language in commercial signboards, a booming sex

industry in the case of Sihanoukville, and other related identity conflicts are some of the sources of tension between the two communities, especially during the drastic increase in the number of Chinese immigrants over the past few years. In the case of Sihanoukville, it is estimated that Chinese make up about 20 percent of the resident population. Chinese nationals own more than 90% of businesses in Sihanoukville (Heng, 2019). This has fueled rising hostility among locals toward the influx of Chinese residents (Ellis-Petersen, 2019). Anti-China sentiment has been on the rise, fueled by some irresponsible politicians and individuals (Capital Cambodia, 2019). Analyst Heng Pheakhdey argues, “If the situation continues to deteriorate and more social chaos is caused by the Chinese community in Cambodia, I think... it’s possible that it will create a negative sentiment towards Chinese nationals in Cambodia,” he said. “It’s a real risk for Cambodia” (Millar, 2018).

Challenges and Issues

REGULATORY QUALITY AND INSTITUTIONAL CAPACITY

In 2016, China invested USD 3.6 billion in Cambodia. This figure nearly doubled in 2017, with Chinese investment totaling USD 6.3 billion. The remarkable magnitude and velocity of Chinese investment in Cambodia

has outpaced the speed and capacity of Cambodian government bodies to regulate, monitor, and manage these investments. Cambodia lacks a regulatory regime capable of effectively managing investment projects, particularly in light of the high rates of corruption and the lack of transparency in Cambodia. Moreover, due to the lack of policy and coordination mechanisms to promote technology and knowledge transfer to the local labor force, Chinese investment has brought with it an influx of Chinese migrant workers to Cambodia.

Some Chinese investors have contributed to projects that have led to criminal activity, social and cultural tensions, environmental issues, and other unintended negative impacts on local communities. Due to the lack of regulation and weak law enforcement, Cambodia is vulnerable to these “irresponsible” investors (Khmer Times, 2019a). Cambodia’s judicial system lacks the institutional capacity to address those crimes and otherwise faces political constraints limiting its effectiveness (Cox, 2012).

Weak law enforcement and corruption are the main root causes of these adverse impacts. In January 2018, Preah Sihanouk provincial governor Yun Min expressed frustration over the growing crime and public disorder in Sihanoukville. These problems are frequently associated with the influx of Chinese funds and migrants. In a letter to the

Interior Ministry, Min also bemoaned rising property rent, the inability of local businesses to compete with Chinese companies, and the oversaturation of Chinese laborers in the construction sector (Nachemson, 2019). The collapse of a Chinese-owned apartment block under construction in June 2019 was a case in point illustrating the weakness of the local government in monitoring the quality and standard of construction (BBC, 2019).

LAND OWNERSHIP ISSUES

Some Chinese companies are allegedly involved in land disputes and forced eviction. According to local NGO Coalition of Cambodian Farmer Community (CCFC), some 20,000 families have suffered as a result of land disputes related to Chinese investment since 2003 (Reaksmey, 2018). According to Cambodia's Investment Law, ownership of land for the purpose of carrying out investment activities shall be vested only in natural persons holding Cambodian citizenship or in legal entities in which more than 51% of the equity capital is directly owned by natural persons or legal entities holding Cambodian citizenship.

Due to some loopholes in implementation and law enforcement, land disputes have not been effectively resolved. A study by the Mekong Region Land Governance argues that, "long running disputes over land abound, but access to justice through

the Cambodian court system or other dispute resolution mechanisms is limited" (Scurrah, 2015). Since the government began selling off land in 2001 to private investors for development, about 800,000 people have been displaced, according to the International Federation for Human Rights in 2016 (Ng, 2019).

LABOR ISSUES

Some Chinese investment projects have stirred local discontent due to infringements of labor rights, and degradation of local livelihoods and environmental quality (Vannarith, 2017). Moreover, the huge inflow of Chinese workers to Cambodia has also caused social tensions. Concerning the employment of Chinese workers, Cambodia's Investment Law stipulates that investors can hire foreign employees on the condition that workers with the necessary qualification and expertise are not available among the Cambodian populace. In addition, the investors have an obligation to provide adequate and consistent training to Cambodian employees and promote Cambodian staff to senior positions over time.

In accordance with Cambodia's Labour Law of 1997, foreign workers must apply for work permits and employment cards issued by the Ministry of Labour. These work permits are valid for one year but may be extended. The maximum percentage of foreigners who

can be employed in any given enterprise shall be determined by a *Prakas (Declaration)* of the Ministry of Labour. However, the implementation of the investment law and labor law faces limitations, mainly due to corruption and insufficient transparency. Specifically, unclear employment contracts, poor oversight of minimum wage adherence, and the absence of a labor court are common challenges to implementation of Cambodia's labor regulations (Nop, 2017).

TECHNOLOGY TRANSFER

Technology and knowledge transfer by Chinese companies is low (Lam Thanh Ha, 2019). Chinese firms have little interaction with local firms and contribute little to capacity and skill development for the local workforce (Kubny, 2010). Moreover, although some studies suggested that Cambodia has economically benefitted from the inflow of Chinese investments and development assistance, "economic gains from China are taking place at the expense of social dislocation and environmental destruction" and the deterioration of good governance (Pheakdey, 2016).

As an illustration of these negative impacts, some local people in Sihanoukville are not happy with China's presence in their communities. Increases in both cost of living and crime rates, weak links between Chinese investment and local

small businesses, and degradation of local livelihoods have all been linked to the Chinese presence (Ng, 2019). Other issues include a public perception that the growing influence of Chinese entrepreneurs and politicians in Cambodia may result in the marginalization of local Cambodians and that Cambodia might fall into a debt trap especially under the infrastructure megaprojects under the Belt and Road Initiative (BRI) (Touch, 2018). Responding to these concerns, analyst Keo Piseth suggests that "mechanisms for transparency and accountability for BRI projects, especially in infrastructure, should be established to prevent elite capture and corruption in these gigantic, loan-based infrastructure projects." (Piseth, 2019)

Implications for Cambodia's Foreign Policy

Some Western media outlets and political analysts tend to portray Cambodia as a vassal state of China. In fact, Cambodia is implementing a diversification and hedging strategy instead of bandwagoning with any major power. Strengthening an open, inclusive, and rules-based multilateral system is the key objective of Cambodia's foreign policy (Vannarith, 2016). Cambodia's recent embrace of Chinese investment can be attributed to strategic and economic interests; (Kimkong Heng, 2019) a desire

to counter pressures from the U.S. and its allies on human rights and democracy issues (Var, 2015); and an attempt to counterbalance against existential threats posed by Cambodia's neighbors, Thailand and Vietnam (Thearith, 2017). Cambodian analyst Cheunboran Chanborey argues that "Cambodia's geography of being sandwiched by its two powerful historically antagonistic neighbors—Thailand and Vietnam—has been a persistent compelling factor shaping the country's strategic direction. To address this geopolitical predicament, Cambodian leaders have frequently adopted alignment politics with external great power(s)." (Chanborey, 2018)

The rumor that China is eyeing a naval base in Cambodia's Koh Kong province is stirring public debate both inside and outside the country. Domestically, concerns over national security are high because there is precedent of China building port facilities for dual civil-military use. Some foreign powers are also concerned that Koh Kong will serve as a forward operating base for the PLA Navy in the Gulf of Thailand and the South China Sea. The U.S. 2019 Indo-Pacific Strategy states, "we remain concerned about reports that China is seeking to establish bases or a military presence on its coast, a development that would challenge regional security and signal a clear shift in Cambodia's foreign policy orientation" (DOD, 2019).

The Cambodian government has repeatedly denied that it intends to align with any major power, and stresses that it will never permit any foreign military bases on its soil, citing a foreign policy stance of permanent neutrality and non-alignment (Sakhuja, 2019). There is no legal basis, security need, or strategic intention to host foreign military bases in Cambodia (Vannarith, 2018). Prime Minister Hun Sen recently stated, "the Constitution of Cambodia bans the presence of foreign troops or military bases in its territory... whether naval forces, infantry forces or air forces." (Straits Times, 2018)

Cambodia is determined to stay relevant in the international system by leveraging its international role. Taking sides with any major power could push Cambodia into a geopolitical trap. Some Cambodian leaders are aware of the risks stemming from over-reliance on any single major power. According to this perspective, Cambodia must be cautious and has to adopt a strategy to mitigate geopolitical risks posed by over-reliance on China (Khmer Times, 2019a).

Cambodia's ability to implement a hedging strategy to dilute and mitigate these risks is crucial for long-term peace and stability in the country. Competition between China and the West will continue to influence Cambodia's foreign policy and will chart the nation's course as it navigates through turbulent times ahead (Khmer Times, 2019a). Cambodia has

neither interest nor intention to become a vassal or client state of any major power. Cambodia has benefitted from reforms and opening up, and therefore continues to support an open, inclusive, and rules-based multilateral system (Khmer Times, 2019b).

The ruling elite is very much aware of the risk arising from Cambodian overdependence on China, but Cambodia has limited capacity and strategic space to maneuver (Chanborey, 2018). Hedging and diversification are recognized as important strategies, but implementation remains an issue. It will take a few more years for Cambodia to develop a concrete action plan, build institutional and leadership capacity, and strengthen institutional coordination and synergies between ministries (Vannarith, 2019c). Mey Kalyan, senior adviser to the Supreme National Economic Council said, “Cambodia welcomes Chinese investment but is concerned about the growing dependence on China. We should not allow just one country to dominate investment” (Heijmas, 2019).

Conclusion

China is the top foreign investor in Cambodia, enabled and facilitated by deep political trust and ties between the two governments, the relatively open and liberal investment regime in Cambodia, and bilateral and multilateral agreements and mechanisms. The BRI is the main catalyst of growth as well as the

facilitator of Chinese investment in Cambodia. While there are economic opportunities and interests deriving from the influx of Chinese investments, there are also concerns and questions over the quality and real impacts of the investments. For instance, there is an upsurge of anti-China sentiment across Cambodia as result of mismanagement of Chinese investments in a number of instances. The case of Sihanoukville exemplifies the risks associated with Chinese investments such as increases in living costs, higher crime rates, and environmental degradation.

The perception gaps among the ruling elite, small-scale local entrepreneurs, and grassroots communities are also a matter of concern. The legitimacy of the government is affected if the local people cannot fairly benefit from the growing economic presence of China in their localities. Trilateral dialogue among the state, private sector, and civil society is therefore required to explore acceptable solutions to the problems and issues caused by Chinese investments. Overall, Cambodia-China relations will be affected if the majority of the local Cambodians continue to hold negative perceptions of China.

The case of Sihanoukville illustrates the weakness of the local authorities and their inability to prevent or manage crime, ensure the quality of construction, or support local businesses. The decision of the central

government to ban online gambling was welcomed by the general public, but it also caused short-term economic shock as thousands of workers were laid off after the resulting business closures and a sudden slowdown in the construction sector. The real estate bubble in Sihanoukville also started to deflate. The lesson learned is that overreliance on Chinese capital is risky. The local economy is not resilient enough to mitigate shocks.

Due to the excessive speed and magnitude of Chinese investments in Cambodia over the

past two years, local authorities have found it difficult to manage these investments. Strengthening the capacity of public institutions and law enforcement agencies, conducting a comprehensive analysis of Chinese investment projects, implementing better management of foreign workers, and ensuring fair and just distribution of benefits and opportunities arising from FDI are some of the possible measures by which Cambodia could improve its governance of Chinese BRI investment projects (Piseth, 2019).

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CHAPTER 5

CHINESE INVESTMENT IN VIETNAM

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Introduction

21st-century economic trends in Vietnam are being driven by certain factors on both the national and regional levels, namely:

- (i) Lowering of barriers that had previously restricted the growth of the private economic sector;
- (ii) Reducing government intervention and related crowding-out effects generated by state-owned enterprises (SOEs);
- (iii) Deepening integration into international economic activities;
- (iv) Intensively attracting

foreign direct investment (FDI) to stimulate national exports.

In the interest of attracting foreign investment, Vietnam enacted its first Foreign Investment Law in December 1987, implementing price, exchange and property ownership reforms which laid the foundations for long-term economic growth. In 1990, three years after the passage of the law, Vietnamese export turnover still amounted to only USD 2.4 billion. By 2017, this number had increased to almost

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USD 214 billion, or 95% of GDP (GSO, 2018)⁴. Foreign firms from more than 100 countries contributed to this growth, and FDI contributed to nearly 70% of Vietnam's total export turnover. In the 10-year period from 2007-2017 the total FDI capital disbursed to Vietnam reached USD 134 billion, accounting for 47.8% of the total registered capital in the country (GSO, 2018a).

Adding to the effects of increased FDI, reforms to Vietnam's bilateral and multilateral free trade agreements (FTAs) have helped maintain the momentum of economic integration with other nations. Important trade agreement milestones for Vietnam include joining the ASEAN Free Trade Area (AFTA), effective from June 1996, signing the U.S.-Vietnam Bilateral Trade Agreement, effective from December 2001, and becoming a member of the World Trade Organization (WTO) in January 2007 (MPI, 2016). Vietnam has entered into other bilateral trade agreements over this period, including the Comprehensive Trans-Pacific Partnership (CPTPP) Agreement and the Vietnam-EU Free Trade Agreement (EVFTA) and has also participated in negotiations on the Regional Comprehensive Economic Partnership (RCEP).

Integration into the international economy has expanded Vietnamese access to not only

external sources of capital and technology, but also to modern management practices and expertise. In many ways, Vietnam's regulatory environment for doing business has been moving closer to international standards, and market barriers to FDI have been diminishing.

In 2014, after issuing numerous legal documents to adopt international practices into property rights, business law, and investment law, Vietnam introduced the 2014 Investment Law. This law replaced the Investment Law of 2005 and served to meet the stringent requirements of important FTAs such as EVFTA and CPTPP. The promulgation of the new investment law has produced outstanding results, among them moving Vietnam from a positive list mechanism to a negative list mechanism. Since 2017, Vietnam has experienced a net improvement of 12 places in the World Bank's Ease of Doing Business ranking, from 82nd to 70th in the 2020 report (a slight decline from its 69th-place ranking in 2019). Compared to other ASEAN countries, Vietnam made particularly strong progress in improving its rank over this period.

As a result, in the first six months of 2019, Vietnam attracted USD 351.66 billion from FDI inflows. China has quickly emerged as a major investor, with a dramatic increase in

4 Industrial goods contributed approximately 75% of this amount.

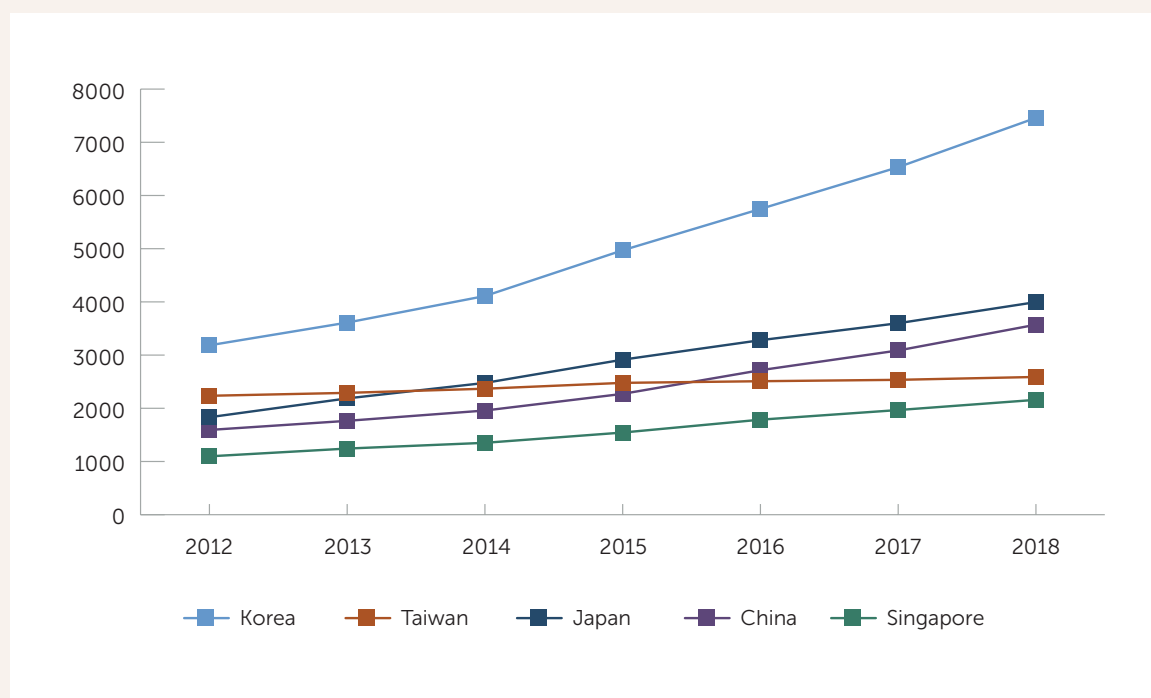
both registered capital and total number of projects. Accordingly, this report will examine the scale and the trend of development of Chinese direct investment into Vietnam in comparison with investors from neighbor countries, and its effect on the Vietnamese economy. As previously discussed, the opacity of Chinese capital investments poses major complications to analysts. The standard “input approach” to analysis is not possible when data on Chinese inputs is not available. Therefore, this report uses an output-based approach, using Chinese engineering/procurement/construction (EPC) contractors as a case study. This is a valid approach because 90% of Chinese EPC contracts to build Coal-Fired Power Plants in Vietnam are funded primarily by Chinese capital (GreenID Vietnam, 2016). However, contractors may win bids funded by other capital sources, so this may not be the case in other sectors of the economy. This report acknowledges that there is scope for further research. The report also offers policy recommendations for ameliorating the effect of corrosive capital in Vietnam.

Chinese FDI in Vietnam

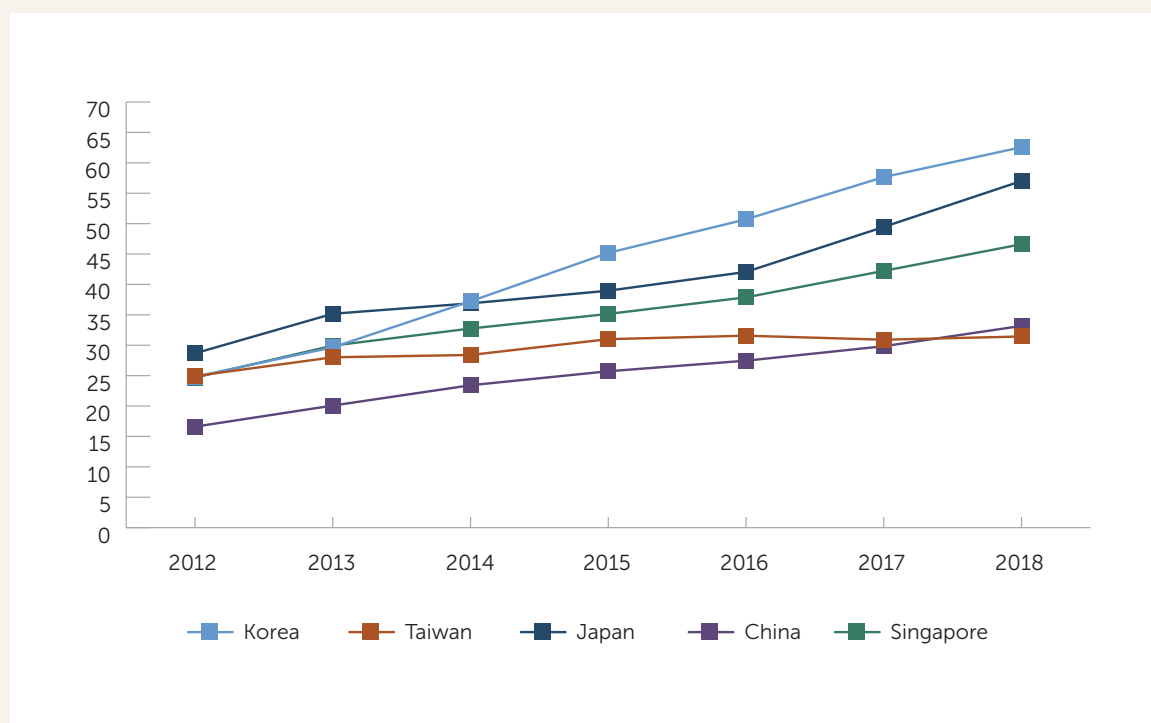
China’s policies to promote FDI outflows have been meticulously planned since 1992. In 1997, during the 15th National Congress of the Chinese Communist Party, China first announced the “Going Out

Policy” to promote outward investment as a tool to fully deploy China’s comparative advantages. The Going Out Policy also featured in China’s “10th 5-year plan to develop national socioeconomics.” That document highlighted several needs: (i) To enhance the scope and modalities of China’s international economic integration and technical cooperation in order to adapt to globalization; (ii) To encourage competitive companies to expand overseas operations, particularly in the exploration of resources, participation in international contracts, and expansion of labor exports; and (iii) To implement mechanisms to facilitate the overseas operation of domestic companies (Figure 1, PG. 108 and Figure 2, PG. 108).

Since 2012, Vietnam has witnessed a clear increase in the number of projects and total registered FDI capital from countries and territories such as South Korea, Japan, and Taiwan. In 2012, FIA’s reports indicated a total of 1,832 registered projects from Japan. While this number only exceeds China’s total by 239 projects, total registered Japanese capital in Vietnam reached USD 28.67 billion in 2012, 12.06 billion higher than that of China. In the six-year period from 2012 to 2018, South Korea, Japan, and China all steadily increased the number of registered projects in Vietnam, yielding average growth rates in project quantity of 15.3%, 13.93%, and 14.44% respectively (Figure 3, PG. 109). Increases in

FIGURE 1: Number of Registered Projects by Northeast Asian Countries in Vietnam, 2012 - 2018

SOURCE: FIA(a)

FIGURE 2: Total Registered Capital of Northeast Asian Countries in Vietnam, 2012 – 2018 (USD \$ Billions)

SOURCE: FIA(a)

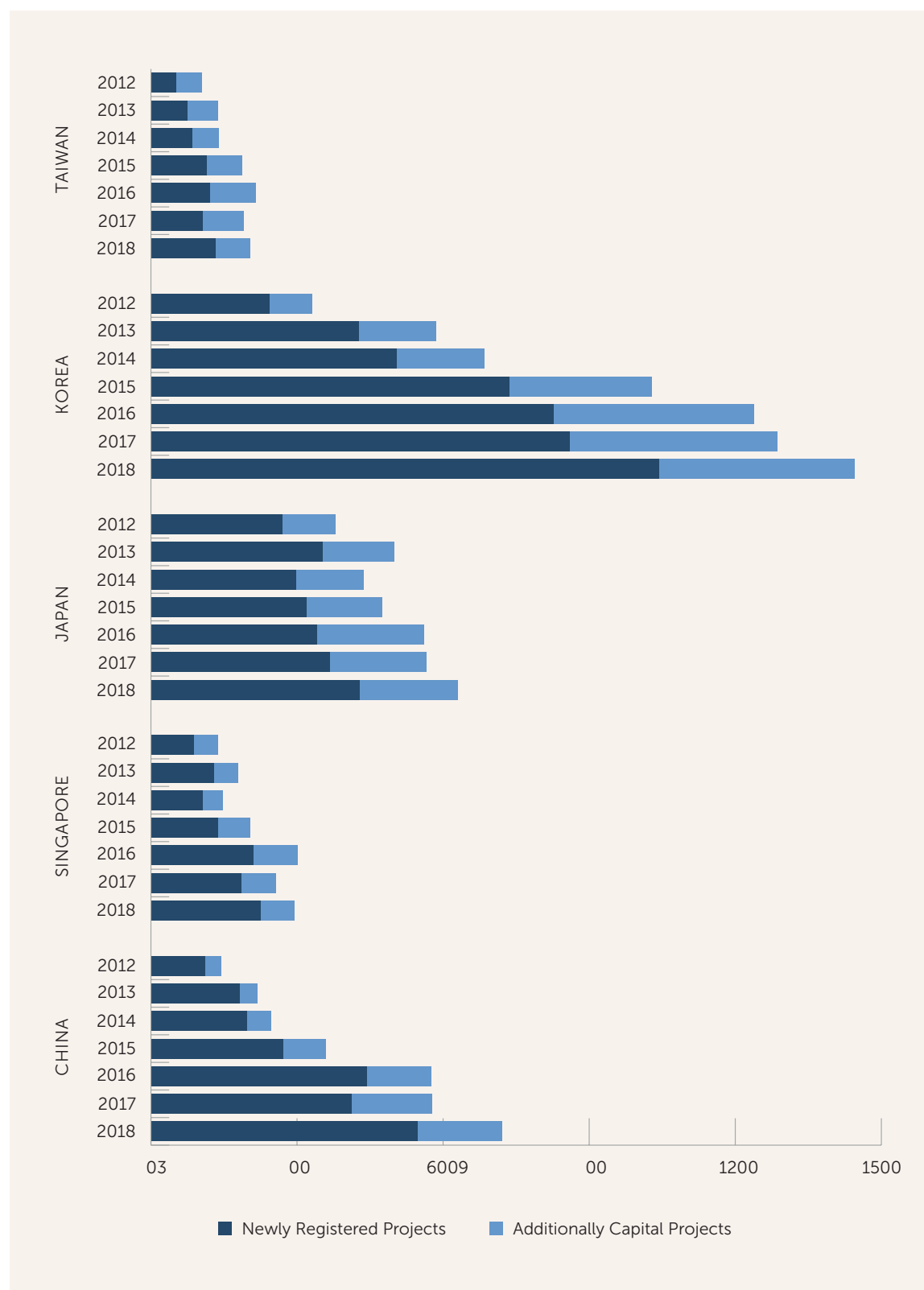
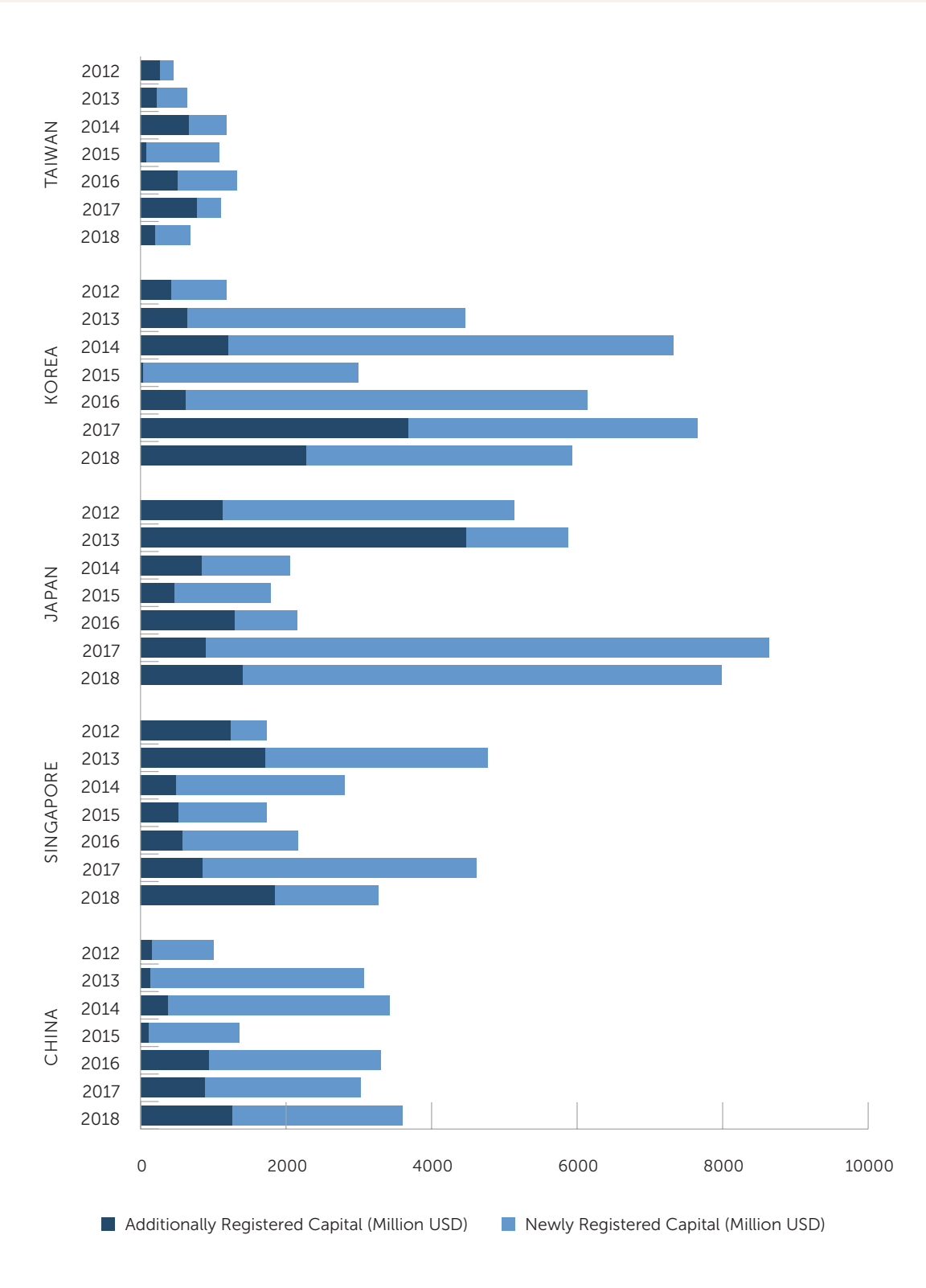
FIGURE 3: Number of Newly Registered and Additionally Capital Projects in Vietnam, 2012 – 2018**SOURCE:** FIA(a)

FIGURE 4: Total Newly and Additionally Registered Capital in Vietnam, 2012 – 2018 (Million USD)



SOURCE: FIA(a)

total invested capital, as opposed to number of projects, also differ among these countries: Japan and South Korea have shown the fastest growth in total invested capital, with average annual growth of 12% and 17% respectively (Figure 4, PG. 110). Taiwanese FDI doubled in 2016-17 due in large part to vigorous Taiwanese business campaigns in Vietnam and growing popularity of Taiwanese goods (Van, 2019). Meanwhile, China has contributed the lowest total registered capital in the group of countries surveyed. This finding suggests that Chinese investment has focused on increasing the quantity of small-scale projects rather than investing in large projects.

In fact, in the years of 2012, 2014, 2016 and 2018, China showed a clear trend of increasing its number of registered FDI projects (see Figure 4), but the total size of capital inflows slowed over that same period (see Figure 5). In 2016 and 2018, the average size of Chinese FDI projects registered in Vietnam decreased from USD 5.326 million per project to 4.27 million per project, lower than its average project size in 2012 and 2014. In contrast, South Korea and Japan enjoyed a period of booming investment in Vietnam. In the period surveyed, South Korea increased both the number and size of its projects relative to China. Japan similarly displayed rapid growth from 2012 to 2018, from 270 to 429 projects and a total

registered capital increase from USD 4 billion to 6.5 billion (see Figures 3 and 4). China's expanded FDI in Vietnam has not yet shown signs of becoming an investment boom as in the case of South Korea and Japan.

By 2016, China's investment in Vietnam had spread across many economic sectors, focused on mining, processing, manufacturing, water and electric utilities, and real estate. Outside of these specific sectors, very small amounts of capital have been dispersed to other industries. Direct investment from China (including Hong Kong) into Vietnam tends to focus on industrial rather than service sectors. Japan and South Korea, in contrast, undertake diverse and in-depth investment across different economic sectors.

Chinese FDI increased rapidly, but China's share of FDI inflows remained low. Chinese FDI into Vietnam increased year by year, but still accounted for a relatively small proportion compared to FDI from Japan and South Korea. China's investment, including investment by entities registered in the Hong Kong Special Administrative Region, amounted to USD 7.1 billion over the first five months of 2019 (Hong Kong: 5.08 billion, China: 2.02 billion), making China the leading investor over this period.

China's FDI projects in Vietnam are mostly small scale. Chinese projects primarily target

small-scale businesses, with little investment in large corporations. As of 2018, the average volume of investment projects stood at only USD 9.29 million per project, lower than that of Japan (14.26 million per project) and Taiwan (12.14 million per project). In the first half of 2019, among 279 new projects of Chinese investors, average project investment totaled approximately USD 6 million per project.

Chinese FDI in Vietnam often funds imports from China.

The General Statistics Office of Vietnam (GSO) does not provide the amount of imports by source country or FDI sector, but it can be seen that the import proportion of the FDI sector has increased significantly since 2001, from 30.7% to over 57%. According to the Vietnam General Department of Customs, FDI enterprises account for a large share of Vietnam's import structure. China has invested in most of the commodity groups comprising this structure, in addition to providing a large proportion of total imports to Vietnam. Among 51 commodity groups, China is the supplier of 46 groups. More importantly, the number of imported products from China that serve the demands of the FDI sector is increasing.

China's investment structure has changed significantly.

The above analysis of investment structures based on newly registered projects from China indicates a clear focus on manufacturing, labor and

resource development, including production of metal, textiles and clothing, leather, wood, and paper. This shift has been particularly evident in light of Vietnam's negotiations for new generation FTAs such as EVFTA and RCEP. Chinese investors have focused on the leather, footwear, and textile industries, which are considered to be among Vietnam's industries of comparative advantage. This may imply that a desire for economic integration is driving China to shift its labor-intensive industries to Vietnam. This trend has recently increased significantly with the formation of a series of heavily invested Chinese textile and yarn factories clustered in Nam Dinh, Quang Ninh, Binh Duong and Hai Duong.

China's FDI distribution is not significantly different from other countries.

In general, there is not much difference in the distribution of recipient enterprises of Chinese FDI compared to enterprises receiving investment from other countries. Most businesses receiving direct investment are located in geographical areas with high population density and developed infrastructure. However, Chinese FDI projects exhibit higher prevalence in Vietnam's central region relative to projects of other countries. This finding could reflect China's interest in real estate investments, rather than an intention to occupy economically strategic positions in the Central Highlands region. At the provincial scale, in the first 5 months

of 2019, China's investment focused most prominently on Tay Ninh Province, where registered Chinese FDI amounted to USD 514.4 million (accounting for 25.4% of the period total).

Chinese FDI may increase if the U.S.-China trade dispute persists. In terms of trade and investment data, it is extremely difficult to collect enough data to support the conclusion that Chinese enterprises might promote investment in the Vietnamese manufacturing sector with the explicit intention of exporting Vietnam-produced goods to American markets. Should China undertake such a strategy in order that Chinese enterprises could avoid tariffs imposed by the U.S. on targeted Chinese imports? While trade tensions between China and the U.S. escalate, it is likely that Vietnam and Cambodia will become new investment destinations for Chinese businesses seeking to avoid the negative impacts of the trade war.

Are China's FDI inflows in Vietnam problematic?

As shown above, Chinese FDI inflows into Vietnam were not significant and the average scale of projects was smaller than that of other investors from Northeast Asia. On August 20, 2019, the Vietnamese Politburo issued Resolution No. 50-NQ/TW on directives to improve institutions and policies to enhance the quality and efficiency of

foreign investment by 2030. This Resolution imposed stricter constraints and regulations on foreign capital flows. Consequently, the research team concluded that it was difficult to clearly describe major problems incurred by Chinese investment based on analysis of China's FDI into economic sectors.

Other Forms of Investment: Engineering-Procurement-Construction Contracts

Investment types can be divided into direct investment and indirect investment. The previous section of this report discussed the types of Chinese direct investment. Research data indicates that these investments are generally small-scale, market-oriented, and profit-driven. Because this type of investment is subject to the purview of clear guidelines and laws developed by the government, these direct capital flows have relatively low impact on society, the environment, or transparency in governance. In addition to FDI, Chinese investment in Vietnam also includes official development assistance (ODA), commercial loans, and government-guaranteed loans. In Vietnam, these types of investment significantly exceed foreign direct investment. Since the official implementation of the Belt and Road Initiative (BRI), the quantity of government loans from China has increased significantly. This increase has caused domestic debates over the impact

of these loans on certain communities. This study aims to assess the impact of these non-FDI capital inflows.

Studying Chinese capital inflows into Vietnam using an “input approach” from the Chinese side tends to be very difficult, because this information is often not published. The terms of Chinese loans often stipulate that the terms themselves be kept from the public. This study instead relies on an output approach: studying Engineering, Procurement, and Construction (EPC) model projects to assess the impact of Chinese loans. There are two reasons why this approach is significant in Vietnam. First, regardless of where the loan originates (e.g. Japan, the World Bank, China), the ratio of Chinese public works to EPC bidding is very high, facilitating assessment of the impact. Secondly, EPC projects are large-scale (with budgets ranging from hundreds of millions to billions of dollars), so the results of environmental, political, and social well-being are more readily apparent.

Defined in Item 3, Article 1, Circular No. 01/2002/TT-BXD, the term “engineering/procurement/construction contract” (abbreviated to “EPC contract”) or turn-key contract refers to a written agreement concluded between a project investor and a contractor or a contractor partnership (referred collectively to as general EPC contractor) for performing the work of designing and providing supplies, equipment,

and technical services, and/or constructing and installing a project or bidding package.

According to the provisions of Vietnamese law and international practice, EPC is a type of construction contract often applied to large-scale projects, especially energy projects. An EPC contract usually designates a single individual responsible for the design, procurement, or construction covered under the contract. However, in order to mobilize sufficient capital for these projects, Vietnam regularly utilizes loans from World Bank, Asian Development Bank (ADB), Export-Import Bank of China (CHEXIM), Industrial and Commercial Bank of China (ICBC) and ODA from Japan, Korea, China, etc. These financial liabilities often include conditions that the borrower must choose contractors from the lender country. Consequently, EPC contractors from the investor country tend to win bidding packages. This practice, known as “Tied Aid,” requires that the recipient of bilateral aid use that aid, loans, or grants to purchase goods and services from the donor nation. Tied aid ensures that the donors’ commercial interests benefit directly from the funds thus disbursed, while keeping the money from reaching local producers and suppliers. As a result, recipients derive significantly less value than from untied aid (Meeks, 2018).

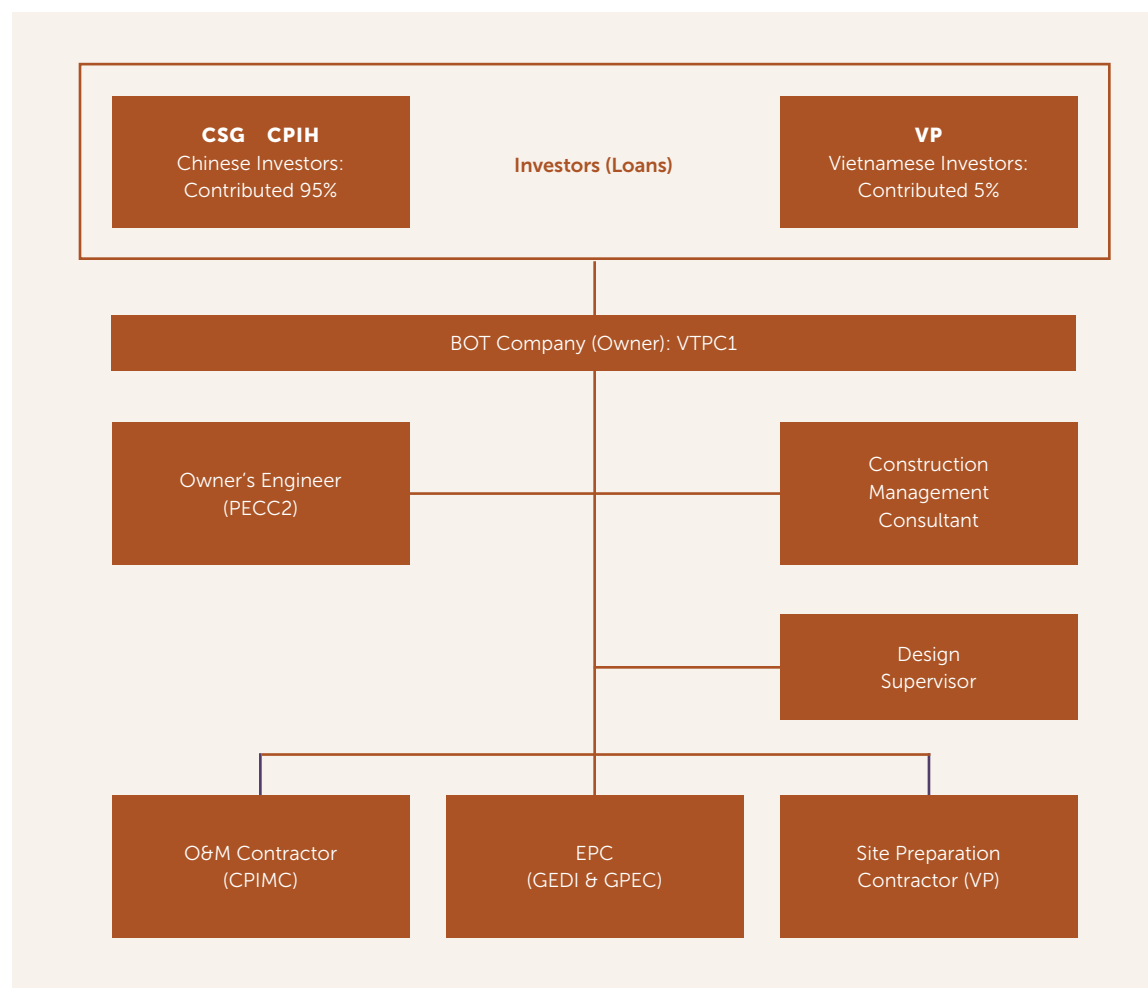
In March 2005, the Development Assistance Committee (DAC) signed the Paris Declaration on Aid Effectiveness, calling for

an end to the practice of tying aid. Vietnam committed to the Paris Declaration that year via the Hanoi Core Statement on Aid Effectiveness (HCS). However, the HCS did not include any metrics for measuring untied aid (McCarty 2). DAC members have largely kept their commitment to untying aid in Vietnam: by 2008, 74.3% of DAC aid to Vietnam was untied (McCarty, viii). China is not a DAC or OECD member, and has made no such commitment. Aid from other nations has not followed suit: as of 2009, Vietnam

received a high proportion of concessional lending from non-DAC donors, including China and South Korea. Japan, another major investor in Vietnam, also reserves its right to use tied aid for certain low-income countries. (DAC, 6) Due to the opacity of Chinese investment, without metrics on the Vietnamese government side it is difficult to fully assess the extent of this problem.

Figure 5 (PG. 115) illustrates two points regarding the participation of Chinese

FIGURE 5: The financial structure of Vinh Tan 1 Coal Fired Power Plant (CFPP)



SOURCE: Authors' collection from field survey (2019)

contractors in a typical EPC project: (i) CFPP is a project that was predominantly funded by Chinese loans; (ii) A Chinese company won the contract. Out of 19 EPC contracts, there were only two cases in which a Chinese bidder won a contract funded primarily by non-Chinese capital. This implies that the problems associated with EPC contractors may be representative of problems with Chinese investment in general. Indeed, in Vietnam, a majority of infrastructural projects have Chinese EPC contractors: for example, 80% of EPC contracts in the energy sector were Chinese; 65% and 70–80% in the chemical and mining sectors, respectively. Therefore, in this report, except for cases with a specific footnote, the term “EPC project” and its equivalents will be used to describe Chinese EPC contractors.

In addition, an EPC contract also predetermines the completion price and time, which is typically decided on the day the contract is signed (PwC, 2016). Due to these advantages, EPC contracts are often chosen for energy and infrastructure projects in Vietnam. In those projects, EPC contractors come from many different countries, including Japan, South Korea, and European countries. Vietnam has also entered into EPC contracts with a relatively large number of Chinese contractors.

In fact, in Vietnam, Chinese contractors tend to be selected for EPC bidding packages

over contractors from other countries.

The first reason for this preference relates to Vietnamese regulations on contractor selection. According to provisions in the Bidding Law of 2013, a bid assessment will be conducted using one of three different methods: (i) Lowest price method; (ii) Assessment price method; and (iii) Through a combined assessment of technical capacity and project cost. For the “lowest price” method, technical, financial, and commercial proposals are considered on the same basis when attempting to satisfy project requirements, and the bidder with the lowest price receives the highest ranking. However, the law does not stipulate in a clear and detailed manner under which situations this method should be employed over the other methods established under the Bidding Law.

In the absence of such guidelines, the law suffers from a loophole allowing bidders to approve contractors offering the lowest prices for their services for the sake of simplicity and convenience. For many projects, Chinese contractors often bid at a very low price compared to contractors from other countries, such as Japan and South Korea. Although Chinese contractors offer attractive prices to bidders, China’s technical and environmental standards are lower than those of Japan and South Korea. If the lowest price method is applied, Chinese contractors will often win these packages.

In other cases, Chinese contractors win bidding packages because of specific terms in the investment contract itself. The construction of infrastructure projects always requires a large amount of investment, and for many such projects, neither the government nor domestic enterprises in Vietnam can mobilize sufficient capital without the assistance of external loans. Borrowing from multilateral development banks such as the World Bank or the Asian Development Bank is often subject to very low interest rates and long maturity, but borrowers may be deterred by numerous requirements for environmental impact assessment reports and stringent conditions on technical issues. Meanwhile, borrowing from China is much easier, with more relaxed terms related to environmental protection and the use of technology. Therefore, for many infrastructure investment projects in Vietnam, Chinese investors often contribute a large proportion of project capital requirements. Many Chinese investors are able to gain controlling rights to a project's output when they supply more than 50% of the total investment. With such large control over key capital flows on investment projects, China is able to wield influence and press for favorable terms for Chinese domestic companies to be the sub-contractor of these projects.

Bräutigam (2011) argues that the lion's share of Chinese overseas financial support takes

the form of export credit or concessional loans and does not meet the criteria for ODA. For example, following the classic model of tied aid, Chinese aid to African states often utilizes concessions to promote the import of Chinese goods and services. Bräutigam (2011) and Sun (2014) criticize China for using ODA to disguise a cynical effort to expand its own interests on the African continent.

Kim, S.-K. and Kim, Y.-H (2016) outlined three major impacts of tied aid as follows:

- Tied aid decreases the recipient's value-for-money. According to the DAC, tied aid increases the cost of supplies by 15-40%, due to the donor country contractors' effective monopoly and increased cost of transport compared to locally-sourced supplies.
- Tied aid prevents developing countries from taking full ownership of their own development. It leaves procurement in the donors' hands, resulting in decisions that channel aid money back to the donor, bypassing the local economy.
- Tied aid deprives developing countries of the full potential of the long-term sustainable development that untied aid might have provided by channeling funds into the local economy.

International assessments of China's ODA practices tend to agree that Chinese aid

tends to be a vehicle for Chinese interests, but it is difficult to evaluate the economy-wide impact of Chinese ODA in Vietnam due to inadequate data. However, analysis of EPC case studies involving Chinese investors and contractors shows the same problems emerging in the Vietnamese context.

Overview of China's EPC Contracts in Vietnam

Vietnam's electricity output is the third highest of the ASEAN countries, only lower than that of Indonesia and Thailand. Hydropower production has been climbing, and it has recently played an integral part in Vietnam's power generation. However, this recent trend may soon end, as the proportion of hydropower among all Vietnamese electricity output has remained stable at roughly 33% for several years while coal power has continued to grow. Coal power accounted for 11% of Vietnam's electricity output in 2000 and increased steadily to one-third of electricity output by 2016. Coal power will continue to be crucial to meeting Vietnam's energy needs, and its cheap price and ease of use will make coal power difficult to replace in the near future. According to some estimates, coal-power generation will grow at 10% every year and will provide half of the energy supplied in Vietnam by 2028 (Proctor, 2019).

Even as some banks are terminating their financing of coal projects, China remains a

major investor in Vietnam's coal-based energy sector. The Hanoi-based environmental group Green Innovation and Development Centre said in a recent report that Chinese investors are involved in 15 operating coal plants in Vietnam, along with another 6 under construction, and 2 more under development. And China is not the only country investing in the Vietnamese energy sector. In April 2019, Japan Bank for International Cooperation signed a USD 1.2 billion loan agreement with Vietnam's Van Phong Power Co. Ltd., to develop the two-unit, 1,320-megawatt Van Phong 1 coal-fired power plant.

In order to collect information for this report, the research team first constructed a list of active and under-construction coal-fired power plants (CFPP) in Vietnam as of 2018. The list was prepared based on the information provided by Vietnam Energy Map (JETRO(b)), 2016 Power Industry Reports announced by Vietnam Electricity (EVN), and the Revised Power Development Plan VII provided by Vietnam's Electricity Regulatory Authority.

Based off of this list, the research team collected project information from the following sources:

- National bidding network: <http://muasamcong.mpi.gov.vn/>
- Ministry of Industry and Trade: <http://www.moit.gov.vn>

- Vietnam Electricity's website and its affiliates: <https://www.evn.com.vn>
- News reports from Vietnamese and Chinese newspapers

The research team successfully compiled a list of 51 CFPP projects. Over the course of the investigation, the research team found that five projects had been terminated; one project was put into operation with no available information about project contractors; and nine projects had not yet announced contractor selection results. After eliminating these above projects, the research team was left with a list of 36 coal-fired power plants with comprehensive information about contractors. The team used information related to these 36 projects to prepare this report.

Of the 36 coal-fired power plants constructed under EPC contracts, 19 plants (52.7%) were constructed by Chinese contractors. China's contribution is surprising in terms of both quantity and scale of projects in comparison with contractors from other countries (Figures 6 and 7, PG. 120). As these figures indicate, the CFPPs contracted by Chinese entities offer a potential cumulative 14,850 megawatts. In addition, CFPPs built by Chinese contractors are mostly located within power centers. For example, the EPC contracts include four plants in the Vinh Tan power center in Tuy

Phong District, Binh Thuan Province, two of which have been completed and are now operating. Chinese contracts cover three of these plants, while the fourth was contracted to a South Korean contractor. Similarly, in Quang Ninh, there are eleven CFPPs currently under operation, of which Chinese contractors built eight. This illustrates the concentration of Chinese contractors on key power centers of Vietnam.

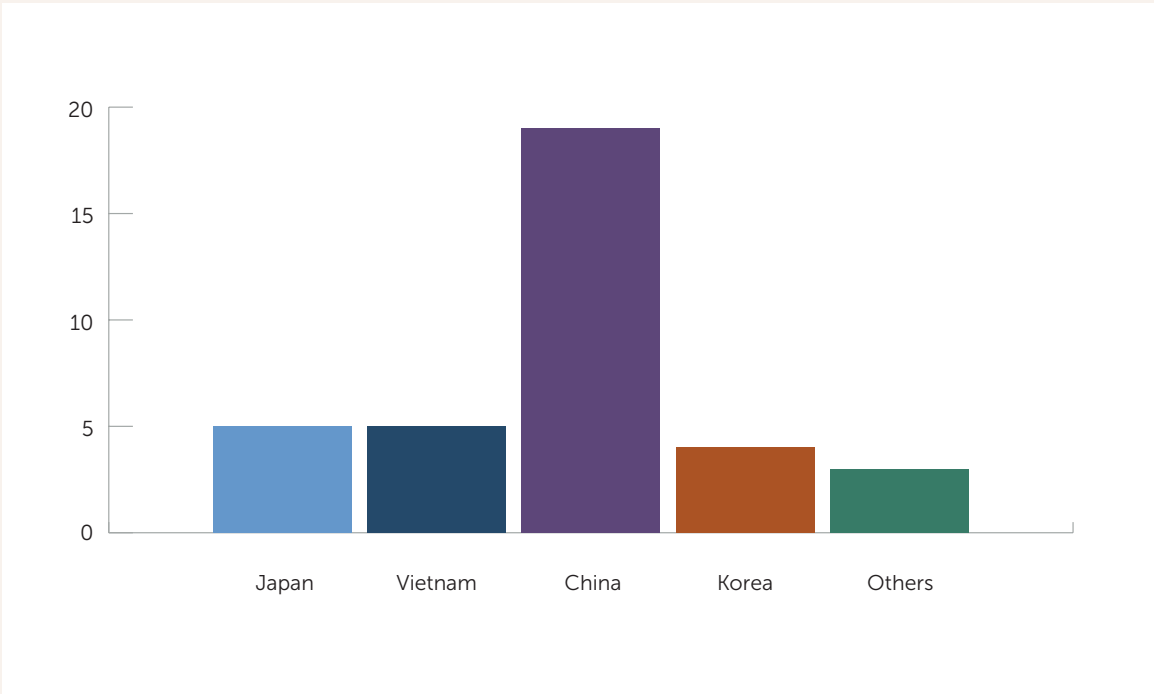
Major Problems Related to Chinese EPC Contractors

Many Chinese-contracted projects in Vietnam face delays in construction progress and suffer from poor quality. Similar problems affect Japanese and Korean contractors. Controversies surrounding Chinese EPC projects primarily relate to environmental, labor, and legal issues.

ENVIRONMENTAL ISSUES

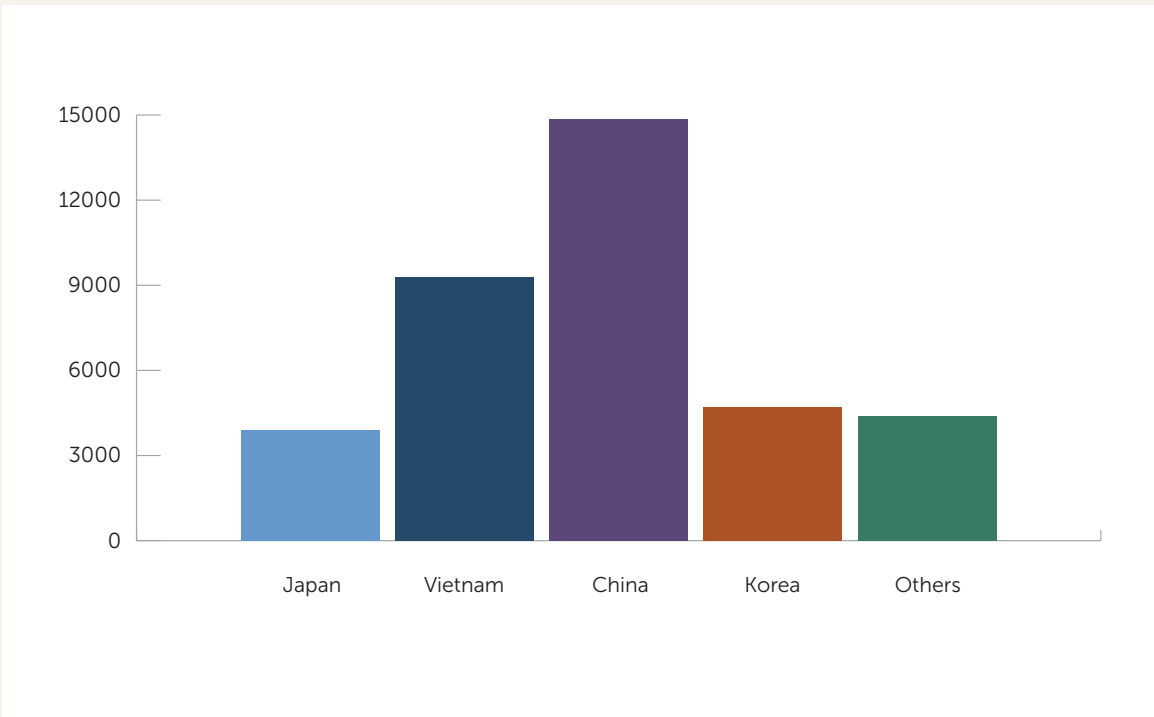
Anthracite coal is the most widely used type of coal in Vietnam, with large reserves found in Vang Danh, Mao Khe, and Trang Bach mines. Anthracite is also the primary input for CFPPs in Vietnam. However, anthracite coal carries a relatively large slag ratio, accounting for 30-37% of the total coal mass used in power plants and 6-14% of their emissions (Truong Duy Nghia, 2013). Continued operation of coal power plants in Vietnam will harm the environment due to the large

FIGURE 6: Number of Coal-Fired Plants by Contractors' Countries

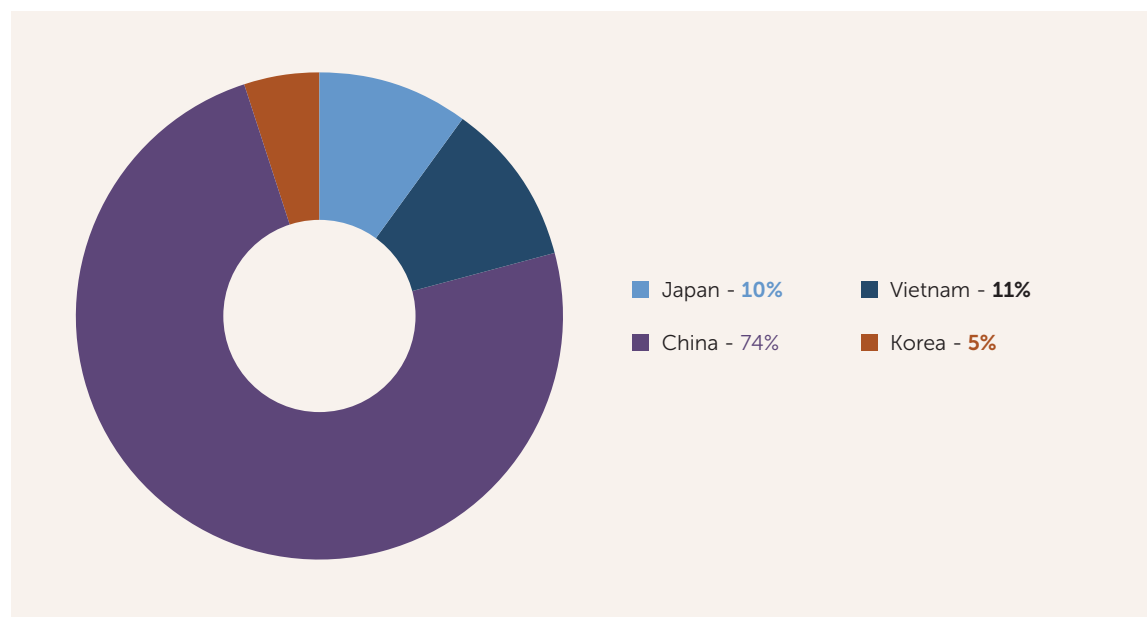


SOURCE: Author's collection

FIGURE 7: Contribution to Total Capacity by Contractors' Countries (MW)



SOURCE: Author's collection

FIGURE 8: Number of Coal-Fired Power Plants with Environmental Record by Contractor Country**SOURCE:** Author's collection

amount of waste slag and emissions (Figure 8, PG. 121).

Among 36 examined operating CFPPs, 19 of these plants have been involved in environmental incidents. Of these 19, 14 were constructed by Chinese contractors. Negative effects of these environmental incidents mainly relate to dust pollution, slag disposal, and processing of industrial wastewater.

The Vinh Tan 2 Thermal Power Plant, a CFPP constructed by the Shanghai Electric Company, is a representative case. Vinh Tan 2 went into operation in January 2014. During its operation, Vinh Tan 2 was involved in several environmental incidents, such as failing to implement measures to properly

cover coal dust during transport, failing to properly transport waste, illegally discharging waste, and failing to comply with regulations on the operation of a contaminated water treatment system. As a result, the plant was fined by the General Department of Environment for environmental violations with a total fine of USD 62,000. Vinh Tan 2, however, was late in paying its fines and took no further action to minimize pollution. This led to public demonstrations in 2015, when protestors obstructed adjacent highways to prevent the continued transportation of plant waste. The demonstrations quickly escalated, and many people threw stones and gasoline bombs.

The transportation of coal ash on residential roads and the overloading of waste dumps are common among many CFPPs in Vietnam, including plants in Son Dong, Long Phu, Mong Duong, Vung Ang, and Duyen Hai. These harmful practices are widespread among plants built by contractors from a variety of countries, including Japanese and Korean contractors. The problem of environmental incidents is attributable not only to contractors, but also to Vietnam's own mechanisms of environmental regulation, planning, and enforcement.

Specifically, there is a lack of synchronization in urban and electricity development planning regarding the treatment of ash and waste slag, and the number of slag disposal sites is insufficient to meet demand. There are also no designated roadways for transportation of plant waste: Duyen Hai, Vinh Tan, and Vung Ang Thermal Power Plants all transport their waste via National Route 1A. Currently, Vinh Tan 2 Thermal Power Plant has implemented a successful program to recycle coal slag into building bricks or for use as an additive in concrete production. However, the Ministry of Industry and Trade has not yet issued technical standards or legal frameworks on the treatment and disposal of slag.

The combustion of coal produces two types of slag. Light slag is relatively "pure," with physicochemical properties capable

of neutralizing soil acidity and fertilizing plant growth (Set, 2017). Light slag is often released through plant chimneys. Heavy, bottom layer slag contains many impurities, including solid and heavy elements, and is unable to escape through plant chimneys. This second type of slag must be mechanically discharged from the CFPP. Heavy slag contains toxic chemicals and radioactive isotopes produced during high-temperature coal combustion and requires relatively advanced technological processing and treatment methods and strict quality control procedures.

This problem raises the issue of technical capacity when constructing CFPPs. Indeed, in China there are CFPPs built with world-class combustion technology. Advanced Chinese technology used in these CFPPs has allowed the plants to achieve a 50% combustion efficiency rate and emission levels approximately 50% lower than the world average (IEA, 2014). This shows that Chinese entities are able to produce power plants that meet high environmental standards. After all, the choice of technology for CFPPs in Vietnam is still the choice of investors and relevant authorities. Key stakeholders in Vietnam must consider the cost-benefit implications of environmentally safe technologies.

During a research trip to Vinh Tan 1 and Vinh Tan 2 CFPP, both constructed by

Chinese contractors, the plants' technical manager informed the research team that the plant had implemented an online environmental monitoring system, which is updated daily and connected directly to the Provincial Department of Natural Resources and Environment. In addition, the wastewater treatment of the two plants operates efficiently and strictly complies with environmental standards. For the exhaust filtration system, both plants apply electrostatic filtering technology to eliminate many impurities and toxic emissions arising from coal combustion. The plant's wastewater and emissions control policies are relatively strict, contrary to media reports. However, coal slag treatment still poses the greatest challenge, while Vietnam lacks specific regulations and management mechanisms.

LABOR SAFETY AND OTHER PROBLEMS RELATED TO CHINESE LABOR

Chinese EPC contractors in a number of projects have committed numerous violations of Vietnamese labor law. In one typical case, that of the 2015 construction of the Cat Linh-Ha Dong railway, inspectors from the Invalids and Social Affairs branch of the Ministry of Labor discovered several violations by the Chinese contractor including:

- The contractor failed to meet the minimum wage requirement. The minimum wage provided by the

contractor was VND 3,000,000, VND 100,000 lower than the regionally mandated minimum wage;

- The contractor did not notify competent authorities about wage scale, payroll information and labor quotas;
- Some one-third of employees (28 out of 82 people) did not participate in social and unemployment insurance;
- The contractor failed to conduct technical safety inspections for certain machines and equipment, despite strict occupational safety requirements on the use of this equipment;
- The contractor did not provide a comprehensive statistical report about the number of employees engaging in jobs with strict safety requirements.

In addition, a report submitted to the General Secretary by the Vietnam Energy Association stated that many thermal power projects under Chinese contractors use a large amount of imported labor from China. Indeed, interviews conducted by the research team with the board of managers of Vinh Tan 1 and 2 revealed that during the peak construction period of these plants, both plants employed a large number of Chinese workers and engineers.

Vietnamese authorities are concerned that this influx of foreign labor into Vietnam poses

a risk of social or economic turmoil. Local authorities and EPC contractors therefore impose strict regulations to manage the perceived risks posed by the presence of this foreign labor force. Chinese workers and engineers working in Vietnam live in private dormitories with strict protection and management; and workers are required to return to their dormitories before 10 pm. If any disputes with local residents arise, foreign laborers may be deported. Once their working contract ends, they must return to China. To promote local job creation, plant operation after the completion of the construction process uses primarily local workers. Plant managers retain only a small number of Chinese technical and maintenance personnel to better support plant management and operation.

LEGAL CONFLICTS WITH EPC CONTRACTORS

In Vietnam, legal conflicts have arisen in many EPC projects under Chinese contractors. Some of these conflicts have yielded serious consequences and economic damages.

The Case of Ninh Binh Fertilizer

Ninh Binh Fertilizer Plant, whose investor is the Vietnam National Chemical Group, is a key project in the development plan of Vietnam's chemical industry. The EPC contractor of the Ninh Binh plant is China Huanqiu Contracting & Engineering

Corporation. It began construction on the USD 667 million plant in 2008. In addition to the primary EPC contractor, 16 Chinese subcontractors, 1 European subcontractor, and 1 Vietnamese subcontractor are also participating in the project.

The first problem is that the EPC contractor initiated construction 420 days after the starting date stipulated in the contract, resulting in an additional cost of VND 527 billion (USD 24.33 million). The investor and the EPC contractor have not yet agreed on a plan to deal with this cost. Furthermore, according to a feasibility study on the Ninh Binh project, the plant was expected to make losses over its first three years of operation before achieving profitability in the fourth. However, in the fourth year of operation, the accumulated loss reached VND 364 billion (USD 16.81 million).

In addition, EPC general contractors violated terms of the signed EPC contract. During the trial run, the contractors exceeded certain limitations stated in the contract, ultimately preventing the contractor and investor from liquidating the contract. When the project was handed over to operators, the new managers learned that the plant's technical specifications were not in accordance with the initial feasibility study report, nor as specified in the signed EPC contract.

The Case of Thai Nguyen Steel Plant Phase 2

The Thai Nguyen Iron and Steel Plant was funded by the Thai Nguyen Iron and Steel Joint Stock Company (“Thai Nguyen”) with a total investment of VND 3.8 trillion. This plant is a key project in the “Vietnam Steel Development Plan up to 2010.” The plant’s Chinese EPC contractors, the China Metallurgical Construction Corporation (MCC), started construction in 2007. The initial construction period was projected to last 30 months. But as of 2019, minimal construction has taken place, and some completed items have suffered damage or degradation. Construction delays resulting in part from MCC’s failure in 2013 to mobilize sufficient capital for the plant’s construction forced the contractors to put construction activities in abeyance and withdraw Chinese laborers back to China.

At that time, Thai Nguyen Iron and Steel Company had delivered funds for almost 92% of the contract value, but MCC did not transfer all associated equipment to Thai Nguyen. Furthermore, of the equipment and machines that MCC did hand over, several items were of incorrect origin and specifications or otherwise not in accordance with Vietnamese standards. In February 2019, the Government Inspectorate required the investor to review the terms of the EPC contract in preparation for a suit against the Chinese EPC contractor.

Legal conflicts are not unique to Chinese contractors. In the case of Dinh Vu Fiber Factory, the EPC contractor is a joint group of contractors from South Korea and Vietnam. During the construction process, a dispute arose between the investor and the EPC contractor due to unclear terms of the initial EPC contract. In another case, a Quang Ngai biofuel producer was unable to liquidate a contract with Vietnamese EPC contractor PetroVietnam Technical Services Joint Stock Corporation due to unfinished work by the contractor and failure to complete a required assessment before starting operations.

Cooperation with Chinese EPC contractors has undeniably involved numerous practices contrary to Vietnamese regulations, which have in turn caused serious financial losses. However, this problem is not limited to a single sector such as energy or infrastructure. Rather, these problems stem from inefficiencies in state management and legal frameworks regulating foreign contractors in general and EPC contractors in particular.

Governance Gaps in Vietnamese Regulation

It is undeniable that the practices of Chinese EPC contractors have damaged Vietnamese interests in critical infrastructure projects, even violating Vietnamese laws in some cases. Contractors from Japan or Korea, while incurring fewer technical faults and

accidents during construction and operation, have also violated environmental standards and/or failed to meet construction deadlines, as have Chinese contractors. This implies an overall deficiency in Vietnamese regulation of both the operational and construction phases of infrastructure projects.

In principle, EPC should generally be applied for power plants or large infrastructure projects that require a fixed predetermined price and high compatibility in component technology. However, many EPC projects in Vietnam experienced cost overruns, as in the case of Cat Linh–Ha Dong railway. This problem was engendered by lenient contractual terms that failed to stipulate responsibility for excess costs.

Prior to 2015, Vietnam had only two official Circulations (Circulation No. 01/2002/TT-BXD issued in 2002 and Circulation No. 08/2003/TT-BXD issued in 2003) that provided detailed guidelines on managing EPC projects. At that time, contract terms were simply negotiated by the investor and contractor. It was not until 2015–2016 that the Vietnamese government introduced new regulations covering the pre-bidding process and terms and clauses of EPC contracts. These regulations were made in an effort to partially comply with the International Federation of Consulting Engineers (FIDIC) conditions of EPC contracting. Indeed, the comprehensiveness and transparency

of FIDIC's conditions were proven by the success of projects conducted by North American and European contractors, who based their EPC contracts on FIDIC.

However, these regulations are only compulsory for projects that receive government funding. Other projects are merely encouraged to comply. Cost overruns are also the result of delays by responsible authorities in authorizing contractor access to the construction site. The land clearance process has faced opposition from residents due to inadequate compensation. Vietnam lacks a transparent and effective framework to determine compensation prices equivalent to market price. In some cases, this situation resulted in lawsuits that significantly delayed construction and increased costs.

Authorities did little to keep Vietnamese quality-control standards up to international standards. Vinh Tan 2 CFPP is a typical case study. As the amount of coal ash and slag are about to exceed the capacity of waste dumps, engineers from Vinh Tan 2 proposed a detailed plan to transform ash and slag into construction bricks. However, responsible authorities were slow in issuing new standards and a legal framework to enable this proposal, and the Vinh Tan 2 initiative has been put into abeyance for months. The Directorate for Standards, Metrology and Quality, a governmental body responsible for advising the Vietnamese

government on standardization, metrology, productivity and quality management issues, has developed limited numbers of standards related to CFPP. Only 15 standards have been issued and published online that could partially cover technical features of CFPP. This shortage in technical guidance makes it difficult for investors to evaluate the technical quality of contractors and creates gaps allowing contractors to use inferior technical benchmarks that might degrade the quality of CFPPs.

There are several case studies in which EPC contractors breached contractual obligations to Vietnamese investors, resulting in severe economic damages (the cases of Thai Nguyen 2 steel plant and Ninh Binh Fertilizer) to Vietnam. The Vietnamese legal framework is deficient in its investor protections against damages incurred by EPC contractors breaching their contracts. The Vietnamese government has recently issued new regulations to prioritize the technical quality of contractors' proposals over lower bidding in order to improve the standard of Vietnamese economic infrastructure.

Policy Recommendations

RECOMMENDATIONS TO IMPROVE TRANSPARENCY

- Government reporting: Large-scale and key projects should periodically report to

the National Assembly or State Council. The Assembly and State Council do not typically publicize data; this practice should be changed.

- Expert influence: The government should utilize dialogue channels including scholars and influential public figures to publicize objective statements about project development.
- NGO participation: The government should defend and strengthen the capacity of civil society organizations to serve as monitors of the social and environmental behavior of firms and government alike and increase the accountability of investors and construction parties. The government should construct a dialogue mechanism for resident communities, investors, and authorities to solve problems.
- Clear regulations: Clear legal regulations on the participation of private enterprises are vital in infrastructure projects. There is also a need to limit, and clearly report on, the participation in these projects of businesses established by government officials or their families, or others with close ties to government leaders. This practice invites collusion among vested interests and promotes corrupt behavior. It is therefore essential to establish mechanisms for information

disclosure regarding infrastructure projects. From international experience, many governments, such as the United Kingdom, Chile, or Peru, have proactively publicized information about PPP projects or contractual information without waiting for specific requests from the community, encouraging the community to make contributions or supervise the construction of these projects. Such action will contribute significantly to enhancing transparency and limiting corruption.

RECOMMENDATIONS ON VIETNAMESE GOVERNMENT POLICY REGARDING FOREIGN CAPITAL FLOWS

- Apply multilateral development bank (MDB) standards to BRI loan projects. For instance, to better utilize loans from CHEXIM or AIIB, Vietnam could encourage co-funding from the Asian Development Bank or other MDBs to better meet financial and environmental standards adopted by experienced donors.
- The Vietnamese government should adapt and expand the 2005 Hanoi Core Statement on Aid Effectiveness to include indicators and targets for untying aid. The state should take a strong stance against tied aid, including actively promoting local contracting and publicly

questioning donors' selections of sources for contracts.

- Move from Low-Bid Procurement to Life-Cycle Cost Analysis (LCCA) to promote a quality infrastructure approach. The government should implement detailed guidance on technical standards so that investors have a benchmark to compare technical proposals among contractors. Obviously, the project with higher technological standard will require a larger initial outlay. Accordingly, the government should only allocate money to projects that would have a major economy-wide impact, rather than squandering capital on inefficient projects.

RECOMMENDATIONS FOR IMPROVING EFFECTIVENESS OF ENVIRONMENTAL PROTECTIONS

- Enforce and upgrade existing environmental and social protections.
- Defend and strengthen the capacity of environmental and social ministries to enforce and upgrade laws.
- Spearhead collaboration among governments, local civil society, and foreign investors to achieve informed consultation before extractive projects begin, and to address local concerns in good faith.

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CHAPTER 6

CHINESE INVESTMENT IN MYANMAR

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Introduction

Bilateral trade between China and Myanmar has been growing since 1988, but Chinese investments in Myanmar only began to demonstrate noteworthy growth in 2004 (Travis, 2012). Chinese investment in Myanmar peaked in 2010 at USD1.52 billion (ASEAN Secretariat, 2018). This sudden surge between 2004 and 2010, and the concurrent concentration of almost all investments in hydropower, oil and gas, and extractives, is unprecedented in Myanmar (Travis, 2012).¹

China is currently Myanmar's second largest investor, after Singapore.

The surge of Chinese investment in Myanmar, and its concentration in extractive industries, has caused ample negative public perception, provoked criticism, and inspired protests, including those launched against the construction of the Myitsone Dam and Letpadaung copper mine. Public perception often views Chinese investments as exploitative of Myanmar's natural resources and internal political divisions. These perceptions significantly damaged bilateral

1 99% based off research by the Beijing-based Global Environmental Institute in 2016.

relations between the two countries during the previous Thein Sein administration, and they constitute one of the factors that led to the National League for Democracy's (NLD) landslide victory in 2015. However, even for the current NLD government, managing public perceptions of the resumption of the Myitsone Dam project and the establishment of the China-Myanmar Economic Corridor (CMEC) is difficult and potentially politically damaging (Zaw, 2019). Therefore, the government is taking a cautious approach in the implementation of new Belt and Road Initiative (BRI) projects and the resumption of existing projects.

However, Chinese investments will continue to play an important role. At the BRI Second Forum in 2019, the governments of China and

Myanmar signed a cooperation framework for the CMEC (2019-2030) along with other bilateral agreements. The framework outlines implementation of up to nine Chinese-funded early-harvest mega-projects, including the Muse-Mandalay Railway and the Kyaukphyu SEZ deep-sea port. The Myanmar government signed these agreements in order to achieve the UN's Sustainable Development Goals and the targets set by the Myanmar Sustainable Development Plan (2018-30). Therefore, instead of rejecting Chinese investments outright, it is important to identify and address the underlying governance factors that encourage Myanmar to accept Chinese FDI. This chapter attempts to identify these factors and provide suggestions on promoting responsible foreign direct investments in Myanmar (Table 1, PG. 133-134).

TABLE 1: Major Chinese Greenfield Projects in Myanmar

TARGET	CHINESE INVESTOR	VALUE (USD MILLIONS)	INDUSTRY
Oil and gas pipelines	CNPC	1,225	Energy
Letpadaung copper mine	CNIC (Norinco)	1,000	Basic Materials
Tagaungtaung mining project	China Non-ferrous Metal Mining Co.	800	Basic Materials
JV project	CNOOC	N/A	Energy

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TARGET	CHINESE INVESTOR	VALUE (USD MILLIONS)	INDUSTRY
Hydropower construction	China Southern Power Grid	N/A	Transport, Utilities and Infrastructure
Sinopec Myanmar Petroleum	Sinopec	N/A	Energy
COSCO Shipping Lines	China COSCO	N/A	Transport, Utilities and Infrastructure

SOURCE: The Rhodium Group

Chinese FDI and Its Evolving Patterns

Although China is now the second largest investor in Myanmar on the basis of total approved investment, total Chinese capital stock in Myanmar was minimal until 2004.² This situation changed between 2004 and 2010, when total Chinese investment grew from USD 20.18 million to nearly 2 billion, with most of the growth occurring after 2007 (Travis, 2012). By 2010 Myanmar had become the second largest recipient of Chinese outward investments in Southeast Asia.

Between 2006 and 2010, Chinese state-owned multinational companies signed memoranda of understanding and framework agreements with Myanmar's Ministries of Mining, Electricity, and Energy to implement mining, hydropower, and energy projects (ERI, 2008) (Jones, 2017). According to EarthRights International, there were 69 Chinese multinational corporations involved in at least 90 planned or completed hydropower, oil and natural gas, and mining projects in Myanmar as of 2008. Among these projects is the well-known Myitsone Dam project, one of the seven dams in Kachin State (total installed capacity of 13,360 MW) planned

2 Over USD \$20369.197 million of approved total investment and represents 25.79 percent of total FDI in Myanmar (DICA, 2019)

for construction under the Ayeyarwady River Hydropower Project. China Power Investment Corporation (CPI) reached an agreement with the Myanmar government in 2006 to implement this gigantic, USD 20 billion project and signed the “Sino-Myanmar Framework Agreement on Hydropower Development Cooperation in Myanmar” in 2009 (Jones, 2017). As mentioned above, the sudden surge of Chinese investment, and its concentration in hydropower, oil, gas, and mining, was unprecedented. According to the Beijing-based Global Environmental Institute, 99 percent of Chinese investment was concentrated in the natural resource-based sectors of hydropower, oil, gas, and mining as of 2011. The Institute also found that most of the investors in these projects were Chinese state-owned enterprises (SOEs) (GEI, 2016).

There are several reasons behind the sudden surge of Chinese investment between 2004 and 2010 (Travis, 2012, GEI, 2016). First, China launched its “Going Out” Policy in 2001. This policy coincided with China’s admission to the World Trade Organization, which encouraged Chinese firms to invest overseas in order to meet the country’s energy and mineral resource needs and to maintain the momentum of domestic industrialization (China Policy, 2017). Second, Chinese SOEs like CPI were operating at a loss at that time and unable to identify suitable sites for new mega-dam projects while domestic pressure

was mounting on issues like environmental degradation and violations of domestic regulations. This led Chinese SOEs to move operations to less-regulated neighboring countries, particularly Laos and Myanmar (Jones 2019). Myanmar is unique as it is not only a resource-rich country, but it also shares a long border with Yunnan, China’s least-developed province. Third, since 1988 and particularly after the 2007 Saffron Revolution in Myanmar, international sanctions isolated the ruling military government and forced it to increase reliance on China for military, diplomatic, and economic support. Chinese SOEs, in turn, were very willing to invest in Myanmar, despite its ruling regime and governance conditions, in order to fulfill China’s resource needs.

However, this influx of Chinese investment in the years leading up to 2010 met with heated public opposition. The public perceived that China was exploiting Myanmar’s valuable natural resources, and anti-Chinese sentiment increased nationwide. There were also concerns that Myitsone Dam could prove harmful to the local environment. China Power Investment prepared a report on the expected impacts of the project, but the report was never publicly released (Fuller, 2011). In general, popular backlash to Chinese investment coincided with a redirection of that investment in 2010, when Chinese investors refocused from the

natural resource sector to infrastructure and manufacturing projects. Despite this shift, Chinese SOEs continue to serve as major project investors or sponsors and often take a “land for equity” approach. Certain projects, like the Muse-Mandalay Railway, have created tension with local ethnic minorities desiring compensation for the land claimed for these projects. In September 2011, protests over the Myitsone Dam culminated in the suspension of this project by the Thein Sein administration (Tha, 2019).

After years on an upward trajectory, Chinese investment suffered a steep decline after peaking in 2010 at USD 1.52 billion, plunging to just USD 52.4 million in 2015. It subsequently recovered to 205.5 million in 2016 and \$554.5 million in 2017 (ASEAN Secretariat, 2018). This decline from 2011 on could be due in part to the suspension of the Myitsone Dam project. The suspension mirrored the relationship between China’s government and the Thein Sein administration during this period: Myitsone was a hindrance to the China-Myanmar bilateral relationship, and by various accounts it diminished the trust the Chinese government had in Thein Sein. Because of the reforms initiated by the Thein Sein government, Western governments lifted sanctions and re-engaged with Myanmar. This created the impression that his government was pro-Western and

that it was trying to keep its distance from China’s sphere of influence. During that time, the Chinese government carefully built a relationship with the NLD opposition party. After the NLD won a landslide victory in the 2015 election, Chinese investments gradually increased in 2016 and 2017 (ASEAN Secretariat, 2018). Moreover, as part of the Belt and Road Initiative, a large number of Chinese-funded projects are scheduled to begin under the CMEC cooperation framework. These projects included the USD 8.9 billion proposed Muse-Mandalay Railway project, China Communications Construction Company (CCCC)’s USD 1.6 billion New Yangon City project, and China International Trust and Investment Corporation Group (CITIC)’s USD 1.3 billion Kyaukphyu SEZ project, among others.

Governance Gaps Exacerbated by Chinese FDI

CEASEFIRE CAPITALISM

The sudden surge of Chinese investment in Myanmar occurred during military rule and coincided with an increase in crony capitalism and corruption at all levels of government. During that time, ceasefire agreements were signed with ethnic armed groups in Northeast Myanmar. These agreements allegedly were put in place to appease domestic political opposition

and aimed to ease pressure on the army, which was fighting the Karen National Union (KNU) in Southern Myanmar. Some of the groups involved in these ceasefire agreements are known to be involved in the drug trade. The ceasefires paved the way for what Yizheng Zou and Lee Jones call “ceasefire capitalism,” defined as “business deals which focused on natural resource exploitation that enrich military, ethnic armed groups leaders, crony capitalists and foreign investors” (Jones, 2019). The majority of foreign investors involved in these business deals were Chinese, because China shares a long border with Myanmar and the ceasefire groups had close relationships with authorities in Yunnan Province. Additionally, with the increase in bilateral trade and informal Chinese investments in border areas and upper Myanmar, many Chinese migrated to Myanmar and became naturalized citizens, a process facilitated by corruption and weak enforcement of rule of law. The effects of this process are very visible in Mandalay (U Myint, 2019), the capital of pre-colonial Myanmar, where naturalized citizens of Chinese origin have set up businesses, some illicit, with close links to China. The sight of Chinese laborers working at Myanmar construction sites has fostered the perception that Chinese investment is of limited benefit to local employment and economic development. According to Vice-

President of the Mandalay Region Chamber of Commerce and Industry Win Htay, “out of 10 top entrepreneurs in Mandalay, seven are Chinese” (AP, 2018).

CRONY CONNECTIONS WITH MILITARY OLIGARCHS

Collusion among Chinese SOEs, powerful military oligarchs, cronies, and armed groups further contributes to a negative perception of Chinese investment in Myanmar. For example, in the Letpadaung mining project, the Chinese SOE China North Industries Corporation (NORINCO) formed a joint venture with military-owned Myanmar Economic Holdings Limited (MEHL) through its subsidiary Wanbao Mining (GEI, 2016). Similarly, the Asia World Company, which is owned by the son of former drug lord Lao Hsiang Han, holds a 5 percent equity in the Myitsone Dam project and is a local partner in many other hydropower projects (Tha, 2019). Other powerful cronies are also partnered with Chinese SOEs to implement hydropower and other projects. The IGE Group, a conglomerate owned by sons of the powerful former SPDC minister U Aung Thaung, was involved in many hydropower projects as well as the Kyaukphyu SEZ project. Moreover, CITIC’s subsidiary CITIC Construction Company had an agreement with HTOO group, which is

owned by political crony Tayza. All of the deals mentioned here were bilateral agreements that did not pass through any tender process and were conducted without any semblance of transparency. These joint ventures aggravated local grievances about land confiscation and forced relocation without proper compensation in project areas, which are mostly in ethnic minority regions. A 2019 report by the Myanmar-China Pipeline Watch Committee identified violations of existing laws and environmental safeguards committed before and during construction of oil and gas pipelines related to the above projects. An informal interview with a member of the Letpadaung Commission demonstrated that governance gaps have enabled illegitimate land appropriation. In comparison, the implementers of the Thilawa SEZ project had to follow guidelines and safeguards set by Japanese investors, and so the local community viewed the land compensation processes as fair.

These are but a small sample of cases of Chinese investments corroding the rule of law, human rights, and democratic governance in Myanmar. These cases highlight two specific governance gaps: incomplete ownership laws in Myanmar which allow cronies, foreign governments, and known human rights violators to hold secret equity positions in public enterprises,

and weak enforcement of environmental, procurement, labor, and immigration laws.

In summary, the military oligarchy, cronyism, and ceasefire capitalism in Myanmar facilitated the sudden surge of Chinese investments in the natural resource, energy, and construction sectors between 2000 and 2010. The public in Myanmar is aware of governance gaps linked to Chinese investment in the country, and thus holds a negative perception of these investments. Unless they address these governance gaps, Chinese investment projects will continue to pose the risk of corrosive economic and political effects on Myanmar.

Impact on the Local Private Sector

ZERO-DOLLAR TOURISM

As part of an effort to boost tourism, Myanmar started a pilot “visa on arrival” system for Chinese tourists that ran from September 2018 to October 2019. The strategy worked, as 650,000 Chinese visitors came to the country in the first four months of 2019, a 30 percent increase from the same period the year before (Hein, 2019). However, these tourists were largely part of low-budget tour groups owned and operated by Chinese nationals, with most profits and revenue leaving Myanmar and going back to China. These companies are accused of

leading tourists only to Chinese-operated stores and coercing them to purchase cheaply-made goods for inflated prices, while cutting into profits of local tour guides and companies. In addition, the government has allowed WeChat Pay, a digital payment system attached to the popular Chinese messaging app, to have three-month trials in 14 areas popular with tourists (Hein, 2019). Chinese-run tour companies in Myanmar are mostly paid through this platform, skirting taxes and rerouting all funds back into Chinese accounts, with the amount of lost tax revenue still unknown.

The companies in question often argue that they are licensed and follow all proper procedures to operate in Myanmar. Current tourism laws do not provide any enforcement on foreign tour leaders. Increased zero-dollar tourism has been encouraged by these lax policies, as the government has only *requested* that domestic tour companies not follow this practice (Mon, 2018). While the government has threatened to issue violations in certain cases, few concrete actions have been undertaken to combat the growing issue.

UNFAIR ADVANTAGES OF CHINESE MANUFACTURERS

The private sector, generally speaking, welcomes foreign direct investment as local industries grow after years of relative

isolation from the global economy. With regard to FDIs from China, some companies from the manufacturing industry voiced concerns about local manufacturers being wiped out when facing Chinese-made goods. The manufacturing industry in China has been heavily subsidized by the state with tax breaks, discounted land, and discounted utilities. Many industries in Myanmar are still in their infancy. If not managed properly, domestic industries might not even have a chance to develop. That said, Chinese companies have been eager to invest in Myanmar, particularly in the mining and textile sectors, where labor is cheaper than in China. However, several Chinese-owned factories have gone on strike and have suffered damage in attacks by workers protesting for pay raises and shorter working hours in recent years (Lo, 2018).

Laying the Foundation for Transparent Chinese Investment in Myanmar

Despite criticism over the lack of transparency in the implementation of CMEC projects, there are clear signs that the current government is taking a cautious approach. It is evident that the Myanmar government is laying the foundation for successful implementation of CMEC projects by enacting rules and regulations to address governance gaps. These steps are creating

an environment that promotes mutual trust and understanding.

First, in furtherance of campaign promises of transparency and accountability, the current government instituted Project Bank Notification 2/2018, outlining a regulatory framework for public private partnerships (PPPs), in November 2018. In addition, the Ministry of Planning and Finance will launch an interactive and publicly accessible online project bank to share information on approved priority projects. In an interview with *Frontier Magazine* Set Aung, the Deputy Minister of the Ministry of Planning and Finance, asserted that the project bank would enhance transparency and competitiveness (Frontier, 2018). Notification 2/2018 also sets guidelines and procedures for developing projects in accordance with strategies and action plans under the Myanmar Sustainable Development Plan (MSDP) and encourages the use of multiple financing mechanisms. The document also establishes a Public Private Partnership Center to monitor PPP projects, as well as setting standards and processes to implement PPPs, review unsolicited proposals, identify sources of funding for projects, evaluate environmental and social impacts, set contractual requirements for PPPs, monitor and supervise PPPs, and transfer state economic enterprises to the private sector. Implementing government agencies (IGAs)

must identify strategic projects that will contribute to the MSDP and share this information with the general public, the Office for Development Assistance, and bankable PPPs. This represents a clear and comprehensive regulatory framework for implementing PPPs in Myanmar.

Second, the two governments signed three bilateral agreements in connection with CMEC at the second BRI Forum: the CMEC Cooperation Plan (2019-2030), the Formulation of the Five-Year Development Plan for Economic and Trade Cooperation, and an agreement on Economic and Technical Cooperation. Although terms and conditions of these agreements have not been released, it can be argued that government is taking a gradual, long-term, and holistic approach to China's CMEC Cooperation. The government is strengthening regulatory frameworks, building the capacity of implementing agencies by setting up the PPP Center, and taking into consideration the need for technology transfer, human resource development, solutions to bilateral trade imbalances, resolutions to informal/illegal trade and human trafficking issues, and even the promotion of peace and stability along the China-Myanmar border and within the Rakhine state. The government of Myanmar stated that the May 2019 CMEC MOU had been signed only after China agreed to three

conditions: that Myanmar be allowed to seek financing from international institutions; that Myanmar be allowed to invite international tenders; and that the proposed projects be chosen by Myanmar (Lwin, 2019). Moving forward, legal and regulatory enforcement of these stronger policies will be key and must be monitored by civil society and the local business community.

Conclusion and Recommendations

The confluence of military oligarchy, cronyism, and ceasefire capitalism in Myanmar, along with national and international economic pressures on Chinese businesses, has accelerated the dramatic expansion of Chinese investment in extractive sectors and public works projects. The speed and lack of transparency of these investments has fueled negative public perceptions, which have led to demonstrations against Chinese companies' exploitation of natural resources in Myanmar, the lack of transparent environmental assessments, and inadequate land compensation. The new Myanmar government is taking steps to increase transparency in the funding of public works through the creation of regulations including Project Bank Notification 2/2018. While it is understandable that the negotiation of the early harvest projects of CMEC are ongoing

and that details are still being discussed between the Chinese and Myanmar parties, there are still immediate steps the government of Myanmar can take to mitigate the political, social, and environmental risks associated with these projects.

Proper land, social, and environmental assessments should be conducted prior to project implementation. This will raise public awareness of these projects, clarify land acquisition procedures, protect the livelihoods of local people, and put in place measures to prevent environmental degradation. Further actions can be taken in order to better explain to local communities how land acquired under eminent domain for use in public works projects will be compensated for. This public education should be discussed well in advance so that suspicions and anxieties about land confiscation can be reduced.

The Project Bank Notification 2/2018 is a good first step, but it is important that its policies be enforced so that projects will be implemented in accordance with the rules and regulations prescribed by the mandate. The Myanmar government can further increase the transparency of PPP projects and its agreements with China. The PPP Center or the Ministry of Planning and Finance should issue regular press briefings and host project information sessions in order to increase public participation, address misinformation,

and ensure that the projects are being planned and implemented in accordance with national laws and regulations.

Undetermined pricing standards have been exploited in up-charging unknowing project clients. Mandatory price analysis by an expert third party on all large-scale public works projects funded from abroad would ensure transparency in investments, business acquisitions and agreements. The government of Myanmar recently demonstrated its ability and willingness to intercede in problematic Chinese investment. For instance, the Myitsone Dam project was suspended due to increasing environmental concerns over damming the Irrawaddy River. These concerns grew into nationwide protests from nearly every part of society, an unusual occurrence in a country with fractured relations between ethnic groups. The government has remained steadfast in spite of ongoing and increasing pressure from Chinese authorities.

Terms of the Kyaukphyu SEZ deep-seaport project also were renegotiated because of concerns over the high levels of debt the Myanmar government would owe to China. Also, the size of the project was considerably pared down to a level more plausible for near-term usage. After seeing similar issues in Sri Lanka where the government had to

lease a deep-water port back to China after falling into default, Myanmar is cautious about the financial viability of any major project while still encouraging foreign investment at appropriate levels.

In short, Myanmar must consider what types of investment best stimulate domestic industrial growth and provide the greatest feasible value-for-money to its people. Chinese capital and technical skills can help meet Myanmar's tremendous infrastructure needs. For the local economy, from tourism to manufacturing, the government must continue improving infrastructure and clearing investment bottlenecks to sustain economic momentum. However, it is also key to mitigate the governance risks associated with this influx of Chinese capital. Myanmar may be able to use the new PPP project bank mechanism to increase transparency and oversight. Meanwhile, the government also needs to recognize that industrial subsidies and pervasive state-led economic planning from China is going to destroy its infant industries at home before it can develop and compete. Policymakers need to ensure that Myanmar is "open for business" while establishing risk mitigation strategies that allow its citizens to reap the benefits of foreign investment.

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CHAPTER 7

THE OUTCOME OF CHINA'S INVESTMENT IN INDONESIA: LESSONS FROM THE NICKEL INDUSTRY

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Introduction

As the largest country in Southeast Asia, Indonesia is among the top destinations for Chinese investment. Several researchers, including Priyandita (2018) and Damuri et al. (2019), have tried to analyze the impact of Chinese investment in Indonesia, but these studies have tended to focus only on investment in the infrastructure sector. In addition, the aforementioned reports do not adequately assess the positive and negative side effects of Chinese investment in Indonesia. For example, Damuri et al. provide evidence for benefits from Chinese investment in Indonesia, but include limited

commentary on the social, economic and environmental impacts of such investments.

In light of the scant critical analysis on the impact of Chinese investment in Indonesia, the Paramadina Public Policy Institute (PPPI) provides a more comprehensive analysis of the nature and characteristics of China's investment in the country. This paper explores the complexities of Chinese FDI through a case study on nickel mining and the midstream operations industry in Sulawesi.

China's economic growth and industrial policy have fed a growing, aggressive demand for nickel in recent years. The PRC established a policy framework and

committed financial assistance to develop its electric vehicle (EV) industry in the early 2000s. What was once a nascent sector has become a booming industry which demands increasing quantities of nickel to produce EV batteries. This demand is a driver of China's rapidly growing presence in the mining sector of Indonesia, which holds the largest laterite nickel deposits in the world according to the U.S. Geological Survey. While there is evidence that such Chinese investments have harmed Indonesian national interests, especially with regards to the local economy, environmental sustainability, technological advancement, and absorption of local workers, the complex impacts on the Indonesian economy remain poorly understood.

This study examines these impacts in greater depth in order to generate policy recommendations that will help Indonesian government officials better manage the threats and opportunities related to Chinese investment and foster Indonesia's sustainable economic development.

This report is based on data collected through document analysis and in-depth interviews with 22 stakeholders from both government and non-government agencies. Between February and June 2019, researchers interviewed representatives from the Ministry of Industry, state-owned enterprises (namely, GAG Nikel subsidiary

of PT Antam), the Corruption Eradication Commission (KPK), and the China Chamber of Commerce in Indonesia. From the non-government sector, researchers conducted field interviews with business stakeholders at the national and local Sulawesi levels, including representatives from companies such as PT Vale Indonesia (Ex-Inco), PT Sulawesi Mining Investment (SMI-IMIP), PT Virtue Dragon Nickel Indonesia, Cipta Smelter Indonesia, and the Indonesian Nickel Mining Association.

This research aims to deliver both theoretical and practical lessons that can subsequently be applied in other Southeast Asian countries. In theoretical terms, this research seeks a realistic perspective, one balanced between the optimistic and pessimistic views about the outcomes of China's investment for Indonesian social, political and economic contexts. Meanwhile, the practical contribution of this research will be to drive policy debates pertaining to foreign direct investment (FDI). This research will serve two significant roles in this regard. First, this study will conclude with policy recommendations for the design and implementation of constructive and productive investment at local and national levels. Second, the research will encourage a more neutral, fact-based national debate on the impact of Chinese investment. These findings will be informative for many citizens of newly

economically-liberalized societies that are pursuing economic development requiring financing from abroad. They will learn that non-transparent financing from authoritarian states is particularly risky.

Chinese FDI in Indonesia

In 2005, Indonesian President Susilo Bambang Yudhoyono (SBY) and Chinese President Hu Jintao signed a joint declaration for a “strategic partnership” (Qin, 2005). The declaration included agreements on visa exemption for diplomatic and service visits, maritime co-operation, infrastructure and natural resources, economic and technological assistance, finance, preferential buyer’s credit, and earthquake and tsunami relief. In 2013, the relationship was upgraded again to a “comprehensive strategic partnership,” with a focus on infrastructure construction, manufacturing, agriculture, investment and finance (Xinhua, 2005). It is worth noting that Indonesia was the first country in Southeast Asia that President Xi Jinping visited after taking office. It was during his inaugural trip to Indonesia that President Xi announced his plans for the Asian Infrastructure Investment Bank (AIIB). More recently, President Joko Widodo (“Jokowi”) agreed to establish a “new level of bilateral and global partnership” under China’s Belt and Road Initiative (BRI).

Against this bilateral policy backdrop, Chinese FDI in Indonesia grew from USD 300 million in 2012 to 3.36 billion in 2017. This exponential annual growth makes China the third largest foreign investor in Indonesia, up from 12th just five years before.

Composition

This section presents data on annual Chinese FDI transactions and cumulative FDI inflows to Indonesia based on 2019 research by the Rhodium Group (hereafter RG). Foreign direct investment is classified into various types, namely acquisition (buying shares of an existing firm) and greenfield (newly established) projects. For an acquisition to qualify as FDI, the investing party must purchase more than ten percent of the target firm’s shares. For greenfield projects, investment funds are frequently used to buy factories, offices or subsidiaries, or to fund research and development.

From 2000 to 2017, the cumulative gross value of Chinese acquisition and greenfield FDI transactions amounted to USD20 billion in top sectors, the majority of which was invested in basic materials, transport, utilities, infrastructure and energy. Nickel mining, the industry highlighted as a case study in this report, is classified as a “basic materials” industry.

Based on RG 2019, there were 27 mergers and acquisitions completed from 2002 to 2018, 30% of which targeted the basic materials sector. In addition to that, Rhodium has documented 49 greenfield projects initiated from 2000 to 2018, with 27% of this total targeting basic materials. Among the investors covered in these statistics is the Jinchuan Group, which had invested USD500 million in the WP&RKA nickel project on Nov 25, 2016. Jinchuan is a Chinese state-owned enterprise (SOE). Construction of the WP&RKA laterite nickel mine officially began on Obi Island on November 25, 2016 (China Metal News, 2019).

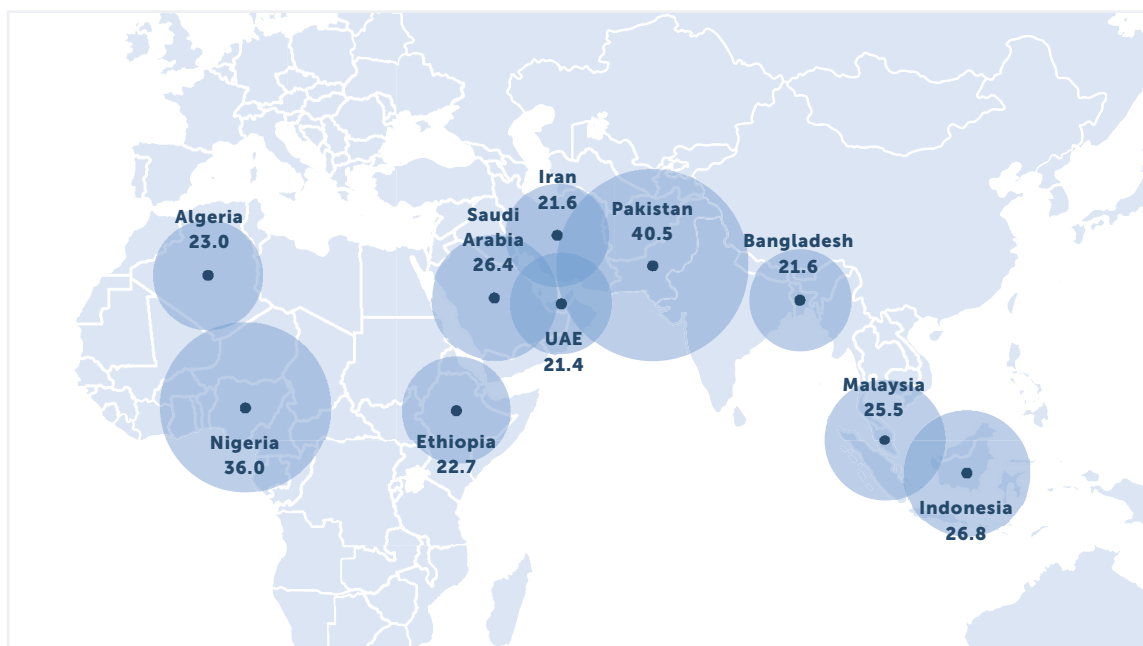
Construction contracts refer to work completed in a target country under a contracted agreement. Besides merger and acquisition and greenfield projects, Chinese FDI also takes the form of construction

contracts. In fact, in 2019, Indonesia has been one of top target countries for Chinese construction activity, as shown in Figure 1 (PG. 147), taken from a China Global Investment Tracker (CGIT) map produced by the American Enterprise Institute in collaboration with The Heritage Foundation.

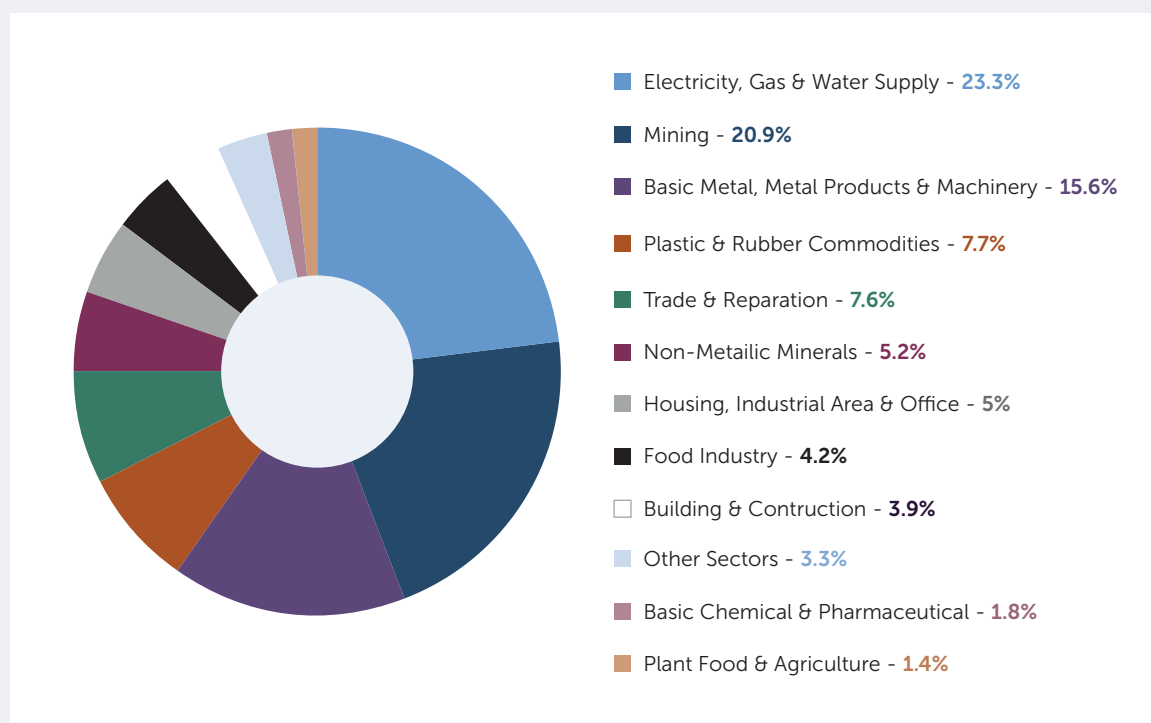
Types of Industries

Based on recent official data from the Indonesia Investment Coordinating Board for years 2017 and 2018, Chinese investment in the form of inward FDI focused on several sectors and industries, including mining, electronics, chemicals, pharmaceuticals, electric and gas utilities, water supplies and others. Figure 2 (PG. 148), depicts the proportion Chinese FDI in these sectors over the period 2010-2015 (Table 1, PG. 148-149).

FIGURE 1: China Global Investment Tracker



SOURCE: Scissors (2019)

FIGURE 2: Chinese Investment in Indonesia by Sector (2010-2015)**SOURCE:** CSIS (2019)**TABLE 1: Chinese FDI in the Mining Sector 2011-2018**

YEAR	MONTH	CHINESE ENTITY	QUANTITY (USD MILLION)	SHARE	TRANSACTION PARTY
2011	July	Jilin Nonferrous	930	100%	
2011	October	China Nickel Resources	270	80%	PT Yiwang Mining
2012	Juni	China Nickel Resources	1,260	61%	PT Jhonlinto
2012	July	Beijing Shenwu	420	N/A	Titan Mineral
2012	July	Beijing Shenwu	180	N/A	Balinton Resources

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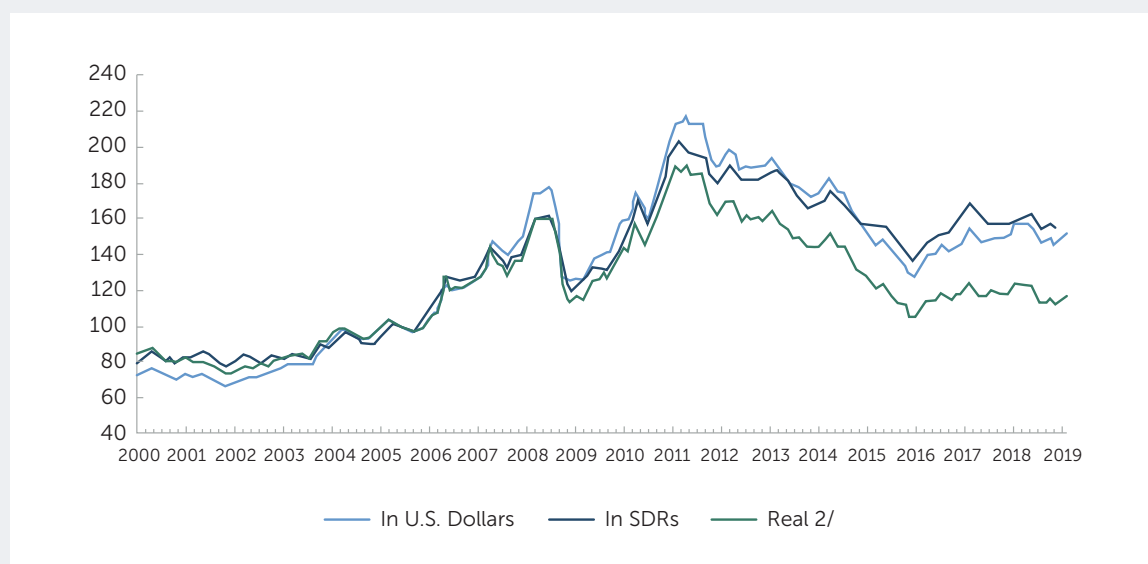
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YEAR	MONTH	CHINESE ENTITY	QUANTITY (USD MILLION)	SHARE	TRANSACTION PARTY
2013	May	Fosun	100	N/A	Gunung Gahapi
2013	July	Tsingshan Steel	320	50%	Bintang Delapan
2013	December	MCC	180	N/A	SMI
2014	July	CIC	1,360	19%	Bumi Resources
2014	August	Hongqiao	840	56%	Well Harvest
2015	May	Sinosteel	120	N/A	DBM
2015	July	Tsingshan Steel	510	50%	Bintang Delapan
2015	November	MCC	110	N/A	Tsingshan

SOURCE: American Enterprise Institute (2018), All fourteen separate Chinese firms listed here are owned or controlled by the Chinese government.

China's economic growth during the first decade of the 21st century was the fastest and most resource-intensive economic expansion in history..(Garnaut, 2015). This rapid development led to extraordinary rates of growth in demand for almost all commodities. This effect was strongest in the market for energy and metal commodities, which the Chinese required in unprecedented amounts.

Nickel was one of the basic metal commodities impacted by the global resource boom between 2000 and 2011. Indices for non-fuel primary commodities prices increased gradually from 2000 to 2011, with a brief falling period during the 2008 global financial crisis. Figure 3 (PG. 150) depicts these movements.

FIGURE 3: Non-Fuel Primary Commodities Indices from IMF Primary Commodities Prices**SOURCE:** IMF Primary Commodities Prices (from Garnaut, Ross, 2015)

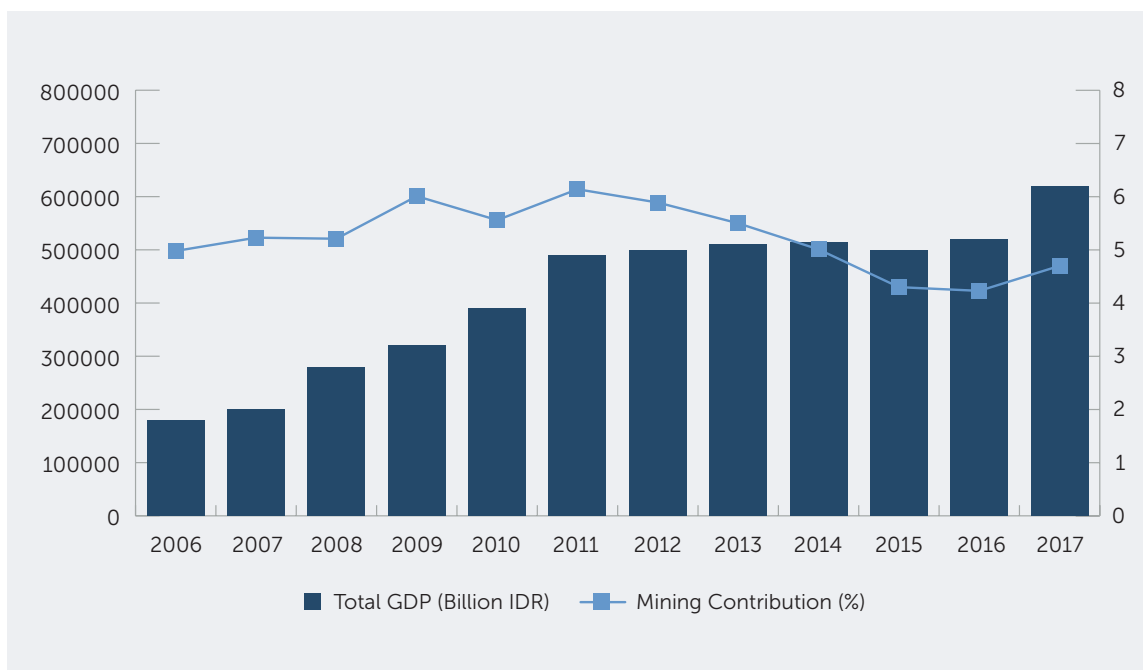
Indonesia's Nickel Mining Industry—Background

The mining sector has been critical to Indonesia's economic growth for several decades. Mining contributes to Indonesia's gross domestic product (GDP) through exports, government revenue, worker salaries, and perhaps most importantly, through associated development projects in many remote regions of Indonesia. Mining companies are often the largest employers in these remote areas (Figure 4 & 5, PG. 151).

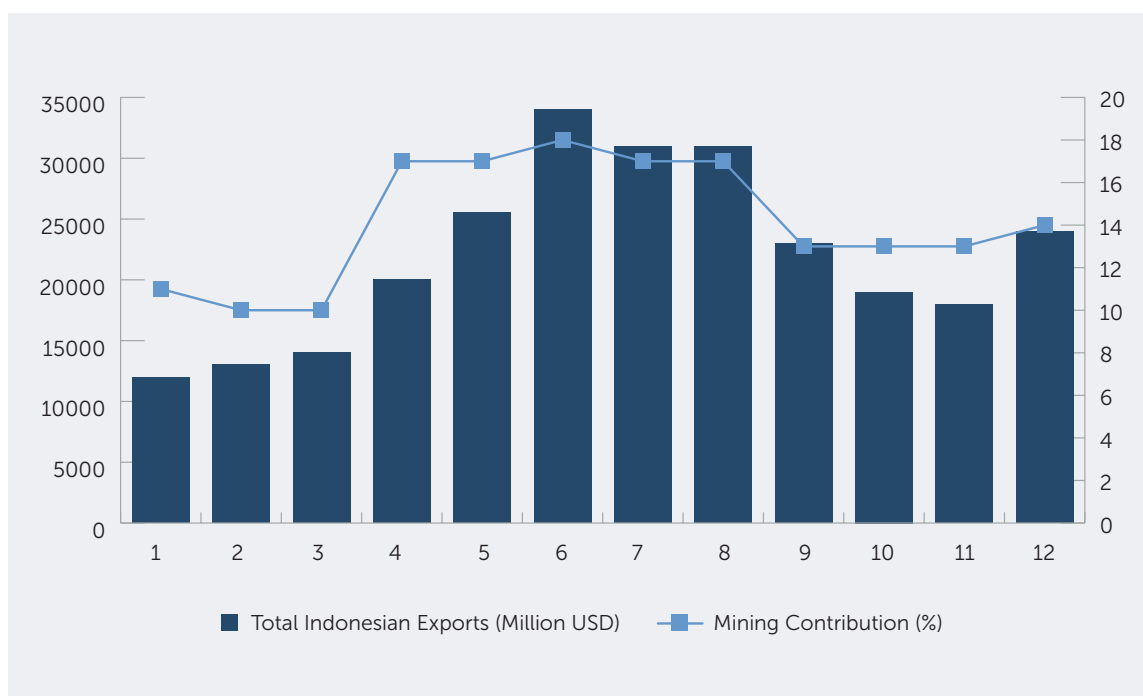
This paper focuses on the development of nickel processing at the national level and the Indonesia Morowali Industrial Park (IMIP) provides an illustrative case study.

IMIP was established in the nickel-rich Central Sulawesi Province of Eastern Indonesia, and it is owned by a holding company called Sulawesi, which is two-thirds owned by a Chinese SOE. The Indonesian partner owns only 33.75%. Morowali's holding company, Sulawesi Mining Investment (SMI), is jointly owned by China-based Shanghai Decent Investment (66.25% shareholders) and Indonesian mining company Bintang Delapan Group (33.75% shareholders) (See Box 1: Indonesia Morowali Industrial Park) (Figure 6, PG. 152).

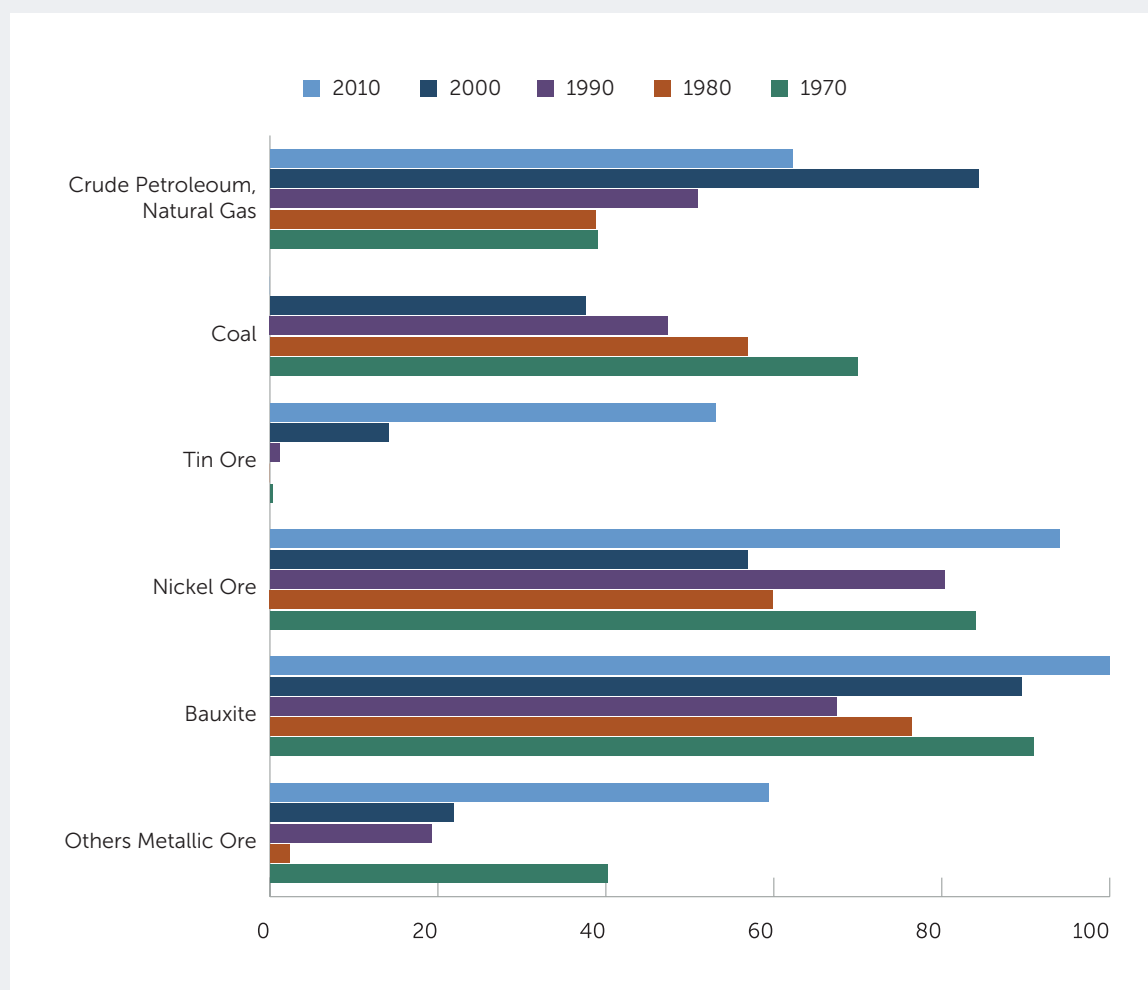
The natural resources sector, particularly mining, has been a backbone of Indonesia's economy for a several decades. Owing to the country's vast mineral resources,

FIGURE 4: Mining Industry Contribution to Indonesian GDP

SOURCE: PriceWaterhouseCoopers (2019)

FIGURE 5: Mining Industry Contribution to Indonesian Exports

SOURCE: PriceWaterhouseCoopers (2019)

FIGURE 6: Time Series Oil & Gas and Mining Contribution

SOURCE: Pierre van der Eng (2014)

Indonesia has made significant contributions to the global mining industry. Up to early 2000, a number of global mining companies had their operations in Indonesia. In addition to Canada's International Nickel Company mentioned above, other multinational mining companies including Freeport, Newmont, Barrick Gold, Rio Tinto and BHP have all been very active in Indonesia.

While the presence of giant exploration companies is good for upstream mining sectors, turning latent mineral deposits into exploitable resources and reserves, the country's downstream sector was barely developed. For decades, Indonesia's mining sector was an export-oriented industry, with commodities sent to advanced industrial countries such as Japan, South Korea and

European states. Indonesia enjoyed the status quo of being a commodity exporter, although it was generally recognized that exporting processed materials rather than raw commodities would be a better strategy for the country (Maulia, 2018). Not only is the price of processed materials less susceptible to global price fluctuation, but developing a domestic mineral processing sector would also support industrial growth, providing additional income for the state and creating new jobs.

The golden years of mining eventually came to an end when changes in the national political landscape slowed industrial growth. As part of the democratic transition that occurred after the 1998 economic crisis and reform, Indonesia decentralized political power, ceding autonomous economic control to regions that formerly had been left behind by Jakarta under the Suharto regime. Under Suharto, economic development had focused on Java, Bali and some parts of Sumatra, neglecting other areas. Those neglected areas were now granted authority over certain industries, including mining.

Unfortunately, abuses of power by heads of government regencies¹ (including over-regulation, corruption, nepotism, and arbitrary fees levied against companies), have driven

many mining companies to pack up and leave Indonesia, driving the mining sector into decline (Hamidi, 2015). Excessive demands by authorities on mining companies have also harmed the industry (Devi & Prayogo, 2013). In 2017, the Fraser Institute recognized Indonesia as one of the least attractive jurisdictions for mining investment, along with Venezuela, Democratic Republic of Congo, China, the Philippines, Bolivia and Ecuador. Indeed, political factors account for some 40% of the reasons investors decide to put money into a country' (Stedman & Green, 2018).

After the departure of the larger mining companies, local miners took over the sector. Local government officials began lavishing mining licenses, known locally as IUPs (Ijin Usaha Pertambangan or Mining Business License), upon designated recipients. It was not unusual for IUPs to be concentrated in the hands of local kingpins, relatives of high-ranking government officials, or even government officials themselves (JPNN.com, 2012). Mineral exports increased sharply, and the central government soon realized it was time to address the issue of exporting raw materials.

In 2009, Indonesian mining policy underwent a major shift. The government mandated that mining companies must build smelters or processing facilities or face revocation of their

1 Regencies are administrative subdivisions of Indonesian provinces.

export licenses. Companies were granted a five-year grace period to comply, and targeted companies were expected to have their smelters ready by 2014. This decision was supported in particular by the Ministry of Industry, which had multiple reasons for supporting the ban of raw ore exports.

Based on this decision, it seems that the state failed in its objective to strengthen regional autonomy and increase freedom for regions to manage their own economies. High levels of corruption and abuse of power have left investors reluctant to invest outside the more developed areas of Java, Sumatra and Bali. Supported by more advanced infrastructure, these three regions have remained more attractive destinations for investment, and the gap between them and Indonesia's remote areas only grew larger during this period. While mining resources are also plentiful in areas outside of Java and Bali, the mandate to build processing facilities is projected to spur development (United Nations, 2017).

The new regulation on smelter construction sent shockwaves through Indonesian mining communities, which usually operate locally on a small-to-medium scale. Even large corporations like Freeport and Newmont ended up in protracted negotiations over the new policy. Scraping nickel from the ground and refining the nickel ore are two different things, and smelter construction requires

sizable investment. Smelters are so expensive that even mining giant Freeport McMoran found smelters very challenging to finance and build (Bisara, 2019).

Nickel smelter construction requires an estimated USD5-7 million before commission fees (Adjie, 2019), a difficult financing target for Indonesian miners. In fact, many smelter projects failed to achieve their target completion date, forcing the government to extend the deadline to 2022 because the target would not be achieved by 2019. Even the government has admitted that smelter construction is not easy (Hukumonline.com, 2017). The export ban was also relaxed because the government needed the revenue from mineral export.

China Nickel Investment in Eastern Indonesia

Other than nickel mining giant Brazilian Vale, which was already operating smelters (under contract with Japanese investors since the 1970s), no Indonesian nickel miners had thought to build smelters until the government forced them to do so. At the time of Indonesia's smelter push, Chinese firms were already involved in Indonesia's nickel mining sector through capital injection or other partnerships. One of the first Chinese companies to get into the smelter business was Tsingshan Group, a company headquartered in Zhejiang Province.

Tsingshan, the largest stainless steel producer in China, with a record of 9 million tons of crude stainless steel produced in 2018, and one of the world's major stainless steel producers, had actually been partnered with the Bintang Delapan Group in the nickel mining business long before the government imposed its smelter policy.

The idea for Bintang Delapan to build an industrial complex instead of just a smelter may have come from the Ministry of Industry, which said that Tsingshan Group's participation in the deal could draw additional investment. The Ministry of Industry took a "mall approach" in this project, hoping that one large, central brand would attract other tenants (Suryawirawan, personal communication, 2019). The Tsingshan Group–Bintang Delapan Group joint venture has now developed the Indonesia Morowali Industrial Park, or IMIP, in Morowali Regency, Central Sulawesi Province. IMIP was completed in only five years and now hosts 16 tenants, including an Australian nickel mining company and producers of stainless steel and other steel products. The latest addition to the industrial park is PT QMB New Energy Materials, a joint venture between Chinese and Japanese companies that produces the material for electric vehicle batteries (Asmarini, 2018). Backed by strong capital, IMIP is an impressive industrial park with its own hotel, ports of 100,000 tons deadweight,

and 1,830-megawatt steam power plants. Currently, IMIP operates 20 smelters with possible expansion in the future. The industrial park employs 32,000 people, including workers not only from the Morowali area, but also from other regions in Indonesia, as well as workers from Mainland China. As of April 2019, an airport with an 1,800-meter runway was under construction. One interviewee said of the project,

When Tsingshan and the Bintang Delapan Group said they wanted to build a smelter, we told them, "why not build an industrial complex instead?" They are big investors, and as owners of the industrial park, they can invite and select companies that fit with the park (Suryawirawan, personal communication, 2019).

Tsingshan is also reported to be cooperating with French company Eramet to develop the nickel concession in Weda Bay of Eastern Indonesia. The plan is to build another industrial park worth USD5.5 billion that will also produce materials for electric vehicle batteries (Silaen, 2018).

Another noteworthy Chinese investment project in Indonesia's nickel sector is Virtue Dragon Nickel Industry (VDNI) in Morosi–Konawe, South East Sulawesi Province, eight hours' driving distance from Morowali. With a plan to build a total of 45 smelters, VDNI

is projected to be bigger than IMIP. VONI is a subsidiary of DeLong Nickel Co. Ltd., headquartered in Jiangsu Province, China. Like IMIP, VONI also exports its intermediary products, ferronickel, to China.

China's appetite is not limited to large-scale projects. Most of the sources interviewed for this research said there are traces of China's investment and Chinese components in every new smelter facility in Sulawesi and Eastern Indonesia. Currently there are more than 15 smelters across Sulawesi and Eastern Indonesia.

The Chinese smelters, through trading companies, finance miners' operational expenses. The lending is made on one condition: the nickel ore mined must be sold to the traders. When the miners fail to repay their loans, they are forced to sell the nickel at a very cheap price. In some cases, indebted miners are forced to give up their mining concession. This demonstrates China's weaponization of debt. China has monopolized these companies, becoming the only buyer. Such constraints limit these companies' abilities to diversify partnerships and scale their businesses. Many local miners operate as small or medium enterprises and often suffer from low cash flow. Due to the opaque terms of financing agreements, these miners often go into default and are seized by their Chinese creditors.

China's Dominance in the Nickel Industry

Chinese nickel mining business practices reflect customary Chinese investment behavior where the promise of quick funding is made at the expense of domestic and international law. There has been a debate over the extent of Chinese investment in both the upstream and downstream sectors of Indonesia's nickel industry.

The biggest controversy over Chinese investment in the nickel industry centers on IMIP. PT Sulawesi Mining Investment (SMI), the managing company of the industrial park, has been accused of employing illegal workers from Mainland China. Illegal workers are the most controversial issue in regard to Chinese investment, and IMIP management has repeatedly denied the use of illegal Chinese workers in the park. In response to these allegations, then-Minister of Manpower Hanif Dhakiri visited the site to check on the issue; he later released a statement claiming that no illegal manpower was being used at the site (Dwinanda, 2018). Another debate has focused on the park's patronage by military generals. Both of these issues will be covered in a later section of this report.

The strong presence of Chinese investment in Indonesia, of course, cannot be separated from China's ambition to control the global market. China knows exactly how to make

itself welcome in a resource-rich country like Indonesia. For example, Chinese investors are known to be very flexible when doing business. In one anecdote, a major local nickel producer made a purchasing agreement worth USD32 million over text message after only hours of negotiation; the legal contract was ready the next day. The Chinese also understand when their counterparts are facing difficulties, and the Chinese investors are willing to make exceptions and to compromise. A mining company was recently obliged to pay a USD24,000 penalty due to high moisture content in a quantity of ore delivered to a purchaser. When the mining company that sold the ore came to the Chinese buyer saying it actually needed the money used to pay the penalty, the buyer returned the USD24,000. However, winning the trust of a Chinese counterpart is not easy. Despite the general perception that it is easy to do business with Chinese investors, just like any other investors, Chinese investors require assurance of the security of their investment (personal communication, 2019).

China's competitive technology also makes partnerships with Chinese firms attractive. The pioneer in Indonesia's nickel mining and processing, PT Vale Indonesia, has announced a joint venture with a Chinese company to improve its undeveloped Bohodopi concession, also in Central

Sulawesi. PT Vale's current smelter in Sorowako is linked to a hydropower plant; competitive technology is needed to help the company develop its other concession in Bohodopi.

We need competitive technology that can help us manage the costs in our Bohodopi site. We have carefully selected a potential partner who will not dent our reputation. I tell you, there are some excellent Chinese companies. If we're conducting the Feasibility Study with any western companies, it would cost us \$70 billion compared to a maximum \$15 billion with the Chinese, not to mention the time needed to complete the project. Working with the Chinese partner would also reduce the necessary capital expenditure by 30%. We recognized differences between the two companies. There are things that we can change and can't change, practices that we can and can't adopt. But it is certain that we won't sacrifice our good reputation by carelessly selecting a partner (Superiadi, personal communication, 2019).

These comments suggest the Chinese company has a superior product at a lower price, validating the decision to partner with Chinese firms. Yet in truth, Chinese start-up costs are so low because they are subsidized

by the Chinese government, and projects are completed at an unmatched speed because the Chinese firms ignore local laws that would inevitably slow project development.

China also has in-depth knowledge of Indonesian nickel resources. The president-director of a local nickel mining company shared his company's experience in conducting open tenders for smelter projects:

Of the nine companies submitting tenders, six are Chinese; one is Finnish; one Korean; and one Filipino. The Finnish had the technology, but they didn't have people to do the project due to other engagements in other countries, while the Koreans didn't have the right technology. Eventually, it's the Chinese who won the tender. They have all the technology and expertise on Indonesia. But I have to admit that Chinese technology is still inferior to the Japanese (personal communication, 2019).

One of the controversies involved in accepting Chinese investment is the "all China technology" requirement of many projects, leaving Indonesian vendors a very tiny piece of the cake. Because Indonesia continues to lag behind in smelter technology, Chinese investors must ship in all the technology from China (Sen, personal communication, 2019).

And of course, China offers the cheapest technology in the world. A source at the Indonesian Nickel Mining Association provided rough comparisons of smelter technologies available on the market:

A US machine would cost you \$15 million, while a China-made machine will cost you only \$7 million. This excludes the commissioning cost. The cost of electricity is also higher for non-China technology. An electric furnace needs at least 33 megawatts per line. The cost of electricity per megawatt would be \$900 thousand using Chinese technology, \$1.5 million using Japanese technology, and \$1.7 million using German or US technology (Adjie, personal communication, 2019).

China also has the speed-of-work Indonesia needs. In its ambition to dominate the world's steel and battery markets, China has been very quick in building processing facilities, at the expense of upholding environmental protection laws. By contrast, Freeport and Newmont had engaged in long and tiring negotiations with the Indonesian government regarding smelter building. China and Indonesia are complementing each other in the case of the nickel industry. While Indonesia is hoping to build a national downstream industry, China needs the nickel to feed its home industry and to fulfill its global ambition. This has helped

the two countries to accomplish their joint smelter projects. China's lavish funding is also a driver. Finally, the Indonesian Ministry of Finance has provided special zero-tariff conditions for machinery imported for industrial development for all investors (Minister of Finance, 2015). This has also helped the growth of China's investment in Indonesia.

While China seems to find Indonesia a rewarding place to invest, Chinese businesses may still find Indonesia a challenging place to do business. Indonesian counterparts need to ensure that Chinese investors feel confident. According to one interviewee, Mr. Suryawirawan, "...it was really not an easy job, but we need big investors to attract even more investors to come to the area."

PT Bintang Delapan, the Indonesian partner of Tsingshan Group at IMIP, feels heavy pressure to ensure the security of its Chinese counterpart's investment. It seems that IMIP enjoys high favor from the central government, as evidenced by countless visits from high-ranking government officials, an inauguration event hosted by President Jokowi, and special attention from the Coordinating Minister of Maritime Affairs. Nevertheless, a senior officer, Irsan Wijaya, still believes that IMIP lacks necessary attention from the central government:

We want the government to pay more attention to our operation. It is not easy to secure such a big project. We have had to deal with worker demonstrations over some wages and other issues as well as inter-ethnic tensions between the natives and people of other ethnicities. This project has benefited the country. It brings revenue and opens up employment. I think we deserve extra attention from government. The extra cost we have to bear in this operation is huge (Wijaya, personal communication, 2019).

Mr. Bai Sen of VDNI told of challenges he has faced in managing a plant with a diverse labor force:

Infrastructure in this area [Konawe Utara] is so bad that we can't go anywhere. The working culture is also different. The Indonesians have never worked in a plant before. Indonesian workers have a rest day, but the Chinese workers don't. We work 12 hours per day, every day. I envy the Indonesian workers. But the Indonesian workers are getting better now. Their reputation is better than before. Their conceptions are changing, too, and they really needed to change. Our plant is producing 24 hours a day, 7 days a week. If the workers are always absent and late, we definitely don't want them.

We respect Indonesia's laws as well. The workers can rest during their days off. On working days, they have to follow the company's rules and regulations.

Costs vs. Benefits of Chinese Investment in the Nickel Mining Industry

The massive influx of Chinese investment has undoubtedly created economic opportunities that Indonesia desperately needs. Indonesia's economy relies heavily on Chinese investment both for capital injection and technological know-how, and the liquid capital and speedy execution typical of Chinese investment have supported China's rapid growth and market dominance in Indonesian nickel mining. These assets have already established China as Indonesia's top investor in the mining industry. Chinese investment in Indonesia has been flexible, involving the acquisition of raw materials as well as establishment of new markets for Chinese products. In the case of the mining industry, it is clear that the primary investment motive was to obtain raw materials to meet industrial demand back in China. Nevertheless, Chinese investment has also involved development of target markets, as exemplified by the chemical, pharmaceutical and electronic industries.

The speed of project execution by Chinese companies is second to none. The

consortium of Tsingshan–Bintang Delapan built the IMIP in less than five years. The industrial park has 20 smelters with its own ports, power plants and other infrastructure, and it is projected to be Indonesia's largest integrated nickel-based industrial complex. Delong Group, the owner of VDNI, has also set up a large plant and delivered its first export only three years after breaking ground. This has made China a favored investor for Indonesia, which has seen many projects stalled or failed for numerous reasons. China's ability to execute large projects in a blink of an eye is also a result of its flexibility. However, this rapid execution in nickel mining increases environmental risks. The ease with which Indonesian environmental and labor regulations can be ignored reveals a widely exploited governance gap through which Chinese money can easily flow.

Although China's government actively supports state-owned enterprises (SOEs) and private companies investing abroad, there are ample examples of business-to-business cooperation between China and Indonesia. A study from Gammeltoft and Tarmidi found that nearly two-thirds of companies report business-to-business to be their most important market, while a quarter of companies sell primarily to private consumers and the remaining 10% primarily export their products (Gammeltoft & Tarmidi, 2013).

While acknowledging the benefits of Chinese investment, it is important to also highlight some potential risks. In recent months, Chinese FDI has spurred debate over issues of imported labor and small and medium-sized enterprises (SMEs) losing out to monopolistic Chinese firms. This research will analyze these issues and explore solutions to mitigate associated risks.

Exploitation of Illegal Workers

As in most places where Chinese investment exists, use of illegal workers is a major issue in China's nickel projects in Sulawesi. During field research, we observed Chinese workers in all work sites funded by Chinese nickel investment. While we did not obtain proof of the legal status of these workers or ascertain whether they held working permits from the local Ministry of Manpower office, a simple analysis can help to answer this question. Chinese FDI-funded projects are implemented very rapidly and require thousands of workers, both high- and low-skilled. If one worker quits, the replacement worker from China arrives and begins work only a few days later (PT VDNI staff, personal communication, 2019). Due to the notoriously slow Indonesian bureaucracy, it is unlikely that workers from Mainland China could receive working permits this quickly, even if their employers have the

intention of obtaining proper authorization from the relevant authorities. Because of the lack of workers possessing skills and knowledge of nickel processing in the Indonesian market, Chinese investors must fly these workers into Indonesia from China (Sen, personal communication, 2019). It is very easy for Chinese visitors to enter and leave Indonesia, because Indonesia provides a visa on arrival for Chinese tourists in an effort to boost Indonesia's tourism sector. Monitoring from the Office of Manpower might be insufficient, however, because the closest office is often located hundreds of kilometers away from a project site (*Jakarta Post*, 2017). Thus, we believe the presence of illegal Chinese workers is very likely in China-funded projects.

Control of the Price of Nickel

Vast Chinese investment has opened up the possibility of price control by smelters. Although the government's Mineral Purchasing Price Reference (Harga Patokan Mineral, HPM) regulates the price of nickel ore, smelters rarely comply with the HPM. In reality, nickel's sale price is very low due to an oversupply of nickel ore in the domestic market. The selling price thus could be as much as 50% lower than the regulated market price (Mulyana, 2019). The miners themselves have no option but to sell the ore to the China-controlled smelters at

the offered price. The Indonesian Nickel Association (APNI) says miners do not receive a fair profit due to the low buying price of the smelters. The APNI is currently working to establish an Indonesian Nickel Index (INI), an initiative that has gained support from government authorities who have admitted that the sale price of nickel ore in the domestic market remains an issue. However, the smelter association denies the APNI's statement, saying that the purchasing price is in accordance with the international market price.

Low nickel prices could harm the environment. Small profits may induce miners to disregard expensive environmental protections at mining sites. The cost of environmental protection often constitutes a significant portion of the total production cost for miners (Superiadi, personal communication, 2019). Thus, a depressed sale price for nickel ore can also lead to environmental consequences if miners lack sufficient funds to repair environmental damage caused by mining. Chinese enterprises customarily ignore environmental protection laws. Indonesia has laws mandating environmental protection for precisely this reason—miners cannot choose when to obey them and when to ignore them. To best address this governance gap, CIPE launched a project with Paramadina under the premise that when there is

compliance with environmental laws, there is an increase in transparency, a legitimization of rule of law, and a reduction in environmental damage.

Lack of Health, Safety, and Environment Assessments

Because Chinese FDI-funded projects tend to operate quickly and cheaply, health, safety, and environment (HSE) issues remain a concern. We made a comparison of HSE treatment between PT Vale Indonesia, IMIP and VDNI. Although we do understand the methodological concerns in directly comparing two industrial parks with a standalone company, we did note that PT Vale has the best safety procedures in place, while IMIP and VDNI need improvement on HSE. Company budgets do not yet place high priority on HSE items (PT VDNI staff, personal communication, 2019).

Military Connection

The Indonesian military is known for its long history of running businesses in Indonesia, both institutionally and personally. Some retired army generals who are currently serving civilian roles in government are said to be involved in IMIP's operation through local partner PT Bintang Delapan. These individuals were involved with the company long before IMIP was constructed (Wijaya, personal communication, 2019).

It is not hard to make the case that military connections help to “grease the wheels” of economic growth. Therefore, it is noteworthy to look at the number of capital investments related to the industrial park. Transaction-based data from AEI presents 21 transactions from 2011 to 2018 related to the metal and mining sectors and the steel subsector, illustrated in Table 2 above. From this list, we have identified five transactions that directly relate to the Indonesia Morowali Industrial Park:

- In July 2013, Tsingshan Steel took a 50% share in a new firm with Bintang Delapan Group with an investment of USD 320 million.
- In July 2015, Tsingshan Steel took a 50% share in a new firm with Bintang Delapan Group with an investment of USD 510 Million.
- In December 2013, MCC group invested USD 180 million in a project with Sulawesi Mining Investment.
- In November 2015, MCC group invested USD 110 million in a project with Tsingshan.
- In June 2017, Tsingshan Steel engaged in a joint investment in IMIP with Delong Holding, with an investment of USD 150 million.

Together, these five transactions amount

to USD1.27 billion. This is a huge investment considering the challenging business environment and the number of environmental permits that must be obtained.. The necessary condition for businesses to operate is to obtain political support from the military and local authorities. By securing support from military and political elites, businesses are able to operate securely and smoothly without impediment.

Prone to Potential Corruption

In a country where corruption is still a major issue, investment from China may open the possibility of corrupt practices. Laode M. Syarif, the chief of the Corruption Eradication Body (KPK), even warned state-owned companies to be careful in their selection of investment from China (Adharsyah, 2019).

Lack of Good Corporate Governance

To end the practice of companies offering bribes to authorities, it is necessary to establish a system of values, principles, and implementation of good corporate governance. Namely, companies need to embrace the concepts of transparency, accountability, responsibility, independence and fairness in their daily operations and policies. Many foreign companies are forbidden under their home country's

law to pay bribes and are thus limited in their capacity to engage in corruption. To our limited knowledge, many companies engaged with Chinese FDI lack good corporate governance principles and practices. Another issue related to corporate governance is the troubled implementation of corporate social responsibility, because many Chinese companies have no experience with this concept.

Conclusion and Recommendations

Based on various information obtained through document analysis, in-depth interviews, and field observation in the nickel-rich region of Sulawesi, we conclude that China's investment in Indonesia's nickel industry has produced mixed results. As a developing country, Indonesia needs productive foreign investment to boost its economic power. China has seized on this need and established itself as a primary investor in Indonesia, and in doing so has also secured a supply of natural resources, particularly nickel and other metals, for sustaining and developing its own industry. For decades, Indonesia's mining sector was an export-oriented industry, while most of the giant exploration companies did their business in the upstream sector. As a consequence, Indonesia lost its potential to generate the higher revenues available in

downstream sectors. Subsequently, China arrived in Indonesia with large amounts of cash to develop Indonesia's first downstream industry and support generation of bigger revenues from selling processed materials, compared to those from selling raw materials mined for export.

Even though the downstream industry developed with Chinese investment has increased the competitiveness of Indonesian export commodities, China's investment has also created opportunities for mid-stream market power, under which the sale price of the nickel ore falls below market price, while local miners have no option but to sell their ore to China-controlled smelters. In the long term, these minimal profits will be insufficient to manage the environmental damage caused by the mining industry.

Indonesia's Corruption Eradication Commission (KPK) has warned the government and business communities about Chinese investors failing to meet their obligations for environmental sustainability. The rise of vibrant new economic sectors has the potential to increase the misuse of power by state officials, who may be offered incentives to provide official assistance, such as concessions involving more flexible application of regulations, to business actors intent on maintaining their successful positions in the new, openly competitive market system.

This situation incentivizes business groups to seek political patronage and support from government leaders by providing funds and other forms of support to policy makers in the circle of power. The interaction of these groups can create a powerful coalition of vested interests, which in turn may foster technocratic incompetence, hindering reforms via both legal and illegal channels and endangering good governance efforts in the newly democratic Indonesia.

In light of these concerns, KPK commissioners have warned state-owned companies to be careful in their selection of Chinese investment partners. However, China's companies face limited checks on their activities due to political support from those in Indonesia's circle of power, including high-ranking members of political, economic and military networks. Many retired army officials allegedly benefit from this business process. While the presence or involvement of military persons is unconfirmed, given the fact that big projects in Indonesia are generally difficult to execute due to bureaucratic delays, China's ability to efficiently navigate business obstacles in Indonesia may indicate that these investors are receiving support from military networks. Due to this support, Chinese companies investing in Indonesia enjoy certain benefits and flexibility.

Given the concerns identified in this research and analysis, we propose four

policy recommendations. If the concerns behind these recommendations are addressed, Chinese investment in Indonesia can proceed in a way that is beneficial for both countries.

1. Improving the system of working permits and business licenses for foreign investors. In a related case study, when an issue concerning a project using illegal Chinese workers emerged, the government acted swiftly to address the problem. However, there is still room for improvement in the availability of up-to-date data about the exact number of foreign workers involved in projects. Without improvement to the systems providing and tracking work permits and business licenses, the problem of illegal foreign workers will persist in any region that gets large amounts of foreign investment.
2. Establishing a fair and transparent nickel trading system. This will involve preparing and implementing a nickel price index to set benchmark prices for all market participants. The proposed Nickel Price Index will ensure that local mining companies and foreign buyers pay the same price for nickel. As of the publication of this report, Indonesia still does not have a Nickel Price Index. As a result, the price of nickel can occasionally fluctuate widely.

3. Becoming more selective in welcoming Chinese investment. In January 2020, Indonesia banned nickel ore exports. The implication of this is a further increase in Chinese investment.
4. Inviting more international competitors to invest in downstream industry and nickel refinement. The case of IMIP provides a great example of how business-to-business schemes can fulfill downstream policy and comply with the current regulatory framework, while at the same time provide quality investment and new job opportunities for the local economy.

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CHAPTER 8

IDENTIFYING GOVERNANCE GAPS IN FINTECH: COUNTRY EXAMPLES AND INDONESIA CASE STUDY

AJISATRIA SULEIMAN, PINGKAN AUDRINE KOSIJUNGAN, & GALUH OCTANIA
(CENTER FOR INDONESIAN POLICY STUDIES [CIPS])

Introduction

As addressed in the previous chapter, Chinese foreign direct investment (FDI) in Indonesia's mining industry is significant and it appears that more money is beginning to flow to other sectors. Indonesia's Investment Coordinating Board (*Badan Koordinasi Penanaman Modal*, or BKPM) announced that Indonesia received USD 2.7 billion¹ in FDI from China in 2016. When FDI from Hong Kong is included, this figure rises to an unprecedented USD 4.9 billion. In 2017, China overtook Japan and now trails only

Singapore on the BKPM list of Southeast

Asian countries investing in Indonesia.

Although China's investment fell to USD 2.4 billion in 2018, behind Singapore (9.2 billion) and Japan (4.9 billion), BKPM did not include investment from Hong Kong (2 billion) in this figure. A significant amount of Singaporean investment is also assumed to have originated from China (Van der Eng, 2018).

Chinese investment occurred in the electricity sector, where it funded the construction of power plants and supporting facilities, such as ports, and increased in Indonesia's downstream industries, mainly

1 Unless otherwise specified, all dollar amounts are in United States dollars.

nickel smelters. Much of this investment is related to China's Belt and Road Initiative (BRI), and both governments have agreed to joint infrastructure projects in three Indonesian provinces specifically designated for BRI investment: North Sumatra, North Kalimantan and North Sulawesi.

Reflecting global advancements in technology, Chinese companies have also expanded overseas investments in emerging technologies. In the case of Indonesia, Chinese investments in financial technologies, or fintech, have drawn considerable attention. These businesses are dominated by electronic/digital payment (e-payment) systems and online/digital lending, popularly known in Indonesia as "fintech lending."

In addition to these two major fintech sub-sectors, major fintech players operate to a lesser extent in the financial marketplace², artificial intelligence (AI), big data for financial services (e.g., credit scoring), and wealth management (including robo-advisory). Fintech has flourished in Indonesia, especially since 2016, in part because Indonesia's more traditional financial industry cannot keep up with the growth of the middle class and its increasing demand for technology-based services.

On one hand, digital adoption is growing at a rapid rate. The majority of Indonesia's almost 270 million citizens are under the age of 35, and a study by *We Are Social* in 2019 shows that the total number of active internet users in Indonesia reached 150 million, 56% of the total population, with 13% annual growth in users from 2017 to 2018. Mobile internet (smartphone) penetration is also high in Indonesia (WAS, 2019). A study from Morgan Stanley shows that Indonesia's smartphone penetration steadily rose from 28% in 2014 to 54% in 2017, which is similar to China's at 52% in 2014, and double India's level in 2017 (Morgan Stanley, 2019). An estimated 60% of the adult population owns a smartphone and the total number of active mobile internet users reached 142.8 million in 2019, representing 53% of the total population (WAS, 2019). In a recent Boston Consulting Group survey, 88 million people—35% of the population—were designated as middle-class, affluent consumers who regularly spend more than \$140 per month on food, utilities, communications, and regular household supplies (Morgan Stanley, 2019). By 2020, this number is expected to reach 141 million, or 53% of the country.

On the other hand, penetration by the traditional financial sector is lacking. The

2 The financial marketplace here refers to the platform through which financial products including insurance, mutual funds, credit cards, and personal loans from banks are sold.

2018 World Bank Findex Report shows that 49% of Indonesian adults have savings accounts with a bank. That is an increase from 2014 when the survey found 36% of adults had savings accounts (World Bank, 2019). In a market with nearly 270 million people, approximately 17 million credit cards were held in Indonesia in March 2019, up only slightly from 2012, when about 14 million were in circulation. These approximately 17 million cards are held by approximately 10–11 million individuals, only 6% of the total adult population. Financial access touch points between customers and traditional financial institutions are also lagging behind demand, in part because Indonesia's archipelagic nature makes it challenging to service all geographic locations. There are only about 38,000 bank branches, about 109,000 ATM machines, and around 500,000 merchants that can accept card payments (IFA, 2018).

All of these conditions in the Indonesian financial market are signs that the country needs more efficient financial products (whether for saving, payment, or loans) that are cardless and branchless—in other words, less physical and more digital. The best way to accomplish this is by leveraging smartphone penetration. The strong appetite

for consumption among the middle class has been fueled by easy access to online loans and aggressive marketing behavior of payment platforms. Fintech companies looking to expand in Southeast Asia would be remiss if they were to overlook Indonesia as a potential market.

Despite the bullish fintech market, fintech in Indonesia has a negative public image. In March 2018, Wimboh Santoso, the newly appointed Chairman of the Indonesian Financial Services Authority (OJK)³ for the first time raised the issue of using regulation to address the ultra-high interest rates of 1–2% per day at which some fintech lenders offer cash payday loans. From July through December 2018, a series of protests and mass rallies throughout cities in Indonesia targeted fintech payday lenders for these interest rates and the aggressive way in which they offer some services. The claim is that fintech lenders that offer payday loans exploit the absence of adequate interest rate regulations and insufficient price transparency rules.

Most protests targeted fintech lenders that are not registered with OJK, although a handful of registered fintech payday lenders were also targeted. In December 2018, the Indonesian Legal Aid Foundation, a reputable

3 The government agency that oversees Indonesia's financial services industry and grants registration and licenses for fintech lending businesses.

legal assistance organization, compiled a list of violations committed by fintech payday lenders (CNN, 2018a). These included:

- Charging an ultra-high interest rate of 1–2% per day
- Insufficient pricing transparency (hidden fees and penalties)
- Changing business names without properly notifying consumers
- Lack of proper registered address and contact number
- Poor administrative and record keeping systems (which meant that compliant customers were accused of default)
- Accessing sensitive personal data in customers' mobile phones (including contact lists)
- Using the borrower's contact list to make calls and otherwise reach out to contacts without the borrower's consent
- Threats and persecution during the collection process

The aggressiveness of personal data collection and use by fintech payday lending firms can be attributed primarily to the lack of a reliable system to provide credit scores or equivalent information about Indonesians. Indonesia has a weak credit reporting infrastructure and only around 10% of adult

Indonesians have credit data recorded at OJK's central financial repository system, SLIK (previously known as BI Checking).

These data were developed through contributions by approximately 1,600 licensed financial institutions in Indonesia that used consumer credit reports from sources such as credit card payment records, mortgage defaults, and consumer loans.

Because there is no way to reliably check creditworthiness, most people go to a bank or other financial institution to get a loan, only to have their application rejected when they cannot prove their creditworthiness. In response, consumers may decide to seek out unlicensed or unregistered (fintech) lenders in spite of their higher interest rates. Fintech lenders employ alternative (non-SLIK) data for underwriting, ID verification, address verification, income prediction, spending habits, and (if a client is seeking a business loan) merchant analytics.

Fintech firms operating in retail payment and consumer lending may request around 3,000 data points for their credit assessment. These include:

- Identity and location: fraud-proof identity, location, gender, education;
- Behavioral: browser history, footprints, cookies, interaction of apps;
- Financial: deposits, withdrawals;

- Technical: operating system, browser, hardware;
- Social Media: social graph, sentiment analysis;
- E-commerce: consumption pattern;
- Repayment records: punctuality.

In short, fintech payday lenders are operating in a space where the requirements are still evolving, and public and semi-public institutions are still taking shape. While the promulgation of OJK Regulation No. 77 in December 2016 was meant to facilitate innovation in this new sub-sector of financial services, fintech payday lenders are still able to operate in a largely unregulated environment. For example, in contrast to regulations governing banking, to date there have yet to be any requirements on interest rates, pricing and information disclosure, or on collection standards. There is also no specific prohibition on lending money without a license. This lax regulation contrasts with strict requirements that banking activities can only be conducted with a license, or otherwise be subject to criminal sanctions. The state regulator responsible for managing and sharing credit information with banks—OJK—has yet to expand such activities with licensed credit bureaus.

These governance gaps, in turn, enable fintech operators to grow their business at

the expense of consumers. A recent review of consumer protection law and policy in Indonesia by the United Nations Conference on Trade and Development (UNCTAD) concluded that Indonesia's consumer protection system needs to address emerging issues with e-commerce and data protection. The review concluded that general provisions exist in Law No.19/2016 on electronic information and transactions but "specific laws on data protection, data sovereignty and other issues have yet to be formulated and certain standards applied across all sectors" (UNCTAD, 2019). But there are plans to fill these legal gaps. The blueprint of Indonesia's central bank (Bank Indonesia) for Indonesia's Payment Systems (IPS) 2025 includes the protection of consumer data as one of its five principles. Working groups were established in early 2019 that aim to create a regulatory framework that determines what financial information can be shared, what information is private, and what method would be used to share information (Harsono, 2019).

One of the key issues raised by consumer groups is that personal data protection has been unable to keep up with fintech developments, leading to data abuse by some fintechs. These abuses included using the borrower's contact data to call close relatives for repayment without the consent of the borrower or the borrower's relative.

Collection calls were problematic not only because of the misuse of data but because of the behavior of these debt collectors, which in the case of several companies was reported as aggressive.

Central to the heated public debate in Indonesia and major controversy surrounding fintech payday loans is the association of this particular business model with Chinese-controlled companies. During the second half of 2018, OJK noted that the arrival of predominantly Chinese fintech lenders, which often did not register at OJK and employed aggressive debt collection practices, started to alarm the regulator. It produced a blacklist of 222⁴ banned fintech lenders in July 2018 and continuously updated the list until April 2019, when the total number of banned apps reached 947.⁵ In early January 2019, the cybercrime unit of the Indonesian National Police Force (*Kepolisian Negara Republik Indonesia*, “Republic of Indonesia State Police” or POLRI) arrested three employees working for a Chinese-owned fintech payday lender for aggressive debt collection behavior including online threats and harassment.

Whether protests of fintech payday lending were the result of a problem with lending regulations and practices or of underlying

anti-Chinese sentiment in Indonesia, they shine a critical light on Chinese fintech investment. An appropriate response requires finding the root problems that need to be addressed. Are Chinese fintech payday loan providers importing unethical business practices that harm Indonesians? If so, does this provide evidence to the claim that Chinese capital undermines democratic governance in other countries? Is this investment a move coordinated by the Chinese government or were decisions made by largely autonomous Chinese businesses attracted by opportunities in the Indonesian market?

China’s Fintech Investment in Indonesia

THE NOTION OF “CONTROL” AND IDENTIFICATION OF THE FLOW OF CAPITAL

The issue of corporate control is important to understanding the policy environment in which fintechs operate in Indonesia. There are several ways to determine who legally controls the company. A quantitative measure relies on the control of shares in the company. The standard rule is simple majority rule, or 50% +1. However, in some cases, including the case of companies

4 Previously 227, but five were later excluded because they were found to be licensed financial institutions.

5 Based on official data released by OJK. See further discussion on Section C5.

listed publicly in Indonesia before 2008, the threshold can be set lower so that any person or entity controlling as little as 20% or 30% can be considered in control of the company.

Control can also be measured qualitatively, by the ability to control the management and/or the policy of a company. An organization can have a small stake in a company but retain control through its authority to appoint the board of directors, for example.

Both quantitative and qualitative approaches to evaluating company control are recognized in securities regulations that apply to publicly traded companies and may be adopted to assess the fintech sector. For tech businesses and digital companies, the qualitative approach can be more suitable for determining company control even though it is harder to measure. There are many instances in which even a small minority stake (below 5%) can retain control of the company, especially in venture capital-backed companies that have undergone multiple funding rounds. In these cases, the founders typically retain a management control right—for appointing the board of directors and board of commissioners—even when their share of the company's total capital has been substantially reduced by the inclusion of new funders.

It is also possible for a venture capitalist to own a majority stake of a tech company

without gaining control. Venture capitalists are generally more interested in financial returns from startups than they are in controlling the companies in which they invest. They typically have authority in financial decision making, including decisions to secure new funding from investments or through a loan, but not necessarily management control.

A nominee structure that represents a foreign interest—a common model in Indonesian fintech—can be considered a vehicle for financial control. This can be seen in the composition of many boards of directors and boards of commissioners, which are often mostly local to make it easier to qualify for work permits or qualification assessments. Strict and thorough assessments by the regulators (OJK or BI) of the identity of license applicants prior to the issuance of a business license has made it more difficult to use a nominee structure in financial services compared to other sectors. If the parties decide to proceed with a nominee arrangement, pursuant to the Indonesian Investment Law of 2007, the agreement will be deemed void and the foreign shareholders will have no legal protection in the company. They will be responsible for covering their own risks and liabilities.

Indonesian financial regulation does not allow 100% foreign ownership in fintech. The limit on foreign ownership varies with the

business model, from 85% (for P2P lending) to 49% (for e-money enterprises). Given this restriction, within this paper we divide the term control into “exclusive control,” in which the controller has exclusive control regardless of whether they work with a local partner, and “joint venture” or “shared control,” in which the structure of the partnership more resembles an equal arrangement between the foreign and the local partner. Shared control occurs in large part because the local partner is a considerably larger or more reputable business group with strong bargaining power. Exclusive foreign quantitative control of e-money licenses is impossible because of the 49% foreign ownership cap, but in online lending it is possible to exercise exclusive foreign control through the 85% maximum foreign ownership threshold.

Once control is determined, the next step is to identify the country from which that control is exercised. For years, the Indonesian Investment Coordinating Board (BKPM) has listed Singapore as the top country of origin for foreign investment in Indonesia. Singapore is known as Asia’s business hub because capital in-flows from various regions including the United States, Europe, China, India, and Southeast Asian regions are aggregated through the country. It is therefore likely that some Chinese investment facilitated through

Singapore would be officially recorded as investment from Singapore rather than as Chinese investment. In 2015 Singapore held 51% of the USD 62.8 billion outward stock of Chinese FDI to ASEAN countries. This is almost as much as the USD 64.7 billion outward stock of Singapore’s FDI in other ASEAN countries in 2015 (Van der Eng, 2018). Indonesia hosted 51% of Singapore’s outward stock of FDI that year. It may also be the main recipient of Chinese FDI channeled through Chinese subsidiaries located in Singapore (Kong, 2017).

The combination of qualitative ownership control, the potential for nominee structure, and investment flows through Singapore make it impossible to accurately assess the level of foreign ownership and control of fintechs operating in Indonesia without access to each company’s confidential legal documents. This paper therefore approaches the problem of assessing foreign ownership through a deal or transaction basis, relying on disclosed deals and/or in-depth interviews with key business insiders conducted by CIPE.

IDENTIFYING DEAL SIZE OF UNICORNS, INDEPENDENT FINTECH STARTUPS, AND CHINESE SUBSIDIARIES

A first attempt to understand Chinese investment in fintech is to divide these companies into *startups* and *subsidiary*

companies (in this case, subsidiaries of a Chinese parent company). Startups are typically portrayed as led by local founders/entrepreneurs trying to implement new business models in Indonesia, whereas Chinese subsidiary companies import already successful business practices from China to Indonesia. In terms of control, the founding team in startups usually retains management control⁶ even when the majority of shares is held by financial investors, while the controlling shares of a Chinese subsidiary remain with the Chinese parent company.

Startups can be further divided into *independent fintechs*, which usually have a single business focus (online lending, e-payment, insurtech, etc.) and *unicorn startups*, which leverage their main, often non-fintech businesses (e-commerce, ride-hailing, or online travel) to drive their fintech arms. The unicorns are key players in fintech because they attract the majority of funding and allocate those funds to build their fintech products or acquire fintech companies.

Unicorns

Since 2016, the Indonesian tech ecosystem has been dominated by the rise of the unicorns: private companies valued at \$1 billion. Unicorns are flourishing in Indonesia. Some are home-grown, such as Go-Jek,

Traveloka, Tokopedia, Bukalapak. Some are regional companies based out of Singapore, such as Grab, SEA Group, and Lazada. Some are out of China, such as JD.com. A recent study by Google shows that between 2015 and 2018, total funding raised for unicorn startups in Southeast Asia was raised in Singapore (approximately USD 16 billion) and Indonesia (roughly USD 6 billion), with the remaining USD 2 billion raised in the rest of Southeast Asia. It is not safe to assume that only USD 6 billion of this funding went to the Indonesian market. The same study concludes that almost 80% of funds raised went to the unicorns of Southeast Asia (and Indonesia), and that these unicorns afterwards invested heavily in Indonesia. Grab, Lazada, and Sea Group (in addition to local Indonesian unicorns) have deployed funds to build businesses across the region, including, and especially, in Indonesia.

Unicorns have invested substantial funds into fintech product development. In many cases, these products are well-integrated into the company's main app, although legally they can be part of different but affiliated companies.

Table 1 (PG. 178-180) shows how Chinese funds have played a major role in the establishment and rise of seven Southeast

6 There are some exceptions to this rule, including the acquisition of Lazada by Alibaba.

Asian unicorns, all of which have substantial fintech operations in Indonesia. Underlined companies originated from China.

Of these seven unicorns, Lazada is the only company in which corporate control has changed from the original founders to a new, Chinese controller (upon its acquisition by Alibaba). Other unicorns remain under

the management control of their founding teams, but this does not diminish the importance of Chinese investments in fueling their growth. As indicated in the published transaction deals above, Chinese investors have been active in acquiring financial stakes in Indonesia’s and Southeast Asia’s technology giants.

TABLE 1: Chinese Funds and the Rise of Southeast Asian Unicorns

UNICORNS	FINTech RELATED BUSINESS IN INDONESIA	RECORDED DEALS
		The author does not have access to what percentage of these amounts went to the respective company’s fintech arms.
Go-Jek	<ul style="list-style-type: none">Go-Pay (e-payment)Kartuku (e-payment)Mapan (payment agent network)Midtrans (e-payment)Findaya (lending)	<ul style="list-style-type: none">2016: valued at \$1.3 billion and secure over \$550 million from investors including KKR, Warburg Pincus, Farallon Capital, and Capital Group Private Markets.2017: valued at \$2.5 billion and secures over \$1.2 billion in funding. China Giant, Tencent reportedly led this round.Early 2018: secured another \$1.5 billion fund injection at a \$5 billion valuation, from Google, Singapore’s Temasek Holdings, and BlackRock.October 2018: raised \$1.2 billion and sought a valuation of \$9 billion. Investors are said to include Google, Tencent, and JD.com.
Bukalapak	<ul style="list-style-type: none">In-app financial marketplaceIn-app bill-paymentPayment agent network	<ul style="list-style-type: none">Major shareholder is EMTEK, through PT. Kreatif Media Karya, holding 36.86% of shares.Alibaba’s Ant Financial was reported to lead Bukalapak funding rounds in 2017.Another major shareholder is GIC, the Singapore government’s investment arm.January 2019: Bukalapak announced the arrival of another key shareholder, Asset-Naver Asia Growth Fund from Korea.

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UNICORNS	FINTECH RELATED BUSINESS IN INDONESIA	RECORDED DEALS <small>The author does not have access to what percentage of these amounts went to the respective company's fintech arms.</small>
Tokopedia	<ul style="list-style-type: none"> In-app financial marketplace In-app bill-payment Payment agent network 	<ul style="list-style-type: none"> 2014: The company raised \$100 million from SoftBank and Sequoia in 2014. Beenos, East Ventures, and CyberAgent Ventures are among its early backers. <i>Tokopedia</i> has raised a total of \$2.4 billion in funding over nine rounds. In December 2018, Tokopedia had secured \$1.1 billion in its latest financing round, led by the SoftBank Vision Fund and Alibaba Group with participation by Softbank Ventures Korea and other existing investors. August 2017: Alibaba has led a \$1.1 billion investment in Indonesia's Tokopedia.
Traveloka	<ul style="list-style-type: none"> Recently acquired DIMO (e-payment) 	<ul style="list-style-type: none"> <i>Traveloka</i> has raised a total of \$920 million in funding over five rounds October 2018: raised roughly \$420 million reportedly led by GIC, Singapore Government's investment arm. July 2017: raised \$400 million in a funding round led by Expedia, valued a \$2 billion valuation. Previously the company raised roughly \$100 million from by East Ventures, JD.com, Sequoia Capital, and Hillhouse Capital Group.
Grab	<ul style="list-style-type: none"> OVO (Grab as the largest shareholder) Taralite (lending) 	<ul style="list-style-type: none"> <i>Considered Southeast Asia's first Decacorn</i>, Grab's latest funding round in March 2019 was reported to be \$1.5 billion, led by Softbanks' Vision Fund. In total, Grab has raised \$9.1 billion Grab's latest valuation is reported to be \$14 billion. Grab has attracted funding from many sources and sectors, including the United States (500 Startups), Japan (Softbank), Australia (Macquarie Capital) and China (Ping An Capital, China Investment Corporation, China Cinda Asset Management, Didi Chuxing). Key banks (HSBC, Kasikorn) and automotive manufacturers (Yamaha Motor, Hyundai Motor, and Toyota Motor) have also invested in Grab.

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UNICORNS	FINTECH RELATED BUSINESS IN INDONESIA	RECORDED DEALS <small>The author does not have access to what percentage of these amounts went to the respective company's fintech arms.</small>
SEA Group	<ul style="list-style-type: none"> • ShopeePay (e-payment) • ShopeeKredit (lending) 	<ul style="list-style-type: none"> • <i>Sea is a NASDAQ listed company (listed in October 2017) that has raised a total of \$2.6B in funding over eight rounds.</i> • <i>In March 2019, the Company is raising additional \$1.5 billion from a new share offering in American Depositary Shares (ADS) to be funneled into its Shopee e-commerce business.</i> • <i>Prior to the 2017 IPO, Tencent was the largest shareholder in Sea group, followed by founder Forrest Li.</i>
Lazada	<ul style="list-style-type: none"> • HelloPay (e-payment) 	<ul style="list-style-type: none"> • <i>2016: Lazada was acquired by Alibaba</i> • <i>2018: Alibaba's stake increased to an undisclosed size following the latest investment, a spokeswoman told Reuters. It held an 83 percent stake prior to the investment, which now doubles to \$4 billion from a \$2 billion infusion over the past two years.</i>

Independent Fintech

Outside of the unicorn-linked mega deals that fueled the fintech arms of these companies, independent fintechs, which are not affiliated with international or local groups, have also been attractive targets for investment in Indonesia. Media announcements have revealed that fintech startups raised around \$280.3 million, of which \$170 million went to Akulaku, which was founded by an independent Chinese entrepreneur who relocated to Indonesia and secured funding from a group of investors led by Alibaba's Ant

Financial. Other significant deals included those by Kredivo, a consumer installment platform worth roughly USD 30 million, Modalku, an SME lending marketplace worth roughly USD 25 million and led by Softbank and Sequoia, and Cekaja, a marketplace for bank and insurance products worth roughly USD 25 million and led by Experian. None of the funding for these three companies was led by Chinese companies or investors, although some Chinese venture capitalists did participate in the deals.

Chinese Subsidiaries

While Chinese investors into Indonesian unicorns or independent fintech startups are typically not able to control these companies, which are generally controlled by their founding team, Chinese investors definitely control the operations and management of the subsidiaries of Chinese firms in Indonesia. Significant Chinese influence in the Indonesian market originates from internal deals formed by strategic partnerships or the opening up of local subsidiaries by Chinese companies. Key China-related transactions are⁷:

- Xiaomi's financial arm, Mi Credit, aggregating financial products for the purchase of Xiaomi phones;
- JD Finance Indonesia, a fintech arm of JD.ID, a Chinese e-commerce company;
- The launch of OneConnect Indonesia, the subsidiary of Ping An Group, China's insurance firm and largest consumer finance provider;
- Several key investments by Chinese operators to enter the e-payment market, as described below; and
- Several Chinese operators setting up subsidiaries in online lending, as described below.

Identifying the Control Structure of Fintech Payment Companies

A substantial portion of the funding that went to the unicorns was used to develop fintech products in Indonesia, although the exact numbers are known only to the companies themselves. The same applies to major Chinese investments that open e-payment businesses in Indonesia. All of these companies have similar strategies when it comes to fintech: start with payment products and later build various offering on top of the payment platform.

Digital money and digital wallets are payment products that interact directly with users such as retail customers. Table 2 (PG. 182 lists the five of 18 Indonesian companies (28%) that are joint ventures with foreign entities.

Interestingly enough, three of these five companies are directly linked to China and the remaining two are linked to Grab and SEA Group, which although not Chinese-controlled have substantial investors from China. Didi Chuxing reportedly invested as much as USD 2 billion into Grab in 2017 (Russell, 2017b), while Tencent owned about 34% of SEA Group through 2017 (Chandler, 2018). Another company worth mentioning is Go-Pay, which although locally-

7 No transaction values have been disclosed for any of these deals.

TABLE 2: Joint Venture with Foreign Entities

COMPANY	JOINT VENTURE
Visionet	Brand: OVO, a local financial partner of Grab of Singapore which has invested substantially in the Lippo-owned company, according to which now Grab owns at least 41% of OVO pursuant to PT. Visionet public corporate registry.
Witami	A local affiliate of Thailand-based True Money, in which Ant Financial owns around 20% in the Thai holding.
DANA	A joint venture between EMTEK local conglomerate group with Ant Financial that has leveraged Bukalapak's online outreach using the close relationship between EMTEK, Ant Financial, and Bukalapak.
Blue Pay	A China-based fintech company.
Airpay	A subsidiary of Garena and SEA Group of Singapore.

controlled, has received substantial funding from Chinese giants such as Tencent and JD.com, most notably in 2018 when roughly USD 1 billion in investment was led by Google, Tencent, and JD.com, but also included Meituan Dianping (Potkin, 2019), and in 2017 when roughly USD 1.2 billion of investment was led Tencent, in which Tencent reportedly contributed around USD 150 million and JD.com USD 100 million (Russell, 2017a).

Before 2017, Alipay and Tencent attempted to apply for e-money licensing without local partners but had difficulty obtaining

regulatory approval. It is not clear whether they would still pursue this license given that they eventually managed to secure the license through partnerships with, or investment in, local businesses.

Identifying the control structure of fintech lending companies

Fintech lending can be divided into four general products: the SME lending marketplace, microfinance marketplace, consumer loans, and cash payday loans. This division allows us to see how the country of

origin affects which business model a fintech will pursue. For example, all fintech lenders in the microfinance marketplace are domestic, while Chinese-controlled companies dominate the payday loan market.

It is also worth noting that the majority of fintech lenders in Indonesia are properly registered with the designated authority, OJK. Further, all unregistered fintech lenders were operating payday loan businesses.

REGISTERED FINTECH LENDERS⁸

Below is our finding based on the controller's country of origin:

- The SME lending marketplace is dominated by domestic companies (96%), except for one company from Singapore.
- All microfinance operators are locally controlled.
- As illustrated in Figure 1 (PG. 184), the ownership and control of consumer loan companies are more diverse, but still dominated by domestically controlled businesses (57%), whereas four companies are from China and one is a Chinese joint venture. Of the four Chinese-controlled companies, three

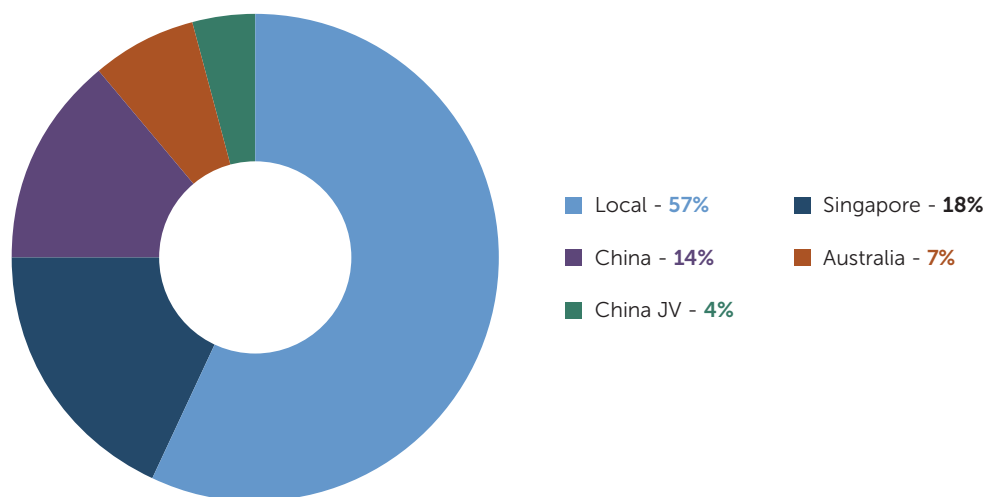
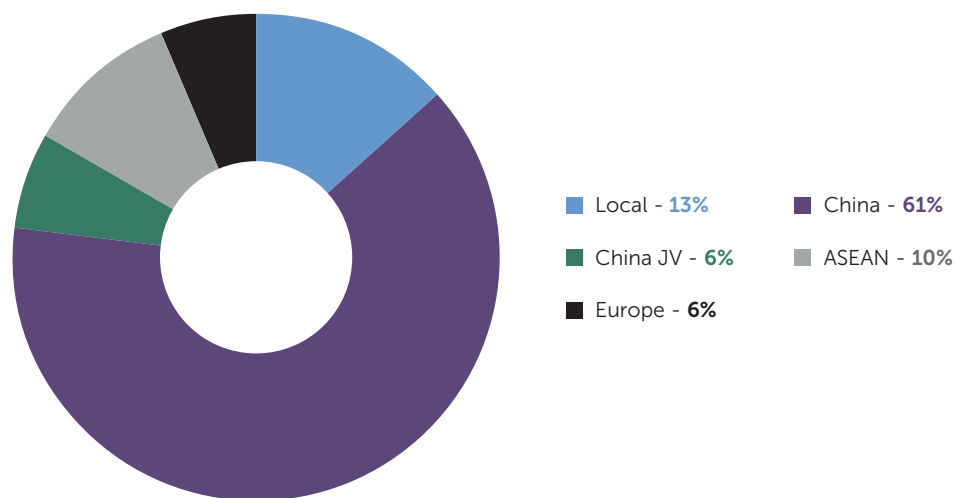
originally planned to offer payday loans, but OJK has temporarily suspended the granting of new payday lender registrations due to controversies.

- In payday lending, two-thirds of controlling stakes are either Chinese (61%) or Chinese joint ventures (6%), as illustrated in Figure 2 (PG. 184).

Among the four main product offerings by fintech companies, Chinese-controlled companies are only dominant in the payday loan sector. Among offerings for SME loan marketplaces, microfinance marketplaces, and consumer loans, the controllers' countries of origin are either balanced or dominated by the domestic businesses.

The predominance of Chinese control in payday loans compared to other fintech products is important because payday loans are the main source of controversy revolving around fintech in Indonesia. Complaints about fintech tend to relate to the use of ultra-high interest rates, the potential for abuse (non-consensual use) of personal data, and threats and persecution during call collection. Rather than assuming these concerns are a product of fintech, it's useful to ask whether these problems

8 OJK 77/2016 Regulation recognizes two licensing steps: registration and full license. A company will receive registration status and will be given 1-2 years to complete the audit and documentary requirements before being fully licensed. Once registered, a company can fully operate as if it is licensed. Therefore, being registered is more of the same of being licensed in terms of permitted activities.

FIGURE 1: Controlling Shareholder of Fintech Operators Providing Consumer Installment Products**FIGURE 2: Controlling Shareholder of Fintech Operators Providing Pay Day Loan/Cash Loan**

are the result of the business model used for payday lending or in the controllers' approach to the Indonesian market, which may not be in line with Indonesian business practices.

The top lending platforms by transaction volume and the number of borrowers are all payday lenders from China. Below are the top five companies by transaction volume through the end of 2018, as ranked according to analysis by the authors through interviews, listed in alphabetical order.⁹

- Akulaku, founded by an independent Chinese entrepreneur, William Li, with substantial investments from Alipay's Ant Financial, offering consumer installment products;
- Dana Rupiah (a subsidiary of China-based Weshare Group), offering payday loan products;
- Kredit Pintar (a subsidiary of China-based Advance.AI), offering payday loan products;
- Pendanaan, founded by an independent Chinese entrepreneur, Jasmine Hao Dai, offering payday loan products; and
- Rupiah Plus (recently changed to Perdana), founded by an independent

Chinese entrepreneur, Rebecca Wang, offering payday loan products.

Akulaku Finance is the number one company by transaction volume, but as discussed earlier it is not a fintech company, though it operates in the same way that fintech lenders do. Akulaku Finance is a Chinese-controlled company.

UNREGISTERED / ILLEGAL FINTECH LENDERS

Starting in June 2018, the spread of improper debt collection practices carried out by fintech lenders made national headlines. Only later was it discovered that these practices were largely undertaken by fintech operators not registered with OJK (although some registered fintech payday lenders have also been caught using such practices). Since that time, OJK has regularly published a list of unregistered fintech lenders. OJK can only govern and supervise business activities under its licensing regime because it relies on administrative sanctions on the 106 companies it has recognized as licensed entities for enforcement. OJK lacks the tools and the authority to act against unregistered entities. Almost all unregistered apps conducted payday loans, which by their nature (immediate, cash loans under USD

⁹ Unfortunately, OJK does not publish transaction volume by company for comparison.

140 offered at a high interest rate) target the poorer population, who receive minimum wages and lack access to more traditional consumer loans that offer better interest rates, such as credit cards or personal loans from banks.

To try to deal with the creation of so many unregistered fintech lenders, OJK sent the list to the Ministry of Communications and Information Technology (Kominfo), which responded by sending instructions to licensed Internet Service Providers (ISPs) to block the IP addresses of these unregistered apps. Kominfo also requested that Google remove these apps from the Google Play Store.¹⁰ From July 2018 to April 2019, OJK has blocked 947 mobile apps. Nearly all of these apps¹¹ were operating as fintech payday lenders. Table 3 (PG. 187) displays the series of blocked apps during July 2018 to April 2019.

OJK also sent the list of illegal fintech lenders to the Indonesian National Police (POLRI), but unlike accepting deposits (considered illegal banking), unlicensed moneylending is not a crime. Because fintech lending merely matches borrowers with lenders (even when they are super-lenders), POLRI and the Attorney General's Office have no authority over unlicensed money lending activities.

As of the July 2018 release, OJK had discovered that at least half of the 227 unlicensed P2P lending providers identified – more than 100 – were developed by Chinese firms, (Aisyah, 2018). In December 2018, OJK issued a statement that out of roughly 400 apps that had been closed down in July and September, the majority were from China (CNN, 2018b).

The high number of apps being shut down could mask a much smaller number of actual companies operating these apps. A single firm may develop multiple lending platforms. This appears to be the case for at least some firms. For example, a developer named Xinhe had uploaded at least nine P2P lending apps to the web and Google Play Store, and other developers with Chinese names such as LiChen, Tupulian, Xiehualei also established lending apps with Indonesian names such as Dompot Pinjaman (loan wallet), DompotKamu (your wallet) and Duit Instan (instant cash).

At the next round of app closures in February 2019, the illegal foreign fintech services operating in Indonesia were mostly from China, Russia, and South Korea, according to the OJK Investment Alert Task Force. But they are not overwhelmingly Chinese—the

10 The segment of the population targeted by unregistered payday loan apps is much more likely to own an Android-based phone, as iPhones are normally not affordable to poor Indonesians.

11 Five apps were blocked in error.

chief of the task force, Tongam L. Tobing, reported that only 23 of 231 fintechs that were forced to stop their activities during January-February were Chinese firms (Dwinanda, 2019).

In March 2019, the OJK Investment Alert Task Force reported that out of 803 fintech lenders blocked (by that time), further analysis of their IP locations showed that the country of origin of 323 (40%) were not identified, while 178 companies (22%) were from Indonesia and the rest (38%) were

from various jurisdictions, including China, Singapore, Russia, Hong Kong, and Malaysia.

Of course, analysis of the server location based on IP addresses is not a reliable indicator of the country of origin. Many companies operating in Indonesia can be owned and operated by foreign nationals, including Chinese controllers, either directly or through nominee arrangement. However, it is safe to conclude from OJK's analysis that at least half of the apps have been owned and operated by Chinese-linked

companies. **TABLE 3: Chinese Funds and the Rise of Southeast Asian Unicorns**

NO.	RELEASE DATE FROM OJK	# OF FINTECH BANNED
1	27 July 2018	222 (previously 227) ¹²
2	7 September 2018	182
3	13 February 2019	231
4	14 March 2019	168
5	28 April 2019	144
TOTAL		947

¹² Previously 227, but later 5 excluded because they were found to be licensed financial institutions.

Taking into account that almost all blocked apps were conducting payday loan activities, and OJK's assessment of the registered payday loan businesses, it is likely that this sub-sector of fintech lending is largely operated by Chinese-controlled companies.

The Impact of Chinese Capital on Indonesian Fintech Development

GENERAL PERCEPTION ON THE IMPACT OF CHINESE CAPITAL IN INDONESIAN FINTECH FROM A MARKET PERSPECTIVE

Indonesia's fintech growth since 2016 and its rapid market adoption since 2018 are undoubtedly fueled by funding from China—exponential growth in e-payments and online lending cannot be separated from investments by companies connected to China. The development of Indonesian companies also mirrors that of China's earlier digital path. Similarities include:

- Focus on transactions through payment facilitation and the extension of various financial products built on top of the platform (from loan, insurance, and wealth management), mirroring the Chinese models of Alibaba or WeChat

and contrary to the more prominent use in the U.S. of advertising-based businesses like Facebook or Google;¹³

- Strong emphasis on the online-to-offline (O2O) model, in which a mobile phone is used for physical payment (for example, for QR-based payment) or brick-and-mortar outlets or individual agents facilitating online transactions that eventually bridge Indonesians without mobile internet access; and
- The emergence of "super-apps" to aggregate different services—again mirroring Alibaba or WeChat, in contrast to the more fragmented services and products, in which consumers still prefer to use different apps to perform different transactions/functions, prominent in the United States.

In 2017, Adrian Li, a reputable venture capitalist, argued that three metrics in particular reveal that Indonesia is a lot like the China was in 2007/2008:

"E-commerce as a percentage of retail sales (1.4 percent in 2015), Internet penetration (28 percent in 2015) and GDP per capita (USD 3,834 in 2015.) The economy grows about five percent annually, e-commerce is expanding

¹³ Amazon is the exception, rather than the rule.

rapidly (by USD 10 billion a year and forecast to hit USD 130 billion by 2020), and smartphone use is forecast to swell to 100 million by 2020... All that, coupled with weak infrastructure and poor logistics systems, makes it an especially big opportunity for e-commerce growth.” (Li, 2017)

Another reason the Chinese model works better for Indonesia compared to the U.S. model results from the revolutionary impact of the mobile internet on daily activities. In China (2007) and Indonesia (2016), the rise of the digital economy coincided with the growth of mobile internet penetration, and therefore changing habits to incorporate mobile internet use is relatively easy. By contrast, in the United States consumers had internet access before the rise of smartphones, so “the landscape was pretty much set when iPhone was introduced: Facebook in social, Twitter in news, Google in search and Amazon in e-commerce.” (Zhao, 2019)

For this reason, Chinese investments and technologies are perfectly suited to support the growth of Indonesia’s digital aspirations. Chinese investors understand the Indonesian market better and may be able to replicate the formula that produced Chinese success with some degree of adaptation for the Indonesian market.

PUBLIC ANGER DIRECTED TOWARDS FINTECH PAYDAY LENDERS ASSOCIATED WITH CHINESE OPERATORS

The rapid development of the fintech industry has left Indonesian regulators catching up to an evolving industry, struggling to react as it adapts and innovates to meet consumer needs rather than trying to anticipate consumer needs and control the industry’s development. In many ways, this catching-up by regulators feeds into public perception that fintech lenders, and especially Chinese fintech lenders, are bypassing, ignoring, or undermining Indonesian regulations.

One of the key complaints raised by consumer groups is the feeling that existing personal-data protection systems are inadequate at governing fintechs, leading to data abuses and this has led to data abuse by the majority of fintech payday lenders. Many fintech payday lenders used the borrower’s contact data to call close relatives of the borrower for repayment without the consent of the borrower.

These collection calls were problematic not only because of how the data was used, but because of the behavior of the debt collectors. In early January 2019, the cybercrime unit of POLRI arrested three employees working for a Chinese-owned fintech payday lender called V-Loan. They

were charged with committing threats during debt collection calls. The owner of the company, a Chinese national, fled Indonesia and has not since resumed business operations in Indonesia.

During July through December 2018, there was a series of protests and mass rallies throughout urban cities in Indonesia targeting fintech payday lenders for improper behavior. Most of these protests were addressed to fintech lenders not registered with OJK, although a handful of registered fintech payday lenders were also the targets of public protests. In December 2018, the Indonesian Legal Aid Foundation (YLBHI), a reputable legal assistance organization in Indonesia, compiled a list of violations committed by fintech payday lenders specific to personal data abuse:

- Accessing sensitive personal data in the mobile phone (including contact list);
- Calling any person in the borrower's contact list, without the borrower's consent; and
- Making threats during debt collection calls.

The Indonesian Consumer Watch, a reputable NGO on consumer affairs, recorded 234 consumer complaints about fintech lending—all of which regard payday loans (Reily, 2019). As of February

2019, YLBHI has received more than 3,000 complaints specifically regarding payday lenders (Heriani, 2019).

In February 2019, a local taxi driver committed suicide. He had failed to repay his debt and being chased aggressively by fintech payday lenders and their debt collectors. An investigation by OJK showed that he had borrowed from more than 10 fintech apps, most of which were unregistered apps, allegedly Chinese-owned. The authorities could not directly attribute which app caused the victim to commit suicide.

In response to the growing concerns over personal data abuse, on 12 February 2019 under OJK Fintech Lending Department Director Letter No. S72/NB/13/2019, OJK issued a decree that restricts fintech lenders' access to mobile internet data, except for:

- Microphone;
- Camera; and
- Location.

OJK requires all fintech companies to be audited under the framework of ISO 27001 and found in compliance in order to be eligible for full operational licensing. This move is more restrictive than the previous letter issued on 17 October 2018 that prohibited access to "contact lists" and "other data unrelated to credit assessment." The Indonesian Fintech Lenders Association

(AFPI), however, demands the right to also access app histories and call logs.

There are valid reasons for fintech lenders to challenge the OJK directive. As discussed in the first part of this paper, Indonesia has a weak credit reporting structure and its national ID system has not stopped widespread identity fraud. Providing consumer loans is therefore extremely risky because it is difficult to learn with whom a lender is dealing and their creditworthiness. Contact list assessment is one of the ways that fintech lenders have developed to perform a credit-risk analysis in the absence of a developed credit report or trustworthy identification system. For example, fintechs are able to analyze communication patterns to learn a great deal about someone who has applied for a loan. However, none of these reasons justify harassment and bullying of consumers or those on their contact lists, as this behavior violates both the ethical and legal use of personal data.

There is no direct relationship between the fintech operator's country of origin and its likelihood to commit privacy violations, but several factors feed the popular perception that it is the result of foreign, and specifically Chinese, involvement. The following three issues in particular have shaped the perception by regulators that China-linked companies not only contribute directly to the problems with payday lending in Indonesia

but also risk inspiring other companies to employ abusive tactics to secure their financial interests:

- All consumer complaints about fintech lenders are about payday lenders. This is in part because higher value loans cater to more sophisticated market segments, such as SMEs, more wealthy borrowers, and the socio-entrepreneurs serviced by microfinance;
- Most fintech payday lenders (both registered and unregistered) are Chinese-controlled;
- Despite high media coverage and public outcry (including a series of public protests by and for "fintech victims"), OJK so far has sanctioned only one registered company: Rupiah Plus (now Perdana), which is owned and operated by a Chinese national, and POLRI has made an arrest for online harassment to only one unregistered company: V-Loan, also owned and operated by a Chinese national.

At the end of the day, despite public concern about them, Chinese fintech operators are not particularly adept at bypassing Indonesian regulations. Exploitation of regulatory gaps is not an inherent feature of Chinese fintech operators - except when it comes to personal data and customer protection in payday loans.

The business model for payday loans regardless of the origin of their controlling shareholders, on the other hand, does exploit the existing regulatory framework, which was not originally designed to govern payday loans. High interest rates, a lax approach to personal data protection, and aggressive debt collection are closely associated with fintech payday lenders. It happens that the majority of fintech payday lenders are linked to China, but there is no evidence that their poor behavior should be attributed to China instead of the poorly regulated state of the fintech industry itself. However, the perceived correlation has been enough to cause public outcry and consequences for Chinese-linked firms.

There are certainly gaps in the regulatory environment in which fintech payday lenders operate that these companies have exploited in terms of data and consumer protection. But the actions of fintech payday lenders have alerted OJK, which has been keen to close those gaps. This is not evidence of failure, but evidence that the system addresses the concerns of consumers as service providers adapt to meet their rapidly evolving needs without restricting their choices or stifling innovation by blocking Chinese or other firms from the market without sufficient evidence. As such, there is no reason to believe that democratic or governance systems have been corroded by Chinese fintech operators in Indonesia.

GOVERNANCE CHALLENGES IN FINTECH LENDING

Ever since the 1998 financial collapse, the Indonesian financial regulators (BI and OJK) have been focusing on detailed and specific regulations for financial prudence and market conduct. On one hand, this creates high barriers to enter into the Indonesian financial services sector. On the other hand, it also led to a large segment of the market not being properly served. Since the fintech lending regulation was introduced in 2016, the requirements for fintech have been somewhat more open, but regulators have been expected to tighten the rules to match banking regulations. In addition, the open nature of the digital space further exacerbates the difficulties of controlling market entry.

Fintech payday lenders have taken advantage of a weak regulatory regime that provides:

- Minimum guidance on interest rates, pricing transparency, and disclosure standards;
- Minimum guidance on data protection;
- Minimum guidance on debt collection standards;
- Insufficient credit information and institutional governance to facilitate data sharing to minimize credit risk; and

- Almost no barriers to market entry, leaving app stores such as Google Play Store or Apple App Store to act as the “gate-keeper” to determine which applications are fit for consumers to download.
- This paper found no evidence of a link between Chinese fintech investors or operators and the Chinese government. Instead, each sub-sector of fintech has different levels of investment and control by Chinese investors, whether Chinese technology giants or independent Chinese investors. However, Chinese technology giants are predominantly found in e-payment, either as strategic investors in unicorns or as direct operators, arguably because e-payment is a capital-intensive business and only a few companies can compete in the market as it exists.

Summary, Recommendations and Conclusions

- The Indonesian digital financial market is growing exponentially, led by local and regional unicorns and independent tech entrepreneurs. This growth is happening most rapidly in two areas: e-payments and online lending. Chinese and Chinese-linked companies have been backing this growth through capital investments in and strategic partnerships with these leading companies. Some have attributed these capital investments to the similarity between Chinese and Indonesian markets being interpreted as an opportunity by Chinese opportunities to apply their knowledge from the Chinese experience to the Indonesian market.
- In most cases, consumers enjoy the benefits that have come from fintech innovation. Retailers now have the ability to use digital payments at a lower cost than credit card payments, consumers who once lacked access to credit can now find willing lenders, and the public has more options for financial products.
- As is the case in many sectors (such as ride-hailing, hospitality, and fintech) and jurisdictions, the key success factor of fintech has been about “creative compliance” with existing regulatory regimes in order to drive innovation and push the boundaries of what is permitted by law.
 - There is one area of fintech that has received completely negative coverage, not only from regulators but also from tech communities for the reputational damage they have caused to the whole industry: the area of payday lending. Payday lending grants micro consumer loans of up to USD 140 disbursed in cash with repayment in full at the end of

the month. These lenders charge ultra-high interest rates, up to 2% per day, prompting discussions about how to reduce the maximum interest rate. Some consumers of these loans borrowed from too many lenders, and lenders failed to effectively screen for creditworthiness in their customers and failed to clearly disclose all penalties for delayed payments. This combination harmed customers who were less legally or electronically savvy.

- Many payday loan operators acted unethically, but the fact that this sector is dominated by Chinese-owned or controlled companies is incidental and not the explanation for these practices. Hundreds and thousands of consumer complaints have been lodged to consumer organizations, legal aid, and regulators to report these practices of fintech payday lenders.
- The remaining gaps in data and customer protection have breached ethical standards with tragic individual consequences. In response, the Indonesian government is working to fill these gaps. This is not evidence that the system is broken, but that it is working. What remains crucial is that the regulatory environment is meant to facilitate the growth of the fintech sector instead of stifling it along the lines of the existing limitations for the traditional financial service institution.
- As such, in terms of policy recommendations, consumer protections can be further advanced if the governance gaps are properly addressed. Rules on pricing transparency, data protection, and debt collection are emerging gradually to respond to the regulatory demands. The enforcement of these rules, however, will not be straightforward considering any non-compliant firms can still offer their products and reach any consumer in the current structure of an open digital market. Long-term institutional reform, such as the development of a robust credit information institution, is therefore crucial because it will provide more comprehensive data in loan decision-making.
- Moreover, the government needs to address the loophole concerning capital inflows from foreign P2P lending platforms. Foreign platforms lend to Indonesian fintech lenders, which will in turn loan the funds to their debtors. Given this practice, foreign online lending companies lend to Indonesian debtors without an Indonesian license. The practice has led to accusations of being “online loan sharks” (Ginting, 2019).

The media scrutiny of these practices contributed to the issuance of OJK Regulation No. 77/2016 on P2P lending. It also resulted in OJK's increased protection of both the existing industry players and the consumers.

- The absence of a Data Protection Law remains a burden to the law enforcement process in Indonesia's fintech industry. If data protection is meant to be covered by this law, then OJK and MOCI need to cooperate to ensure that the law

will accommodate the growing fintech industry while protecting the consumers' data. Cooperation with the National Consumer Protection Body is highly advised. The government had proposed a Draft Bill on Personal Data Protection (PDP) but the bill did not pass into law before the end of the parliamentary term in September 2019. Because of overlapping authorities, the PDP Bill is on-hold for further review (Pos, 2019). More needs to be done.

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CONCLUSION

Investments from China into Southeast Asia have contributed to economic growth and the development of the private sector in the host countries. For example, in Malaysia the solar panel and glass industries have seen leaps in growth due to Chinese investments. Yet there are also cases in Southeast Asia in which the local private sector received marginal benefit from Chinese investments. For instance, in Cambodia, the report showed that Chinese firms have little interaction with local firms and do not contribute much to the capacity and skill development of the local workforce. As a result, the spillover effect of Chinese investments on local SMEs has been limited.

Local firms in host countries seek to benefit more from investments from China. Several

authors pointed out that small businesses are concerned about being unfairly outcompeted by Chinese firms, which are supported by state-led industrial policies and cheap credit from the state.

Foreign direct investments from China sometimes goes into high risk and lightly regulated industries, such as mining, online gambling, and payday lending. In the cases of the Philippines and Indonesia, the authors documented that these investments bypass, ignore, or undermine regulations in the host countries. Problems include importing illegal workers, evading taxes, and exploring military networks which are deeply vested in the economy. Southeast Asia's young democracies have suffered from weak rule of law and lax enforcement. Chinese

investments at times exploit and exacerbate these governance gaps.

Chinese-funded megaprojects raise more concerns than traditional FDI due to a lack of transparency and the opacity of the deal-making processes. The deals are made among the ruling elites of China and the host countries without proper scrutiny or oversight. It is widely recognized that the influx of Chinese capital and contractors help to alleviate the massive infrastructure

gap in the region. To better utilize these capital inflows, the governments in Southeast Asia need to strengthen their capacity to mitigate the risks identified in this report, such as weak public procurement regulatory regimes, a lack of information on and robust oversight of BRI projects, weak governance of SOEs, and corruption.

Table 1 (PG. 198-199) lists recommendations to help mitigate risks stemming from large Chinese investment inflows:

TABLE 1: Recommendations to Help Mitigate Risk Stemming from Large Chinese Investment Inflows

PROBLEMS	SOLUTIONS
Lack of transparency in public procurement	<ul style="list-style-type: none">• Increase transparency of the public sector and public procurement process• Have clear legal regulations on public procurement• Follow public procurement international best practices, such as competitive and public bidding• Replace low-bid procurement practices with Life-Cycle Cost Analysis (LCCA) to promote quality infrastructure project• Empower civil society and interested stakeholders to advocate for greater transparency on public procurement process
Corruption	<ul style="list-style-type: none">• Strengthen anti-corruption work through institutional changes• Lawmakers should exercise oversight of loans that the government undertakes• Implement Freedom of Information act• Publicize government loan terms• Disclose ownership of companies which participate in mega infrastructure projects (especially if these companies are owned by government officials, their families, or close associates).• Provide for third party quality control/independent audit mechanism of the mega infrastructure projects• Implement PPP laws to facilitate investments and monitor PPP projects in hopes to increase transparency and accountability

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PROBLEMS	SOLUTIONS
Weak governance of state-owned enterprises	<ul style="list-style-type: none"> • Demand greater scrutiny of SOEs by lawmakers • Require disclosure of SOEs' annual reports and detailed financial statements as well as disclosure of remuneration of company directors, any financial liabilities potentially borne by the taxpayer and justification of the entities' activities against public policy objectives • Implement mechanisms for SOEs to reduce conflicts of interest among directors
Illegal worker/migration	<ul style="list-style-type: none"> • Implement better management systems for foreign workers • Improve the system of working permits and business licenses for foreign investors
Social tension, environmental degradation, land grabbing and force eviction	<ul style="list-style-type: none"> • Apply multilateral development bank (MDB) standards (such as financial feasibility, environment assessment, social and governance impact analysis) for Belt and Road Initiative loan projects • Promote Corporate Social Responsibility and corporate governance among Chinese firms
Little contribution to local private sector	<ul style="list-style-type: none"> • Provide a level playing field for local and foreign contractors by requiring foreign firms to abide by the OECD guidelines on export credit assistance • Ensure any local content requirements focusing on promoting technology and knowledge transfer between foreign and local firms

The countries of Southeast Asia should strengthen their regulatory environment to reduce the likelihood of corruption, increase transparency, enhance oversight mechanisms, and improve their public procurement framework. In addition, civil society organizations can play a more significant role as a bridge between foreign investors and local communities to spearhead inclusive dialogue among governments, local civil society, and foreign

investors before megaprojects begin so as to ensure that local voices are heard. Civil society and a free press can also help monitor foreign business behavior and promote OECD guidelines for multinational enterprises in agriculture supply chains, the extractive sector, mineral supply chains, and textile and garment supply chains to advocate for more responsible business practices.

Governments can also use regional platforms such as ASEAN to gain stronger negotiation power when advocating for more responsible investments from China.

For China

Chinese civil society is eager to work with foreign counterparts to encourage Chinese firms to engage in more corporate social responsibility and be more responsive to local communities' concerns. Chinese companies could seek Chinese civil society's assistance to try to act more responsibly and inclusively.

The Chinese government could work with Chinese companies abroad to ensure that they are abiding by guidelines released by Chinese business associations. The mining and construction industry associations from China have published guidelines that are on par with international standards.

More broadly promoting and sharing these guidelines would help improve business behavior overseas.

Regarding investments with an international development purpose, China should try to employ the standards of AIIB in all its BRI projects to ensure that this new global power is also advancing development goals by acting more responsibly. Greater transparency in business engagements and MOUs between governments would help improve China's image in the region and counter a reputation of colluding with ruling elites.

Lastly, the report highlights research questions requiring further scholarly attention, including:

- Whether Chinese private firms are driven purely by the profit motive or instead act based on the policy guidelines from the state
- Whether SOEs and private firms from China respond differently to local pressure and incentives
- The extent to which China uses its economic leverage to influence host countries' domestic politics or foreign policy

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