Chinese economic development, the next stage: outward FDI?

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Abstract

China's development path has been widely recognised as being unique, with gradual privatisation and marketisation, massive private capital inflows, and extensive exporting. All this has been achieved without political democratisation. This paper draws attention to a new emerging phenomenon—significant Chinese levels of outward FDI (OFDI)—and takes a first step towards understanding this development at an aggregate level.

The question arises, is China's OFDI another unique characteristic of Chinese distinctive economic development path and reform policies, or does it follow an established, universal pattern, specifically Dunning's investment development path (IDP) hypothesis, or rather a refined version of the IDP? In other words, do Chinese OFDI patterns suggest refinements to established theories, or even their refutation?

To address these questions, however, exogeneity tests reveal a need to use GMM estimation methods rather than straightforward regressions, since relations between economic development and OFDI are complex and inter-dependent.

The GMM results suggest that the level of economic development, proxied by GDP per capita plus refinements, is still the main factor explaining China's rate of OFDI. This is quite consistent with the refined IDP hypothesis and patterns broadly noted elsewhere. Conclusions are drawn for theory, policy and international business.
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This study has two main objectives, one theoretical and one methodological. After observing and recording the extent and character of the important and novel, recent phenomenon of Chinese outward foreign direct investment (OFDI), the paper considers whether Chinese OFDI follows a universally standard pattern and sequence proposed by Dunning's (1981) investment development path (IDP) hypothesis, as subsequently refined, or whether new theories are needed for (a) transition economies and/or (b) developing economies, as already proposed in the literature, but based on regression analysis.

Of course a link between per capita income and OFDI may be considered to be mere common-sense. Therefore, the paper develops IDP development stages (and subsequently IDP hypotheses) from the first principles of Dunning's eclectic paradigm (see Dunning, 2003), explaining how locational advantages can 'flip' to produce OFDI. Furthermore, a common-sense view of the IDP could imply a uni-directional relationship between per capita income (supplemented by other variables such as inward FDI, investments in education and exporting). Further consideration, however, could raise causal complexities behind this common-sense view. Is OFDI determined by incomes and/or are incomes influenced by OFDI? Does interdependence exist between inward FDI, investments in human capital, exports and OFDI, or are such variables themselves determined by income levels, perhaps in a lagged fashion? Do time trends obscure underlying relationships?

Fortunately, appropriate econometric procedures have been developed to untangle causation, and the methodology proposed by this paper is to apply Generalised Method of Moments (GMM) techniques for the first time to an IDP study, in order to handle the interdependent and time-dependent nature of relations between the variables proposed.

The outcome of these theoretical and methodological issues also has consequences for policy and business in other transitional and/or developing countries. For example, such countries, seeking internationalisation and economic progress through investment overseas, may decide whether to follow the unique Chinese path, or simply wait for per capita incomes to grow enough to generate OFDI.

Our first section provides a brief background to Chinese economic reforms and the nature of China's OFDI. The second presents Dunning's theory of OFDI. His IDP path hypothesis is considered as a proposed explanation of China's scale and pattern of OFDI, albeit at a highly aggregative level, and a modified version of this theory is used to derive sub-hypotheses. This is followed by the first GMM tests on these hypothesised relations. The methodology for hypothesis testing is described, followed by a results section, and finally some conclusions, for theory, methodology, policy and international business.

1. Background: Chinese economic development and OFDI

OFDI from a developing country that was previously perceived by MNEs as merely a destination for inward FDI may be a significant new competitive threat for those same MNEs, and OFDI from a developing country like China must be based on new ownership advantages developed from extant localisation economies generated with the support of earlier inward FDI from MNEs. One task of this paper is to analyse the determinants of China's OFDI, untangle these relationships and to contemplate the best theoretical basis for its analysis.