WHAT DRIVES CHINA'S OUTWARD DIRECT INVESTMENT?

Chih-Hai YANG – Mei-Chun CHENG – Chun-Hung LIN

This study examines the determinants of China's outward direct investment (ODI) between 2003 and 2009. We first analyse the structure and dynamics of ODI. We propose three testable hypotheses including technology sourcing, resource seeking, and political linkage. Various estimates show that technology sourcing is supported moderately, whereas resource seeking serves one of primary driving forces. Crucially, the motive of political linkage is significantly related to ODI and it is particularly relevant to developing destinations. This finding indicates that China tends to invest in developing countries with high political risk, which is in contrast with the prediction of the FDI theory. Furthermore, a developing country with high political risk seems to be the favoured destination for China's ODI to acquire technologies and resources.

Keywords: FDI, energy, political risk, China

JEL classification indices: F21, F23, F50, O32, P45

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1. INTRODUCTION

China was well known as the most popular destination of foreign direct invest-
ment (FDI) in the past two decades. However, a relatively recent but important
phenomenon has been China's aggressive engagement in outward direct invest-
ment (ODI). This growth in ODI has been evident since 2001, when the Chinese
authorities declared the "Going Global" policy to promote its overseas investment
activity.[1] In 2004, China announced the "Guidelines on Investment Overseas", that
introduced her major industrial goals, preferential development industries, and ad-
mittance rules for foreign invested industries, thereby stimulating boomed ODI.

As shown in *Figure 1,* the size of China's ODI remained trivial before the
early 2000s. In 2003, the amount of ODI was US$2.85 billion and then increased
sharply from 2004, coinciding with the drastic expansion of China's current ac-
count surplus (Huang – Wang 2011). By 2008, China's ODI (US$52 billion) had
significantly jumped, doubling 2007 flows (US$22 billion). In 2011, China be-
came the largest developing country investor (US$65 billion) with its ODI cap-
turing a global share of 3.48%, thereby ranking sixth in the world following the
US, Japan, the UK, France, and Hong Kong.

Why do Chinese enterprises undertake ODI so much at an early stage in
China's economic development? Does this phenomenon follow a unique model
that is different from the traditional FDI theory? This intriguing issue has at-
tracted growing attention among economists recently. Earlier studies in this area
are descriptive in nature, reviewing historical trends, the evolution of govern-
ment policies, and in-depth case studies; only limited studies have used rigorous
econometric techniques to implement empirical analyses, while they reached in-
consistent results (Buckley et al. 2007; Huang – Wang 2011; Zhang – Daly 2011),
suggesting the need for further empirical studies.

Although the traditional FDI theory in terms of Dunning's eclectic paradigm
provides a good theoretical foundation for explaining the determinants of China's
ODI (Hurst 2011), there are various other potential explanations for China's ODI.
Child – Rodrigues (2005) argue that the motivation of China's ODI is not to ex-
ploit existing competitive advantages, but to redress competitive disadvantages.
It is because multinational enterprises (MNEs) from developing countries might
have different advantages and motivations from those of developed economies.

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[1]   Buckley et al. (2007) classified China's ODI policy development into five key stages. Stage
      1: cautious internationalisation between 1979 and 1985; Stage 2: government encouragement
      between 1992 and 1998; Stage 3: expansion and regulation was implemented between 1992
      and 1998; Stage 4: implementation of the "Going Global" policy was enacted between1999
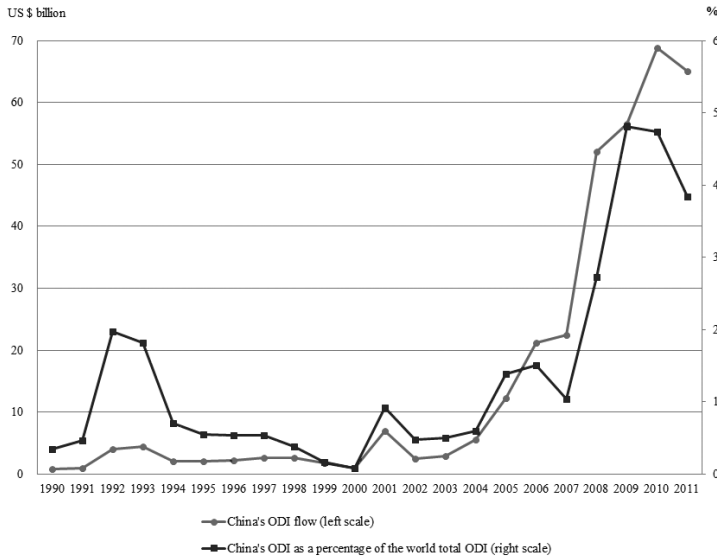   and 2001; Stage 5: undertaken during the post-WTO period.

Figure 1. China's outward foreign direct investment

This might explain why Chinese ODI in Australia and Africa has been a cause of serious concern to local governments (Drysdale 2011; Song 2011). China's ODI could also be motivated by the desire to upgrade the industrial technological ladder through acquiring advanced technologies, better management skills, and stable supplies of raw materials.

We first briefly introduce the structure and dynamics of China's ODI, and then propose the hypotheses of technology sourcing, resource seeking, and political linkage. The influences of the technological capabilities and resource abundance of host countries in attracting Chinese investments are examined. In particular, the study examines the role of the political situation in the recipient countries on influencing China's ODI. Examining the determinants of China's ODI based on the mainstream FDI theory of eclectic paradigm (Dunning 2000, 2001) enables the testing of the robustness of Dunning's paradigm for China's ODI during the post-WTO accession period.

The remainder of this study is organised as follows: Section 2 reviews the literature regarding determinants of ODI, with its main focus on China. Section 3 briefly introduces the stylized facts of China's ODI and then establishes three testable hypotheses. Section 4 presents the empirical models and introduces the dataset utilised in this study. Section 5 reports and discusses various empirical results. The concluding remarks are summarised in the final section.

2. LITERATURE REVIEW

The long-standing question of why firms undertake ODI can be traced back to the seminal thesis of Hymer (1960), which contends that firms engaging in ODI possess and exploit their specific monopolistic advantages, enabling them to expand their international production capabilities. These monopolistic advantages include technological capability, firm scale, product differentiation, and so on. Consequently, Kojima (1973) and Ozawa (1979) proposed an alternative perspective, arguing that ODI is driven by the worsening of macroeconomic conditions (e.g. labour cost, exchange rate, and stringent environmental regulation). Along with the rapid ODI growth of Asian developing countries in the early 1990s, Dunning (2000) proposed the eclectic paradigm that emphasised the influence of both asset exploitation and cost push on deriving ODI for MNEs in developing countries.[2]

Owing to China's rapid ODI growth, some studies have begun to empirically examine the determinants of China's ODI. Based on the aggregate ODI of 49 countries between 1984 and 2001, Buckley et al. (2007) concluded that Chinese ODI is associated with high levels of political risk and cultural proximity to host countries as well as to host market size, geographic proximity, and natural resource endowments.

A growing number of studies use the aggregate data to revisit this issue. Cheung – Qian (2009) and Hurst (2011) investigated the potential difference in the determinants of China's ODI between developing and developed countries using the total ODI and the ODI of state-owned enterprises (SOE), respectively. They indicated that Dunning's eclectic paradigm provides an excellent theoretical framework wherein, (1) both market-seeking and resource-seeking motives drive China's ODI and (2) Chinese exports to developing countries induce China's ODI. However, substantial evidence to prove that China invests in African and oil-producing countries mainly for their natural resources was not found. Biggeri – Sanfilippo (2009) examined the determinants of China's ODI in African countries and found that it was driven by the strategic intersection of three channels (FDI, trade, and economic cooperation) as well as by pull factors, particularly the natural resource endowments of the receiving countries.

Zhang – Daly (2011) quantified the main drivers of China's ODI for the 2003–2009 period. These results were consistent with traditional FDI theory where bilateral trade, market size, GDP growth, openness, and resource endowment had a considerable influence. However, using a dataset for the same pe-

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[2]   There are several comprehensive reviews on the determinants of FDI such as Blonigen (2005) and Bellak et al. (2008).

riod, Huang – Wang (2011) found that traditional variables such as market size, production cost, and legal environment did not impact Chinese investors' choice of location for ODI. They argue that the main purpose of China's ODI model was not to expand production overseas, but to strengthen industries at home. Kolstad – Wiig (2012) focused on institutional and natural resource-related determinants and their interaction. Econometric analyses show that Chinese ODI is attracted to large markets and countries with a combination of large natural resource endowments and poor institutions. In particular, the interaction effect is seen in non-OECD countries.[3]

Drawing from the above discussions, the influence of technology sourcing and institutional environment on China's ODI is not well examined and has reached mixed results. Moreover, despite the resource seeking hypothesis being widely recognised as one of the main drivers of Chinese investments, the question of how the institutional environment of recipient countries affects China's ODI is rarely examined.

3. CHINA'S ODI AND HYPOTHESES

3.1 China's ODI

Some studies such as Buckley et al. (2007), Huang-Wang (2011), and Hurst (2011) have observed the structure and dynamics of China's ODI and summarised three distinct features. First, there is a large share of ODI conducted by state-owned enterprises (SOEs). They accounted for 43% of total ODI in 2003, while this share decreased to 11.1% by 2011 gradually (NBS, 2012) and the share of ODI undertaken by private firms increased sharply. However, SOEs continue to play a dominant role in China's ODI in terms of accumulated capital. By the end of 2011, China's ODI investments by SOEs reached an extremely high share (62.7%) of the total ODI stock.

SOEs that are administered by the central or local governments generally enjoy privileges such as government-supported subsidies, loans, procurements, and regulations, implying that they are often tasked to achieve specific strategic goals. The political influence in SOE investment decision-making suggests that China's ODI contains strong political motivations, as the approval system allowed the authorities to allocate ODI according to the objectives of the state (Cheung – Qian 2009). Indeed, China's extensive foreign exchange reserves provided opportuni-

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[3]   Another emerging line of research focuses on the choice of entry modes or locations by using firm-level data, e.g. Cui – Jiang (2009) and Ramasamy et al. (2012).

ties to acquire discounted assets in crisis periods. This specific ODI phenomenon has attracted policy attention and – as already noted – caused problems for Chinese investors in recipient countries.[4]

Second, the geographic distribution of China's ODI remained stable over time, where the dominant flows are to its Asia neighbours and Latin America. The main Asian destinations are Korea and the member countries of the Association of Southeast Asian Nations (ASEAN) such as Singapore, Thailand, Indonesia, Malaysia, and Myanmar. The share of ODI flows to Latin America is so high that it exceeds the corresponding number for Asia and accounted for 52.6% and 48% in 2005 and 2006, respectively.[5] Africa and Europe receive a small share of capital inflow, but higher than that to North America and Oceania. Moreover, China's ODI targets mainly non-OECD countries, while its share decreased from 94.6% in 2008 to 81.8% in 2011 gradually (NBS 2012). In contrast, OECD countries received more investment from China recently.

Africa ranked third or fourth in China's ODI destinations before 2008, while it became the second largest recipient region, accounting for 9.8% of China's total ODI in 2008. Nigeria, South Africa, South Sudan, Algeria, and Zambia are the main host countries of China's ODI in Africa. Crucially, China has undertaken more ODI in Africa relative to other countries with an accumulated stock of investment amounting to more than US $8 billion (Song et al. 2011).[6] Aiming to secure its access to critical raw materials is one of the possible reasons for increased investments in Africa because the Chinese government has recognised strategic ODI as a necessary tool for sustaining further growth. In the existing FDI literature, the resource-seeking hypothesis is a long-standing issue and seems particularly relevant to China's ODI; however, existing studies do not lead to a consistent conclusion (Cheung – Qian 2009; Biggeri – Sanfilippo 2009).

Actually, African countries are relatively restrictive to foreign investment and have a non-democratic political system with corruption issues. FDI literature suggests a negative impact of corruption on FDI (Habib – Zurawicki 2002; Egger – Winner 2006). Still, this type of investment environment involving the execution

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[4]   For example, Chinese overseas mergers and acquisitions (M&A) in Australia, which target the resource sector, has raised the question of whether investments by China require special scrutiny (Drysdale 2011).

[5]   However, much of the investment in Latin America was made in two tax havens there: Cayman Islands and British Virgin Islands.

[6]   If we exclude the specific role of ODI to Hong Kong, the Cayman Islands and the British Virgin Islands, the shares shown in parentheses suggest that Asia and Europe rank as the top two destinations. The ODI share toward Africa increases sharply, highlighting the special role of Africa.

of political power and provisioning of financial incentives can have a positive effect on market attractiveness for China to damage these countries of their natural resources and raw materials. The impact of this institutional factor on China's ODI may differ from that of the developed countries.

Upgrading the technological ladder has been the primary goal of industrial policy in China. Thus, the authorities may direct Chinese MNEs to obtain foreign technologies, to upgrade the domestic technological ladder. As the capital outflow to OECD countries has been gradually increasing, one of the reasons why Chinese MNEs undertake ODI to higher wage countries is to redress competitive disadvantages (Child – Rodrigues 2005), implying that the motivation of technology sourcing might be the driver.

Third, the sectoral distribution of China's ODI is diversified rather than concentrated, although China enjoys comparative advantages in information and communications technology (ICT) industries under the global production chain since the early 2000s. However, the mining sector is one of the targeted industries China invested in, which accounted for almost one-half and one-third in 2003 and 2004, respectively. In 2006, this number stood at 48.4%. Surprisingly, China's ODI in the manufacturing sector dropped from 21.9% in 2003 to 9.4% in 2011 (NBS 2012). The sectoral distribution seems to differentiate China's ODI behaviour from that of developed countries and its Asian neighbours such as Korea and Taiwan.

3.2 Hypotheses establishment

3.2.1 Technology sourcing

Why does China, a developing country, undertake ODI in developed countries? The possible goal is to acquire advanced technologies by establishing foreign affiliates in developed countries. This prospective technological spillover may induce technology sourcing ODI as firms seek to upgrade their technology. In practice, this behaviour applies to both technologically advanced and technologically lagging firms (Neven – Siotis 1996; Bjorvatn – Eckel 2006).

Technological acquisition is influenced by a variety of institutional factors such as access to R&D personnel; access to external sources of knowledge; the political, legal, and administrative environment; and the organisation of knowledge transfer (Hemmert 2004). Access to advanced technologies through ODI provides a more aggressive and effective approach to China's technological catch-up (Amighini et al. 2010). This aggressive ODI strategy of technology sourcing can

be effective in achieving the goal of promoting domestic technological capability, while China's ODI toward OECD countries is moderate.

Hypothesis 1: Technology sourcing. China's ODI is associated positively with the technological capability of host countries, especially for advanced countries.

3.2.2 Resource seeking

China has become one of the largest resource importing countries. Gaining security over access to raw materials is often cited as a reason for Chinese firms to invest overseas (Buckley et al. 2007; Biggeri – Sanfilippo 2009; Kolstad – Wiig 2012). This strategy can also be witnessed in the aforementioned discussion that mining accounts for the largest ODI flow in the past couple of years. It suggests that the motivation of resource seeking, aimed at securing a long-term supply of resources, plays a crucial role in China's ODI.

China's ODI toward Australia is a good example of resource seeking. According to the "Annual Report 2009–10" released by the Foreign Investment Review Board (FIRB) in January 2011,[7] China was Australia's third largest investor in 2009–2010, with a total proposed investment of US$16.3 billion. The majority of this investment was in the mineral exploration and development sector, accounting for US$12.2 billion and representing 75% of the total proposed investment. China's investment in Africa is another example of resource seeking; a *New York Times* (2007) report explored China's deepening economic and political ties with Africa. "We are back where we started, sending raw materials out, and bringing cheap manufactured goods in. This isn't progress. It is colonialism," Wilfred Collins Wonani, leader of the Chamber of Commerce in Zambia told *The New York Times*.

Even though China is well endowed with its own natural resources, its per capita availability of resources such as timber, iron ore, aluminium, copper, and petroleum is very low. China's overseas expansion has also been driven by the need to secure access to raw materials and natural resources.

Hypothesis 2: *Resource seeking*. China's ODI is positively associated with natural resource endowments of host countries.

3.2.3 Political linkage

The FDI theory predicts a negative association of how corruption and political risks of recipient countries affect FDI inflow because market-oriented firms may

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[7]   http://www.firb.gov.au/content/publications.asp

substitute FDI behaviour by exporting or licensing (Habib – Zurawicki 2002; Egger – Winner 2006). Buckley – Casson (1999) argue that resource-oriented firms are also discouraged from committing to substantial costs in the form of FDI projects. Although inefficient institutions in terms of corruption and political risks are deterrents of FDI inflow to Africa (Wei 2000; Asiedu 2006), Egger – Winner (2005) claimed that corruption can be an incentive for FDI development, especially toward less developed countries.

Indeed, recent theoretical works propose alternative views. Field Jr. et al. (2003) assume that corruption takes place because foreign firms try to reduce their settlement fixed costs and obtain illegal preferential tax treatment from corrupt host government officials. The negotiation process between firms and corrupt officials leads to an inverted U-shaped relationship between corruption and FDI. Kendell – Zhou (2008) studied the possible effects of corruption on a MNE's choice between FDI and exporting when it faces competition from a local firm. Analyses drawn from a game theory model showed that discriminatory corruption can encourage a foreign firm to switch from exporting to FDI.

As mentioned previously, China's ODI prefers to invest in countries with a political environment of autocratic regimes, higher corruption levels, and/or high political risk such as African and South American countries and the ODI is mostly undertaken by SOEs. China has become an increasingly important investor, while it might also want to be the leading power of the developing countries in a coveted multipolar world. In its ODI to Africa and Latin America, China not only meets its demand for energy and raw material, but also significantly contributes to the economic growth of these areas because the "Chinese package" contains the variety of concession contracts, the development of local infrastructure, preferential loans, agreements on debt remission, aids, and preferential conditions to improve the developing country's export potential. At the same time, China builds its own sphere of influence, where it can decide – based on its own economic and political interests. Therefore, ODI helps China to establish a good political relationship with those countries, probably through bribing in countries with a high level of corruption. From the political perspective, this type of ODI also helps to cement bilateral political relationships. This deviation from standard FDI theory thus inspires the following hypothesis:

Hypothesis 3: Political linkage. China's ODI is positively associated with the political risks of host countries.

4. EMPIRICAL SPECIFICATION AND DATA

4.1 Empirical specification

To examine the determinants of China's ODI, with a focus on testing the proposed hypotheses, this study adopts the gravity-type model of the eclectic paradigm because this model still remains a powerful and robust framework for examining contextual specific theories of FDI (Dunning 2001). By indexing China as the source country to examine ODI from the Chinese perspective, the empirical model is specified as

$$\ln ODI_{ijt} = \beta_0 + \beta_1 \ln GDP_{jt} + \beta_2 \ln EXP_{jt} + \beta_3 OPEN_{jt} + \beta_4 INF_{jt} \tag{1}$$
$$+ \beta_5 \ln DIS_{ijt} + \beta_6 TECH_{it} + \beta_7 RES_{jt} + \beta_8 PR_{jt} + \varepsilon_{jt}$$

where represents *(i)* China's ODI to country *j* in year *t*. It is measured by the total amount of ODI to individual host countries.[8]

As for the inclusion of explanatory variables, we refer to the eclectic paradigm of FDI theory to consider asset exploiting, cost push, distance, and other factors. Variables of technology sourcing, resource seeking, and political linkage are the main concerns that might increase ODI flow. Term *GDP* is the host country's gross domestic product, representing the market size and capturing the effect of market seeking. Market size directly affects the potential profits obtained by undertaking ODI, thus implying potentially larger and more promising prospects. Consequently, FDI tends to flow to countries with a larger market size. The market-seeking motive has been shown to positively relate to ODI (Dunning 2000), we thus expect a positive coefficient.

Previous studies, e.g., Grosse – Trevino (1996) and Zheng (2009), have suggested that trade has a strong relation with the amount of a country's ODI, and we thus include the trade variable of China's exports *(EXP)* to destination countries. Firms prefer to invest in trade markets they are more familiar with, and high trade volumes might indicate a high economic integration between the countries. Because export and FDI behaviours are generally viewed as complementary rather than substitutive (Grosse – Trevino 1996), the estimated coefficient for exports is expected to be significantly positive. Moreover, Chakrabarti (2001) and Buckley et al. (2007) suggest that ODI is positively associated with indicators of the "openness" of the economy because FDI is stimulated if the trade regime of the host economy is more liberal. Hence, we include the openness variable *(OPEN)*,

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[8]   We excluded ODI in the service sector in this study. However, the Chinese ODI statistics do not separate investments across sectors in most host countries. The limitation might induce an underestimation of the influences of the proposed hypotheses.

which is measured by the ratio of inward FDI stock to the host country's GDP, and predict a positive impact on attracting investments.

The term INF_{jt} denotes the inflation rate of country j in year t, acting as a proxy of macroeconomic stability. Higher inflation rates in a host country will deter FDI because it not only reduces the book value of capital inflow, but also increases the uncertainty of long-term decision making. This is because the volatile and unexpected inflation rate is generally caused by worsening macroeconomic conditions. *DIS* denotes the geographic distance between China and its investing countries. The greater the distance, the higher the transaction cost, naturally decreasing the amount of FDI (Buckley – Casson 1981).

To test Hypothesis 1 that China's ODI may aim to access the advanced technologies of host countries, we adopt two alternative measures for the *TECH* variable. Firstly, is using the number of total European patents granted by the European Patent Office (EPO) *(PEPO)* adequate for measuring a country's technological capability? Because EPO patents can be treated as "new to the world" innovations, it is an adequate indication of innovation performance. However, using patent statistics, either domestic or foreign patents, as an innovation indicator has some drawbacks (Nagaoka et al. 2010). When investing in advanced economies, Chinese firms are primarily motivated by the quest for strategic resources and capabilities, and the underlying rationale for such asset-seeking FDI is strategic needs. These assets include globally established brands, technological know-how, and R&D capacity. Thus, we alternatively adopt the degree of human capital *(HUM)* as the indicator of a country's technological capability. As the quantity of higher education is one of the widely adopted measures (Barro 2001), we adopt the enrollment ratio of higher education as the indicator. As predicted in Hypothesis 1, the estimated coefficient of the *TECH* variable should be positive.

The term *RES* denotes the ratio of raw material imported from country j, including agricultural products, fuel, ores, and metals. This variable is used to test Hypothesis 2, which states that one of China's primary ODI goals is resource seeking. The resource-seeking motive is to ensure a stable supply of certain resources that the home country has a shortage of, or those that are expensive in the home country. Recent studies, for example Buckley et al. (2007), Biggeri – Sanfilippo (2009), and Kolstad – Wiig (2012), found that ensuring the sufficiency of raw materials is one of the main reasons for China's ODI, in order to meet the growing requirement for raw materials and natural resources to sustain China's growth. Even though China is well endowed with abundant natural resources such as timber, iron ore, aluminium, copper, and petroleum, its per capita availability is very low. Therefore, resource seeking remains a critical factor for spurring China's ODI.

To test the political-linkage hypothesis, two institutional variables are included. The term *PR* refers to the political right index, which is surveyed by Freedom House. It ranges from 1 to 7, with a higher value indicating a lower level of political freedom. Even though democratic countries are generally more attractive in terms of capital inflow (Harms – Ursprung 2002) and corruption seemingly deters FDI as it represents an extra tax (Brouthers et al. 2008), this situation may not apply to the case of China's ODI[9] because its level of corruption remains high.[10] China is an economic superpower and wants to be the opinion leader of the developing world. Centralist/corrupt countries are generally not the favoured investment destinations of Western countries. However, due to economic and political interests as discussed previously, China might try to establish good political relations with those centralist nations through ODI. Therefore, this study expects a significantly positive coefficient for the *PR* variable.

As is common in the specification of the panel data model, we allow the existence of individual effects that are potentially correlated with the right-hand side regressors. Using a "within firm" panel estimator (fixed effect (FE) or RE technique) to eliminate the individual effect is a standard estimation method. Because the variable of distance is time invariant that will be eliminated from the FE model, this study adopts the RE model to implement the empirical estimations.

4.2 Data source

The dataset used in this study is the yearly investment data from China and its 111 major destinations from 2003 to 2009. The sample set is representative, because the ODI toward these countries accounts for more than 90% of China's capital outflow during the sample period. Moreover, we separate the sample into two subsamples of OECD and non-OECD countries. The groups of developed and developing countries contain 30 and 81 countries, respectively.[11]

Data on the annual flow of China's ODI was obtained from various issues of the *Statistical Bulletin of China's Outward Foreign Direct Investment*. Other variables were mainly drawn from the World Bank's World Development Indicators and various other sources. *Table 1* summarises the definition, basis statistics, and data sources of variables.

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[9]   Some studies find a negative relation between democracy and capital inflow, e.g. Resnick (2001) and Resnick – Li (2003).
[10]   For example, China's corruption perceptions index (CPI) score was 3.5 in 2010, ranking 78 out of 178 countries (Transparency Internationals, http://www.transparency.org)
[11]   Due to the specific role of ODI to Hong Kong, the Cayman Islands, and the British Virgin Islands, they are not included in this analysis.

Table 1

Variable definition, basic statistics, and sources

Variable	Definition	Mean	Standard Error	Source
lnODI	China's outward investment to country j (US$)	1.305	2.167	Statistical Bulletin of China's Outward FDI
lnGDP	Market size: measured by the host country's GDP (US$)	10.582	1.999	World Bank Development Indicator
lnEXP	China's exports to the host country (US$)	6.459	2.364	China Statistical Yearbook
$OPEN$	Ratio of inward FDI stock to host GDP	4.787	6.465	World Bank Development Indicator
INF	Annual inflation rate of the host country (%)	7.008	7.837	World Bank Development Indicator
lnDIS	Distance between China and the host country (km)	3.058	1.001	CEPII-Centre d'Etudes Prospectives et d'Informations Internationales
$PEPO$	The total European granted patent by the EPO	7.103	15.247	European Patent Office
HUM	The enrolment of tertiary education (%)	43.992	24.964	World Bank Development Indicator
RES	The ratio of raw material export including agricultural products, fuel, ores and metals (%)	30.539	30.497	World Bank Development Indicator
$ORES$	The ratio of ores and metals exports to total merchandise exports of the host country (%)	8.681	16.942	World Bank Development Indicator
PR	Political rights: 1 to 7 (1 a high level of political freedom in the host country)	3.023	1.997	Freedom House
CL	Civil liberties: 1 to 7 (1 a high level of civil liberties in the host country)	2.925	1.595	Freedom House

Note: The mean and standard errors are calculated by pooling data for the 2003–2009 periods.

5. EMPIRICAL RESULTS

5.1 Main results

Table 2 presents a series of estimations and serves as the baseline models. Estimates in models (1) – (3) are obtained by including the corresponding variable of tested hypotheses (1) – (3), whereas model (4) includes three tested variables.

Table 2

Determinants of China's ODI

	Model (1)	Model (2)	Model (3)	Model (4)	Model (5)
Constant	–2.839***	–3.145***	–3.994***	–4.085***	–4.305***
	(0.902)	(0.815)	(1.004)	(0.911)	(1.154)
ln*GDP*	0.404***	0.562***	0.559***	0.436***	0.379***
	(0.076)	(0.085)	(0.089)	(0.073)	(0.092)
ln*EXP*	0.048*	0.083*	0.075	0.050*	0.045
	(0.027)	(0.046)	(0.046)	(0.027)	(0.033)
OPEN	0.020**	0.023**	0.022**	0.021**	0.031*
	(0.0096)	(0.011)	(0.011)	(0.0010)	(0.018)
INF	–2.70E-05	–0.004	–0.002	–0.002	0.001
	(0.008)	(0.009)	(0.009)	(0.008)	(0.011)
ln*DIS*	-0.180	–0.004	–0.003	–0.198	–0.292*
	(0.130)	(0.003)	(0.003)	(0.123)	(0.160)
PEPO	2.81E-05			8.62E-05	
	(7.03E-05)			(6.72E-05)	
HUM					0.017**
					(0.007)
RES		0.013***		0.011***	0.014***
		(0.004)		(0.004)	(0.005)
PR			0.198***	0.194***	0.265***
			(0.070)	(0.061)	(0.074)
Observation	777	777	777	777	490

Notes: The numbers in parentheses are standard errors. ***, **, and * represent statistical significance at 1%, 5%, and 10% levels, respectively.

By observing the estimates in models (1) – (5), the overall results support arguments in the traditional FDI theory of Dunning's eclectic paradigm. The host country's market size *(GDP),* China's exports to a destination *(EXP),* and the openness variable *(OPEN)* are associated with a significantly positive coefficient. This suggests that the market size of host countries is a stimulus to attract China's ODI. Furthermore, China invests in countries that are more open and/or have a closer trade relation with China. These results are consistent with the previous findings by Buckley et al. (2007), Zheng, (2009), and Zhang – Daly (2011).

As argued in Hypothesis 1, China's ODI should be motivated by technology sourcing. However, the estimated coefficient of the technology sourcing variable *(EPTO)* is positive, but not statistically significant in models (1) and (4), whereby it does not support the hypothesis of technology sourcing. It is possible that technology embodied in FDI is one of the primary external sources for ac-

quiring technologies. When we adopt the quality of human capital as the indicator of technological level, estimates in model (5) show that the coefficient of *HUM* is significantly positive at the 5% statistical level.[12] It implies that China tends to invest in countries with superior technological capabilities, *ceteris paribus,* supporting thereby Hhypothesis 1. One point worth noting is that if the motive of technology sourcing is crucial, China's ODI should be geared toward developed countries because their technological capacity is much higher than that of China.

For Hypothesis 2 of resource seeking, the estimated coefficient *RES* is significantly positive at the 1% level in columns (2), (4), and (5). It yields evidence supporting that China's ODI may aim to ensure the security of sufficient natural resources. This finding is not only consistent with most previous studies (Buckley et al. 2007; Biggeri – Sanfilippo 2009; Kolstad – Wiig 2012), but also echoes the serious concerns of many resource-abundant countries that China's ODI is probably motivated by the goal of plundering the natural resources of host countries.

Regarding the test of Hypothesis 3 (political linkage), the *PR* variable is a significantly positive coefficient in models (3) – (5). It indicates that countries with a low level of political freedom attract more capital inflow from China, supporting thereby the political linkage hypothesis.

Why does China's ODI behaviour contradict the FDI theory? In general, market-oriented firms may substitute FDI by exporting to or licensing in high political risk countries to secure their property rights (Habib – Zurawicki 2002; Egger – Winner 2006). The developing countries considered risky by Western or developed countries do not appear as such to China and are not an obstacle because, on the one hand, it may consider those destinations less risky, while on the other hand, China's ODI favouring destinations with low political freedom, *ceteris paribus,* is likely to be driven by non-economic purpose. As mentioned previously, the political linkage through ODI helps China to be the mouthpiece of the developing world. Our finding echoes Eggers – Winner's (2005) argument that corruption could be an incentive for FDI.

Previous studies, e.g. Cheung – Qian (2009) and Hurst (2011), claim that the determinants of China's ODI may vary between developed and developing countries. It implies that the effectiveness of the hypotheses may depend on the development degree of host countries because the levels of technological capability, political freedom, and resource endowment differ considerably between developed and developing countries. To examine the roles of technology sourcing, resource seeking, and political linkage on China's ODI in developed and developing countries, we include two dummy variables, *non-OECD* and *OECD,*

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[12]   The information regarding the enrolment rate of tertiary education is available for only 70 countries, calling for the reduction of the number of observations to 490.

Table 3

Determinants of China's ODI – further investigation

	Model (1)	Model (2)	Model (3)	Model (4)
	TECH = HUM		*TECH = PEPO*	
Constant	–4.734***	–3.941***	–3.925***	–3.477***
	(1.180)	(1.164)	(0.970)	(0.925)
ln*GDP*	0.462***	0.432***	0.433***	0.428***
	(0.103)	(0.093)	(0.090)	(0.074)
ln*EXP*	0.045	–0.046	0.049*	–0.034
	(0.033)	(0.036)	(0.027)	(0.029))
OPEN	0.029	0.023	0.020**	0.021**
	(0.018)	(0.019)	(0.010)	(0.010))
INF	0.0004	0.007	–0.003	0.005
	(0.011)	(0.012)	(0.008)	(0.008)
ln*DIS*	–0.318*	–0.276*	–0.185	–0.196
	(0.163)	(0..162)	(0.125)	(0.125)
TECH		0.006		0.0001
		(0.007)		(0.0001)
RES		0.021***		0.015***
		(0.006)		(0.004)
PR		0.136*		0.058
		(0.080)		(0.065)
TECH *NON-OECD	0.017**		0.022***	
	(0.008)		(0.008)	
TECH *OECD	0.018*		0.001***	
	(0.010)		(0.0001)	
RES*NON-OECD	0.013***		0.009***	
	(0.005)		(0.004)	
RES*OECD	0.021		0.028**	
	(0.014)		(0.012)	
PR*NON-OECD	0.224***		0.168**	
	(0.085)		(0.066)	
PR*OECD	–0.507		–0.499	
	(0.432)		(0.362)	
TECH*D08		0.012***		0.0001**
		(0.004)		(0.0001)
RES*D08		–0.007		–0.003
		(0.005)		(0.004)
PR*D08		0.189***		0.290***
		(0.061)		(0.046)
Observation	490	490	777	777

Note: See *Table 2*.

to separate these two groups. The estimated coefficients on the interaction terms between the concerned variables and country group enable us to distinguish the possible differences. *Table 3* presents a series of estimations.

Table 3 shows that the estimates are overall similar to those in *Table 2,* and we focus analysing the proposed hypotheses. Surprisingly, both coefficients of *TECH*non-OECD* and *TECH*OECD* are significantly positive, using either human capital or European patents as the proxy of technological capability. It indicates that China's ODI is positively associated with the technological capabilities of the host countries. In contrast with our expectations, this effect of technology sourcing from non-OECD countries is not lower than that from OECD countries.

Two interesting findings worth mentioning are the tests on Hypotheses 2 and 3. As shown in model (1), the interaction term between resource and country group is significantly positive only for *RES*non-OECD* rather than *RES*OECD.* Estimates in model (3) also suggest that the magnitude of the resource-seeking effect is much higher for non-OECD countries. Therefore, Hypothesis 2 of resource seeking is strongly supported for destinations of non-OECD countries. Similarly, the *PR*non-OECD* variable is associated with a significantly positive coefficient in models (1) and (3), whereas the coefficient of *PR*OECD* is insignificantly negative. OECD countries have democratic systems and a high degree of political freedom, which prevents the feasibility of dollar diplomacy through ODI. Thus, the hypothesis of political linkage does not hold in OECD countries. Alternatively, the political linkage hypothesis is strongly supported for China's ODI toward non-OECD countries, implying that in poorer countries, it is easier to bribe government officials in order to implement investment projects.

An observed phenomenon from *Figure 1* is that China invested more aggressively during the global financial crisis as the recession made it much easier to acquire foreign assets and technologies. To verify this conjecture, we include a dummy year (D08) for the global crisis period of 2008–2010 and then analyse its interactive effect with *TECH, RES,* and *PR.* As shown in models (2) and (4) of *Table 3,* the motive of technology sourcing is witnessed for the crisis period. The *RES* variable maintains its significance; however, its interaction with *RES*D08* is insignificant. Crucially, the *PR* variable is significant and accompanies a significantly positive sign for the interaction term *PR*D08*. This lends evidence that since the global financial crisis, China's preference has been to allocate ODI in countries with a political environment of autocratic regimes.

As the behaviour of favouring ODI in high risk countries, especially for non-OECD countries, contradicts the FDI theories, the study explains the specific behaviour from the perspective of political linkage hypothesis. Lying beneath the surface of political motivation, ODI should be mainly driven by economic forces, implying that the political factor is used as a tool to exploit the economic

benefits. To examine this argument, we further estimate the interaction between the *PR* and technology sourcing as well as the *PR* and resource seeking variables. *Table 4* reports the results.

Table 4

The role of institutional factors on resource seeking and technology sourcing

	Model (1)	Model (2)	Model (3)	Model (4)	Model (5)	Model (6)
	TECH = HUM			TECH = PEPO		
Constant	–3.513***	–3.534***	–3.220***	–3.017***	–2.533***	–3.049***
	(1.087)	(1.184)	(1.136)	(0.878)	(0.856)	(0.933)
ln*GDP*	0.408***	0.411***	0.383***	0.398***	0.327***	0.402***
	(0.082)	(0.101)	(0.087)	(0.074)	(0.073)	(0.079)
ln*EXP*	0.044	0.043	0.042	0.051*	0.049*	0.051*
	(0.033)	(0.033)	(0.033)	(0.027)	(0.027)	(0.027)
OPEN	0.035*	0.035*	0.035*	0.020**	0.018*	0.020**
	(0.018)	(0.018)	(0.018)	(0.010)	(0.009)	(0.009)
INF	0.001	0.001	0.001	-0.001	–0.001	–0.001
	(0.011)	(0.011)	(0.011)	(0.008)	(0.008)	(0.008)
ln*DIS*	–0.289*	–0.289*	–0.323*	–0.184	–0.129	–0.183
	(0.161)	(0.163)	(0.166)	(0.125)	(0.122)	(0.127)
*PR*TECH*	0.005***		0.005***	6.18E-05		6.01E-05
	(0.001)		(0.001)	(6.82E-05)		(6.90E-05)
*PR*RES*	0.002***	0.002***		0.002***	0.002***	
	(0.0007)	(0.0007)		(0.0006)	(0.0006)	
*PR*TECH*OECD*		0.005			0.0001	
		(0.006)			(6.69E-05)	
*PR*TECH*NON-OECD*		0.005***			0.009***	
		(0.001)			(0.002)	
*PR*RES*OECD*			0.014			0.001
			(0.012)			(0.011)
*PR*RES*NON-OECD*			0.002***			0.002***
			(0.0007)			(0.0006)
Observations	490	490	490	777	777	777

Notes: See *Table 2*.

Estimates in model (1) show that the interaction terms *PR*TECH* and *PR*RES* are significantly positive, indicating that the political factor plays a crucial role in both technology sourcing and resource seeking. That is, countries with a higher technological capability or abundant resources, but with a higher political risk seem to be favoured destinations for China's ODI. However, the interaction effect between political linkage and technology sourcing seems to be less supported, as shown in model (4).

The political environment of developed countries is generally a democratic regime, leaving less room for political power to affect FDI. Thus, if the political factor matters to technology sourcing and resource-seeking motivations, it

should apply to China's ODI in developing countries. The above conjecture is verified by the estimates in models (2), (3), (5), and (6) that the interaction terms *PR*TECH* and *PR*RES* are significantly positive only for non-OECD countries.

5.2 Robustness check

As one distinct feature differentiating this paper from existing literature is the political linkage hypothesis, we adopt an alternative institutional variable to conduct empirical estimations to obtain robust results. The civil rights index *(CL),* surveyed by Freedom House, serves as an adequate proxy. This index measures the degree of civil liberties and it ranges between 1 and 7. A higher value of *CL* denotes a lower level of civil rights. Thus, the estimated coefficient on the *CL* variable should be positive if Hypothesis 3 – that China tends to invest in high risk (low civic rights) countries due to the political linkage reasons – is supported. A series of these estimates are summarised in *Table 5*.

Table 5

Determinants of China's ODI – Robustness Check

	Model (1)		Model (2)		Model (3)	
Constant	−4.265***	(1.176)	−4.707***	(1.196)	−3.890***	(1.194)
ln*GDP*	0.369***	(0.092)	0.450***	(0.102)	0.426***	(0.094)
ln*EXP*	0.042	(0.033)	0.043	(0.033)	−0.051	(0.036)
OPEN	0.035*	(0.018)	0.032*	(0.018)	0.026	(0.019)
INF	0.001	(0.011)	−0.001	(0.011)	0.007	(0.012)
ln*DIS*	−0.298*	(0.160)	−0.336**	(0.163)	−0.282*	(0.163)
EDU	0.018***	(0.007)			0.007	(0.007)
RES	0.015***	(0.005)			0.022***	(0.006)
CL	0.286***	(0.097)			0.139	(0.103)
HUM*NON-OECD			0.020***	(0.008)		
HUM*OECD			0.015	(0.010)		
RES*NON-OECD			0.013***	(0.005)		
RES*OECD			0.021	(0.014)		
CL*NON-OECD			0.243**	(0.117)		
CL*OECD			−0.146	(0.285)		
HUM *D08					0.011***	(0.004)
RES*D08					−0.008	(0.005)
CL*D08					0.245***	(0.071)
Observations	490		490		490	

Notes See *Table 2*.

The coefficients of *GDP* and *OPEN* remain significantly positive, whereas *DIS* associates with a significantly negative coefficient,[13] suggesting thereby that China's ODI behaviour is consistent with the traditional FDI theory. Although the estimates obtained in the three models are very similar, there are some interesting findings worth addressing.

First, the technology sourcing hypothesis is overall supported, while this purpose seems to be relevant to destinations of non-OECD countries and for the post-global financial tsunami period. The deregulation of the domestic market to attract inward FDI with the desired technologies is an alternative for China to upgrade its technological ladder. It is the possible reason for why the technology sourcing hypothesis is not strongly supported for the OECD countries.

Second, drawing from estimates in *Table 5*, the hypothesis of political linkage is again confirmed. Crucially, the influences of political factors on China's ODI are also particularly relevant to non-OECD countries and the post-global financial tsunami period, as both variables of *CL*NON-OECD* and *CL*D08* are associated with a significantly positive coefficient. The predictions of FDI theories in Habib – Zurawicki (2002) and Egger – Winner (2006) suggest that there is a negative association between FDI and political risk. However, our findings support the hypothesis of political linkage that China tends to invest in high risk countries, after controlling other factors. In fact, the non-democratic political system may create room for China to easily undertake desired investment projects in less-developed countries. As the coefficient of *CL*OECD* (and *PR*OCED* in *Table 6*) is insignificantly negative, our findings tend to support the theoretical prediction in Field Jr. et al. (2003), which states that the relationship between corruption and FDI is probably an inverted U-shape.

6. CONCLUSION

The expansion in Chinese outward (ODI) direct investment in the recent past raises the interesting and important question of what determines China's ODI. It questions whether the traditional FDI theory applies to China. However, China's upsurge in investments is suspected to have specific purposes other than being economically driven. This study examines the determinants of China's ODI by proposing three testable hypotheses, including technology sourcing, resource seeking, and political linkage.

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[13] We adopt also PEPO as the indicator of technological capability to implement empirical esti-mations. The results are similar, while EXP and DIS turns to significantly positive and insig-nificant negative, respectively. To save space, the results are not reported here.

Various estimates show that the traditional FDI theory overall applies to China's ODI behaviour. Market size, trade, openness, and distance have a significant influence on ODI with an expected sign. Our results and comparisons with previous studies also suggest that China's ODI outflow exhibits some distinct features. To promote its technological capability, China's ODI is attracted by countries with higher technological levels, which tends to support the technology sourcing hypothesis. The widely believed notion that China's ODI favours countries rich in natural resources in order to secure sufficient resources to support long-term growth is witnessed in this study. After controlling other variables and using various measures of resources, we find that China's ODI is strongly related to the resource variable in both OECD and non-OECD countries, thus validating the resource-seeking hypothesis.

In particular, this study proposes the political linkage hypothesis to examine the specific feature of China's preference on ODI toward countries with high political instability, *ceteris paribus*. Various estimates confirm this hypothesis and it is particularly relevant to non-OECD countries. This finding is in contrast with the prediction of the FDI theory. This specific investment behaviour reflects the background characteristics of China's ODI, in particular the predominant state ownership of MNEs and the institutional context of China.

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