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PERSPECTIVE

Perspectives on China's outward foreign direct investment

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Abstract
Recent economic data reveal that, at the infant stage, China's outward foreign direct investment (FDI) is biased towards tax havens and Southeast Asian countries and are mostly conducted by state-controlled enterprises with government sanctioned monopoly status. Further examination of China's savings rate, corporate ownership structures, and bank-dominated capital allocation suggests that, although a surge in China's outward FDI might be economically sensible, the most active players have incentives to conduct excessive outward FDI while capital constraints limit players that most likely have value-creating FDI opportunities. We then discuss plausible firm-level justifications for China's outward FDI, its importance, and promising avenues for further research.
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INTRODUCTION

Barely 30 years ago, most would consider China a poor agricultural economy. In 2008 China is hosting the Olympics to signal its emergence as a major economic power. This phenomenal development appropriately draws international business scholars' attention. One especially curious characteristic of China's development path is a recent surge in its outward foreign direct investment (FDI). Successful and not-so-successful foreign acquisitions by companies such as Haier, Lenovo, TCL, and CNOOC (China National Offshore Oil Corporation) grab headlines.

Much discussion is of the phenomenon itself. With over a trillion dollars in foreign reserves and increasing economic clout, China can send flagship companies abroad to acquire technologies, brands, resources, and better access to international markets. In some industries, at least, rising capacity and intensifying domestic price competition are cutting profit margins, and Chinese managers see FDI as a way to upgrade technology and augment earnings. While these are all legitimate strategies under broad ranges of circumstances, we believe it is important to identify specific drivers of the current surge in Chinese outward FDI, and to evaluate its broader implications with economic theories.

In the following, we first sketch the empirical characteristics of China's outward FDI: its size, target locations, and most important players. Then, we offer alternative perspectives on the subject

matter. At the economy level, China's high savings rate, the behavior of its dominant state-controlled banks, and the enduring voice of the state in corporate governance might distort capital allocation in ways that generate outward FDI in certain sectors. Plausible distortions arise from both the identity and the likely motives of the key players. Next, we explain why China's outward FDI will probably grow substantially as different players gain prominence. Given this, we adopt a firm-level perspective, and consider three non-exclusive theoretical explanations of China's outward FDI surge. Implications for corporate management and public policy are discussed in the conclusion.

A BRIEF DESCRIPTION

This section draws on various data sources to characterize China's outward FDI – its size, target locations, and players.

China's Outward FDI is Tiny

Figure 1 tracks the surge in outward FDI from China, excluding the financial sector. Starting from near zero in the 1970s and early 1980s, Chinese outward FDI exceeds $17.6 billion in 2006.

Despite this impressive growth rate, the absolute magnitude remains small. The IMF places China's 2006 purchasing power parity adjusted GDP at $9.98 trillion, nearly 77% of US GDP ($13.02 trillion) and 15% of the global total ($66.23 trillion). However, Table 1 shows China's outward FDI that year to be only 2.3% of the global total. Moreover, China's outward FDI stock accounts for only 0.7% of the world total at the end of 2006 – a disproportionately small sum even among countries at similar stages of development including Russia, another recent command economy in transition.[1] China's rapid growth in recent years might have attracted investment resources to stay home instead of seeking opportunities overseas. Clearly, then, China's outward FDI has substantial scope to grow in the long run, and it is beginning to show a catching-up tendency.

Target Locations

High-profile Chinese outward FDI includes Lenovo's acquisition of IBM's personal computer unit and Minmetals' bid for Noranda in Canada. That these acquisition targets are located in the world's most developed countries attracts much public attention, generating an illusion that China already contains world-class companies joining the ranks of the multinational giants based in developed countries. In reality, Chinese outward FDI targets firms in all continents, with Figure 2 showing a distinct focus on South and East Asia and, to a lesser extent, Africa. In 2006, the 76 newly planned outward FDI projects in these two regions account for over 60% of the 125 total reported. In contrast, only about a third is in developed countries.

The stock of China's outward FDI is even more geographically concentrated. According to the annual statistics from the Ministry of Commerce, as of the end of 2006 Asia, Latin America, and Africa account for 63.9, 26.3, and 3.4% of the FDI stock, respectively, and the shares for North America and Europe are each below 3%.

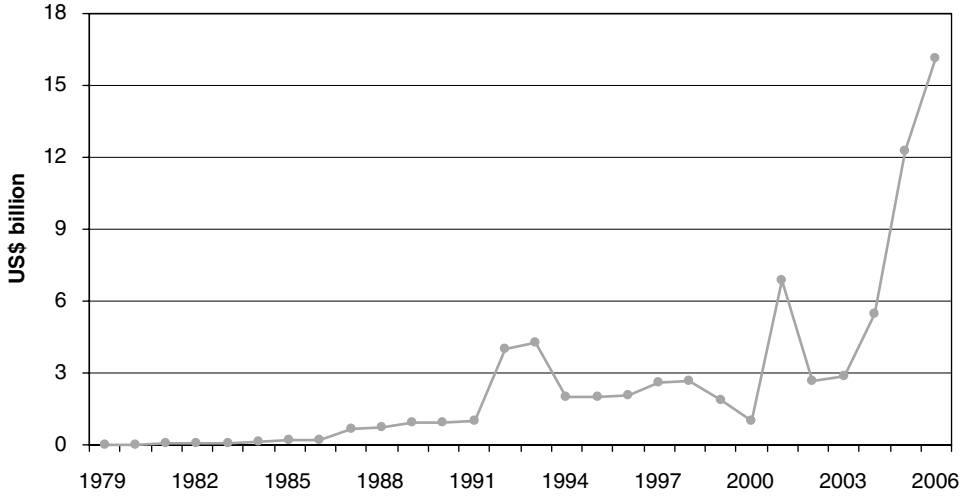

Figure 1 China's outward foreign direct investment, 1979–2006.
Data sources: Ministry of Commerce and China Statistics Bureau.

Table 1 Comparison of outward FDI across countries (US$ billions)

	Annual FDI flow			*Cumulative FDI*		
	2004	*2005*	*2006*	*2004*	*2005*	*2006*
Global total outward FDI flow	561.1	813.1	778.7	9046.3	10,325.2	10,671.9
China outward FDI						
Total	5.5	12.3	17.6	44.8	57.2	75.0
As % of global total	1.0	1.5	2.3	0.5	0.6	0.7
Developed countries						
Japan	—	31.0	45.8	335.5	370.5	386.6
France	—	47.8	115.7	—	—	853.2
Canada	—	47.5	34.1	307.8	369.8	—
Netherlands	—	14.6	119.5	—	—	641.2
Italy	—	19.3	39.7	238.9	280.5	293.5
UK	—	65.4	101.1	1128.6	1378.1	1238.0
Spain	—	54.3	38.8	207.5	332.6	381.3
USA	—	229.3	—	2069.0	2018.2	2051.3
Developing countries						
Brazil		9.5	2.5	54.6	64.4	71.6
Mexico	1.4	2.2	6.2	13.8	15.9	28.0
South Korea	3.4	4.8	4.3	34.5	39.3	36.5
Malaysia	1.4	2.1	3.0	29.7	13.8	44.5
Singapore	5.5	10.7	5.5	90.9	100.9	110.9
Russia	5.1	9.6	13.1	51.8	81.9	120.4

Data sources: World Investment Report and World Investment Report of UNCTAD; China Ministry of Commerce, various years.

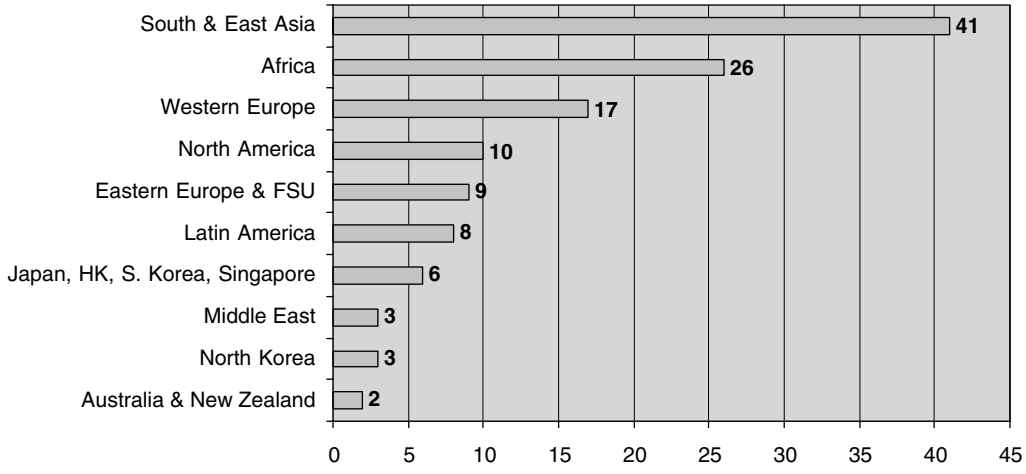

Figure 2 Number of planned FDI projects by destination, 2006.
Data source: FUAS/MIGA Firm Survey, World Bank.

Table 2 separates China's outward FDI volume by host country/area. The top destinations are Hong Kong and Caribbean tax havens, which consistently account for about 80% of the flow. These countries provide confidentiality to foreign investors, and so are commonly used by multinational firms to store wealth beyond the purview of tax authorities (Harris, 1993). FDI into these locations by Chinese firms might also be designed to hide wealth from tax authorities, other authorities, or even public shareholders. Mainland companies may also invest in these countries, particularly

Table 2 Top destinations of China's outward FDI flows

Country/Region	*2003*		*2004*		*2005*		*2006*	
	Amount	*% of Total*	*Amount*	*% of Total*	*Amount*	*% of Total*	*Amount*	*% of Total*
Hong Kong	11.5	40.4	26.3	47.8	34.2	27.9	69.3	39.3
Cayman Islands	8.1	28.3	12.9	23.4	51.6	42.1	78.3	44.4
British Virgin Island	2.1	7.4	3.9	7.0	12.3	10.0	5.4	3.1
South Korea	1.5	5.4	0.4	0.7	5.9	4.8	—	—
Australian	—	—	1.3	2.3	1.9	1.6	0.9	0.5
USA	0.7	2.3	1.2	2.2	2.3	1.9	2.0	1.1
Russia	0.3	1.1	0.8	1.4	2.0	1.6	4.5	2.6

Amounts: US$ billions.
Data sources: China FDI Statistics Report, Ministry of Commerce and China Statistics Bureau.

in Hong Kong, because these locations give them convenient access to trade and financing opportunities.[2]

Moreover, Chinese subsidiaries in these countries might serve as holding companies for investments elsewhere; or even back into China. For example, a Chinese firm's FDI into Hong Kong can rebound to China if its Hong Kong subsidiary acquires ''foreign-owned enterprise'' (FOE) status in the mainland. FOEs pay lower taxes than domestic firms through the end of 2006. Unfortunately, we are not able to trace the funds pouring from China into tax havens to their final destinations.[3] Yet another possibility is that Chinese-controlled subsidiaries in these countries veil *spontaneous privatization*, analogous to that documented by Lipton and Sachs (1990) in Eastern Europe. That is, the insiders of some Chinese firms might be moving wealth into tax havens to place it under their personal control. These numbers cast doubt on the extent to which economic fundamentals genuinely drive China's outward FDI.

The Players

Table 3 ranks the 30 largest companies in China by their outward FDI in 2004 and 2005. Almost all are either listed or controlling major listed subsidiaries.

Two observations follow. First, the biggest sources of Chinese outward FDI are highly profitable listed SOEs. Lenovo and Huawei are the only FDI heavyweights not explicitly state controlled. (Haier is a collectively owned enterprise.) Private-sector firms may well conduct some outward FDI; but the scale is too small to register. Second, virtually every one of these significant players has an officially sanctioned monopoly in some major industry, such as natural resources or telecommunications. In 2005 the top 10 SOEs account for over 75% of the total profit of China's 169 national SOEs,[4] and 32% of the profit earned by the entire industrial sector (Table 4). Eight of the top 10 qualify for inclusion in Table 3. Namely, the largest FDI players overlap substantially with the most profitable SOEs in China.

In sum, the data indicate that China's outward FDI remains small relative to the economy's size, and focuses on nearby developing countries and, quite recently, Africa. From 2003 to 2006, Chinese FDI that flowed further abroad poured into tax havens. Whether this is to avoid taxes or to mask other objectives is unclear. High-profile FDI bids for foreign natural resources firms, such as that of Minmetals for Noranda and CNOOC's bid for Unocal, are likely responses to State prodding.[5] To date, the main players are still large, profitable SOEs with lucrative state-enforced monopolies.

PERSPECTIVES AT THE ECONOMY LEVEL

This section examines three features of China's macro environment that are likely to be connected with its outward FDI surge: a high savings rate, weak corporate governance, and distorted capital allocation. Although outward FDI can let firms gain important economies of scale and scope, these three features could conspire to induce excessive outward FDI by the wrong players that works against China's long-term economic prosperity.

High Savings

Savings pay for investment, and China's savings rate is persistently and remarkably high. Figure 3 shows China's total savings as a percentage of GDP, and also breaks the total into savings by households, enterprises, and governments. While household savings have declined slightly as a fraction of

Table 3 Thirty largest companies ranked by outward FDI

No.	Year 2004	Year 2005	Year 2006
1	China Mobile	China National Petroleum Corp.	China Petrochemical Corp.
2	China National Petroleum Corp.	China National Offshore Oil Corp.	China National Petroleum Corp.
3	China National Offshore Oil Corp.	China Mobile	China National Offshore Oil Corp.
4	China Resources (Holding) Co. Ltd.	China Resources (Holding) Co. Ltd.	China Resources (Holdings) Co. Ltd.
5	COSCO	COSCO	China Mobile
6	CITIC	SINOPEC	COSCO
7	SINOPEC	CITIC	CITIC
8	China Telecom	China Merchant Group	China National Cereals, Oils and Foodstuff
9	Guangdong and Hong Kong Investment	China National Cereal, Oil and Foodstuff	China Merchants Group
10	China Merchant Group	China State Construction Corp.	Sinochem
11	China NetCom	China National Aviation	China State Construction & Engineering
12	China State Construction Corp.	China Telecom	China National Aviation
13	Lenovo Holding	SinoChem	China Telecom
14	China National Aviation	China NetCom	China Shipping
15	China Power Investment	China Shipping	China NetCom
16	China Minmetals	Guangdong and Hong Kong Investment	GDH Limited
17	SinoChem	Shanghai Automotive Industry Corp.	China Power Investment
18	China National Cereal, Oil and Foodstuff	Shum Yip Holding Company	Shanghai Automotive Industry Corp.
19	China Shipping	Lenovo Holding	China National Chemical Corporation
20	Sino Transportation Group	China Power Investment	China Minmetals Corporation
21	Shanghai Automotive Industry Corp.	China Minmetals	Lenovo
22	China Huaneng Group	Sino Transportation Group	Shum Yip Holdings
23	Beijing Orient Electrics Group	TCL	China National Foreign Trade Transportation
24	China World Best Group	Beijing Orient Electrics Group	Huawei Technologies
25	TCL Group	China Huaneng Group	Shanghai Baosteel
26	Guangdong Hangyun Group	China Poly	China Huaneng Group
27	Shanghai Baosteel	Shanghai Baosteel	SinoSteel Corporation
28	Beijing Jade Bird Group	China Shou Gang Group	China Poly Group Corporation
29	China Nonferrous Metal Mining Group	China Nonferrous Metal Mining Group	China Nonferrous Metal Mining & Construction
30	China Road and Bridge Corp.	China North Industrial Group	Haier Group

Data sources: China FDI Statistics Report, Ministry of Commerce and China Statistics Bureau.

Table 4 The 10 most profitable state-owned enterprises in 2005

Rank	Company name	Net income (10^8 yuan)	Growth over last year (%)
1	China National Petroleum Corp.	1756.1	46.1
2	China Mobile	782.1	21.9
3	SINOPEC	551.8	27.6
4	China National Offshore Oil Corp.	357.9	55.2
5	China Telecom	338.6	3.8
6	Shen Hua Group Corp.	221.0	85.0
7	BaoSteel	220.5	0.5
8	COSCO	200.4	64.2
9	Aluminum Corp. of China Ltd.	150.2	51.3
10	State Grid Corporation of China	143.9	44.9
Total of the top 10		4722.5	40.05
All 169 National SOEs		6276.5	27.9
All 271,835 SOEs and non-state enterprises above designated size[a]		14,802.54	22.6

[a]The designated size is defined by the National Bureau of Statistics as enterprises with annual revenue over 5 million yuan from principal businesses.
Data sources: State-owned Assets Supervision and Administration Commission of the State Council, and *China Statistic Yearbook*.

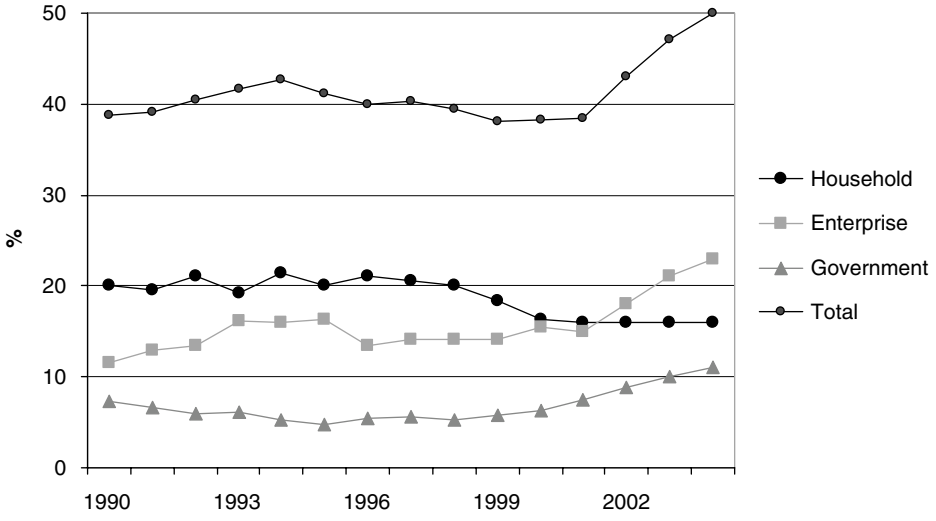

Figure 3 China's savings rate in recent years, as a percentage of GDP.
Data source: *IMF World Economic Outlook*, September 2005.

Table 5 Savings rates as percentage of GDP

Country	*China*	*USA*	*France*	*Japan*	*Korea*	*Mexico*	*India*
Total domestic savings	41.7	14.3	20.7	25.5	31.0	20.8	28.3
Household savings	16.0	4.8	10.8	8.2	4.5	8.0	22.0
Enterprise savings	20.0	10.3	9.5	19.4	14.8	10.6	4.8
Government savings	5.7	−0.9	0.3	−2.2	11.7	2.2	1.5

Data source: Kuijs (2006: Table 4).

GDP, enterprise savings are growing rapidly, and now constitute the most important category.

Table 5 compares China's savings rates with those of other countries. Clearly, China's household, enterprise, and government savings exceed those of other countries by substantial margins.[6]

Chinese domestic savings flow mainly into state-controlled banks as deposits. The reasons for Chinese households' high savings are well known: Chinese save for education, housing, purchases of consumer durables, and security (e.g., pension and medical expenses). China's household savings rate, though high, is lower than India's. The declining trend in China's household savings rates in recent years probably reflects several factors:

(1) greater accumulated savings;
(2) an aging population; and
(3) a gradual improvement in the consumer credit market, which mitigates the need for household savings.

Corporate savings are retained earnings – the portion of earnings not paid out to equity investors. Table 5 reveals that China's enterprise savings rate is among the highest in the world, and comparable to Japan's. Bank involvement in Japanese corporate governance is thought to induce excessive earnings retentions by firms there (Morck & Nakamura, 2000). If enterprises do not plow their retained earnings into economically sound expansions, a high enterprise savings rate reflects an economically undesirable aversion to disburse earnings to shareholders (Jensen, 1986).

Standard corporate finance theory suggests that companies ought to pay out to shareholders all earnings exceeding the firm's profitable investment needs. Information asymmetry makes ''profitable'' investments hard for shareholders to verify, and Jensen (1986) argues that a common corporate governance problem involves management excessively retaining earnings and pouring them into low-return projects to build corporate empires. La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2000) show that sound legal protection for investors is associated with higher dividends, but where legal systems are less at the service of investors, insiders tend to retain earnings excessively for empire-building.

FDI builds particularly impressive corporate empires, spanning continents. Weak corporate governance underlying Chinese companies' high rates of earnings retention and fueling their FDI must be considered a serious hypothesis. It turns out that Chinese SOEs, responsible for most FDI, are particularly dividend-averse. According to

statistics from the Shanghai and Shenzhen stock exchanges, over half of the listed SOEs pay no dividends, despite high earnings. For example, the most profitable SOE in Table 3, China National Petroleum Corp. realized 2005 net profits of 133.36 billion yuan, but distributed only 1% of that, a mere 1.49 billion yuan, to shareholders.

It is possible that, with a less-developed financial system in China, firms hold more cash internally to get ready for growth opportunities, especially when the capital markets are deficient (Khanna, 2000). Furthermore, investing overseas may be Chinese firms' escape response to the restrictive business environment in China (Witt & Lewin, 2007). While these arguments may hold for many private enterprises, they are less applicable to the SOEs that typically enjoy preferential treatment in obtaining bank loans and accessing the financial markets. In fact, the Chinese Securities Regulatory Commission (CSRC) also appears concerned that listed SOEs pay suboptimal dividends, for a series of new regulations in 2004 and 2005 explicitly forces higher dividend payouts. Companies with positive profits but no dividends for three consecutive years must provide ''explanations'' to their public shareholders, or risk lawsuits. Further, companies with dividend payouts below 20% of after-tax profits are ineligible for debt refinancing. Because of these changes, many Chinese companies have announced dividends precisely equal to the 20% minimum.

Corporate Ownership Structures

Potential reasons for these low dividends become apparent if we look into the ownership structure of listed companies. Figure 4 provides a snapshot of the ownership structures of the 1381 listed companies at the end of 2005. Of all the shares outstanding, fully 65.9% are non-tradable shares. Of these, over half are owned by governments and government organs, with the remainder owned by other legal entities – mostly large state-controlled enterprises or state-managed investment funds. Non-tradable shares are also inalienable – they cannot be freely bought or sold. Their existence has ensured continued state control of the economy by giving the state majority voting power in the shareholder meetings of major listed firms.[7]

This figure may understate the total state-related equity control, as state investment funds also hold tradable shares, and cross-shareholding by SOEs is prevalent. This typical ownership structure has several implications.[8] First, small public shareholders have little or no influence on corporate

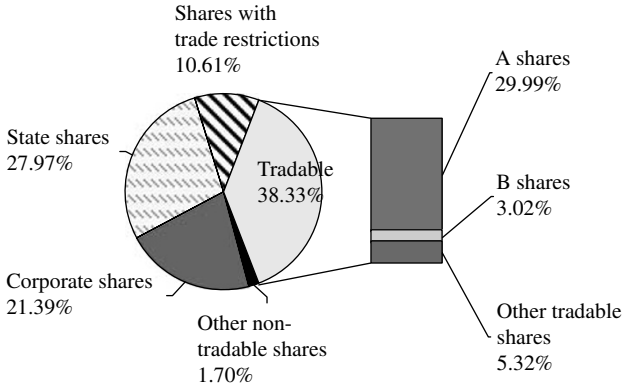

Figure 4 Ownership structure of China's listed companies, 2005. The major classes of tradable shares are ''A'' shares for domestic investors, ''B'' shares that are locally traded but originally reserved for foreign portfolio investors, and cross-listings in Hong Kong or abroad.
Data source: China Securities Regulatory Commission (CSRC).

decisions, since the state wields sufficient voting power to appoint the board of the typical listed firm. Second, listed firms do not typically pay dividends on non-tradable shares directly owned by the state, even if they pay dividends on other classes of tradable and non-tradable shares.[9] Naturally, vested interests within the state organs see a high dividend as undesirable, because they have 100% of the control if the earnings are retained, but little to gain once they are distributed.

A sequence of legal and regulatory reforms has done little to alter this fundamental power imbalance. State-appointed independent directors often see the world much as do state-appointed CEOs. Moreover, every listed firm's board has a parallel authority structure – the firm's Party Committee – headed by its Party Secretary. Reforms to the board leave this hidden – or not-so-hidden – real power structure untouched. The Party Secretary may or may not chair the board, and Party Committee members may or may not serve as directors. Where the two structures do not overlap, real power flows through the Party channels, leaving the board and formal corporate top executives with scant real authority. In the large SOEs the Party Secretary appoints the top executives and directors, often simply relaying orders from the Communist Party of China's Organizational Department, and exercises a leading role in the company.

The ultimate function of the Party Committee and Party Secretary may change as corporate governance reforms occur, but this remains unresolved. For example, whether listed companies'

managers might some day report to shareholders, rather than the Party, is debated. At present, the Party Committee monitors and evaluates corporate executives, determining their prospects for career advancement. The CEOs of the largest 53 national SOEs are appointed directly by the Communist Party of China's Organizational Department. The other senior management positions are mostly appointed by the State-Owned Assets Supervision and Administration Commission (SASAC), which is directed by the State Council. Similar patterns hold for the local SOEs.[10]

The full extent of State and Party influence over corporate management is rendered obvious with examples of top executive turnover. PetroChina, a subsidiary of China National Petroleum Corporation, trades on both the New York Stock Exchange and the Hong Kong Stock Exchange. In April 2003 Mr. Li Yizhong, then Chairmen of the Board of CNPC, was appointed to the SASAC and replaced by Mr. Chen Tonghai, a former State Planning Commission official. In October 2003 Mr. Wei Liucheng, then CEO, Chairman of the Board, and Party Secretary of CNOOC, was appointed Governor of Hainan Province. In November 2004 the top managers of the three largest telecommunication companies in China – China Mobile, China Telecom, and China Unicom – exchanged positions almost overnight without prior notice to public shareholders. In short, executive positions in listed firms are filled by State and Party bureaucrats, and are seen as steps in the career of a successful civil servant.

The current corporate governance structure is unlikely to reward managers who honestly admit that investment opportunities are limited and advocate disbursing excess earnings to shareholders. Unpaid dividends are, of course, corporate savings![11] For Party officials who have real control but little personal stake in their company's long-term economic performance, underwriting unprofitable, but politically important, projects is likely sound strategy for career advancement in both Party and State bureaucracies.[12] High retained earnings can finance feather-bedding, and thus provide social stability by keeping unemployment low. They can also finance overt symbols of power and grandeur, such as ''national champion'' SOEs taking over companies in foreign countries.

Capital Market Distortion

Distortion in China's capital markets compound distortions in managerial incentives. China's capital markets are dominated by banks, especially the ''Big Four'' state-controlled banks – the Bank of China, Industrial and Commercial Bank of China, China Construction Bank, and Agricultural Bank of China – together responsible for about three-quarters of all commercial loans and just over half of total banking assets as of the end of 2005.[13] Household savings and idle corporate funds both turn up as bank deposits, and these are recycled as bank loans. Most of the loans go to the state sector, often owing to the preferential policies set by the local government and the banks' lack of competence in evaluating risks (Tsai, 2002). According to the *Financial Statistics Yearbook* (2005) published by the People's Bank of China, SOEs account for 73% of the short-term bank loans between 2001 and 2004. This means that even SOEs that merely hoard earnings as bank deposits, without actually initiating foreign acquisitions, still help fund the FDI of other SOEs.

The OECD's (2005) Economic Survey of China shows the private sector to be the true engines of economic growth, accounting for 59.2% of value-added in the economy.[14] These growing companies face ongoing capital constraints, and must finance their growth largely with informal financing (Allen, Qian, & Qian, 2005). Ayyagari, Demirguc-Kunt, and Maksimovic (2007: Table 7) show that firms that do obtain bank loans subsequently post elevated sales, but not productivity growth, while firms that rely on alternative channels of financing post slower sales growth, but stronger productivity growth. Dollar and Wei (2007) also show that, even after years of reform, state-owned firms still have significantly lower returns to capital, on average, than domestic private or foreign-owned firms. This is consistent with China's banking system channeling savings to firms with limited capabilities and profitable investment opportunities. Some of these funds may end up in China's highly visible outward FDI, but this may well be the visible tip of a much larger capital misallocation iceberg.

In summary, China's recent outward FDI surge is probably a manifestation of its inability to reinvest its high corporate and individual savings efficiently. This distorted capital flow is propelled by the governance structure of large SOEs and by inefficiencies in its banking sector. Grandiose and patriotism-inspiring initiatives, such as takeovers of foreign companies, legitimize the continuation of the political *status quo*. Over the longer term, deflecting capital away from more efficient private sector ventures may compromise both continued economic growth and political stability.

We do not argue that all outward FDI from China is unjustified. We just caution that the current parameters of governance and bank lending do suggest a high likelihood of wasteful investments. Meanwhile, private companies with otherwise great overseas opportunities may be kept away from the door. It is worth pointing out that the risks of outward FDI are not going unnoticed in China. The rationale and efficiency of companies going abroad have been frequently discussed in Chinese newspapers, academic journals, and some high-profile economic forums.[15] Many scholars, practitioners and policymakers have called for caution and patience, emphasizing that FDI would be a long learning process for Chinese companies. Managers also try not to repeat the experience of their Japanese counterparts in the 1980s, and frequently seek the help of external advisers with their due diligence investigations. Last, but not least, the large number of FDI cases truly reflects the strong performance of Chinese firms. We devote the next section to a more in-depth analysis of these firms.

PERSPECTIVES AT THE FIRM LEVEL

Regardless of the above economy-level considerations, FDI may be economically rational from an individual firm's perspective. To explore this, we therefore turn to the theory of the firm and discuss microeconomic justifications of China's outward FDI.

Internalization: Political Wiles as an Asset

Much FDI by multinational firms is thought to add value by raising the returns to corporate investment in research and development (R&D), brand creation, and other ventures with large fixed costs and high risks of market transactions (e.g., Buckley & Casson, 1976). (For empirical evidence, see Morck and Yeung, 1991, 1992.) For example, an auto company can invest more in R&D if any productivity-enhancing innovations can be applied to large-scale operations around the world, rather than in a smaller-scale operation confined to its home country. The company may want to conduct *internalization* FDI because, by keeping productivity enhancements internal to the company, it can gain higher returns while reducing the risk of intellectual property rights misappropriation.

At first blush, this perspective seems off in China's case. It implies that firms with large past investments in enhanced productivity should lead China's FDI surge. This is not observed; instead, large, relatively inefficient SOEs lead the charge, and more efficient private enterprises remain largely domestic. The internalization theory also suggests that China's FDI surge should be disproportionately into countries with larger domestic markets that can better contribute to economies of scale and scope in the use of such productivity enhancements. This too is not observed, for the targets of China's outward FDI are mainly in Southeast Asia and Africa, not Europe, Japan, or North America.

Nonetheless, some Chinese FDI does accord with the internalization concept. For example, China's vast but highly regionalized domestic markets may school Chinese businesses in catering to large and complex customer bases. Firm-specific advantages, the basis of internalization, include not only proprietary technologies and brand names, but also transactional advantages, such as firms' capabilities to manage internal as well as external relationships (Rugman, 1996; Rugman & Verbeke, 1992). If so, Chinese firms' expertise in managing complex markets might qualify as a large fixed-cost investment, like the automaker's R&D, whose return is magnified by expanding into more regions. One possible case of this might be Chinese telecommunication companies' recent attempt to expand in Southeast Asia. Given this interpretation, these Chinese firms' FDI fits the standard internalization model nicely, assuming that this expertise really exists, and that it is valuable outside China.

A modified internalization perspective might therefore have more general traction in explaining the trend in China's recent FDI. Many of the Asian and African countries targeted by Chinese FDI have chronically weak institutions. Huang, Morck, and Yeung (2004) show that most ASEAN economies have a high level of direct state intervention, insecure property rights protection, and opaque corporate governance. These institutional deficiencies impede capital market development (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1997, 1998), and raise costs of capital for local firms (Morck, Yeung, & Zhao, 2005).

For Western and Japanese multinationals with financial resources (Desai, Foley, & Hines, 2004), corrupt or otherwise dysfunctional institutions in these countries create difficulty for their local operations, and trigger investor pressure to withdraw from such locations. In contrast, the ''emerging giants'' from developing countries have already survived financial and bureaucratic disadvantages in their home markets (Khanna & Palepu, 2006). Compared with firms from highly developed

countries, Chinese firms are more experienced with such institutional features, and as a result are probably far more capable of dealing with burdensome regulations and navigating around the opaque political constraints. Perkins (2005) shows that past experience in certain institutional environments significantly predicts survival when a firm invests in another such environment. Such capabilities become an intangible asset that might make FDI into like environments far more profitable for Chinese companies than for other foreign firms.

Our internalization theory thus posits that Chinese SOEs have developed sophisticated measures that help them operate despite endemic government interference and related problems. By expanding into economies with similar institutional environments, they can achieve large returns on these past investments. In 2005 PetroKazakhstan, a Canadian-owned concern with operations primarily in Kazahstan, found itself unable to enforce its previous agreements with a Kazakh government bent on expropriation. The state-owned CNPC again stepped in and bought out PetroKazakhstan for $4.2 billion. PetroKazakhstan's investors exited with some capital intact, and CNPC was able to enforce contracts and property rights where a private sector Canadian firm could not.

Who Is the Boss, and Why?

Another perspective may further reconcile standard explanations of FDI with Chinese firms' multinational expansion. In the automaker example above, we imagined a US automaker with unique productivity-enhancing technology taking over foreign automakers and applying its new technology to their operations as well as its own. This lets the innovative US automaker not only apply its innovation on a global scale, but also keep knowledge of the innovation internal.

In recent years, China has become a global manufacturing hub. In most cases, foreign firms with unique technological expertise or valuable brand names direct FDI into China, building or acquiring control of manufacturing facilities there. But in a few high-profile cases Chinese manufacturing firms sought to acquire the firms in rich countries that provide them with up-to-date technology. In this category perhaps fall Lenovo's acquisition of IBM's PC manufacturing unit and Haier's bid for Maytag. These cases stand opposite to our carmaker model, as if a low-tech Chinese automaker bought the innovative US firm and its technology, and then undertook to apply the technology on a global scale.

In a typical FDI venture, the firm that developed the intangible asset – the technological or advertising-heavy firm – is the acquirer, and retains control to protect its property rights over that asset. Grossman and Hart (1986) argue that control should reside with the party whose non-contractable effort is more important in creating value for the firm. In the traditional FDI setting with the acquirer from a developed country, this party is the firm that initially produced the critical intangible asset. A new technology must be updated continuously, or risks eclipse by advances elsewhere. A brand name made valuable by a reputation for high quality must be safeguarded by continual rigorous quality control. Failure to keep pace with the expanding technology frontier or to safeguard the value of a brand name courts disaster, and the Chinese manufacturing firm typically lacks the ability to contract and monitor the foreign firm's performance in these dimensions. The foreign firm, in contrast, can monitor and control the Chinese production operation, at least to a considerable extent. Thus, in a typical inward FDI investment into China, a foreign firm with a technological edge or a brand name acquires physical assets in China that help it produce for Chinese or global markets.

However, this logic need not apply in all cases. IBM saw PCs becoming commoditized, with rapidly evaporating profit margin. While technology advances continue to affect key components, actual PC assembly becomes routine, which made technology maintenance and upgrading more contractable and less critical. The terms of competition tilted towards production cost and quality control. In this setting, actions by the managers of the Chinese assembly plants became important enough to justify Lenovo taking control of IBM's PC unit. Conceivably, similar logic induced TCL's takeover of Thomson's TV and DVD businesses in Europe and elsewhere.

More generally, in maturing industries, intensifying price competition in increasingly standardized products renders manufacturing quality more important than cutting edge R&D, and rigorous cost control more important than brand name recognition. In such circumstances a reversal of roles becomes rational: the production unit takes over the R&D or brand-building unit because its non-contractable effort becomes more important in creating value.

Private Benefits of Control

Above, we suggest that China's outward FDI surge *per se* is not necessarily economically wasteful, but its many and profound institutional infirmities, especially the corporate governance and banking system deficits highlighted above, are reasons for concern. The civil servants manning the Party Committees that govern China's SOEs, listed or not, and the Party appointees governing China's state-run banks are economically rational people with well-defined goals, which they can be expected to pursue. These goals may not accord with the long-term financial viability of the firms or banks they govern; and to understand China's outward FDI better, a deeper understanding of those goals might be useful.

Private benefits of control are benefits enjoyed by a dominant controlling owner above and beyond dividends and other cash flow rights, which also accrue to public shareholders. Much evidence shows that controlling shareholders in many countries preserve their control with, for example, super-voting shares, even though these structures are empirically linked to depressed valuations. Insiders also lock in their control with staggered boards, pyramiding, and various other entrenchment devices that empirically prove value-destroying. These actions suggest that corporate insiders, including controlling shareholders, derive private benefits large enough to compensate the controlling shareholder for the depressed value of his or her shares. While there are multiple ways to combine the Chinese and foreign firms' capabilities, executives who value private the benefits of control sufficiently highly may choose acquisitions over other possibilities, such as long-term contracts or technology licenses, and are willing to pay for this with a depressed share valuation.

These private benefits may be pecuniary, such as wealth accumulated through self-dealing or insider trading. The FDI flowing from Chinese SEOs into Caribbean tax havens, where it essentially disappears from sight, might ultimately become a pecuniary private benefit of control for the SEOs' insiders. But the private benefits of control also include non-pecuniary gains, such as status, power, and respect. Conceivably, China's outward FDI is a manifestation of executives pursuing such intangible benefits.

Indeed, there are plausible reasons for expecting such insiders to value control highly indeed. First, some top executives – especially the Party Committee members governing SOEs – may have difficulty escaping the mindset of a command economy, in which direct control is the only way to coordinate economic activity. Even now, many Chinese executives are uncomfortable with contractual arrangements and market forces. In part, this may be an understandable response to judicial inefficiency and market failures in China, where free market institutions remain a work-in-progress. Assuming similar problems in world markets, Chinese executives might overvalue direct control over, for example, natural resources. This mindset may persist until a new generation of Chinese executives, with more confidence in markets, takes over.

Weak corporate governance probably further reinforces the importance of ''control'' to many Chinese executives. Experience proves, in China at least, that investing in firms one does not control puts one at the mercy of their controlling shareholders. Weak corporate governance creates a jungle-like ethic of ''control or be controlled'' – investors who do not wield control find themselves at the mercy of whoever does, and cannot expect to be treated tenderly. Not trusting institutions outside China either, they may perceive outward FDI as necessary to control their dealings abroad. In countries with well-developed institutions, contracts and legal rights may be cheaper, and hence more efficient ways to organize their dealings, but Chinese executives may have to learn this from experience.

Finally, enhancing national pride is quite likely a hugely important private benefit of control. Although many Chinese call for caution in overseas expansion, citing the examples of earlier failures, phrases such as ''The Age of Chinese Acquisitions'' still frequent media headlines. The corporate executives, Party Committee members, and bankers seen thus restoring China's honor as a true economic power arguably gain respect and status unattainable by any other means.

CONCLUSION

Despite the media buzz, China's outward FDI is still relatively small. Its flow and stock are tiny relative to its GDP, even compared with those of other developing countries. Moreover, China's outward FDI is mostly acquisitions in neighboring Asian countries and resource-rich parts of Africa. As China develops rapidly, the scope and scale of Chinese outward FDI merits ongoing analysis by international business scholars, for it is a manifestation of the economic, organizational, and managerial transformation in the country, and of its

relation with the rest of the world. This paper develops perspectives we hope can facilitate a better understanding of the deeper causes and consequences of China's outward FDI.

From economy-wide perspectives, we show that China's outward FDI is unsurprising, given the economy's remarkably high savings rate, but there are reasons for caution. Currently, the leading players are large SOEs with lucrative state-enforced monopolies in natural resources or infrastructure sectors. Because of their peculiar ownership and incentive structures, large SOEs tend to hoard retained earnings, rather than distribute dividends to shareholders. China's bank-dominated capital allocation also probably channels savings disproportionately to these SOEs. Hence the insiders, especially their Party Secretaries and Party Committee members, may use these retained earnings to fund investments that advance their careers as bureaucrats, such as ''flagship'' projects overseas, rather than investments with high economic returns.

In spite of the causes for concern, standard economic rationales for FDI take on unexpected new forms in China, and may justify some, perhaps even much, of China's outward FDI. Three rationales are of note. First, the internalization theory of FDI, appropriately reinterpreted, suggests that Chinese companies, with vast experience in navigating complex bureaucracies, might do well in countries with similar institutional environments. Second, in certain maturing industries, outward FDI from China, even into advanced economies, might make economic sense. This ownership reversal, which we develop from the perspective of Grossman and Hart (1986), argues that the party possessing manufacturing capabilities becomes the ''boss'' as the locus of competition shifts from innovation to production cost and quality control. Third, China's outward FDI may be justified economically to SOE insiders who overvalue control owing to their distrust of markets and sense of national pride. This third rationale can continue as long as those who control China's business enterprises continue to accept below-market share valuations in exchange for these perceived benefits of control.

All the above perspectives are consistent with the stylized facts we observe, and are potentially at work behind China's outward FDI surge. Thus, depending on the actual mechanism, Chinese outward FDI may have very mixed performance as the future unfolds. Moreover, we focus on pre-entry motivations, and disregard the very real challenges of post-entry integration. Owing to substantial differences in culture and managerial practices, even *a priori* well-justified FDI investments may be mired in unexpected difficulties. For example, the Chinese steelmaker Shougang Group has been plagued by strikes and labor conflicts in South America. Shanghai Automotive Industrial Corporation had similar experiences in South Korea after acquiring SsangYong Motor in 2004.

Further study of China's outward FDI is likely to be rewarding. In the years to come, we expect significant growth in China's outward FDI, not only in volume, but also in variety across industries and organizational forms. More importantly, we expect that the globalization experience will transform many Chinese companies, especially those entering developed countries and competing in higher-end product markets. It has long been argued in international business studies that firms may grow in their international experiences (Casson, 1995). How will Chinese firms establish a global identity, design flexible operations across countries, and improve corporate governance at both the headquarters and global network levels? How will corporate governance improve in Chinese firms as they compete in global markets, and as Chinese domestic institutions develop? What sort of modern management system is compatible with the path that China has followed? These issues have profound consequences for China's long-term economic and institutional development, and for our deeper understanding of international business.

Studying these phenomena in their infancy also provides scope for longitudinal research. The dynamic evolution of firms and institutions not only offers a rich empirical setting for various research questions, but also lets researchers avoid *ex-post* observation biases. For example, a common problem in studying globalization is that only surviving firms are observable *ex post*. Since there will always be good learners and success stories, the estimated efficiency of any country's outward FDI may be misleadingly high, for the accounting misses failed projects that are essentially ''tuition paid'' – lessons about how to succeed. Careful work beginning now will give us a much more comprehensive picture.

Finally, international business research is cross-disciplinary in nature, and China's outward FDI promises a cross-disciplinary research cornucopia. As our earlier discussion indicates, the structural transition in China mandates that any sensible economic analysis of firm strategies will have to take institutional, political, and social aspects into

consideration. Given the visible hands of the Chinese State and the Party in the economy, any micro-level analysis will not be complete without a macro-level background. Exciting new insights are likely to be gleaned from this rich context.

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NOTES

[1]This pattern of comparisons is particularly clear if we consider the outward FDI on a per capita basis.

[2]Cross-listing abroad may also provide Chinese companies with greater access to overseas capital markets. However, merely cross-listing abroad need not constitute FDI. For example, so-called ''red chip'' stocks – Chinese SOE firms listing in Hong Kong, but locating all their assets on the mainland – do not constitute outward FDI to Hong Kong. A Chinese company must locate actual capital assets abroad to contribute to China's outward FDI.

[3]Indeed, we are not even sure if the published data adequately capture the funds flowing from China into Hong Kong.

[4]National SOEs refer to SOEs controlled by the central government. In China, there are SOEs controlled by various level of government, for example, provincial and municipal.

[5]On 16 May 2007 the Development and Reform Commission of China announced government support for outward FDI projects that can alleviate China's resource bottleneck, facilitate industrial upgrade, improve innovation capabilities, and increase the competence of Chinese firms on the global market.

[6]Note that the total savings rates in Tables 4 and 5 are not fully comparable because they are from two difference sources.

[7]A recent reform beginning in 2005 aims at eliminating trading right differences between tradable and non-tradable shares, that is, making all shares tradable. However, even after the reform, the state shareholders can sell their holdings only with the approval of the state-owned assets authorities.

[8]Parts of this discussion draw on Morck, Yeung, and Zhao (2005).

[9]For example, the 169 national SOEs have never paid dividends to the state. A new proposal is under consideration to require dividend payment on state shares, beginning in 2007.

[10]*Caijing*, Volume 174, 11 December 2006.

[11]If earnings beyond profitable investment needs were disbursed to shareholders, they would show up either as consumption and household investment goods (e.g., houses, cars), or as additional household savings (bank deposits or portfolio investments).

[12]These are often called ''image projects'' (形象工程) or ''political achievement project'' (政绩工程).

[13]Stephen Thomas and Chen Ji: Banking on Reform, in *China Business Review*, a publication of US–China Business Council, May–June 2006.

[14]See the table in Chapter 2, *Economic Survey of China,* Paris: OECD, September 16, 2005. The survey defines private enterprises as those controlled by individuals or legal persons, in contrast to the ''state-controlled'' and ''collectively controlled''.

[15]For example, the Ministry of Commerce and the UNCTAD jointly organized the annual ''International Forum on Chinese Companies Going Global'' in Beijing in 2006 and 2007.

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