

Discovering Chinese Integrative Outward Foreign Direct Investment and the Influence of the Chinese State

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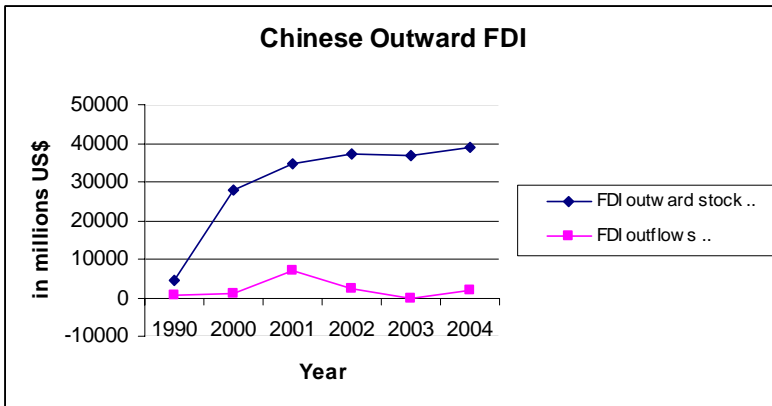
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1 Introduction: The opening of the outbound Chinese investment market

“Foreign direct investment,” claims *The Economist*, “is globalization in its most potent form . . . far more than mere ‘capital,’ it is a uniquely potent bundle of capital, contacts, and managerial and technological knowledge.”¹ While much popular attention has been directed at firms from developed economies investing *into* developing countries, within the growth of global FDI is a surge of direct investment emerging outward from developing economies. According to Kofi Annan’s preface to UNCTAD’s World Investment Report 2005:

The conventional wisdom of developed countries as capital and technology exporters and developing countries as importers is gradually giving way to a more complex set of relationships. The geography of international investment flows is changing. Developing countries are emerging as outward investors, and their importance as recipients of foreign direct investment in more knowledge-intensive activities is increasing.²



1.1 Chinese Outward FDI

Source: UNCTAD 2005

¹ “The cutting edge,” *The Economist*, February 24, 2001, p80

The emergence of Chinese investors investing abroad is part of this trend. According to IMF estimates, Chinese³ ODI flows increased from US\$0 to US\$6884 million per year between 1970 and 2001.⁴ From 2001 to 2004, official Chinese ODI stock steadily increased to a level of US\$38.8bn, comprising 2.4% of Chinese GDP.⁵ By 2002, Chinese foreign affiliates were providing employment to some 34,000 employees in the United States. Hong Kong companies employed 120,000.⁶

While the absolute levels of Chinese ODI are still relatively small in comparison to most other developed countries, among developing economies, China is a leader.⁷ In 2003, China overtook Ireland and Israel as a source of direct investment.⁸ In the same year, officially monitored Chinese overseas investment stocks outgrew South Korea’s.⁹

² UNCTAD World Investment Report 2005 p “v”

³ Since investment data is collected separately for Hong Kong and the mainland, I will henceforth refer to mainland PRC as “China,” in accordance with the nomenclature conventions of UNCTAD reports.

⁴ Chan, Sarah and John Wong “China’s Outward Direct Investment: Expanding Worldwide” *China: An International Journal* 1, 2 (SEP. 2003): 273 – 301
Online statistical appendix
http://muse.jhu.edu/journals/china/v001/1.2wong_ta_b03.html

⁵ UNCTAD World Investment Report 2005

⁶ Zeile, William J. “US Affiliates of Foreign Companies: Operations in 2003.” Bureau of Economic Analysis.

⁷ Chan and Wong p273 – 301

⁸ Buckley, Peter J., Jeremy Clegg, Adam Cross, Lui Xin, and Hinrich Voss. “Host Country Determinants of Chinese Outward Foreign Direct Investment.” Presented to the 33rd AIB-UK Conference 2006, Centre for International Business, Leeds University Business School. Accessed April 2006.
<<http://66.102.7.104/search?q=cache:PLHLIzzvP7Ij:www.personal.mbs.ac.uk/rsinkovics/aibukproceedings/papers/AIBUKpaper116.pdf+host+country+determinants+of+Chinese+foreign+investment&hl=en&gl=us&ct=clnk&cd=3>>

⁹ UNCTAD World Investment Report 2005

Within this trend is another. As the internal Chinese market sheds state investment and control, so too has Chinese ODI become increasingly dominated by private firms. A report produced by the Asia Pacific Foundation of Canada and the China Council for the Promotion of International Trade (APFC-CCPIT) describes private investors increasingly moving capital overseas:

State-owned enterprises have slipped from a dominating position to be just some among the major players, as shown by the share of ODI held by SOEs dropping from 43% in 2003 to 35% in 2004. Publicly-owned companies, including limited liability companies, shareholding companies and collective companies, accounted for 45% of total investors, up from 39% in 2003. Private companies accounted for 12%, gaining two percentage points from a year earlier.¹⁰

Of the factors pushing Chinese investment outwards, not all are the product of government policy; of such policies, not all were intended to encourage ODI. The transnational nature of outward investment is such that it implicitly reduces the degree to which a given government can control it. Even so, China does not have the institutional capacity to micromanage outward investment. Like so much of Chinese policy in other arenas, Chinese ODI policies have developed partly according to cautious forward-looking strategy and partly in incremental reaction to external and events.

The degree to which a given policy influences firm decision-making varies from firm to firm. Sometimes firms make investment decisions motivated by greed, poor information, or other un-extraordinary human or institutional failings. Sometimes they invest for research, sometimes for markets, sometimes for speculative purposes. Sometimes political,

¹⁰ Asia Pacific Foundation of Canada, China Council for the Promotion of International Trade (APFC-CCPIT Survey). “China Goes Global: A Survey of Chinese Companies’ Outward Direct Investment Intentions.” September 2005. Annex C.

fiscal, or monetary policies exert a pushing or pulling effect. But more and more, modern firms invest overseas to *integrate* with networks of global business value chains that every day become more granular, more interdependent, and more widely distributed across the globe, linked by rapid communications systems that allow companies to run 24 hour product development and manufacturing cycles on which the sun never sets. This paper asks, what role is the Chinese state playing in encouraging the integrative quality of its outbound investments now, and what role should it play in the future?

2 Argument and structure

This paper argues for research on the incentive structure producing Chinese ODI that establishes correlations (or the lack thereof) between state policies and the “integrativeness.” State policy matters because the Chinese state is highly motivated to produce integrative FDI, since it is most likely to produce the “spillover” (i.e. innovation, efficiency, human capital, and global competitiveness) that China needs to advance into the ranks of more developed Asian economies such as South Korea and Japan. What is the state doing to produce ODI spillover, and is it working?

Given the relative paucity of firm level data regarding the quantity and quality of state influence over a given firm’s outward investment decisions, hypotheses must be advanced with some caution. However, I argue that the many government policies that can encourage Chinese aggregate outward investment—such as fiscal policy, local protectionism, monetary policy, and regulations favoring SOEs—are unlikely to influence its integrative quality.

Since China does not make investment decisions as a national unit, it cannot dictate the quality of such investments at the aggregate level. It cannot order a shipping company to act like a software company, or

vice versa. Direct investment is ultimately a firm-level decision. The integrative quality of Chinese ODI must therefore be evaluated using the firm as the primary unit of analysis. While there have been a few surveys conducted by the World Bank, MOFCOM, and CCPIT, which I will refer to later in the paper, firm-level data that testing correlations between indicators of “integrative” outward investments and relevant government policies is not available. This paper will therefore serve as the basis to argue how such research should be conducted, and what questions it should hope to answer.

First I will describe the general theory of what integrative FDI is. Then I will describe factors in the Chinese environment that produce or hamper integrative FDI. I will describe the situation of certain Chinese firms. Driving from my survey of the literature, firm surveys, and case studies, I will then suggest firm-level indicators of the relative presence or absence of “integrativeness” in a given outward investment. I will propose a set of political variables which my research will test for any correlations with the proposed integrative indicators. I will conclude with a more precise description of the hypotheses to be tested, and the potential policy ramifications of the findings.

3 What is integrative ODI?

My paper relies on a premise, advanced by “Partners in Prosperity” by Dan Hamilton and Joseph Quinlan, that trade (in terms of imports and exports) is less and less important to modern economic relationships than FDI. They also argue, along with many others, that the nature of the global business environment increasingly demands a new kind of FDI, which they call “asset-augmenting” FDI (which corresponds with the term “integrative” FDI which I have adopted for usage in this paper.) “This type of FDI,” they argue, “is driven by the emergence of intellectual capital as the key wealth-creating

asset in most industrial economies.” Using Thomas A. Stewart’s work on intellectual capital¹¹, Hamilton and Quinlan estimate that the “knowledge component” of manufactured products has risen from 20% in the 1950s to 75% today.¹² Their conclusion coordinates with suggestions made by Barry Naughton and Eric Thun about the nature of global economic changes in business structure vis a vis China, which I will discuss later in the paper.

Quinlan and Hamilton contrast asset-augmenting FDI to “asset-exploiting” FDI, also called “traditional” FDI in other literature. They suggest that the depth of relationship integrative FDI produces is of a profoundly different quality than traditional “asset-exploiting” FDI, and they use the relationship between the US and Europe as the foremost example of an economic relationship based primarily on integrative investment, not trade. For the same reason, they consider the investment relationships between the US and developing economies like China and India to be overrated as it is of considerably lower integrative quality.¹³

While I will provide even more nuanced definition of “integrativeness,” for a basic comparison see Table 2 below:

3.1 Traditional versus Integrative FDI

Traditional Direct Investment	Integrative Investment
Focused on the sale and shipment of simple goods	Focused on package of goods, services, and components thereof

¹¹ Stewart, Thomas A. *Intellectual Capital*. New York: Doubleday/Currency Publishers, 1997.

¹² Hamilton and Quinlan, p7.

¹³ Ibid

Foreign markets are end-users of product: low foreign content of traded products	Global consumption of products made from components with diverse national origin ; domestic content of an exported product is rarely over 40%.
Is frequently used to “jump” trade barriers	Occurs between open economies
Unidirectional: policy focuses on encouraging exports, minimizes positive role of imports	Bidirectional: Exports and imports, goods and services form balanced portion of supply chain.

Source: EDC Economics ¹⁴

3.2 Additional qualities of integrative ODI

The critical theme of integrative ODI is self-evident to a certain extent. Integrated investments are more interdependent on other firms, other societies, other markets. However, this interdependence makes them behave differently from traditional firms in certain ways.

1. To reiterate Hamilton and Quinlan’s point, the product is knowledge-intensive. Therefore it demands more human capital, including management capital and political connections specific to the target market. Therefore integrative direct investment has a greater demand for more stakeholders from more nations. For the same reason, the firm has a relatively high dependence on foreign human capital markets. The firm demands local employees.

¹⁴ Hodgson, Glen “Trade in Evolution: the Emergence of Integrative Trade” *EDC Economics* Export Development Canada. March 2004.

2. If we take the transatlantic relationship as our template, integrative investment exhibits a relatively high ratio of foreign affiliate sales to exports. In 2001, for example, German foreign affiliate sales in the US were four times greater than its exports to the same market, despite Germany’s popular image as an export-based “trading” nation.¹⁵
3. As part of the knowledge economy, it must engage in R&D, but as it forms part of a chain, that research benefits from cooperation and collaboration among various members of the value chain—which also motivates diverse stakeholding. It produces patent, trademark, and copyright applications in multiple countries along the chain.
4. Therefore the assembled product has a relatively diverse mixture of components by national origin.
5. Since the firm is present in the market based on the qualities of the market (not of the natural resource endowments of the geography the market happens to be situated in) and its ability to generate demand (or produce innovations) for the firm’s product, a relatively high ratio of earnings are reinvested instead of remitted to the source country (of course, given the multinational ownership structure, the question of which country is the home country becomes increasingly vague as an investment becomes more integrative). Integrative investment is necessarily the inverse of a mercantilist strategy.
6. Because the firm is internally integrated across borders, the firm engages in a relatively high level of intra-firm (a.k.a. “related-party”) trade

¹⁵ Hamilton and Quinlan. p26

between the source country and the affiliates to produce its end product.

7. The product is a modular component in a more complex product. It is relatively similar in value to other components in the assembled product. Therefore integrative firms are also more likely to have an ownership stake in other firms in its value chain, and vice versa. For the same reason, the firm must engage in relatively high levels of intra-industrial trade.

A quick caveat: I am not positing that “integrative” ODI is by definition indicates a *beneficial* economic relationship and therefore non-integrative (henceforth “shallow”) ODI always indicates the reverse. “Traditional” trade retains a functional role. Trade in natural resources, for example, cannot be “asset-augmenting;” one cannot somehow create oil in China by investing in oil production in Venezuela. But can one create a computer industry in China by investing in the computer industry in Taiwan?

On the other hand, the *ratio* of integrative to non-integrative ODI is a significant metric that says a great deal about the quality of an economic relationship between nations, as the political, economic, and social ramifications of the two types of trade are very different. For example, it is very easy to frame competition for oil assets in nationalist, mercantilist terms. It is difficult to frame the argument between Boeing and Airbus, both of whom are essentially transatlantic companies with relatively large numbers of employees and contractors on both sides of the pond, in such terms. That popular discourses attempt to do so indicates the poor quality of the discourse, not business or economic reality. However, this paper is not primarily concerned with the relationships between nations as whole entities, much less arguments in the punditocracy over which country’s firms are invading which country’s markets and stealing whose jobs.

4 Integrative direct investment in China

4.1 ODI policy liberalization

The “going outward” policy was originally designed to create “national champion” SOEs and pushing them abroad. Originally SOEs were the only entities allowed to engage in ODI at all. According to Friedrich Wu, between 1991 and 1997 the State Council assembled a group of 120 putative state-owned “national champions” in order to “spearhead the internationalization of Chinese enterprises.” Such champions were afforded “high levels of protection, generous state financial support, and special rights in management autonomy, profit retention, and investment decisions.”¹⁶ It was not until 1998 that private enterprises were allowed to borrow money from state banks for any purpose, including ODI. The cramping effect this had on private industry will be discussed further in the paper.

However in recent years China has steadily lowered barriers and streamlined processes to allow private firms and individuals to invest abroad. Following the Asian financial crisis, China reestablished a degree of control over ODI due to concerns over illicit currency smuggling and capital flight, but such controls have largely been lifted. Firms are now able to apply for permission to invest abroad online, and approval standards are being eased. SAFE has relaxed foreign currency controls and rescinded deposit and remittance requirements. After running a pilot program, in 2002 SAFE discarded its policy of requiring overseas profits to be remitted to China immediately in the pilot localities, allowing Chinese investors to reinvest abroad.¹⁷ In

¹⁶ Wu, Friedrich “The Globalization of Corporate China” *NBR Analysis* National Bureau of Asian Research. Volume 16, Number 3, December 2005

¹⁷ Zhang, Kenny “China Going Global: The Why, When, Where and How of Chinese Companies”

October 2004 the MOFCOM and the NRDC likewise streamlined the process for applying to invest abroad, allowing investors to do so online with minimal review. In an attempt to improve the performance of Chinese ODI, NDRC and the China Export and Credit Insurance Corporation have established an initiative to identify, communicate, and mitigate risks faced by Chinese firms abroad. In 2004, the National Development and Reform Commission (NDRC) and the Export-Import Bank of China established a mechanism for providing preferential interest rates to stimulate certain overseas projects. Tax incentives are now available for “overseas development projects that can cover the shortage of domestic resources; overseas manufacturing and infrastructure projects that can spur the export of domestic technology, products, equipment and labor; overseas R&D projects that will tap into advanced global technology, managerial skills and talents; and overseas acquisition and merger projects that will enhance enterprises’ international competitive capacity and help them develop international markets.”¹⁸

China’s entry into the WTO required the relaxation of restrictions on outbound investment, but ODI liberalization, like other market liberalization policies embarked on by the central government, preceded WTO accession. In short, the central government is committed to stimulating and supporting Chinese companies abroad.

4.2 Poor performance of Chinese ODI

Unfortunately, such commitment has yet to yield impressive aggregate results. Much of visible Chinese ODI appears to do quite poorly. According to MOFCOM, barely a third of Chinese corporate investments

overseas were profitable in 2004.¹⁹ While some argue that MOFCOM’s estimates are artificially optimistic, in the absence of corroborating performance data one is free to suspect the veracity of this statistic in either direction.²⁰ On the one hand, the domestic performance of SOEs might indicate that poor ODI performance can be simply explained by the fact that up until 1985 only SOEs were allowed to invest abroad. However, as I will discuss further in the paper, private ownership is also subject to incentive distortions. For example, according to a survey conducted by APC-CCPIT, the third most popular motive for Chinese ODI was the search for more favorable tax regimes.²¹ This may help explain why US\$1.67bn of Chinese ODI in Latin America was invested “mainly in the Cayman Islands.”²²

Obviously the desire to find a tax shelter does not imply any implicit business interest in a foreign market, much less an interest in integrating with foreign firms. Such investments may lose the firm money at the foreign affiliate level but nevertheless produce net profitability by reducing the domestic tax bill- another reason why some local governments have attempted to establish distinct controls over ODI from their regions,

¹⁹ China. Ministry of Commerce & National Bureau of Statistics. *China Outbound Investment Statistics Report 2004*, September, 2005.

²⁰ For example, in one survey MOFCOM reported only 188 Chinese enterprises in Singapore in 2003. Singaporean officials contradicted MOFCOM and asserted that there were, in fact, around 1,500 Chinese firms in the country! Wu, Friedrich “The Globalization of Corporate China” *NBR Analysis*, Number 3, Volume 16 National Bureau of Asian Research. December 2005 p8.

²¹ APC-CCPIT Survey

²²China. Ministry of Finance. “Non-financial Overseas Direct Investment, Overseas Project Contracting a Labor Service Cooperation Gained Satisfactory Achievement in 2004” January 11, 2006 <http://fec2.mofcom.gov.cn/aarticle/statistic/200601/20060101340363.html>

Outward Investment Intentions” Asia Pacific Foundation of Canada. November, 2005. p11.

¹⁸ Ibid p7.

in addition to central restrictions. Public and private ownership is relevant, but I argue it is only part of the incentive structures driving integrative ODI.

We should note that not all ODI is undertaken with the profitability of the given foreign affiliate in mind. R&D investment, for example, does not necessarily lead to profits at the foreign affiliate level. However, if a firm invests abroad and loses money doing so, the investment is less integrative *if* the investment threatens to destroy the foreign affiliate and thus sever the firm's links to the host economy.

Clearly competing against domestic firms in a foreign market is an implicitly challenging proposition, and Chinese firms are not unique in finding foreign competitive environments challenging. For example, almost all foreign direct investment in the US produces a relatively lower ROI than domestic firms.²³ This is not a unique characteristic of the US market. Many foreign investors have been disappointed or bankrupted by their ventures in Russia and China due to their difficulty understanding the nature of the target market.²⁴ So why do Chinese firms continue to invest in countries where they are at a relative disadvantage?

4.3 “Pulling” ODI: the USA and the global “savings glut”

ODI, particularly the Chinese instance of it, provides interesting questions for dependency theorists. Much of dependency theory is inclined to view most foreign investment, direct or otherwise, as inherently exploitative and extractive. However, the global situation has seen a curious reversal recently, in which

the world's largest economy and military power has become a net *attractor* of investment, both direct and portfolio. Through its status as the world's reserve currency, the dollar is able to capture the productivity of billions of non-Americans, and borrow against it to sustain unprecedented levels of consumption, reinvestment in speculative housing markets/bubbles, and foreign wars.

Explanations for this phenomenon vary. Ben Bernanke, chairman of the US Federal Reserve Bank, has claimed that the rest of the world has a “savings glut” and the US economy is the only place that can absorb it.²⁵ *The Economist*, on the other hand, blames the US trade deficit on the individual American consumer's “excessive spending and inadequate saving.”²⁶ The article suggests that other countries, particularly China, indulge American consumption by maintaining export-oriented economies that serve to support social welfare schemes.

The European Union also serves as an example of nations “pulling” ODI through fiscal policy. Ireland, for example, has been singularly successful at competing with other EU members for FDI by maintaining a lower corporate tax rate. Poland recently imitated its example, to the displeasure of Germany. China itself attracts inward FDI by extending tax preference to foreign companies (more on this soon). Given that the APC-CCPIT survey discovered that many Chinese firms are motivated to escape onerous tax burdens by investing abroad, clearly we must allow for the importance of foreign government policy in attracting FDI. The Chinese state is not the only state involved. The question remains,

²³ Mataloni, Raymond J. “An Examination of the Low Rates of Return of Foreign-Owned U.S. Companies” *Survey of Current Business* National Bureau of Economic Analysis March 2000 p55

²⁴ For an engaging example, see [Mr. China](#) by Tim Clissold.

²⁵ Bernanke, Ben S. “The Global Saving Glut and the U.S. Current Account Deficit” The Sandridge Lecture, Virginia Association of Economics, Richmond, Virginia. March 10, 2005.

²⁶ “How China runs the world economy” [The Economist \(US\)](#), July 30, 2005 v376 i8437 p11US

given the attractiveness of China to foreign investors, why do the Chinese invest abroad instead of in their own country?

4.4 Pushing ODI by accident

4.4.1 Paradoxes of SOE preference

In his work “Selling China,” Yasheng Huang posits a largely negative role for *inward* FDI in the Chinese economy, which he blames on state policy. Huang believes that FDI’s preeminence in the Chinese economy is the result of “systemic and pervasive discrimination against efficient and entrepreneurial Chinese firms . . . mainly to benefit the inefficient SOEs.”

Huang’s analysis can help us understand some of the non-market political factors pushing Chinese investors outwards. Despite increasing privatization, Chinese ODI is still an area of heavy state involvement, direct and indirect, including SOEs. The largest Chinese MNCs are all state-owned, involved in oil, coal, and shipping. “The driving function of enterprises directly under the Central Government,” MOFCOM claims in a recent report, “was obvious [in 2004].”²⁷ The “driving function” may be obvious to MOFCOM. However, Huang’s critique questions the “steering function.”

Huang believes discrimination against Chinese private enterprises at home explains the preponderance of “round-trip” ODI, which is largely a legal fabrication that allows Chinese investors to invest back in the mainland by routing funds through Hong Kong.²⁸ Per

Huang, the overwhelming and unwarranted amount of FDI pouring into China is caused partly by the regulatory barriers preventing Chinese private firms from attracting domestic capital and second by local protectionism that prevents Chinese firms and individuals from investing in other parts of China. A study conducted by Qiao Liu and Geng Xiao of Hong Kong University supports this assertion; they find that Chinese private sector companies are more likely to conceal profits than SOEs and that they do so largely to overcome difficulties finding financing—yet another reason to suspect MOFCOM ODI performance data.²⁹

Favored treatment to SOEs extends to the realm of outward investment, and produces performance anomalies. The Economist, for example, explains why CNOOC was able to offer US\$2bn more than Chevron in its bid for UNOCAL:

The only reason CNOOC can do this without ruining its financial ratios and potentially crushing its own share price is that \$7 billion of the overall \$20-billion deal costs (the \$18.5 billion bid plus the assumption of some debt and a \$500m “kill” fee to Chevron if the latter is seen off) is coming via a parent entity from its ultimate owner—the government. Another \$6 billion is a loan from one of the big four state banks. Of the \$7 billion, CNOOC has to pay no interest at all on \$2.5 billion, and just 3.5% interest on the remaining \$4.5 billion, a loan that lasts for 30 years. Since a 30-year American Treasury bond currently yields 4.2%, CNOOC is borrowing more cheaply than the American government, clearly nonsense in a world of rational economics.³⁰

On the other hand, Huawei, a privately-held Chinese telecommunications firm, was

²⁷ China. Ministry of Finance. “Non-financial Overseas Direct Investment, Overseas Project Contracting, and Labor Service Cooperation Gained Satisfactory Achievement in 2004” January 11, 2004. <http://fec2.mofcom.gov.cn/aarticle/statistic/200601/20060101340363.html>

²⁸ Huang, Yasheng. *Selling China*. Cambridge University Press: New York, NY. 2003. p4

²⁹ Qiao Liu and Geng Xiao “Why Do Firms Disguise Their Profits? Theory and Evidence from China” First Draft: 31 January 2004

³⁰ “The dragon tucks in” *The Economist*. Jun 30th 2005. http://www.economist.com/business/globalexecutive/dialogue/displayStory.cfm?Story_id=4127399

originally forced to turn to expensive and nominally illegal sources to finance its initial investments in R&D centers. It was not until Huawei had already demonstrated profitability that the Chinese government decided to provide financial and regulatory support for overseas investments in R&D.³¹

Therefore surplus in China's capital account that is available for outward investment is not necessarily a sign of strength. From Huang's perspective, the scale of Chinese inward FDI, and by extension ODI, is partly a product of socialist inefficiencies, not a response to market incentives or business strategies. Huang's case against FDI, particularly FDI that invests in Chinese traditional industries and handicrafts that have no demonstrable need for foreign expertise, is compelling.

Using Huang's logic, we must account for the extent to which recent growth in Chinese outward investment from the private sector is driven by the simple need to move capital across a border for lack of access to viable local opportunities, lack of access to sufficient finance, or to escape predatory tax schemes.

4.4.2 Paradoxes of regionalism and centrifugal forces

Regionalism and decentralization play a part which must be measured. Throughout this paper I have referred to the Chinese state, and yet China has many local governments that do not act in concert with central mandates.

Yet such efforts can still be hamstrung by local governments that attempt to control or prevent investment capital from escaping their bailiwick. Even after recent streamlining reforms, outward direct investment proposals must still pass local muster. For example, the Guangxi Zhuang Autonomous region published a regulation in July 2005 in which it

asserted authority over all ODI emerging from that region and establishes a system by which applications to the central government can be intercepted by local authorities:

The Development and Reform Commission of Guangxi Zhuang Autonomous Region shall be the organ for examining and approving overseas investment projects, and shall be responsible for the examination and approval of or the examination and reporting to the high levels for examination and approval of those overseas investment projects . . . Where an investor intends to apply for the examination and approval of a project that shall be subject to the examination and approval of the National Development and Reform Commission or the State Council, he shall first submit an application report on the project to the districted-municipal development and reform department at the locality of its registration.³²

This particular instance is not illegal per se, but given the enforcement challenges the central government faces, clearly we can anticipate continued regional variation in ODI incentives driven or blocked by local governments. Such Chinese ODI may not be driven by a business strategy focused on accessing a foreign market for profits, technology, or strategic resources; its *raison d'être* is escape from state controls and barriers; its integrative nature, if any, is accidental.

Finally, local governments, and enterprises owned wholly or partially by local authorities, also invest abroad according to their own logics and incentive systems. Distinguishing between central and local incentives and barriers is therefore critical to further research. It is quite possible, for example, that some local governments may be better at encouraging "integrative" investments than the central government.

31 Dongshen Chen, Lili Liu The Truth of Huawei (Huawei Zhenxiang) Beijing: Contemporary China Press 2004. p102.

32 "Interim Measures of Guangxi Zhuang Autonomous Region for the Examination and Approval of Overseas Investment Projects" No. 34 [2005] of the People's Government of Guangxi Zhuang Autonomous Region July 20, 2005.

4.4.3 Information failure and China's ODI

An alternative view of poor ODI performance is suggested by those who believe such investments are particularly vulnerable to market failure. Wang Shaoguang is one of the best known and most clearly-spoken of these critics. He argues that international markets in particular pose information problems for firms which they rarely have the ability to solve for themselves. The imperfections of risk markets, the attraction of monopoly rents, and other various market failures render private firms incapable of operating within a neo-liberal framework. The fact that foreign firms operating in the US generally get lower returns on investment than native firms may support this theory, as does the experience many firms had playing the "incomplete risk markets" in privatizing Russia. He posits a role for the state as a sort of information-clearing house and regulator; he envisions a small space for market incentives enveloped by competent and transparent state guidance. However, Shaoguang is not actually calling for a returned to a central planned economy per se. He simply argues that "the 'optimal' range of government interventions is definitely much larger than the traditional "market failure" school recognizes."³³

There is less daylight between Huang and Shaoguang than one might suspect. Both sides of the debate over the role of the state largely agree that the Chinese state, in particular its market-regulatory institutions, need to be strengthened, not weakened.

4.4.4 Current state capacity

Unfortunately, current studies indicate that the Chinese state has had difficulty stimulating FDI spillover at home, and therefore there is

³³ Shaoguang, Wang. The Changing Role of Government. Chapter 6. Unpublished draft. February 8, 2000 [editors note: is this citable?]

reason to suspect that it may face even greater challenges abroad. In a presentation of preliminary findings from a study of foreign-invested Chinese companies, Ying Lin found that state support had no detectable effect on FDI spillover as measured by patents, or on the positive success of given firms and given sectors. Some Chinese sectors did very well in terms of FDI spillover (telecom, for example) while others performed miserably (pharmaceuticals), without any apparent correlation to state support. Nor did other factors considered to help FDI, such as "triple alliances" between MNCs, local Chinese firms, and the Chinese government, necessarily create profitability or spillover. Lin did, however, find that state management and control had a *negative* correlation with FDI spillover.³⁴ However, when a Chinese firm invests and operates abroad, how much capacity can the state have to produce negative spillover?

4.5 Market drivers of Chinese ODI

Against those who believe the state is the primary driver of FDI, for good or for bad, there are those who believe that state policy is tangential to globalizing market forces that push companies to establish global supply chains across national borders. Barry Naughton, Gary Hamilton, and Eric Thun in particular have examined the business logic behind Chinese firms operating abroad. While this perspective admits that state policy effects ODI, it is not the Prime Mover of ODI. Supporting these arguments are two studies. One working paper produced by the Asian Development bank concluded that FDI

³⁴ Ying Lin and Xun Cao. "Technological Gap, Government Policy, and Spillovers from Foreign Direct Investment (FDI): Empirical Evidence from China's Manufacturing Sector." Paper prepared for the Midwest Political Science Association (MPSA) Annual National Conference, Chicago April 20-23, 2006.

spillover in China is positively related to labor market liberalization.³⁵ Another finds that “Chinese ODI is more influenced by trade intensity with China and by the natural resource endowments of the host market”³⁶ It is important to note that “natural resource endowments” indicate an interest in traditional, not integrative, ODI. Trade intensity, on the other hand, indicates an existing revenue stream that could be improved by FDI. The integrative quality of such an investment should be dictated by the knowledge-intensity of the product.

4.5.1 The challenges of integration

“If China does *not* become a world technology power,” writes Barry Naughton, “it will not be from lack of effort on the part of the Chinese government.” Naughton has written extensively on this topic, and his insights into the political and economic institutions are critical. However, while Naughton gives the central government credit for its achievements to date, and blame for certain errors, he also allows a primary role to integrative innovations in global business structures that mold Chinese firms:

Today, processes of vertical specialization, or ‘modularity,’ have progressed further than in the past, and are beginning to transform manufacturing, services, and innovation in more profound ways. Some stages of production, services, or even research can be incorporated into modules that can be partitioned off from the rest of the value chain. The results of the work or innovation within the module can be summarized through a mutually accepted interface

standard, so that downstream firms can use the results of the previous module without knowing what went on “inside” the module. This enables firms to pursue focused strategies that rely heavily on outsourcing across the value chain. Modularization, in short, allows China to specialize in labor-intensive activities that also involve medium levels of engineering skill, which is has in abundance. These activities then provide a new pathway to technological upgrading, as design teams expand the scope of their competence.³⁷

However, opportunity does not equal capability. Eric Thun, in his study of China’s attempts to create national automobile “champions,” discusses the drawbacks of the Chinese approach. First and foremost, much of national economic growth during the reform period was in fact led by small and medium private firms and collective enterprises; the large SOEs that still hired 65% of the urban workforce in 1995 failed to provide the leadership role the Chinese government hoped. However, according to Thun, the state retained a grand vision of the SOEs. “When these policymakers were not having nightmares about the state sector,” he quips, “they were indulging in dreams of grandeur.” These visions were driven by a desire to imitate the Korean and Japanese example, and thus they pushed the SOEs overseas, qualified or not.³⁸

Given the advantage size appears to lend to firms engaging in ODI, it is likely that SOEs would have been the first out the door regardless of preference. Despite their performance problems, they retained large assets of physical and human capital. And the

³⁵Fan, Emma Xiaolin. “Technological Spillovers from Foreign Direct Investment—A Survey” Asian Development Bank ERD Working Paper No. 33. December 2002

³⁶ Buckley, Peter J., Jeremy Clegg, Adam Cross, Lui Xin, and Hinrich Voss. “Host Country Determinants of Chinese Outward Foreign Direct Investment” Centre for International Business, Leeds University Business School.

³⁷ Naughton, Barry. The Chinese Economy: from Transition to Development. Unpublished draft. October 2005. Chapter 15 “Science and Technology”. Unpaginated.

³⁸ Thun, Eric “Industrial Policy, Chinese-Style: FDI, Regulation, and Dreams of National Champions in the Auto Sector” Journal of East Asian Studies 4 (2004), 453–489

private sector still faced significant structural hurdles, including “fragmented production (and a consequent inability to capture economies of scale), uncoordinated technology transfer (and thus redundant investment), low research and development capability, weak brands, and poor overall quality.”³⁹ This research proposal should reveal the degree to which this “push” ultimately produced integrative SOEs.

4.5.2 The changing nature of the global supply chain

Gary Hamilton’s work studying the emergence of ODI from Taiwan, Hong Kong, mainland China and other emerging Asian economies posits that the first and foremost driver of Asian ODI was the global integration of supply chains caused by changes in the quality of consumer demand and the mechanisms developed by retail firms to supply this demand. Hamilton admits that both neo-liberal criticisms a la Huang and political economy critiques from those like Shaoguang have their utility, but he accuses both of being fixated on the “supply side.” His view of the evolution of Chinese market integration with the US considers the evolution of global *demand* for products that Taiwan and then China were in position to produce cheaply, and the corporate institutions and mechanisms constructed to supply it, to be the critical driving factor:

The single most important driver of China’s growth is that China has become the world’s chief site for sourcing manufactured consumer products. The most important firms that source goods from China are the large retailers and brand-name merchandisers, which are mainly located in the United States. Among the most important manufacturers in China making export consumer goods are firms owned by businesspeople from Taiwan,

Hong Kong, South Korea, and Japan, most of whom have relocated their firms to China in the last fifteen years.⁴⁰

This analysis leads informs the discussion of integrative ODI in two directions. On the one hand, Chinese integration with retail marketers is integrative to the extent that causes Chinese firms to link up to a modular global supply chain. On the other hand, it is asset-exploitative to the extent that the Chinese attraction to such retailers is based on the usage of cheap labor. Such low-end retail products are also generic—their brand is supplied by the retailer, not the producer, and as the Lenovo case will illustrate, they generate less innovative spillover. The recent proportional shift in Chinese investment away from the US towards relatively poorer economies in Asia may support an argument that China is moving up a modular yet largely asset-exploiting supply chain that serves US retailers like Wal-Mart.

However, a note of caution must be sounded. Labor is not the only factor that makes such products cheap. Management efficiency, communication, coordination, and competitiveness are all required to leverage cheap labor to acquire and retain contracts with behemoths like Wal-Mart. Such spillovers do not show up in patent applications but must be measured by the efficiency of assembly lines and delivery systems.⁴¹ Also, as Hamilton points out, such trade involves an increasingly wide range of

⁴⁰ Hamilton, Gary. “Remaking the Global Economy: U.S. Retailers and Asian Manufacturers* Hearing on “China and the Future of Globalization” U.S.—China Economic and Security Review Commission. May 19-20, 2005. http://www.uscc.gov/hearings/2005hearings/written_testimonies/05_05_19_20wrts/hamilton_gary_wrts.htm

³⁹ Naughton, Barry. The Chinese Economy: from Transition to Development. Unpublished draft. October 2005. Chapter 15 “Science and Technology”. Unpaginated.

⁴¹ However, China faces certain challenges in this area as well. According to Naughton, China continues to fail to catch up with the efficiency of Taiwanese microchip assembly lines.

products, not all of which are low-tech knick knacks. And as Chinese companies move up this chain, branding becomes more important. Lenovo, for example, is not a computer manufacturer, but rather assembles, brands, ships and supports components produced elsewhere. This might indicate an increased sophistication in the supply chain with one important caveat; thanks to problems the Chinese IT sector has had in producing efficient microchip assembly lines, Lenovo does not outsource its computer component production to other Chinese companies but rather imports such components from Taiwan!

4.5.3 Opportunity costs

The question of opportunity costs is, of course, a counterfactual, but a necessary one. “What I take issue with,” writes Yasheng Huang, “is the idea that China’s way of attracting FDI, by suppressing efficient domestic firms, is costless.” One of the costs, arguably, is encouraging premature investments abroad due to problems at home. Huang argues that had the Chinese state stimulated its private sector more, and spent less time trying to create state-controlled champions, it could have created a vibrant private domestic market populated by relatively smaller, more efficient firms. This scenario, while charming, involves another possible opportunity cost. Huang notes that larger firms are more likely to move overseas than smaller ones as “overseas investments are a high cost affair.”⁴² Thun, Hamilton, and Naughton’s respective analyses suggest that given changes in the nature of the global economy, the Chinese economy would necessarily have to produce large MNCs capable of bearing the high capital costs and risks of overseas investment if it wants to “go global.”

⁴² Huang p35.

5 The Chinese outbound investor today

As noted earlier, integrative ODI has certain characteristics evidenced most clearly by relationships between developed economies. But what does it look like at the firm level? A comparison between Boeing and Airbus is useful. Both airplane manufacturers, despite their highly publicized trade dispute, oversee vast multinational modular supply networks that provide capital and employment in both markets simultaneously. Boeing recently announced plans to develop the 787 Dreamliner using a distributed production network that spans the globe. Firms producing components will have significant latitude, within Boeing specifications, to design components as they see fit.⁴³

However, while the aggregate relationship between America and Europe is more “integrated”, individual firms from other nations still make integrative investments in other countries. Honda, for example, relocated a significant portion of its manufacturing operations to the US, its largest market and buys various components for its cars from a stable of thousands of American contract suppliers. Last month the American automobile industry announced plans to start an advertising campaign to document the fact that they employ more Americans than Honda or Toyota do. The fact that the American auto industry finds it necessary to run an expensive marketing campaign to convince American consumers that they provide more US jobs than Toyota and Honda says a great deal about the integrated nature of the automobile market.⁴⁴

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http://www.boeing.com/commercial/787family/dev_tcam.html

⁴⁴ “New car ads urge shoppers to ‘Buy American’” CNN.com May 12, 2006: 6:31 PM EDT viewed May 20, 2006

Are there Chinese examples of integrative ODI? No Chinese company is involved with the Dreamliner, and the outcome of China's SOE-driven joint venture with Brazilian airline manufacturer Embraer is uncertain. Airbus recently announced plans to invest in a manufacturing plant in China to build the A320 aircraft, but the nature of the investment is very different from Boeing's. First, the alleged reason for the investment is to leverage "low labor costs, the promise of free land, and the prospect that Airbus' investment could spark more Chinese orders," BusinessWeek notes that "wings, fuselages, and other components would still be made at Airbus' European factories and shipped to China for assembly."⁴⁵ Airbus estimates that just 5% of the plane's components will be produced by Chinese companies, comprising of exit doors and engine mounts. In contrast, 40% of the development costs of the Dreamliner will be borne by Japanese companies who will produce the components, and there are many other national companies in the development mix.

Nevertheless, we can posit a few Chinese examples. They are not as sophisticated or as integrated as Boeing, but they may well be precursors of a new quality of Chinese ODI.

5.1 Huawei

Huawei, the privately held telecom network component manufacturer, created a distributed network of international R&D centers despite an original lack of government support. Following a large success in penetrating the low end of the Chinese telecom market, Huawei was sued by Cisco systems for patent infringement. Cisco

http://money.cnn.com/2006/05/12/news/companies/buy_american/

⁴⁵ "Airbus May Hit an Air Pocket Over China" BusinessWeek online www.businessweek.com April 26, 2006

http://www.businessweek.com/magazine/content/06_17/b3981058.htm

subsequently suspended the suit in exchange for an unspecified settlement. The suit does not appear to have crippled Huawei; one can speculate endlessly about Cisco's motives, or what it received in exchange in the settlement. Regardless, we should note that the lawsuit also involved two existing US subsidiaries of Huawei, and that Huawei went on to sign a joint venture pact with 3M.⁴⁶ Huawei's website promotes FutureWei, a US subsidiary in Texas, and paints a glowing picture of increasing integration with American and European partners. More importantly the website solicits value-added alliance partners to provide mobile media services for 3G networking. As a would-be telecom giant, Huawei has little choice but to integrate and compete. The question remains, if Huawei did not need state ownership, management, or loans to succeed in the first place, what role did the ensuing jump-on-the-bandwagon ODI support provided by the state play?

5.2 Haier

Haier, a large appliance manufacturer, has also successfully penetrated the American market, recently constructing a US\$40m manufacturing facility in Camden, South Carolina. Haier's decision also makes perfect business sense; assembled appliances are large and expensive to ship, whereas the internal components can be built in China and assembled in an attractive and vulnerable target market. Haier also made US\$1.3bn offer for Maytag, then withdrew the offer in what the Washington Post called "a rare sign of caution" once Whirlpool and Ripplewood Holdings entered the bidding.⁴⁷

⁴⁶ "Huawei, Cisco settle IPR dispute" China Daily/Agencies Updated: 2004-07-30 00:41 http://www.chinadaily.com.cn/english/doc/2004-07/30/content_353070.htm

⁴⁷ Goodman, Peter S. and Ben White "Haier Withdraws Maytag Bid: Move Is Sign of Caution in China's Pursuit of Foreign Firms" Wednesday, July 20, 2005. Page D02

Given our understanding of integrativeness, we would consider Haier's investment strategy as integrative, in that it is driven by a desire to access the US market, but the product itself is less so. Washing machines are not particularly innovative, nor is there much demand to reinvent the washing machine. However, this stereotype aside, Haier can still innovate in other ways to increase efficiency, drive down costs, and establish a more streamlined value chain. And of course not all simple products must remain low-tech; look at the bicycle industry.

Also, Haier's challenge in the US market is an intellectual property one. It must establish a marketing presence and a brand name. As press releases on its websites show, Haier clearly believes integrativeness sells: "It is very good," says one press release, "that Haier pursues diversified, human oriented innovation ideas!"⁴⁸

5.3 Lenovo

In terms of acquisitions, Lenovo's acquisition of IBM's personal computer division stands out as relatively successful; much of this paper was authored on a Lenovo laptop assembled in China and shipped to my doorstep from a Hong Kong transshipment center.

Interestingly enough, although Lenovo's purchase of IBM's personal computer sector included permission to continue using the IBM brand name for five years, Lenovo has recently decided to jettison the IBM brand and start building the Lenovo brand in the US.⁴⁹ So Lenovo is an example of both strength and weakness in Chinese ODI. On the one hand, Lenovo is confident (or foolish) enough to attempt to establish a Chinese personal computer brand in the US market.

⁴⁸ <http://www.haier.com/news/view.asp?newsid=816>

⁴⁹ Rifkin, Glenn and Jenna Smith. "Quickly Erasing 'I' and 'B' and 'M'" The New York Times. April 12, 2006, Wednesday. Late Edition - Final, Section C, Page 9, Column 4.

On the other, Lenovo is not a technology innovator per se; it leaves the high-tech production components to Taiwan. Whether this relationship will produce more spillover, and of what kind, remains a question.

5.4 Surveys of Chinese investors

While there are limits to the reliability of voluntary data, there is nevertheless utility in data about the perceptions and intentions of Chinese investors. The APC-CCPIT survey investigated both firms currently engaged in ODI, those inclined to consider it, and those not so inclined. The study designers consider their survey sample indicative of the Chinese economy's industrial, regional, and ownership mix. The survey reveals the following salient facts about Chinese ODI:

- Respondents indicated that their top three motives for engaging in ODI were 1) business expansion 2) **"security of investment"** and 3) **tax regime**. Government assistance was the 8th most important motive, and followed after factors like "membership in regional free trade agreement" and importance of the target market as a motive.
- The most common field of activity for Chinese ODI firms is **trade, including import and export**, followed by manufacturing, and then resource extraction, in that order.
- The most attractive market for future Chinese ODI is **Asia, followed by the US** and then Europe.
- **Regional differences** were significant. Out of 296 surveyed companies, 31 Guangdong firms provided 34.9% of the total ODI. The Shanghai-Pudong region provided another 22%.
- Most of the companies are either entirely or **predominantly owned by**

Chinese nationals (27% and 60%, respectively).

- **Publicly-traded companies** are the most enthusiastic about engaging in future outbound investment. Otherwise the survey detected no correlation between ownership structure and enthusiasm for ODI. “The percentages indicating an expected increase in ODI for publicly owned companies escalate from 22% in 12-months to 62% in 2-5-years. All other types of companies, including SOEs, only increase from around the 20% range to the 35% range. Also, publicly owned companies record the largest decline of no ODI intention, and the percentages indicating no expected ODI drop from 58% to only 10%.”⁵⁰
- 60% of the survey respondent’s current ODI is through **joint venture**.

A preliminary presentation of findings from a more recent survey, conducted by the World Bank’s Foreign Investment Advisory Services (FIAS), roughly coordinates with APC-CCPIT’s findings. However, there are some critical differences which must be explored. First, the FIAS survey did not survey tax factors as motivation for ODI. However, while the top three motives listed for ODI were market oriented (“market seeking,” “strategic assets,” and “competitive strategy,” respectively), the fourth most important factor was “domestic government support.” In this survey, only 35% of respondents indicated an interest in natural resource endowments of the host country.

What did such firms mean by domestic government support? The same firms held that the greatest obstacles to ODI were domestic political and administrative barriers, the greatest of which was foreign exchange

barriers, followed by application time, and limited sources of financing.

Interestingly enough, what these firms wanted from the government is not simply limited to the elimination of paperwork and cheap money. In addition to streamlining application processes, making the requirements more transparent, 49% of respondents wanted the government to organize outwards investment fairs, and 34% wanted the government to provide more information on the host countries markets and regulatory environments. Respondents also wanted the government to provide assistance negotiating with foreign governments to provide investment guarantees and engaging in bilateral trade negotiations.⁵¹

6 Selected indicators and variables

6.1 The challenge of aggregate data

It is impossible to draw any conclusions about causation or correlation from aggregate data. However, aggregate data is important and relevant to state policy, and therefore will be correlated and compared with the firm level findings from the proposed research. However, at the time the aggregate data is challenged as to its quality. Figures provided by the Chinese Ministry of Finance (MOFCOM) are questioned by analysts as they diverge widely from Balance of Payments data and other statistics employed by UNCTAD and other analysis agencies to describe ODI flows. According to Sarah Chan and John Wong, MOFCOM statistics “significantly underestimate the actual

⁵⁰ APC-CCPIT p21.

⁵¹ Battat, Joseph “China’s Outward Foreign Direct Investment: FIAS/MIGA Firm Survey” World Bank Foreign Investment Advisory Group. viewed April 13, 2006
http://rru.worldbank.org/Documents/PSDForum/2006/joe_battat.pdf

investment figures as they include only 'non-trade' capital movements related mainly to manufacturing and natural resources investments while excluding several key sources of financial capital movements, particularly those channeled through countries like Hong Kong.” During the Asian financial crisis of 1997, such “missing” ODI accounted for US\$22bn.⁵²

Likewise my survey of the literature reveals a widespread suspicion that MOFCOM data on Chinese ODI performance, despite the relatively grim picture it paints of ODI underperformance, must likewise be suspected. MOFCOM, the State Administration for Foreign Exchange (SAFE), NRDC and the national auditing office simply do not have the resources or authority to adequately assess ODI performance by firms, state-owned or otherwise, who have both the ability and motive to under- or over-represent their respective returns on outward investments, depending on incentives and legality. It is important to note that the capabilities of all these agencies are in flux. The National Auditing Office in particular has become adroit at making its castigatory annual reports into media events.

6.2 Firm level survey data strategy

That said, firm level data can be surveyed and will be meaningful regardless of aggregate data quality. Most helpful is the relatively small size of the sample. The number of Chinese companies investing abroad is estimated by MOFCOM to be around 5000. Even assuming a significant margin of error in this estimate, a relatively accessible sample of respondents from CCPIT members should provide meaningful results. The data exists,

⁵² Chan, Sarah and John Wong “China’s Outward Direct Investment: Expanding Worldwide” *China: An International Journal* 1, 2 (SEP. 2003): p277. To be clear, Chan and Wong do not attribute the entirety of the errors and omissions line item to unrecorded ODI.

but the data not exposed by publicly-held and reliably audited firms must be voluntary. Thus the provision of anonymity and security will be key for certain data.

Statistically significant numbers of firms will be surveyed according to the presence or absence of given political variables, particularly according to degree & quality of state ownership, degree and quality of state management, and the amount of financing provided by state banks.

6.3 Independent variables

Based on the definitions, literature, and statistics cited earlier in the paper, I propose the following variables for analyzing the relationship between the state and integrative ODI.

6.3.1 Business variables

1. **Knowledge intensity:** what ratio of the product requires knowledge as opposed to raw resources in the form of goods or physical labor?
 - a. What is the relative knowledge intensity of the business sector or activity?
2. **Host country:**
 - a. What is the relative technological sophistication of the host country compared to the source country?
 - b. What was the firms trade intensity with the host country prior to investment? I.e. was the firm already selling into the host country market prior to investing there?
3. **Ownership class**
 - a. **Public versus private holding:** is the firm publicly traded?
 - i. Domestic market?

- ii. Host country market(s)?
 - b. Joint venture
 - i. SOE-FIE
 - ii. Private-FIE
 - c. Pure state owned
 - d. Pure private
 - e. Collective
 - f. Other hybrid
- 4. **ROI:** what is the firm's return on the given outward investment and how is it generated?
 - a. Percentage of companies' gross revenues produced by foreign affiliate.
- 5. **Foreign affiliate sales:** How much do foreign affiliate sales contribute to the ROI?
- 6. **Form of investment:** Greenfield, M&A, or JV?
- 7. **Reinvestment:** what proportion of the outward earnings are reinvested abroad?
- 8. **Intellectual property**
 - a. Patent productivity: does the ODI venture produce patent applications in the host country and/or in the home country?
 - b. Is the product trademarked or copyrighted?
 - i. In the host country?
 - ii. In the home country?
- 9. **Intra-firm:** what ratio of the firm's imports and exports are between firm affiliates?
- 10. **Intra-industrial:** how much of the firm's imports and exports are intra-industrial?

- a. Modularity: Is the product part of a modular global supply chain? Is it a "re-usable" component?
- 11. Is the product component relatively similar in value to other components in the value chain (i.e. a software module) versus being much more or less valuable than other components in the product (i.e. the exit door to an airplane?).
- 12. Does the firm have investments in other foreign firms in the value/product chain?
- 13. **Intentions- business:** what does the firm cite as the primary reason for investing abroad?
 - a. Market-seeking
 - b. R&D
 - c. Trade barriers: Is the firm using FDI to cross an import/export barrier?

6.3.2 Political variables

These indicators must be correlated with the quantity and quality of state investment and control of a given firm, according to the following indicators:

1. **Degree of state investment:** What % of the firm is owned by government entities?
 - a. **Central versus local investment:** Is the firm owned by central, local, or a mixture of government entities?
2. **Degree of state management:** Is management hired according to business experience or political considerations?
 - a. Of management staff, what is the ratio of employment experience within the private

sector compared to the state sector?

3. State financing

- a. Did the firm use state-provided financing or other state incentives to support the firm engaging in ODI?
 - i. Was such financing provided prior to or after the firm invested abroad? In short, to what degree was the decision driven by the availability of capital as opposed to a business requirement to expand into the given foreign market?
- b. Did the firm use private financing to engage in ODI, and if so, what was its source and what were its costs relative to the size of the investment?
- c. What was the % mixture of state/private financing?

4. Host country- political

- a. Is the host country a WTO member?
 - i. Did the state lobby on behalf of the firm in a WTO dispute process?
- b. Does the host country have a bilateral agreement with China?

5. Intentions- politics: what political factors encouraged or discouraged firm ODI decision?

- a. Better fiscal policy
 - i. Escaping local tax regime
 - ii. Escaping central tax regime

- b. Government encouragement
 - i. loans
 - ii. non-financial
- c. Government discouragement
 - i. Local protection preventing domestic investment
 - ii. Foreign competition receiving preferential incentives discouraging domestic investment

7 Conclusion

7.1 Hypotheses

From the literature cited, the statistics exposed, and the case studies, I propose a few tentative hypotheses this study should explore.

First, it is clear that policies produced by the central government can stimulate aggregate ODI. It can do so both through active policy and through policy failures.

The first blunt incentive is tax. The combination of fiscal incentives and the failure of the central state to rationalize or synchronize local taxation schemes to prevent undue fiscal burdens on companies clearly pushes companies outwards, as the APC-CCPIT study shows. However, there is no reason to believe that companies which invest abroad in order to find more advantageous tax schemes are necessarily more “integrative” than any other. Therefore the taxation variable should have no correlation with the integrative quality of the investment.

The second blunt incentive is financing. This is a more complex variable. As we have noted, going abroad is an expensive, capital-intensive process. As the FIAS survey notes, Chinese investors consider lack of capital access a

significant barrier to investing abroad. Until recently, the cost of capital for China's private sector has been disproportionately expensive, and the cost for the SOEs disproportionately cheap. However, asset-exploiting traditional direct investments can demand as much or more capital as integrative investments do, as the size of global oil companies illustrates. Whether integrative supply chains have an intrinsic dependence on large capital infusions remains a question. Software development, for example, does not require sophisticated facilities and other physical capital. However, the human capital it demands is relatively expensive compared to manufacturing labor.

However, a critical part of our "integrative" definition is the need for integrated firms to have multinational stakeholders. This precise quality makes state ownership less critical, not more. The Chinese case is particularly complex here. A purely private company, held entirely by Chinese individuals, may be less "integrative" than a foreign-invested SOE, depending on sector, product, and management experience in the target market. Therefore my hypothesis is that in this area too we will find no little or correlation between access to state financing and integrative investment.

The remaining areas of state influence are more subtle. It remains an open question whether a politicized management structure would be more or less likely to encourage a firm to employ asset-augmenting investment strategies. Given the domestic performance of Chinese SOEs, one might suspect that management would be inclined towards mercantilist, traditional trade strategies in which the firms tries to profit by transferring more physical assets to themselves, and erecting expensive, prestige projects that awe onlookers. One recalls a communist-era East German joke in which state managers brag about building the world's largest computer.

But this may be unfair. As noted earlier, "asset-exploiting" investment is not obsolete

or unnecessary, and while it may require less human capital on the ground floor, when it involves massive transportation logistics, it requires a degree of sophistication not all firms from developing nations can easily acquire. It takes management competence and sophisticated communications to efficiently transfer assets like oil across the Pacific, and China cannot provide favored political appointees much protection against giants like Chevron and Exxon. And China's relatively successful navigation of the challenges of managing economic growth in the context of giant, fumbling SOEs indicates that it may have a much better grasp of their management than their critics suspect.

Nor does the Chinese private sector, composed as it is of small and medium-sized firms, have much experience in dealing with foreign economies. Chinese investors want the Chinese government to provide the services that Wang Shaoguang advocates; information on target markets, lobbying of foreign governments, and other informational and risk-reducing assistance. The more integrative an investment is, the more of this sort of information it requires. On an anecdotal basis it appears that many Chinese companies, public and private, enter foreign markets without adequate information. For an example, take this post on the China Law Blog:

I am convinced it is cultural misunderstandings on the part of the Chinese companies to think they can invest abroad without any assistance from tax consultants. I can speak from our own experiences in dealing with Chinese companies coming to the United States to invest. We so far have had almost no success in getting Chinese companies to pay us minimal amounts to assist them in forming their companies here, reviewing their contracts, and hooking them up with international accountants. However, we have had a lot of success in representing Chinese companies on work (usually referred to us by Chinese lawyers) involving cleaning up their malformed companies, working with accountants to remedy their tax problems, and working to try to resolve contractual conflicts

that arose from poorly drafted contracts. I see this as the equivalent of preferring to buy a new car engine every few years rather than paying to have the oil changed every 3,000 miles/5,000 kilometers.⁵³

Obviously if the Chinese government could provide such information to Chinese firms at a lesser cost than American legal firms, Chinese firms would benefit. And I would posit that integrative investments, given the complexity of the relationships and knowledge posited, particularly demand such informational services. Measuring the information services provided by the Chinese government is a key, but challenging part of the research design. I would hypothesize that this class of government support will be positively associated with integrativeness.

7.2 Ramifications

What would the demonstration of these hypotheses, or the disproof thereof, tell us about China, about outbound investment, about market integration, and about developing economies? Without reaching too far into the meta, I will make a few suggestions.

First, one need not accept integrativeness as a good thing. There are many reasons to distrust the trend, depending on one's values and one's goals. For one, for the time being direct investment, including outward direct investment, is produced and managed by large multinationals. Is an integrative MNC necessarily more benign than an asset-exploiting MNC? Given the recent experience the US has had with software firms outsourcing engineering, quality assurance, and technical support to India, it may be premature to assume that modularity, in and of itself, reduces friction. An even better example of the political and social tensions

unleashed by this philosophy of investment can be seen in the European Union, where internal debates over the liberalizations are heated. For example, clearly the French do not believe that integrativeness means they should allow German and American businesses to acquire French national champions. Many Western Europeans are quite nervous about opening their labor markets to the infamous "Polish plumber," much less a Turkish one. The EU demonstrates that market integration requires a degree of political integration. It also demonstrates that such integration is not without its costs.

Nevertheless, regardless of one's valorization of the quality, clearly there is a case for measuring it. If one values Chinese economic sovereignty for reasons economic, political, or emotional, one should object to policies that produce integrative ODI, since true integration with other markets, other firms, and other political structures and regulatory environments implicitly involves a loss of state control. If one believes, as Wang Shaoguang does, that the first and foremost task of the government is to produce "social equity," then China should spend far more money on internal transfers before dedicating it to expensive outbound investments that disproportionately benefit the very sectors of Chinese business, society, and geography that have already benefited disproportionately from the boom.

Should my hypotheses prove correct, the most effective role of the Chinese state in encouraging integrative ODI is to serve as an information clearinghouse and advocate to other governments and treaty organizations. Its relationship to Chinese businesses engaging in ODI would be contractual, not based on an ideological or national mandate.

On the other hand, one must question what alternative China has, and what it really wants in the long run, before pushing for a return to/maintenance of intrusive state

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http://www.chinalawblog.com/chinalawblog/2006/05/the_chinese_are.html

management of businesses that have already demonstrably failed to produce internal coherence, social equity, or global competitiveness on any level, including military. If China is not to produce integrative ODI, what will it produce? Autarky is not an option. Nor is some non-Malthusian reduction of Chinese demand. It is difficult to imagine a greater human disaster than a modern, mechanized war between China and the US over access to raw materials or other mercantilist trade disputes. If we accept the premise of the European Union, as founded in a strategic integration of the French and German coal industries, that such transnational corporate integrations reduce political frictions, then clearly a nationalist, traditional mercantilist trade strategy is an enormous risk, and pushing such a strategy outwards even more so.

Direct investment, of whatever quality, cannot bear the entire hopes of the nation for increased modernization, improved standards of living, and a national pride that no longer roots itself in remembrances of past humiliations. If we believe that a company like Haier or Huawei or Lenovo has the capability to give Chinese persons pride in their national achievements by proving that they can compete and innovate in the global marketplace, provide jobs to Chinese managers, and put foreign employees under their command, then perhaps this is an arena more worthy of attention than planning a trip, say, to the moon.

8 Statistical annex

8.1 Chinese ODI by regional origin

Province/Municipality	Number of Companies	% of Total	Accumulated ODI by 2004 (US\$M)	% of Total China ODI
Hunan	108	36.5	15.45	0.4
Fujian (Xiamen)	64	21.6	165.02	3.7
Shanghai (Pudong)	55	18.6	981.55	22.3
Guangdong	31	10.5	1,539.97	34.9
Heilongjiang (Harbin)	22	7.4	79.55	1.8
Shandong (Qingdao)	7	2.4	376.38	8.5
Liaoning	5	1.7	53.87	1.2
Undefined	4	1.4		
Total sample	296	100	3,211.79	72.9
Total China			4,408.58	100

8.2 Selected National FDI stocks as percentage of GDP

Selected FDI Stocks as percentage of GDP
source: UNCTAD World Investment Report 2005 Annex B3

