China Invests Overseas:
How Home Institutions Affect China's Outbound Direct Investment

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Boston University

May 2013

EAI Fellows Program Working Paper Series No. 39

Knowledge-Net for a Better World

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Abstract

China has become an influential source of foreign direct investment in the last decade. The growth coincides with a series of regulatory reforms governing China's outbound direct investment (CODI). Current analyses of CODI and its regulatory environment are largely missing in the literature on China's political economy, however. This woking paper studies the new regulation of CODI and explains distortion and disjuncture in CODI, particularly the under-representation of private companies, the market-defying geographic and sector concentration, and generally low profitability of China's outbound investment. The paper uses statistics published by Chinese government and international organizations, as well as a number of interviews at investing companies.

CHINA HAS THE WORLD'S SECOND LARGEST ECONOMY AND LARGEST ACCOUNTS SURPLUSES AND IS BECOMING AN important source of global foreign direct investment. Chinese investors' footprints have spread to 188 countries on the globe. Yet more publicity than prognosis has been offered in studying CODI. In the former category, the U.S is home to much criticism of investing China, stressing the strong role by the central government. It has been argued that, Chinese companies, due to their government connections, not only create unfair competition to investors of other home origins but also are "Trojan Horse" with unwanted challenge to norms, economy, and security in receiving nations.[1] Such critiques and fears underlie American public opinion and politicians' position on

[1] The congressional discourse on Huawei and ZTE's operations in America, as well as the growing economic episonage filed against Chinese individuals in America, clearly tests such convictions of American law makers and thepublic.

China's corporate investments in the U.S, directly leading to the defeat of Chinese oil company CNOOC's bid for Unocal in 2005, Chinese IT maker Huawei's bids for Sprint, 3Leaf, and many other big contracts in the past five years.[2] The high publicity, however, has not examined how China's home institutions have shaped CODI and whether government connection strengthens China's aspirant companies abroad.

On prognosis, two empirical works, both published in *The China Quarterly*, are particularly worth re-accounting here. Kevin Cai published the early study of China's outbound investment and found that by 1997 China was already a leading investor among developing countries and at the time the Chinese government was yet to announce any encouraging policies toward outbound investment.[3] Cai finds, for example, the Chinese share of outward FDI stock among developing economies increased from 0.5 percent in1985 to 6.4 percent in 1996, after only Hong Kong, Singapore, and Taiwan in the developing world. By analyzing the sector and geographic distribution of China's outbound investment, as well as the motivation of investing companies, Cai concluded that CODI's patterns were "generally similar to those from other developing and developed market economies."[4] Indeed, Cai used a general FDI theory, the Dunning theory, to account for China's rapid progress in outbound investment.[5]

At the time of publication, Cai was optimistic, and argued that three factors would ensure China's continual improvement in outward FDI. First, Chinese economy has performed quite well and will continue to grow and create very favorable background conditions for Chinese companies going abroad. Second, the Chinese industrial structure has been upgrading significantly and will continue to do so, making Chinese companies more competitive. Third, an increasingly strong political commitment on the part of the Chinese government to further liberalize its policies and to promote outward investment, in pursuing "world class" industrial-commercial conglomerates, "will surely be conducive to the further development of Chinese outward FDI."[6]

Confirming Cai's optimism, Eunsuk Hong and Laixiang Sun published a 2006 article in *The China Quarterly*, investigating China's "going out" strategy and companies in exploring global markets.[7] They remarked, "in parallel with success in attracting inward FDI, China has achieved initial success in implementing its 'going out' [*zouchuqu*] strategy, which encourages domestic enterprises

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[2] For a summary of Huawei's bids, including failed ones, see Sheridan Prasso, "What makes China telecom Huawei so scary," *Fortune*, January 28, 2011.

[3] Kevin Cai, "Outward Foreign Direct Investment: A Novel Dimension of China's Integration into the Regional and Global Economy," *The China Quarterly*, No.160 (December, 1999), pp. 856-880.

[4] Cai, "Outward Foreign Direct Investment," p.857.

[5] For a summary of the theory, see John Dunning and Rajneesh Narula, "The Investment Development Path Revised: Some Emerging Issues," in Dunning and Narula, *Foreign Direct Investment and Governments*, pp.1-41.

[6] Cai, "Outward Foreign Direct Investment from China," p.879.

[7] Eunsuk Hong and Laixiang Sun. 2006. "Dynamics of Internationalization and Outward Investment: Chinese Corporations' Strategies." *The China Quarterly*, No. 187 (September), pp.610-634.

to play a part in international capital markets and to invest overseas."[8] In the early 2000s, Chinese companies scored many gains in overseas market. Haier, after succeeding in the U.S, acquired the microwave division of Japan's Sanyang and formed strategic alliances with Sony and Toshiba. Lenovo acquired IBM's notebook division in 2004. Other cases included Konka (color televisions), TCL (multi-electronics), Jianlibao (beverage), Tsingtao (beer), Galanz (microwave), and others.[9] Hong and Sun's overall assessment of CODI was similar to Cai's 1997 conclusion, "Generally speaking, China's outward FDI is similar in character to that of other third-world multinationals."[10]

Hong and Sun meanwhile stress the importance of government policies, especially the "going out" policy announced in the Tenth Five-Year Plan in 2001.[11] Although no clear regulatory documents were inaugurated in connection to the policy, visible changes took place, according to them. Government officials in charge of screening and approval changed their attitude and became friendlier to commercial investment overseas, aiming to acquire resources, technology and strategic assets acquisition, and at the firm level, companies were increasingly interested in reputation and brand building, and in innovative investment mechanisms and financing channels.[12] These trends, Hong and Sun argue, "will continue to deepen in the future," as the government continues to liberalization outbound investment policies and companies make internationalization an imperative to acquire strategic assets and proprietary knowledge in developed economies.[13]

A half decade has passed since Hong and Sun's writing, and the Chinese government has implemented various regulatory reforms on approving and encouraging China's outbound investment. Further, the Chinese economy, exports, and industrial strength have grown at faster pace than before. Government revenues and current account balances have likewise risen significantly. In a word, the Chinese state has more power to support its companies' going abroad than ever before. How has the Chinese regulatory environment over outbound investment been improved? What are the effects of the regulations? How have they influenced the outbound investment from China?

A clear oversight in the abovementioned articles is their lack of discussion of China's economic system, that is, the dominant roles of state-owned-enterprises (SOEs), whose strength has additionally increased since 2003. By applying models originating from Western investment studies, they assumed away the importance of home institutions of investing companies. Business scholars, on the other hand, have found that home institutions critically influence outward FDI. Peter Buckley, Jeremy Clegg, Adam Cross, Xin Liu, Hinrich Voss, and Ping Zheng (hereafter Buckley et al) analyzed China's outbound investment statistics from 1985 to 2001 and find that

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[8] Hong and Sun, "Dynamics of Internationalization and Outward Investment," p.610.

[9] A list of these successful Chinese brands and overseas activities is offered in Fiona Gilmore and Serge Dumont, *Brand Warriors: China Creating Sustainable Brand Capital.* London: Profile Boooks Ltd, 2005.

[10] Hong and Sun, p.611.

[11] Zhu Rongji, "Report on the Tenth Five-Year Plan for the national economic and social development," *Renmin ribao* [*People's Daily*], March 5, 2001

[12] Sun and Hong 2006, p.620

[13] Hong and Sun, p.633.

although the general theory of FDI partly explained China's outbound investment, a special theory, taking into account home institutions, ought to be developed.[14] Indeed, Buckley et al hypothesized that state owned companies, embedded in state capital and inefficient banking systems, are more likely to make acquisition deals as a mode of entering and penetrating a host economy. Overbidding also more often takes place than private investors. Home institutions, as Buckley et al finds, also shape investment behaviors of companies. "Given the extent of state control of the Chinese economy, the institutional environment is likely to have had far-reaching and profound effects on the internationalization decision of Chinese firms."[15]

Further, existant literature has understudied the outbound investment by private companies in China, or how the government regulation has been influencing state and non-state companies differently. In addition to analyzing outbound investment statistics, the article combines open-ended interviews with private and state companies on their experiences "investing abroad." Such interviews shed light on the experiences of specific companies operating under China's new regulatory environment.

The following consists of four sections. It first presents the regulatory framework in China since 2004 and the interactive effects on CODI. The second section compares CODI to investments from other Asian nations and address how China's outward investment has been different. Following this, the third section compares post-2000 CODI with CODI in the 1990s and concludes that government regulation has worsened the performance of CODI. The fourth section provides selected case studies of private companies and state companies in investing abroad. Together, the empirical research concludes two arguments on Chinese state's effect on CODI: First, the central state seems not effective in regulating powerful state-owned companies, neither effective in reigning in private investors' covert operations. Second, since the regulatory state was installed, it has weakened CODI and resulted in its underperformance and underrepresentation of private investment.

The State Policy and Rising Outbound Investment in China

When China began economic reform, it welcomed foreign investment inflows, yet restricted capital outflows.[16] In the mid 1990s, driven by deeper opening of China's economy, domestic companies launched investment abroad, and many achieved impressive successes in overseas operation.[17] Then at the turn of the century, the government promulgated the "going out" policy, which

[14] Peter Buckley, Jeremy Clegg, Adam Cross, Xin Liu, Hinrich Voss and Ping Zheng, "The Determinants of Chinese Outward Foreign Direct Investment," *Journal of International Business Studies*, Vol, 38, 2007, pp.499-518.

[15] Buckley, et al, p. 504.

[16] For a detailed process tracing of the emergence of China's pro-FDI industrial policies, see Min Ye, "Diasporas and Foreign Direct Investment," in *China Today, China Tomorrow*, edited by Joseph Fewsmith, New York: Rowman & Littlefield, 2010.

[17] See Kevin Cai and Buckley 2007.

was not initially codified in formal regulations but a set of general statements by the national government to encourage Chinese companies to go abroad, take advantage of international markets, and exploit global resources. In October, 2000, the first official announcement of the "going out" policy was made in the Tenth Five-Year Plan and was later called a national policy (国策). In spring, 2001, the National People's Congress affirmed the policy. Corresponding to this period of loosening restriction and encouragement of CODI, China's outbound investment rose rapidly and economic performance of investing companies was steady.

The interactions between corporate initiatives and responsive policies show that the government was quite effective in facilitating outbound investment from the mid 1990s to the early 2000s. Yet the effectiveness was not derived from clear, formal regulations, nor from industrial policies that explicitly favor some types of investment over the others. Both emerged as new trends after 2005. In the early 2000s, for example, the policy framework of CODI was murky and contradictory. In some sectors, the government encouraged companies to "go out," either exporting or investing abroad, in others, restriction remained.[18] In the same sectors, one document encouraged companies to go abroad, and another set up stringent conditions.[19] Further, it was murky in terms of approving overseas investment project, criteria for approvals, or authorities in charge of such approvals.

Figure 1 shows, starting from very low, CODI rose to an impressive 2.7 billion in 2002. Two years later it was $5.5 billion. Then in later 2004, the government passed the main document that codified the current state regulation of CODI: the Decision on China's Outbound Investment passed by the State Council (hereafter the Decision). The Decision was widely seen as an improvement in liberalization of CODI and followed by a steady increase in China's outbound investment. In 2005, annual CODI reached $12.3 billion, in 2006, it was $17.6 billion, and in 2007, it was $26.5 billion. The biggest increase in the decade occurred in 2008, at $55.9 billions, while the world entered the period of economic recession.

Due to the recession, the government needed to shore up domestic economy and pushed easy credit for CODI, yet such loose credit was mainly enjoyed by large SOEs and resulted in a growing imbalance between central SOEs and private companies in China's outbound investment. In 2008, the central SOEs' share among total outbound investment was 86 percent, compared to merely 0.3 percent by private companies, the rest being made up by local-level SOEs and subsidiaries of government companies in various forms.[20] The share of foreign invested companies in CODI was also minimal.

Concurrent to the rapid growth in CODI was some new moves in the regulatory efforts by the Chinese government. In 2009, the Ministry of Commerce passed a new regulation. Like the 2004 State Council decision, it (1) simplified the approval system, (2) institutionalized the regulation, and (3) eased conditions for investing companies. The National Development and Research

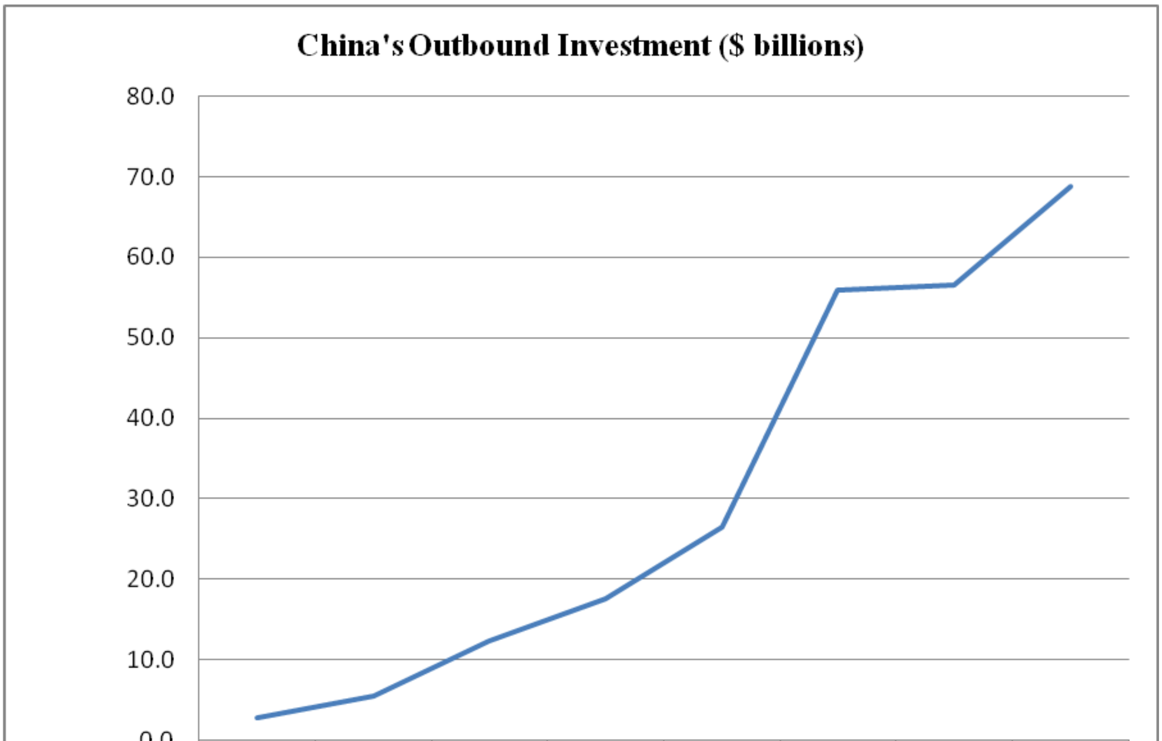
[18] The contradictions and inconsistencies were also offered in Hong and Sun, 2006.

[19] Also see Buckley et al, 2007.

[20] Types of government and SOE-affiliated companies include joint-stock, limited liability, and joint managing companies.

Commission (NDRC) also set up financial support to particular industries every year. Such state efforts have been reasonably effective in shoring up CODI. The patterns show, however, such improved regulatory and financial support for Chinese outbound investment has benefited state companies more than private ones. More concretely, it has narrowed the goals of outbound investment and favored resources acquisition only, and meanwhile it strengthened regulation over private CODI, thus increasing hurdles to private companies investing overseas.

Figure 1: CODI Rising from 2002 to 2010



	2002	2004	2005	2006	2007	2008	2009	2010
billions	2.7	5.5	12.3	17.6	26.5	55.9	56.5	68.8

■ Source: data for 1980 to 2003, see Buckely 2007, and data from 2004 onward, see *China Statistics Yearbook*, 2005-2011 editions.

There remain clear limitations in China's regulation of CODI. First, there are multiple steps of approval for investors to navigate. Even with 2004 State Council Decision and 2009 MOC regulation, at least three agencies are involved in getting approval for outbound investment. The first is the state administration of foreign exchange (SAFE). Investors must apply to the local branch of SAFE and obtain an "Examination Opinion" to verify that they actually own the foreign exchange funds, which they propose to invest abroad or to convert funds in RMB into foreign exchange. Above a certain threshold, the approval of central SAFE in Beijing is required. The second is the national development and reform commission (NDRC). Investors must obtain verification and approval from the local branch of NDRC, and for projects in resources development or using large amounts of foreign exchange, further verification and approval of the central NDRC in Beijing. Where the investment exceeds certain thresholds, approval from the State Council is additionally required. Thirdly, they must obtain approval from provincial-level Ministry of Commerce (MOC) and, for investments in certain countries or industries, from central MOC in Beijing.

Where a proposed outbound investment involves state-owned assets, Chinese investors must also obtain the verification and approval of the state-owned assets supervision and administration commission (SASAC). Finally, once these approvals have been obtained, investors must go back to register with SAFE to remit the foreign exchange funds outside of China.

If all goes smoothly, the whole process can take several months. The stipulation that investment should get a response within 3-5 business days is rarely adhered. A private company without government connections at various levels needs much longer to go through the multi-stage approval process. If a private company makes a large amount investment or investment in resources, it is required to get approval at SAFE, NDRC, and MOC in Beijing, it takes longer and becomes uncertain whether it can have approvals from all these agencies where the investor has few access.

Second, the goals of the "going out policy" have narrowed since 2004. Before the Decision, the government has encouraged companies to "go abroad" to seek market, materials, and technology.[21] The 2001 "going out policy" included the three parallel objectives for CODI. In the late 2004 State Council Decision and the 2005 Five-Year Plan, export promotion was dropped, and access to technology was also diluted. Only acquiring raw materials continued to be emphasized. In the 2010 Government Work Report, particularly, while "going out" remains the "national policy", the only motivation listed was "acquiring resources," and accessing technology was not mentioned. The narrowing goal in regards to CODI has reduced the government credit and policy support for projects (or companies) not in the business of acquiring resources overseas. Such business was a prerogative of centrally listed state companies. Manufacturing industries, which are significant in exports and technology upgrades, have endured the hit, and their share in total CODI has continuously declined.[22]

On liberalization, the approval process was institutionalized, but remained quite onerous and opaque toward private companies. The burden of getting approval has perhaps been intensified for private investors, considering their lack of informal access at the government. Before the 2004 State Council decision, the approval authority of CODI was granted to vaguely defined "supervising agencies." In practice, private investors used informal channels to get approval for their investment project. The Decision centralized the authority to the national government. Specifically, it stipulates that NDRC has the authority to approve overseas investment proposals, while MOC has the authority to approve proposals to set up companies abroad. As private companies have weaker ties at these national agencies, they face irregular approval process, as revealed in the case studies later.

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[21] See Cai 1999, and Hong and Sun 2006.

[22] By the number of investment, as indicated in the Chinese Council on Promoting Foreign Trade 2011 survey, manufacturing still constitutes of the largest share.

The formal decrees also biased against private CODI. The 2004 decision indicates that large resources-related investment projects valued from $30 million to $200 million, and non-resources-related investment projects valued between $10 million and $50 million require NDRC approval. Resources projects valued below $30 million and non-resources projects below $10 million are separated into two types: for centrally-affiliated SOEs, no approval is needed, and for local companies, private ones included, require approval of the provincial office of NDRC. Large projects above these ranges need direct approval at the State Council.

Disadvantage to private CODI was clear. One, only overseas investment by large SOEs valued under $30 million (for resources) and under $10 million for non-resources deals were exempt from licensing. Other companies still need pre-approval at the provincial offices of national bureaucracies (NDRC or MOC). Two, previously, CODI valued under $1 million was not specified in terms of approving agencies, as long as there were agreements with so-called supervising agencies. Various branches of local governments could influence the approval process, as private companies took on their sponsorship when needed. Now as the approval authority is specifically reserved to arms of the national government agencies, private CODI is subject to likely stricter regulation.

By contrast, regulation over large SOEs has loosened, and the national bureaucracies have little oversight of gigantic investments made by them. The 2004 decision stipulates that CODI above $200 million in resources and above $40 million in non-resources areas need approval at the State Council. However, as only the dozen or so centrally-affiliated SOEs make such investment and their access at the State Council is likely unfettered, either by informal patronage or frequent personnel exchanges between SOE managers and the State Council members, securing approvals is uncomplicated. That is perhaps why in oil and gas acquisition alone, Chinese National Petroleum Company (CNPC), Sinopec, CNOOC, Sinochem, China Investment Corp (CIC), etc, have made 65 deals valued above this range from 2002 to 2010, and many were in billions.[23] In 2008-2009, 34 acquisitions were valued above $100 million each, with 90 percent in resources acquisitions by centrally affiliated state companies.

The approved project data at NDRC further concludes that despite the top authority to approve China's outbound direct investment in on-trade areas, the agency has little power over centrally affiliated SOEs when the latter launches overseas acquisitions. In the 2008 project list approved by NDRC, for example, only a dozen or so were filed by the 150 plus central SOEs, which according to Ministry of Commerce statistics constituted over 85 percent CODI in China in that year.[24]

Lastly, the implementation of the same regulation proves cumbersome to private companies lacking government networks. The 2009 Ministry of Commerce regulation set out terms that facilitated investing companies, and it shortened the time for verification and approval of project valued under $10 million from 15-20 days to 3 business days, eliminated the requirement for consulting overseas consulates except for projects valued above $100 million, simplified contents for inspection, and largely eased the use of foreign exchanges. Without government access, however,

[23] OECD/IEA 2011, *Overseas Investment by China's National Oil Companies.*

[24] Zhang Qian and Hu Jianbo, "China's Overseas Investment under Crisis," *Jiangsu Shanglun*, No 2, 2011, pp.96-98.

private companies have difficulty raising enough foreign exchange, and apparently, they seldom get their approval within 3 days limit. Private entrepreneurs could spend up to a year to get proper paper works to invest. In practice, many private companies do not bother waiting around for government approval and invest overseas covertly. Such covert operations, however, exclude private entrepreneurs from accessing support from the government and also suggest the limitation of government oversight of capital flows.

Financial support from the government has mainly favored state companies' outbound investment. In the past decade, China set up a few funds to directly support overseas investment, including: China-ASEAN Investment Fund (2003), China-Belgium Direct Investment Fund (2004), and China-Africa Development Fund (2007). These funds helped to launch large infrastructure projects in recipient nations. Yet such projects only involved state companies and excluded private entrepreneurs. The China-ASEAN investment Fund, for example, invested in infrastructure in Philippines, Cambodia, Laos, and Thailand. The China-Africa Fund typically teams up with centrally affiliated SOEs in infrastructure and resources-associated acquisitions.

Other than ODA-affiliated support, China's development banks have provided favorable loans to investing companies in particular sectors. Due to considerable informalities in banks' lending decisions, SOEs with good access at these development banks again benefited more than private entrepreneurs.

The 2008 increase in CODI was largely boosted by China's stimulus plan, which made substantial resources available to investors, those with government networks acquired disproportional shares. In 2008, CODI doubled from the year before, despite the global, regional, and national recession. The stimulus plan was valued over 4 trillion RMB, and the majority was allocated for domestic infrastructure development, which boosted state companies monopolizing steel production, raw material imports, electrical grids, etc. More directly, the China Development Bank and Ex-Im Bank, two of the three policy banks, received fund in the range of billions of dollars and these banks were able to offer substantial credits to SOEs acquiring overseas equity and resources. Even more dramatic was the ease in commercial bank lending in 2008. The government, in order to maintain high GDP growth against the global recession, urged banks to lend more freely. By all accounts, bank lending increased by 30 to 50 percent from the previous years.[25] Again, state companies benefited unduly from this easy credit.

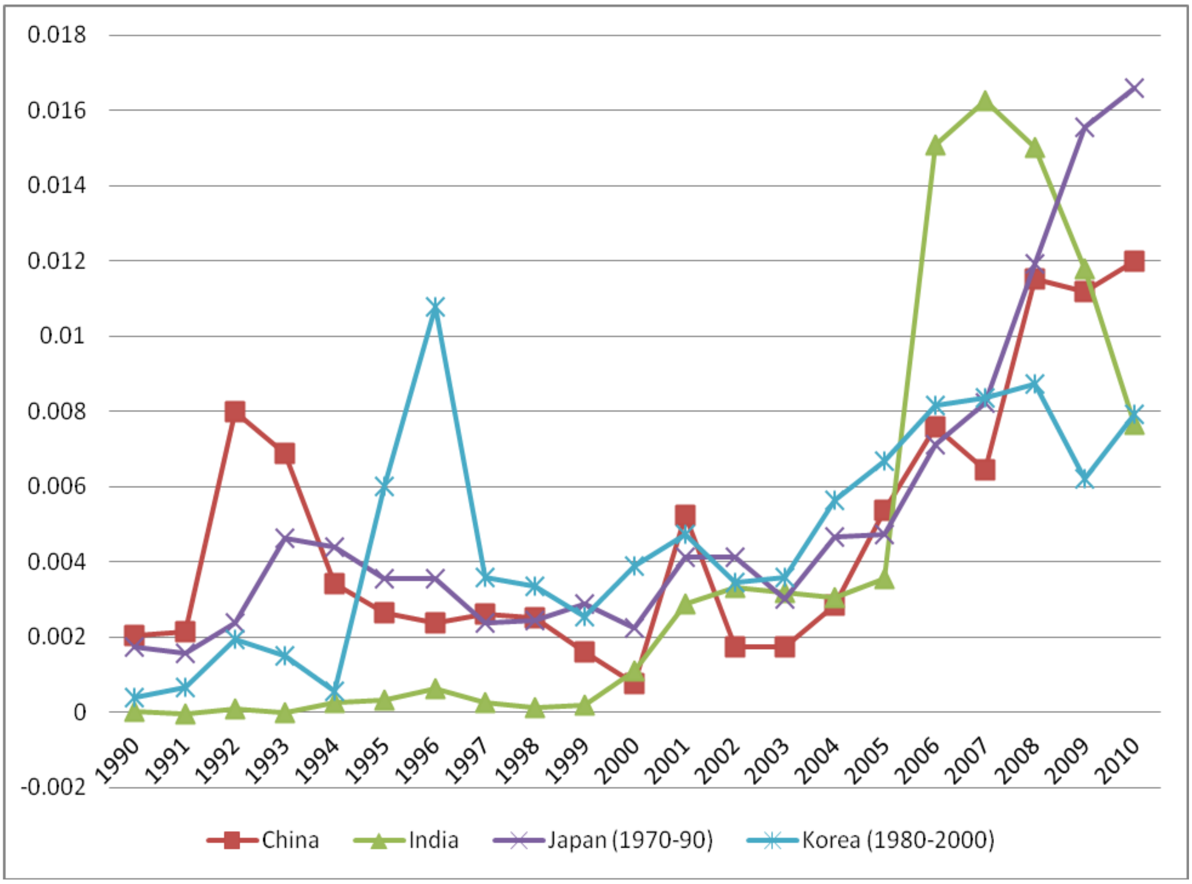
To conclude, the Chinese government has played important roles in influencing China's outbound direct investment. Its policy frameworks since 2000 have improved significantly in liberalization governing regimes and providing financial resources to companies investing overseas. However, the benefits from policy liberalization and financial prowess have accrued disproportionally to central SOEs, making large resources acquisition overseas. The private companies and the manufacturing industry have seen dwindling shares in CODI.

[25] See Barry Naughton, "Understanding the Chinese Stimulus Package," *Chinese Leadership Monitor*, No. 28, 2009.

China's Outbound Investment in a Comparative Perspective

Critics and praisers of China's outbound investment imply that China's government support, codified in the national policy of "going out," enhanced Chinese capacity to invest overseas. A quick comparison with India, a country of China's size and population but far less publicized in overseas investment, shows that the two countries propensity to invest overseas in the recent decade has been comparable. Figure 2 indicates that in the 1990s, when the Chinese government did not implement explicit promotion of CODI, it had much higher propensity to invest overseas than India's. India's outbound foreign direct investment (ODI) versus GDP was next to zero, and China's ratio was 0.2 percent to 0.8 percent in the 1990s. Both converged around 2000. Since then, ODI/GDP ratio increased faster in Indian than in China until 2009, when the world's economic recession hit and investment opportunities were sliding.

Figure 2. Investment Propensity of China in a Comparative Perspective, ODI/GDP



Compared to Japan and South Korea in a historic trend, China also did not appear as an over-investor because of its government promotion. Japan in terms of developmental level was about two decades ahead of China and Korea about one decade. So I compare the ratio of

ODI/GDP for Japan 1970-1990 and for South Korea 1980-2000. The first fifteen years, their ratios were highly comparable, and Japan invested considerably more after the Plaza Accord in 1986, although China's ratio was already boosted by the government's stimulus plan in 2008. South Korea, from 1980-2000, invested more than China's for most of the two decades. The Asian financial crisis of 1997-8 undercut South Korea's outward investment, while China's stimulus plan in 2008 promoted investment, as mentioned before.

Key differences do exist. The theories that explain Japan, South Korea, India, and other countries have found that destination of investment is generally split into three: export market, raw materials, and others (including services connections, technology acquisition, etc). The Chinese patterns are different. The first distinct aspect is its overconcentration in Hong Kong. Table 1 provides the shares of Hong Kong among total CODI. From 1979-91, only 7.1 percent went to Hong Kong. From 1991-96, Hong Kong received 14.9 percent. In Cai and Hong and Sun's studies, Canada, Australia, USA, Russia, South Africa, etc, all received sizable Chinese investment. From 1997 to 2002, over half was invested in Hong Kong. Then, Hong Kong's shares started to decline until 2007. In 2008 and 2009, almost three quarters of China's outbound investment went to Hong Kong. If we combine the shares of Hong Kong and Virgin Island and Cayman Island, all popular tax havens, the vast majority of CODI in the recent decade went to these places.

Table 1. The Shares of Hong Kong in China's Outbound Investment

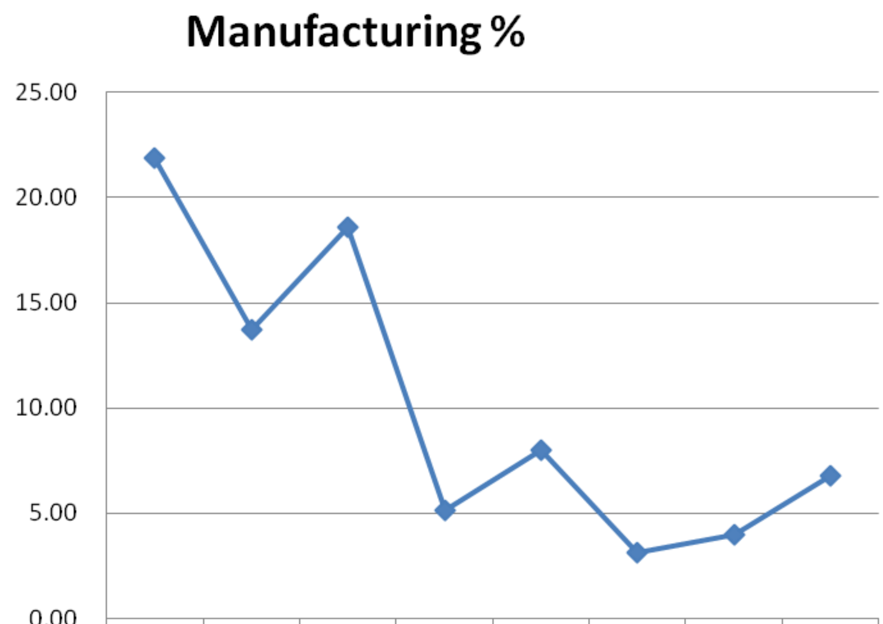
	1979-91	1991-96	1997-02	2004	2005	2006	2006	2007	2008	2009	1010
HK%	7.1	14.9	54.2	47.8	27.9	39.3	39.3	51.8	69.1	63.0	56.0

■ Source: Calculated from the *Chinese Statistics Yearbook* and *Chinese Statistical Bulletins on Outbound Investment*, annual publications.

To be sure, a good proportion of outbound investment in Hong Kong went to other places and Chinese central government has difficulty tracing their final destinations. It does not make a difference in the total flows of China's outbound investment, but demonstrate a clear case of regulation avoidance and indicate perhaps still complicated approval systems in China or assets flight.

The second imbalance in comparative perspective is the minor shares of manufacturing industries in CODI. The earlier analysis of China's regulation and policy concludes that the government initially supported three goals in CODI: expanding export markets, accessing more advanced technology, and acquiring raw materials and natural resources. Yet beginning in 2004, three goals gradually reduced to but one, acquiring raw materials and resources. Despite a major manufacturing powerhouse in the world, the manufacturing share in CODI has been small and getting smaller. Demonstrated in Figure 3, manufacturing CODI accounted for 22 percent to total CODI in 2003, a sizable share. In 2006, the share declined to 5.14 percent. In 2008, as the government was injecting more fund into promoting overseas investment, manufacturing's share was at a historic low, at 3.16 percent. The most recent data in 2010 suggests that its share was only 6.78 percent.

Figure 3. The Manufacturing Shares in CODI, percentage, 2003-2010.



	2003	2004	2005	2006	2007	2008	2009	2010
Manufacturing %	21.86	13.74	18.60	5.14	8.02	3.16	3.96	6.78

The lack of investment in manufacturing sectors will defy some optimistic assessments of China's outbound investment. That is, as China matured its manufacturing industries and began to relocate to other less developed nations, CODI will bring technology, skills, and capital to help industrialization in those areas. Historical precedents of industrial relocation and spill over were clear from Japan to South Korea and Taiwan, further to Southeast Asian nations, and the largest, most recent was to China. However, given China's tardiness in encouraging manufacturing industries' investing overseas, such shift from China to elsewhere, even it happens, will be slow.

The last disequilibrium is the relative low representation of private companies in CODI. From 2006 to 2010, the Ministry of Commerce *Statistics Bulletin on Outbound Investment* suggests that the shares were roughly 1 percent. Indeed, 2006, 1 percent, 2007, 1.2 percent, 2008, 1 percent, 2009, 1 percent, and 2010, 1.5 percent. State companies and companies with dominant state shares made up the rest. Such a distribution does not reflect Chinese private companies' economic weight or innovative capability in comparison to state companies. Table 3 summarizes the economic weight and innovativeness of China's private companies from 2006 to 2010.

The Chinese corporate ownership, however, is complicated. The rough division is SOEs, collectives, private, and foreign-invested firms. However, in the statistic reporting, there are also cooperative enterprises, joint ownership enterprises, limited liability corporations, share-holding corporations, as well as joint stock, limited responsibility, enterprises with Hong Kong and Taiwan fund, foreign-funded companies and many unidentified others. In addition to state-owned and collectives, there is a separate category of state-owned and state-holding companies, in which SOEs, local governments, and other state agencies take dominant shares in the joint ownership, and limited liability and share-holding corporations.[26] Using companies registered as private companies alone may underestimate the strength of private sectors in China. A second test of the under-representation by using the same indicators for companies that are not state-owned, state majority shares, state controlling, or HK and foreign invested companies yields similar results, reported in Appendix B.

Table 3. Private Companies in China, shares percentage

% of private companies	2006	2007	2008	2009	2010
Industrial output	21.24	23.21	26.87	29.55	30.54
R&D expenditure	6.5	6.99	8.73	10.02	10.27
Patents granted	7.34	6.41	9.54	10.03	11.94
New products			10.87	11.6	13.60
Outbound FDI	1	1.2	1	1	1.5

■ Note: These companies only include those with annual revenues above 500 million RMB.

Declining Performance of CODI

The dominance of SOEs, seen as evidence of strong state, has negatively affected the performance of CODI. Compared to the pre-2000 period, CODI less represents China's economic weight, sector strength, global distribution, and most importantly, suffers from a severe under-representation of private investment overseas and underperformance of CODI in general.

First, by economic weight, China remains under-investing in the world, even compared to its recent past. In 1996, CODI amounted to $18 billion, behind Hong Kong $112 billion, Singapore

[26] Based on own interviews of Chinese scholars.

$37 billion, and Taiwan $27 billion in the developing world.[27] Today, by investment versus GDP ratio, China's gap with comparable nations was widening. In 2008, for example, this ratio in China was 0.97 percent. The following year the ratio over GDP was reduced to 0.88 percent. Comparatively, the average ratio of outbound investment against GDP in the developing world was 2.03 percent and in the developed world was 4.71 percent, both much higher than the Chinese rate. Furthermore, CODI share of global FDI was only 2.25 percent in 2008, in no match with its economic weight in the world, which was close to 10 percent.

In sector and regional concentration, current CODI mismatches China's factors of endowment, countering a trend before 2000. In 1994, for example, among China's overseas investment projects, 60 percent went to servicing trade, 25 percent went to strategic assets (technology and natural resources); and 15 percent was in manufacturing. The motivations were seeking export market, finding resources supply, obtaining foreign technology and raising fund.[28] The share of manufacturing investment declined sharply after 2004. In 2009, it was only 4 percent of total CODI, despite that the manufacturing sectors were in Chinese strength and constituted the bulk of exports and gross national economy. In large projects, the bias toward resources acquisition was more evident. From 2008 to 2009, 34 acquisitions were valued over $100 million each, of which 13 were energy-related acquisitions, valued at $28 billion, constituting 49 percent all such projects. Another 46 percent above $100 projects were to acquire mineral resources, totaled at over $26 billion. Among the 34 largest CODI projects, only one was filed for acquiring a public facility, at $1.6 billion, and one to acquire commercial services at $0.86 billion. Manufacturing sector contributed a little over 1 percent of these large CODI: only three of them with the total amount of $0.7 billion.[29]

In geographic distribution, pre-2000 CODI followed conventional economics: big markets, technology, and resources. In 1990, Australia received 30 percent CODI, followed by U.S 28 percent, Hong Kong 10 percent. And in 1998, the U.S share declined to 15 percent, followed by Canada 14 percent, Australia 13 percent, and Hong Kong 9 percent. Access to resources was clear in consideration, but Australia and Canada attracted most resources-driven CODI. The 1990s also witnessed a rapid increase to Russia and Central Asia, driven by opening of markets in these areas.[30] In 2009 and 2010, these conventional heavy-weight destinations only received marginal shares. The U.S share was about 2 percent, Australia a little over 2 percent, and the share of Africa was only 3 percent, with the rest regions and countries having miniscule shares. On the other hand, Hong Kong's shares skyrocketed. In 2009, it was 48 percent and in 2010 it was 56 percent.

[27] Cai, "A New Dimension."

[28] Buckley 2008, "Determinants of China's OFDI."

[29] Liu Hong and Wang Duanyong, "zhongguo duiwai touzi xianzhuan yu tedian yanjiu: 2008-2009," *Juoji jingrong (international finance)*, Vol 26, No.12, 2010, pp.63-68.

[30] See Hsiu-Ling Wu and Chien-Hsun Chen, "An Assessment of Outbound Foreign Direct Investment from China," *Europe-Asia Studies*, Vol 53, No.8, 2002, pp. 1235-1254. Original source, Almanac *of China Foreign Economic Relations and Trade*, 1991-2000.

The total shares of CODI in Hong Kong, Cayman Island, and Virgin Island, namely tax havens, round up to 76 percent in 2010. We cannot find detailed information on the three quarters CODI, but it falls beyond the government oversight and serves as evidence of weakening state regulations over large companies that use tax havens for overseas activities.

Finally, by economic performance, before 2000, 90 percent outbound investment was financed by international market and only 10 percent was raised domestically.[31] The investment was quite profitable in general. For example, when China Investment Trust acquired Australia's Portland Aluminum Refinery in the 1990s, it entirely relied on international funding, and within two years, it recovered its investment and offered millions of dollars profits to its investors. Shanghai Bicycles, such as Yongjiu and Fenghuang, set up manufacturing factories in Ghana and Brazil and earned $100 million profits by exporting to nearby countries. Huangyu electronics set up a branch office in London and recouped investment fund within two months. Even in Africa, successful investment included Friendship textiles mills in Tanzania, SVA in South Africa, and Unix in Nigeria, all starting in the mid 1990s. Other successful cases include China Wuhan International Economic and Technology Cooperation Corp (CWIC) operating contractual labor, Shenzheng Sange and Dongbei Pharmaceutical's investments.

A survey of the 1990s CODI suggests that 55 percent was profitable, 28 percent break even, and only 17 percent was loss making.[32] By contrast, post-2000 CODI reported more losses. According to the UNCTAD ranking, CODI's profitability was ranked in the 68th global position in 2006-2007. Of all investing companies frin China, two thirds made losses or broke even, and only one third had any profit, according to Ma Qiang, an economist at the National Development Research Council.[33]

Cases: Why Chinese Private Companies and non-Resources SOEs not Invest more abroad

Thus far, the analysis of China's regulatory environment, state's role, SOE dominance, and resources dominance in CODI is based on macro-level data. At a micro-level, why has private investors not been more active? What have prevented them from going abroad? Among state companies, why have they not invested more in non-resources areas?

Private investment constituted less than 1 percent in reported CODI. In 2010, the share was only 0.4 percent. Some scholars may argue that the small share of private investment was due to

[31] Wu and Chen, "An Assessment," 2002.

[32] See Shi Lei, "China's Foreign Investment," *touzi yanjiu (Investment Research)*, NO. 5, 1998, pp.33-37; Wu and Chen, "An Assessment," 2002.

[33] See, Ma Qiang, "Why Indian OFDI is More Profitable than Chinese (yindu haiwai touzi yinli weihe chaoguo zhongguo?)", *zhongguo jingji daobao (China Economics Guideline)*, Feb 1, 2011.

their corporate and technological weaknesses.[34] Yet the previous section has explained that private companies are major contributors to China's industrial output and innovation. Sun Xiaohua, the vice chairman of Chinese State Industrial and Commerce Federation, has also confirmed that private companies are the most innovative companies in China. They registered 66 percent innovative technology (*zhuanli*), 74 percent design innovation (*jishu chuanxin*), and 82 percent new products (*xin chanping kaifa*). Among all major automakers in China, Geely (the only private automaker) had been making profits by selling their IPR overseas since 2003. According to Sun, in 2008, of the 500 largest private companies, 245 were ranked as high technology, 209 had their own proprietary intellectual property, and 320 had their own innovative departments. Further, they use modern corporate structures, with 82 percent private companies being registered as modern corporations in 2008. Besides, as many observers would concur, the Chinese private companies are entrepreneurial and low-cost—that is perhaps why they were able to forge strong shares in the world's exports.[35]

At least three barriers have played a part in limiting foreign investment by Chinese private companies: CODI policies, SOE dominance within China, and undercut by state-affiliated enterprises in overseas market.

The current CODI policy was crafted in 2004, which required investing companies to get approval at the national government agencies or the local branches of these agencies. SOEs benefited from the easing of approval. Private entrepreneurs reported that approvals took too long to pursue. Feiyue, a private company in Zhejiang, for example, had 18 subsidiaries abroad and only three received government approval. According to its manager Sun Jianping, the approval procedure was very complicated, and each approval could take quite long to complete.[36] Going underground enabled private entrepreneurs to make quick decisions on outbound investment, but it also prevented them from seeking government support.

For private companies aiming to make large-sum investment, going underground is not an option, and their approval at the national agencies is unpredictable. Tengzhong, a large private auto company in Sichuan, filed application for their acquisition of GM's Hummer in 2010, but after six months it still failed to hear any verdicts. Waiting for another month the company realized that it was impossible to get approval and decided to rescind its acquisition contract. And each approving agency has its *ex post* explanation for inaction, or de facto rejection: the State Council spokesperson said it did not receive the application, the NDRC argued that the acquisition was for service industry thus fell out of its jurisdiction, and the excuse of MOC was that Tengzhong did not explain in its application whether the deal was to acquire technology or pa-

[34] Revealed in personal conversations with scholars in Beijing, many belonging to the New Left.

[35] Sun Xiaohua, "zhongguo minying qiye de haiwai binggou celue (The Overseas Acquisition Strategy of Chinese Private Companies)," *Chinese Finance (zhongguo jingrong)*, No.3, 2010.

[36] Chen Hongwei and Yang Jianping, "Feiyue Jituan: Chinese Companies Going abroad," *zhongguo jingji shibao (China Economic Time)*, May 16, 2000

tents.[37] Tengzhong has very good relations with the local government, but it does not have access to national agencies in Beijing. The "going out" policy that centralized approval to the national bureaucracies adversely affected Tengzhong's overseas acquisition.

Second, SOEs' monopoly of key sectors in China prevented private entrepreneurs from entering profitable foreign business. While large SOEs were acquiring strategic resources overseas, private entrepreneurs had the same motivation, but domestic monopoly of commodity market by SOEs made such business aspiration impossible. In 2008, a private entrepreneur from Shanxi, Mr. Liu, signed an acquisition contract for an iron ore in central Africa. He filed paperwork for his investment. He first faced difficulty in getting approval at the local NDRC. Despite the official document stipulating approval decisions be made within 10-15 business days, Mr. Liu's application was stopped at nowhere. Mr. Liu then channeled fund to a shell company in West Africa and used that fund to acquire the iron ore, without going through the approval process. His second roadblock was from a SOE competitor, which found out Liu's deal and contacted the original owner, trying to steal Mr. Liu's deal. Mr. Liu fortunately had signed exclusive contract with the original owner and was able to secure his investment. The biggest challenge, however, was the license to import into Chinese market. After Mr. Liu acquired the iron ore, he had no way to import the materials into China, despite China's surging demand for raw materials. And there he had no way out. In 2010, after sucking in $800 million, Mr. Liu was looking for buyers of his ore in central Africa. Asked about Mr. Liu's future investment plans, he only shook his head.[38]

Third, dominance of SOEs in China extended abroad and exacerbated business of private companies in overseas markets. In government-related projects, if Chinese SOEs join the competition, no possibility for private companies to win. Only in areas that Chinese SOEs do not touch, private companies competed to gain the share, and at thin profit margins. In an interview, manager Mi of a private manufacturer of water electricity machinery based in Shanghai expressed frustration. His company had been exporting machinery since the 1990s and had invested overseas well before 2005. When the Chinese government tied foreign aid/investment programs in developing countries, he was quite excited and attended public bids for contracts, but after a few times he realized, "They were all for SOEs."[39] In one overseas public bid, his company provided the same equipment at significantly lower price, but it was the competing SOE that got the contract. Starting 2008, Mr. Mi has never participated in any public bids with SOE participants. Another Shanghai-based company, a manufacturer of electrical equipment, reported that it too was blocked from any Chinese official aid-related project bids. Their regional manager in Africa, the most profitable overseas market the company, answered my question on China's foreign aid programs, those projects were all controlled by SOEs.[40]

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[37] See Dean Xu, "Acquisition of Humme," *HKU894*, 2010.

[38] This is a case reported by Zhang Long and Xu Liyan, "Failures of Private Companies Overseas (minqi haiwai touzi zheji ji)," *Chinese Enterprises (zhongguo qiye bao)*, January 18, 2011.

[39] Reported in Zhang and Xu, "Failures of Private Companies Overseas,"

[40] Interviews, Shanghai, Summer, 2010.

The shrinking investment opportunities within China intensified competition among private entrepreneurs domestic and overseas. In the interviews, the sentiment of private entrepreneurs is ironic: they do not see SOEs as real competitors as they are in no position to compete against SOEs but view other private companies in the same business as their most fierce business rivals. In one bid in Indonesia, the regional manager of the interviewed Shanghai company explained that eleven private Chinese companies were competing against two Indonesian companies. These Chinese companies mutually undercut offers. Although one Chinese company ultimately won the contract, it had to operate in almost zero profit margins. Then, why do they have to go abroad? The interviewed managers unanimously explained that because domestic market for high-end electrical equipment was controlled by SOEs, private manufacturers had to expand their business abroad. In one case, when the national grid was put on bid, 78 percent was *kept* for SOEs and private companies—two dozen of them succeeded in getting licenses to join the bid, calved up the remaining share. In order to get the licenses, bribery was a common practice.[41]

The downstream oil services companies face the same pressure. According to an interview on Andong Oil Services, domestic market for oil services was 80 percent controlled by SOEs, 5 percent by foreign companies, and the dozens of, if not hundreds of, private companies were competing for the remaining 10 percent. The successful ones, such as Andong, which was highly profitable, with annual growth rates averaged over 50 percent in 2004-2007, and had a successful IPO in Hong Kong in 2007, heavily relied on SOEs for domestic business. Starting 2007, it aggressively developed overseas market and managed to have 15 percent sales from overseas. Yet, it faces just as fierce competition abroad. In 2009, there were at least 21 private oil services companies that invested abroad and competed among themselves for the remainder of opportunities left out by multinational companies, strong local companies, and Chinese SOEs.[42]

If private companies face all those problems in investing overseas, why have SOEs or state-affiliated companies not invested more in manufacturing sectors?

Among local SOEs, some had strong backing from powerful local governments, and these were among the most aggressively outgoing SOEs. In Shandong, SOEs with provincial government backing launched aggressive takeovers in 2010-2011: Shandong Heavy Industry acquired French Bauduin, Shandong Gold established a large exploration company in Argentina; Shandong Gold set up joint venture with South African state company; Haier took over Japanese Sanyang; Shandong Steel and Minerals acquired two iron ores companies in Australia with $250 million and formed a JV with an African resources giant with $1.5 billion.[43]

Yet local government backing is not always optimal for overseas investment. In 2005, with local government support in Shanghai and Nanjing respectively, Shanghai Auto Group and South-

[41] Interviews, Shanghai, Summer, 2010.

[42] Zhong Wen, "minyin qiye yu guoqi gongwu (Ant versus Elephant)," *zhongguo jingji he xinxi hua (China's economics and Information Technology*, No, 17, November 10, 2010.

[43] Shi Tao, 2010, "mozhe shitou chuhai de Shandong qiye (Going abroad by Groping stones)"*Business Weekly (san zhoukan)*, Aug 29, 2011, pp.46-49.

ern Auto Group tendered bids to acquire British Rover. Their unwillingness to compromise resulted in two separate deals with Rover: Shanghai Auto received the licenses for core technology embodied in Rover model, and Southern Auto acquired all the machinery and equipment necessary to actually make the locomotives and other parts of the vehicles. Even after they sealed the deals, the two SOEs could not collaborate, because the local governments did not want to let go their prize projects. Rational corporate interests were set aside, and millions of dollars investments went unused.[44]

Even for centrally-affiliated, highly privileged SOEs, political logic may work against global expansion. Baogang Steel, the largest steel company in China, failed to keep up "the go out" policy in the recent decade, certainly not for want of finance or human capital.[45] As a privileged SOE, it practically had no budget constraint if it desired to invest abroad. It also had substantial well-trained personnel. Its office of overseas investment research, a surprisingly small branch in the enormous SOE, still had several researchers trained in Western MBA programs. In 2007, when Baogang signed a JV contract with Brazilian Vale to manufacture steel in Brazil, it recouped unlimited financial backing from various commercial banks in Shanghai. It also brought the CNPC into this project. Resistance from the Brazilian government, as well as interventions from competing Western companies, aborted the nascent project. In 2008, Brazil unilaterally cancelled the JV contract, and left Baogang with losses.

However, the bigger barrier to Baogang's overseas investment is political. As a centrally affiliated SOE, Baogang's CEO and general managers are appointed by the CCP Organization Department, and their tenures are typically three to five years. As noted earlier, the managers are career bureaucrats and their ultimate goal is promotion in the Party and State bureaucracies. The state connection and domestic privilege have paradoxically resulted in three disincentives in Chinese SOEs' outbound investment, with the exception of those resources SOEs, such as CNPC and other oil companies, State Electrical Grid Corp, China Aluminum Co, etc.

The first disincentive is the political risk of investing abroad for SOE managers. If SOEs' overseas investment projects lose money, worse if they cause diplomatic backlashes, the managers in charge are liable to political reprimand. The rational response is thus risk averse. The 12th Five Year Plan (2010-2015) explicitly stressed the danger of SOEs' overseas investment in creating diplomatic backlashes and is likely to further disincline non-resources SOEs to invest abroad. The second disincentive is the short tenure of political appointments. Successful international expansion requires long-term commitment and determination. New investors need to invest and learn the lesson and then succeed. Such an error and trial experience is unavailable to managers of SOEs. The last disincentive is related to their domestic market monopoly. In contrast to private CODI pressured out by limited domestic market, SOEs have monopoly in heavy and key sectors

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[44] The auto case, see Han Wei, "Chinese Automakers Went Abroad (zouchuqu de zhongguo qiche)." *Automotive Observer*,pp.54-59

[45] Hui, "qianxi zhongguo gangtie qiye duiwai touzi wenti (Problems in Chinese Steel Companies' Overseas Investment)," *zhongguo sanjie (Business China)*, No.2, 2010, pp. 119-120.

in China. They can make easy profits from domestic market, and the cost (or discomfort) of investing abroad appears too high to persevere. All these explain that why non-resources CODI by SOEs has not gained momentum in the past decade.

Conclusion

China has become an important source of outbound investment in the world. In the public discourse, people have emphasized the importance of the state promotion and the possible impact (negative) on host societies and competitors from the West. None has this topic been analyzed from the perspective of private companies in China. The article traces the change in China's regulatory environment of CODI and explains how state regulation and stronger promotion of state paradoxically weakened outbound investment by private companies, which had accounted for a very small share of CODI. Compared to other economies in Asia, China has not kept up the propensity to invest, and its returns on investment have been disappointing. The statistics and case studies support that CODI so far is an expansion and extension of imbalanced development within China. It heavily concentrated at the hands of powerful SOEs hoarding resources and raw materials. ■

Appendix A. Government Regulations over CODI

Date	Regulatory Body
1989	Regulation on Foreign Exchanged Used in Overseas Investment
1990	Implementation Guideline on Regulation on Foreign Exchange Used in Overseas Investment
2003	Notice on Simplify the Inspection of Foreign Exchange Sources in Outbound Direct Investment by the National Foreign Exchange Bureau
2003	Notice on Deepening Reform of the Management of Foreign Exchange Used in Overseas Investment by the National Foreign Exchange Bureau
2004	Temporary Regulation on the Approval of Overseas Investment Projects
2005	Notice on Managing Overseas Listing by Chinese Companies by the National Foreign Exchange Bureau
2007	Regulating Financial Institutions Transferring Domestic Non-performing Loans to Overseas, Jointly by National Foreign Exchange Bureau
2007	Industrial Guidelines for Overseas Investment, Country by Country III
2007	The Demonstration Guideline for Foreign Investment Projects Applications
2007	Further Reform Central SOEs' overseas Investment under Threshold Back up Report Management

Appendix B. Second test of under-representation of private investment
Non-state, non-foreign companies in China, relative weight and shares in CODI

% Non-State companies	2006	2007	2008	2009	2010
Industrial output	50.5	52.16	55.58	57.85	59.1
R&D expenditure	47	48	52	51.7	53.58
Patents granted	61.6		64.46	60.99	58.87
New products			52.56	55.27	59.1
Outbound FDI	19	28.2	29.5	30.2	33

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Ye coauthored (with Kent Calder) *The Making of Northeast Asia*, Stanford University Press, 2010. She has published articles in various journals and presented papers at professional conferences. She is the recipient of various grants at Princeton, including the Bradley Scholarship and Bobst Peace Foundation. External grants include Japan 's Millennium Education Scholarship and the Pacific Forum Fellowship in Hawaii. She has been a visiting fellow at Waseda University in Japan, Chinese Academy of Social Science in Beijing, SAIS John Hopkins University in Washington DC, and Rajiv Gandhi Foundation in New Delhi.

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- "Overseas Chinese and Late Industrialization in China," in Susan Eckstein (ed.), *Migrants and Homeland Development* (Duke University Press), forthcoming.
- "The Rise of China and Asian Regionalism," in Mark Beeson and Richard Stubs (eds.), *Handbook of Asian Regionalism* (Rowman & Littlefield), 2011.
- "Diasporas and Foreign Investment in China," in Joseph Fewsmith (ed.), *China's Today and China Tomorrow* (Rowman & Littlefield, 2010).
- "Policy Learning or Diffusion: China's FDI Liberalization in the Shadow of Japanese Developmental State," *Journal of East Asian Studies* 9 (fall, 2009), pp.399-432.

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- This working paper is the result of the EAI's main academic and educational activity, the *EAI Fellows Program on Peace, Governance, and Development in East Asia*, which is granted by the Chiang Ching-kuo Foundation for International Scholarly Exchange of Taiwan, the Japan Foundation, and the YBM/Korea International School. It is presented at the seminars and lectures hosted by partner institutions of the program. Subsequently it is distributed to those audiences. The PDF document of this article can also be viewed via the EAI website by the wider public. Any citation or quotation is prohibited without prior permission of the author and the EAI.

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