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# Ethnic Chinese networks and international investment: evidence from inward FDI in China

Ting Gao\*

*Department of Economics, University of Missouri, Columbia, MO 65211-6040, USA*

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## Abstract

This paper studies the role of business and social networks in international investment by examining the effects of ethnic Chinese networks on foreign direct investment (FDI) in China. After controlling for a variety of economic determinants of FDI, this study finds a significant positive role in inward FDI of ethnic Chinese networks proxied by the population share of ethnic Chinese in the investing country.

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## 1. Introduction

The role of business and social networks in promoting international trade has attracted increasing research interest in recent years. Rauch and Casella (2003), for example, provide a theoretical model in which information-sharing social or ethnic networks can improve the allocation of resources and increase the volume of trade in the international market under incomplete information. On the empirical front, Head, Ries, and Wagner (1997) find that immigrants significantly increase trade between Canada and source countries; Rauch (1999) presents evidence that common language and colonial ties play an important role in international trade, more so in differentiated products than in homogeneous products because search barriers are higher to trade in the former; Rauch

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\* Tel.: +1-573-884-8005.

*E-mail address:* [gao@missouri.edu](mailto:gao@missouri.edu) (T. Gao).

and Trindade (2002) show that ethnic Chinese networks increase bilateral trade, again with a larger effect on trade in differential products.

In this paper, I continue this line of inquiry by examining the role of the overseas Chinese in international investment. Specifically, I use data on inward foreign direct investment (FDI) in China from a cross-section of source (investing) countries to examine the role of ethnic Chinese networks proxied by the population share of ethnic Chinese in the source country. In a recent study dealing with a similar issue, Baker and Benjamin (1997) look at the impact of Asia-Pacific immigration on foreign investment between Canada and source countries and report that there is virtually no significant link between foreign investment and the stock of Asia-Pacific immigrants in Canada.

Conceivably, business and social networks promote international trade and investment through similar mechanisms: helping businesses overcome informal barriers. In the case of international trade, as argued by Rauch and Trindade (2002), ethnic Chinese networks increase trade primarily by two mechanisms. First, through formal and informal contact, ethnic Chinese networks facilitate information sharing that helps match buyers and sellers in the international market. Second, ethnic Chinese groups help deter opportunistic behavior such as contract violation through enforcement of community sanctions.

There is no doubt that information sharing and contract enforcement are also crucial in investment decisions. Information on labor and material costs, suppliers, distributors, and other market conditions is often necessary to assess the future profitability of an investment project. Before committing any capital, a potential investor also wants to make sure that agreements with suppliers and customers will not be violated in the future and his or her legal rights are protected. Thus, investment barriers can be high in countries where information exchange through official channels is limited and the legal environment is weak. Foreign investors may face additional difficulties if they are unfamiliar with the host country's regulations, language, and custom.

In this respect, China appears to have been a country with high barriers to foreign investment. Foreign investment in China is only a recent phenomenon. Although China's regulatory framework for FDI has improved gradually over time since it opened up to international trade and investment (Fu, 2000), properties rights and contract laws are still weak and only enforced sporadically. Moreover, language and cultural barriers, corruption, and legal uncertainties also present additional difficulties to foreign (especially Western) investors, as lucidly illustrated by real examples in Weidenbaum and Hughes (1996).

Do overseas ethnic Chinese play a role in FDI in China under these conditions? And if yes, how important is this role quantitatively? This paper attempts to answer these questions. At first glance, it appears that the answer to the first question is a straightforward yes. Among the top 10 largest FDI source countries for China over the period of 1984–1997 are Hong Kong and Macau combined, Taiwan, Singapore, and Thailand, which all have a large population of ethnic Chinese, as shown in Table 1.<sup>1</sup>

However, caution must be taken before one draws quick conclusions from such a casual observation. Besides ethnicity and common language, many other factors may have contributed to the large FDI flows from Hong Kong and Taiwan into China. These two regions

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<sup>1</sup> Hong Kong and Macau are no longer qualified to be “foreign” investors, since Hong Kong was turned over to P.R. China in 1997 and Macau in 1999.

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