

What Motivates Chinese Firms to Invest in Asia? Analysis Based on Dunning's OLI Framework

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Abstract:

This study aims to show the pattern of and magnitude of China's outward foreign direct investment (OFDI) in Asia and respond to an important question: what motivates the remarkable surge in Chinese FDI influx to Asia in recent time? This study will enable policy makers to frame and execute policies to attract further Chinese FDI in future. Our results are based on the panel data of 37 Asian economies over the period 2003 to 2012. Random Effects (RE) method with cluster command is adopted for estimation of models after conducting the Breusch-Pagan LM-test. Our findings revealed that market seeking is the prime motives for Chinese FDI in Asia as GDP and openness to the trade have a positive and significant relationship with Chinese FDI. We did not capture consistent results for resource seeking FDI. Chinese FDI is deterred by inflation, providing an evidence for efficiency seeking FDI. Among the control variables, infrastructural development and bilateral trade are highly influenced by Chinese FDI, while political stability being a key institutional variable is significant but negatively associated with FDI. Policies and Economic strategies should aim at liberalizing trade structure, reducing macroeconomic instability and the provision of better infrastructural facilities to attract further Chinese FDI in Asia.

Keywords: Chinese FDI, Market seeking FDI, Random effect, Asia

1. Introduction

Since the commencement of economic reforms in 1978, The People's Republic of China (henceforth: China) has emerged as a substantial contributor to the movement of capital all over the world¹. China, traditionally being a host country is remarkably acting as a source country for outward FDI since last decade. Over the years, inward FDI has extensively contributed to incredible economic achievements and rightly so considered as an important propelling factor in the process of economic growth and development in China (Kamal et al., 2014). In contrast, Chinese OFDI was generally discouraged and restricted by the central authorities until 2002, when the leadership realized and launched a new strategy to support and encourage Chinese firms to invest abroad. After accession to WTO in 2001 and in pursuit of "Going Global" strategy, China has consistently been able to invest overseas despite financial crisis 2008-09.

Some distinct features are associated with location choice of Chinese FDI as there is a drastic change in the geographical distribution of Chinese OFDI over the time. There is a common perception that China's OFDI has been dominated by two kinds of motivations: resource seeking FDI in Africa e.g. (Alden and Davies, 2006) and acquisition of companies by Chinese firms in developed countries e.g. (Deng, 2009), however, such emphasis have concealed the fact that bulk of Chinese FDI remains within Asian region. For instance, Asia is getting a substantial share of China's OFDI as it has increased from 16% (1991) to 73.8% in (2012). In 2012, China's OFDI in Asia reached an appreciable amount of \$ 64.785 billion, with an annual growth rate of 42.4%². This gradual increase in Chinese FDI is providing momentum to the economic growth of Asian economies to certain extent.

This study contributes to the existing literature in various ways. Firstly, this study explores the location factors influencing Chinese firms' venture in Asia by considering economic along with institutional factors. Secondly, to best of our knowledge, this is the first study to explore Chinese investment motivations by taking a large panel data set of 37 Asian countries and a relatively large period of time. Lastly, this study aims at examining the factors that influence FDI in Asia, enabling us to propose some measures and policies to promote and attract more FDI from China on the continent.

The remainder of the paper is structured as follows. Section 2 presents the theoretical foundation and hypotheses development. Section 3 discusses the data, model specification and econometric methodology. Section 4 contains the main findings of the empirical model, their analyses and assessments and last section offers the conclusion of the study.

¹ In this research study, the term China refers to the People's Republic of China (PRC). Therefore, for this study PRC excludes the special autonomous regions (SAR) of Hong Kong (SAR) and Macau (SAR).

² 2012 Statistical Bulletin of China's Outward Foreign Direct Investment

2. Hypotheses Development and Literature Review

2.1 Market seeking FDI

Market seeking motivation is one of the primary objective of MNEs and highly sensitive to a little variation in the host country's investment environment (Chakrabarti, 2001). Host country's market size influences the FDI location choice significantly, thus have a strong positive relationship with FDI inflow (Bevan and Estrin, 2004). In the case of a market seeking OFDI, Firms seeks new markets through horizontal expansion or secure the existing market position through economic relationship (Buckley et al., 2007a). On the other hand, defensive market seeking OFDI is utilized when a foreign country levies certain restrictions like tariff and import quotas or in case a firm desire to provide better facilities and services to their customers by establishing a foreign unit adjacent to its local customers (Wang, 2012). However, in the case of China, offensive motives dominate the most (Taylor, 2002, Zhang, 2003, Deng, 2004). Host countries' market and economic growth also attract Chinese FDI substantially by providing extensive profit making opportunities. China in recent years is more integrated with rest of the world, following a liberalize economic policy which has created a competitive environment for firms in the home market, therefore, firms seeks market oriented OFDI in foreign markets due to diminishing profits in home markets (Taylor, 2002, Woetzel, 2003). In addition, firms search foreign markets for the sake of brand name and larger market share (Cheng and Stough, 2007). Thus, market size and growth has a significant role in Chinese firms' decisions for OFDI.

China is performing FDI in more open host countries, which is quite in line with the theory of international business. According to the theory, countries which are more appropriate to the global trade and investment pattern, ultimately will attract more foreign investment (Vernon, 1966). China is making substantial investment and trade activities in offshore destinations merely because of trade barriers in host countries like a tariff, import quotas for Chinese exports (Taylor, 2002). These locations are used to serve other markets particularly US and EU. Thus, the ability to export and competitiveness reflects the openness of the market of a host nation, is an essential factor and have a positive relationship with Chinese FDI.

Hypothesis 1a: Chinese Firm's FDI location choice is associated positively with the host country's market size.

Hypothesis 1b: Chinese Firm's FDI location choice is positively associated with the market growth of the host country.

Hypothesis 1c: Chinese Firm's FDI location choice is positively associated with market openness of the host country.

2.2 Natural Resource Seeking FDI

As the Chinese economy is growing, therefore, it is essential to acquire and ensure the supply of scarce inputs (Dunning, 1993). In order to secure natural resources, the Chinese government poured in substantial OFDI in different locations (Gang, 1992, Zhan, 1995). Key locations to seek natural resources include Africa, Australia, Middle East, Latin America, Asia, Canada, and Russia (Gao, 2009), while main segments include minerals, petroleum, timber and fisheries where China has lower per capita availability (Cai, 1999, Wu and Sia, 2002). The theory of internalization also supports the utilization of natural resources on the basis of control of equity (Buckley and Casson, 1976). Some of the acquisitions by Chinese firms also provide evidence for the quest of such motive (Deng, 2004) e.g. China National Petroleum Corp. (CNPC) acquired Canada based Petro Kazakhstan in 2005 and EnCana's (Canada) oil assets in Ecuador.

Hypothesis 2: Chinese Firm's FDI location choice is positively associated with endowments of natural resources of the host country.

2.3 Efficiency seeking FDI

Firms undertake efficiency seeking OFDI having a comparative advantage in economies of scale or to acquire cheap factors (input and labor) for their production activities globally (Dunning, 2001). In theory of international business, efficiency seeking approach has been explained in term of difference in cost associated with business dealings in the home and foreign markets (Vernon, 1966), thus locations which provide the opportunity of low labor cost will certainly attract more FDI (Sethi et al., 2003). According to some scholars and economists, there is a minute incentive for Chinese firms to carry production activities abroad with such motive, chiefly because Chinese domestic market offers plenty of labor with low cost, land and other necessary inputs i.e. raw material (Deng, 2004, Deng, 2007). Thus, it is quite economical to produce domestically with available low cost labor, especially at coastal regions of the country. It is argued that efficiency oriented FDI may not be the prime objective for Chinese investing firms in abroad (Buckley et al., 2008b). However in recent time, this motive is quite relevant to Chinese FDI, as the cost of production in the domestic market is rising persistently, and according to some estimations, the labor cost will raise by 30% to 50% in upcoming 3 to 5 years (Wei, 2010). We have used GDP per capita to capture efficiency seeking motive as data is not available for wages in Asian economies. Countries having low GDPP may indicate low labor cost rather purchasing power of consumers (Rodríguez and Bustillo, 2011). Inflation is used as the second variable to capture efficiency seeking motivation

of Chinese FDI. Inflation shows macroeconomic instability, cost of production in host countries and inflicts a risk to firms operating in the economy.

Hypothesis 3 (a): Chinese firm's FDI location choice is negatively associated with GDPP in the host country.

Hypothesis 3 (b): Chinese firm's FDI location choice is negatively associated with the inflation rate in the host country.

3. Variables, Methodology and Data

This chapter outlines the model specification and econometrics methods used for empirical analysis. Then, we proceed with model selection, description of data sources and variables used for determinants and motivations of Chinese FDI in Asia.

3.1 Model Specification

The following model for estimation of results will be used

$$OFDI_{it} = \beta_0 + \beta_1 X_{it} + \beta_2 Z_{it} + \gamma_t + \eta_i + v_{it}$$

Where, $OFDI_{it}$ is China's FDI in country "i" in time "t" and X_{it} represent Dunning's four variables for motivations of china's OFDI. Z_{it} represents set of control variables (gravity variable, institutional variables, trade variables, macroeconomic variable, infrastructure and human capital variable). η_i represents unobserved country effects that is constant over time, while γ_t is an unobserved period effect which is common across countries. Finally v_{it} is a component that varies across countries and time.

On the basis of theoretical framework discussed above and the structure of the Asian economies as well as the distinct characteristics of China's FDI inflows to Asia, we have proposed and used the following model for estimating the determinants of FDI in the region.

$$\ln OFDI = \alpha + \beta_1 \ln(\text{Investment Ret}) + \beta_2 \ln(\text{Inflation}) + \beta_3 \ln(\text{Natural Res}) + \beta_4 \ln(\text{Financial Dev}) + \beta_5 \ln(\text{Political Stab}) + \beta_6 \ln(\text{Corruption}) + \beta_7 \ln(\text{Infrastructure}) + \beta_8 \ln(\text{Bilateral Trade}) + \beta_9 \ln(\text{GDP Growth Rate}) + \beta_{10} \ln(\text{Openness}) + \epsilon_{it} \dots \dots \dots (1)$$

where:-

- OFDI denotes China's Annual OFDI stock in Asian economies.
- Investment Ret is profitability of investment (log of inverse of GDPP is used as proxy).
- Inflation is annual consumer prices (%).
- Natural Res is Resource endowment rate (annual ratio of ores and metals to total merchandise export).
- Financial Development is proxied by domestic credit to private sector by banks (% of GDP).
- Political Stab is political stability index from 0 to 10 (0= higher political stability, 10= least political stability)
- Corruption is indexed for corruption from 0 to 10 (0= No corruption, 10= highest corruption)
- Infrastructure is telephone lines per 100 people.
- Bilateral trade is annual volume of trade between China and host country.
- GDP growth rate is annual gross domestic product growth in percentage.
- Openness is trade openness in host country (trade % of GDP)

3.2 Methodology

3.2.1 Model Selection

The data set used for the empirical analysis consists of a panel of overall 37 countries and for the period 2003-2012. The data contains more entities and few time periods, so there is slight variation over the time in independent variables included in the model for panel analysis. Therefore, we are using linear estimation methods i.e. Pooled OLS and RE. We did not apply the fixed effects (FE) method as the time span (2003-2012) for our analysis is short, while the number of countries (37) is relatively large, thus within effects are limited which proposes not to use FE method. Pooled OLS assumes homogeneity for all entities, while RE method, based on Generalized Least Squares (GLS) estimator that takes into account time series as well as the cross-sectional dimensions of the data treats the intercepts as random variables across the pooled member entities.

3.2.2 Random Effects Method or Pooled OLS (Breusch-Pagan Lagrange Multiplier (LM) Test)

The Breusch-Pagan LM test is conducted to make choice between Random effects method and pooled OLS for estimation of the model. For the same purpose we devise the null hypothesis that the pooled OLS estimation method is appropriate against the alternative hypothesis of random effects method . The specific hypothesis can be written as:-

Ho: $\sigma_T = 0$ (pooled OLS is appropriated)

Ha: $\sigma_T \neq 0$ (RE method is appropriate)

If the probability of LM-test is more than 5%, we accept Ho against the alternative hypothesis Ha i.e. Pooled OLS is appropriated method to estimate the data and vice versa.

3.2.3 Data Sources

Annual Data on China's FDI stock in the host Asian countries is collected from "2012 Statistical Bulletin of China's Outward Foreign Direct Investment" jointly issued by National Bureau of Statistics, Ministry of Commerce and the Administration of Foreign Exchange of the People's Republic of China. Annual data on investment return, inflation, natural resources, financial development, infrastructure, GDP growth rate and Trade openness are collected from World Development Indicators (2014). Data on political stability¹ and corruption index² is collected from Worldwide Governance Indicators (WGI). Data on Bilateral trade proxied by annual volume China's export and import is calculated from China Statistical yearbook (2013), National Bureau of Statistics of China.

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4. Results and Discussion

In the current section of the chapter, we considered all 37 Asian countries to discover motivational factors influencing Chinese FDI in the region. On the similar pattern in the previous chapter, panel data technique is used for the empirical analysis over the period from 2003 to 2012. For such purpose, RE method with cluster command is adopted for estimation of models after conducting the Breusch-Pagan LM test. The probability value of the test for each regression model has been mentioned in table 5-3. VIF test to diagnose the problem of multicollinearity among the variables is conducted for each model and the mean values of VIF test have been reported at the lower part of table 5-3. The mean value for each regression model is quite low, indicating that there is no problem of multicollinearity. Table 5-2 presents the mean, standard deviation, minimum and maximum values of all the variables included in the analysis. The average value of GDP, GDP per growth rate and GDP per capita show tendency towards their respective max value. The maximum spread in the mean value has been observed for fuel endowment variable.

Table 5-2: Descriptive analysis of the whole sample

Variable	Mean	S.D	Min	Max
FDI	4.48	2.76	-4.61	12.63
GDP	11.39	1.58	7.37	15.29
GDP growth rate	1.65	0.75	-2.56	3.99
GDP per capita	8.24	1.51	5.72	11.02
Bilateral trade	8.90	1.74	4.85	12.74
Trade openness	4.51	0.58	3.40	6.11
Fuel endowment	1.71	3.30	-14.04	4.60
Natural resources	0.27	1.98	-7.54	4.25
Inflation	1.55	1.00	-2.85	3.97
Infrastructure	2.55	1.41	-1.81	4.48
Political stability	1.44	0.59	-4.04	2.09
Corruption	1.48	0.36	0.62	2.29

In order to investigate the motivations of Chinese FDI in the whole sample of 37 countries, Table 5-3 presents the empirical estimation results in 07 different models. Market size (GDP) used as a proxy for market seeking hypothesis, is positively related to Chinese FDI and highly significant. Chinese investment is attracted to the host countries' markets with the larger size. This result is consistent with already concluded studies (Buckley et al., 2007a, Cheung and Qian, 2009, Cheng and Ma, 2007, Hurst, 2011). GDP growth rate which shows the market potential of the host country is although positively related with Chinese FDI but insignificant in the analysis. Trade openness which shows host country policy towards international capital movement and trade relationship is also positively associated with Chinese FDI and mostly significant. The highest magnitude for the variable is 2.25, which shows its importance and strength to attract FDI. This shows that host economy's export oriented policies extensively influenced Chinese FDI. This is consistent with study of (Kang and Jiang, 2012)

¹ Data for political stability is taken from Worldwide Governance Indicators (WIG) and the scale of index has been changed from (-2.5 to 2.5) to (0-10) for model estimation

² Data for corruption variable is taken from Worldwide Governance Indicators (WIG) and the scale of index has been changed from (-2.5 to 2.5) to (0-10) for model estimation.

that openness to trade facilitate expansion of Chinese exports to the third country/region through overseas investment activities.

To capture the motivation of resource seeking FDI, the variable of natural resources (ores, metals, minerals) and fuel endowment as a share of total merchandise exports in the host country are used in the models (Amighini et al., 2011, Pradhan, 2009). The pursuit for natural resources has been found positively related to Chinese FDI but significant only in two models at 5% level. In line with extant literature, poor institutional frame work does not deter Chinese investment in natural resources as control of corruption is significant and negatively associated with Chinese FDI In model 1 & 3.

Now considering efficiency seeking FDI proxied by FDI, GDP per capita and inflation produced different results from conventional findings. As mentioned by (Rodríguez and Bustillo, 2011), GDP per capita might capture negative sign, in such case its shows the labor cost rather the growth of the market. This is also true in our analysis as GDP per capita is negatively associated with Chinese FDI, although it is insignificant in our models. Inflation, the government policy variable, interestingly, positively associated with Chinese FDI. Although, inflation is considered as a cost of production, but can be associated with higher growth rate, which is attractive for Chinese Firms (Buckley et al., 2007a). Thus, moderate inflation allied with rising growth pattern in host countries did not restrain Chinese FDI.

We have taken four control variables, among these Infrastructure and bilateral trade are highly significant and positively associated with Chinese FDI as expected. Political stability and corruption variable are negatively associated with Chinese FDI and significant in a few models. All these four control variables have been discussed in detail in the previous chapter, therefore, detail explanation has been ignored to avoid replication.

Table 5-3: Motivations of Chinese FDI in Asian Countries

	LN FDI (Mod 1)	LN FDI (Mod 2)	LN FDI (Mod 3)	LN FDI (Mod 4)	LN FDI (Mod 5)	LN FDI (Mod 6)	LN FDI (Mod 7)
Market Seeking Variables							
GDP	1.45*** (0.24)	1.48*** (0.26)	1.45*** (0.24)				
GDP growth rate				0.06 (0.07)	0.09 (0.07)	0.09 (0.07)	
Trade openness	2.25*** (0.61)	2.30*** (0.62)	2.26*** (0.61)	0.95 (0.61)	1.03* (0.57)	1.00* (0.58)	1.44** (0.64)
Resource Seeking Variables							
Natural resources	0.27** (0.13)		0.28** (0.13)	0.15 (0.11)		0.12 (0.11)	0.12 (0.10)
Fuel		-0.008 (0.06)	0.01 (0.07)		-0.02 (0.07)	-0.01 (0.07)	0.01 (0.08)
Efficiency Seeking Variables							
GDP per capita				-0.32 (0.29)	-0.43 (0.27)	-0.38 (0.29)	-0.60* (0.32)
Inflation	0.30* (0.18)	0.35** (0.19)	0.31* (0.19)	0.45** (0.19)	0.48** (0.20)	0.47** (0.19)	0.45** (0.19)
Control Variables							
Infrastructure	0.71*** (0.20)	0.76*** (0.20)	0.71*** (0.20)	0.55*** (0.19)	0.57*** (0.18)	0.55*** (0.19)	0.69*** (0.22)
Bilateral trade				1.20*** (0.15)	1.23*** (0.13)	1.21*** (0.14)	1.01*** (0.21)
Political stability	-0.30 (0.23)	-0.35 (0.25)	-0.29 (0.23)	-0.64*** (0.20)	-0.66*** (0.21)	-0.64*** (0.20)	-0.52** (0.21)
Corruption	-2.03** (0.98)	-1.95** (1.01)	-2.11** (0.99)	-0.69 (0.94)	-0.40 (0.94)	-0.57 (0.95)	-0.39 (1.02)
Constant	-21.09***	-21.73***	-21.00***	-8.02***	-8.20***	-8.11***	-7.13***
Observations	291	285	285	271	265	265	281
No. of countries	37	37	37	37	37	37	37
R ²	0.34	0.34	0.35	0.57	0.63	0.61	0.60
Mean VIF	1.90	1.92	1.86	2.33	2.30	2.37	2.52
LM-test (P-value)	0.00	0.00	0.00	0.00	0.00	0.00	0.00

* p<.10; ** p<.05; *** p<.001 (Standard errors are in parentheses)

5. Conclusions

The tremendous growth in China's Outward Foreign Direct Investment (OFDI) has astounded the world of late, becoming the world's third largest source of FDI in 2012. The purpose of this study is to analyze the determinants and motivations of Chinese OFDI in Asia. The study has been carried out for panel data of 37 Asian countries. A series of empirical analysis for balanced panel data was carried by employing various econometric techniques such as panel Ordinary Least Square (OLS) and Random Effect (RE) Generalized Least Square estimation method with the clustered standard error corrected at the country level. Breusch-Pagan Lagrange Multiplier (LM) test is conducted for the choice between pooled OLS and random effects model. Our findings for the whole sample revealed that Market seeking is the prime motives for Chinese FDI in Asia as GDP and openness to the trade have a positive and significant relationship with Chinese FDI. We did not capture consistent results for resource seeking FDI. Chinese FDI is deterred by inflation, providing an evidence for efficiency seeking FDI. Among the control variables, infrastructural development and bilateral trade are highly influenced by Chinese FDI, while political stability being a key institutional variable is significant but negatively associated with FDI.

The findings of this study have some policy implications for policy makers to attract further FDI inflows. The empirical results suggest that in order to attract Chinese FDI, Asian economies should step forward and opt incremental efforts to remove all trade barriers, reduce political instability and build appropriate institutions. Policies and Economic strategies should aim at liberalizing trade structure, reducing macroeconomic instability and the provision of better infrastructural facilities to attract further Chinese FDI in Asia.

The study relevant to motivations of Chinese FDI can be extended and have future directions; (i) The model can be expanded further by including more variables influencing Chinese FDI, thus future studies can include cultural variables and proxies for global competitiveness of the countries for in-depth study of determinants of Chinese FDI in Asia and (ii) Disaggregated data analysis on the basis of industries and firms can also provide useful insights into Chinese FDI in Asia. Further, country wise analysis can also offer better understanding of determinants and motivations of Chinese FDI.

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Appendix 1: All 37 Countries included in the analysis

Bahrain	Kuwait	Saudi Arabia	Bangladesh
Kyrgyz Republic	Singapore	Brunei	Lao
South Korea	Cambodia	Lebanon	Sri Lanka
Hong Kong	Macao	Tajikistan	India
Malaysia	Thailand	Indonesia	Mongolia
Turkey	Iran	Myanmar	UAE
Iraq	Nepal	Uzbekistan	Israel
Oman	Vietnam	Japan	Pakistan
Yemen	Jordan	Philippines	Kazakhstan
Qatar			