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Revisiting the OLI Paradigm: The Institutions, the State, and China's OFDI

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Abstract

We propose a modified theoretical framework based on John Dunning's classical OLI paradigm in the international business literature to analyze Chinese firms' fast-growing and aggressive outward foreign direct investment (OFDI). In particular, from an institutional perspective, we suggest a "state-stewardship" view to incorporate state institutions into the OLI paradigm. This paper supplements our earlier work (Ren, Liang, and Zheng, 2011) on identifying the formal institutional determinants of Chinese firms' OFDI motivations and strategies, by further looking at the impact of direct and indirect policies, and the OFDI state-controlled financial intermediaries. Under our modified OLI framework we also examine the potential concerns on China's state-backed OFDI and its implication on long-term sustainability.

JEL-Code: F230, H810, M480.

Keywords: outward foreign direct investment, institutions, state-stewardship view, OLI paradigm.

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1. INTRODUCTION

China has become a more and more powerful player in the global arena. In 2010, it overtook Japan's 42-year reign in the world's No.2 spot of biggest economy, right behind the U.S.[3] Accompanying this rapid growth is the country's aggressive global expansion, mainly through exports and outward foreign direct investment (OFDI) by Chinese firms. According to the *World Investment Report 2009*, in the recent global financial crisis, China has significantly strengthened its OFDI. While the worldwide FDI flow decreased by 14% in 2008, OFDI flow from China increased by 111%, up to $56 billion,[4] ranking it the 12th largest source country of OFDI in the world (UNCTA, 2009).

China's FDI outflow took off in the 2000s as a result of the government's adoption and promotion of a "Go Global" strategy, aiming at establishing the country's national champions as an international player[5]. Over the recent decade we have observed quite a lot of Chinese firms invest abroad through buying foreign shares, alliances and joint-ventures with foreign partners, mergers and acquisitions (M&As), and establishment of their own production overseas. Among these choices of entry mode, 54% of the overall OFDI flows are via M&As, totaling US$30.2 billion, and with an annual increase rate of 379%. Also, among the non-financial OFDI, 81.3% were conducted by the centrally-controlled state-owned enterprises (SOEs) and bureaus, the other 18.7% were conducted by the local enterprises. The OFDI of the financial sector (mostly state-owned or controlled financial intermediaries) is growing even more rapidly, with recent aggressive investment in major financial institutions such as Morgan Stanley, Blackstone, Standard Bank (South Africa) and Bank of East Asia's subsidiaries in North America through either minority or majority share acquisition.

Accompanying the China's aggressive FDI outflow are the enquiries: what are the fundamental drivers of Chinese firms' OFDI; and how is traditional MNE theory not sufficient to explain the new phenomenon. Beyond other views (Deng, 2007; Gubbi, Aulakh,

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[3] Wall Street Journal: http://online.wsj.com/article/SB10001424052748703361904576142832741439402.html#project%3DJCHINA0111%26articleTabs%3Dinteractive

[4] All monetary units in this article refer to U.S. dollars.

[5] (http://www.vcc.columbia.edu/files/vale/documents/Davies_Profile-_Final1.pdf)

Ray, Sarkar, & Chittoor, 2009; Morck, Yeung, & Zhao, 2008; Mutinelli and Piscitello, 1998; Shimizu, Hitt, Vaidyanath, & Pisano, 2004; Sun, Peng, Ren & Yan, 2010; Tihanyi, Griffith, & Russell, 2005), a growing stream of literature has examined the role of the state in driving China's OFDI from the perspective of political economy (Luo *et al.*, 2010), of institutional determinants (Ren, *et al.*, 2011), and of state capitalism (Bremmer, 2010). This literature point out that there are significant influences of policy and regulation schemes. Informal institutions are also found to play a role. This literature helps shed light on how the unique political and economic institutions shape a country's OFDI trend and behaviors.

On the other side, the OLI paradigm is the most prevalent one to explain the driving forces of OFDI (Dunning, 1981). It serves as a framework for analyzing the decision to engage in OFDI, based on three kinds of advantage that FDI may provide in comparison to other business activities such as export: ownership (O), location (L), and internalization (I). Firms possessing these three aspects of advantage would obtain a competitive edge in their international production and investment. So far, there is no a second paradigm that can render similar explanatory power. For instance, at the organizational level, there is no competing theory like the OLI paradigm which has successfully explained the emergence of Western MNEs such as the American and Japanese multinational corporations.

However, little research has been done on integrating the above mentioned broader political and institutional perspective with this classical OLI paradigm to explain the ongoing new phenomena in international business. Such limitation brought forth two important problems in theory. First, new explanations suggested under the above institutional analysis may be helpful to explain specific OFDI phenomenon, however, little is known about how well it fits into contexts such as the Western countries which is facing greater economic challenges, especially after the 2008 financial crisis. Second, the OLI paradigm is not successfully employed to explain emerging economies' MNCs' OFDI partly because that the discussion is limited in the scope of the theory, particularly, and fails to incorporate the institutional elements into the OLI framework.

To tackle the above limitations, we suggest that more research shall be done to integrate the theoretical elements of OLI and the institutional perspectives and the political economy perspective (Dunning & Lundan, 2008b). In our other work (for example, Ren *et al.*, 2011;

Sun, Peng, Ren, and Yan, 2010), we have discussed the role of the state and their association with the O, L and I-specific advantages or disadvantages and their roles in Chinese firms' internationalization. There are other important efforts in the field as well (for example, Lenway & Murtha, 1994). These studies helped us to build a theoretical link between the traditional MNE theories, the institutions and the role of the state in analyzing the firms' OFDI activities.

In line of Dunning & Lundan (2008b), and grounded on our earlier discussion about Chinese firms' internationalization (e.g., Sun et al, 2010; Ren, et al, 2011), this paper tries to integrate the OLI paradigm and the institutional and political economy perspectives on the role of state, by examining how the institutional regime shaped by the state affects Chinese firms' ownership, location and internalization advantages and their OFDI strategic choice. It suggests a "modified" OLI paradigm and discusses the potential concerns surrounding China's policy community, the direct FDI policy scheme, the indirect macroeconomic policy scheme, and the OFDI of Chinese state-controlled financial intermediaries. It then discusses the potential concerns surrounding the impact of such state institutions on sustaining Chinese firms' OLI advantages in their OFDI.

2. THEORETICAL FRAMEWORK

To achieve a unified framework within which to accommodate both firm and country specific considerations, we have chosen to use and to extend the analysis of John Dunning's "eclectic paradigm", or OLI paradigm (Dunning, 1981). Dunning argues that the three kinds of advantage that FDI may provide in comparison to other business activities such as export: ownership (O), location (L), and internalization (I), would help firms obtain a competitive edge in their international production and investment. Dunning (1981) further argues that there is a relationship between a country's net foreign direct position and its structure and the level of economic development, which is regarded as a process of structural change. Such structural change affects both inward and outward investment (Durán and Ubeda, 2001). Ideally, as a country develops, the conditions for domestic and foreign economies change, affecting not only FDI flow but also OLI advantages and vice versa. Furthermore, Dunning &

Lundan (2008b)'s breakthrough work incorporates institutional analysis into OLI paradigm, emphasizing the role of various "institution" in shaping OLI.

2.1. Dunning's past and present OLI paradigm

Getting back to the rationale behind OFDI and international production, FDI activities by multinational firms add value by increasing returns to corporate investment in R&D, brand creation, and other ventures with large fixed costs and high transaction risk in the market (e.g., Buckley and Casson 1976). Over the recent decades, the composition and significance of competitiveness-enhancing assets have changed (Dunning & Lundan, 2008b), from pure production-capability related assets such as patent and technology to more institutionally related assets such as brands, corporate cultures, and human capital. As "the tangible resources and intangible capabilities available to firms have become more knowledge-intensive and relationally based" (Dunning and Lundan, 2008b: 574), these have largely led to the development of ownership-based theories and institutional-related theories for multinational firms by Dunning and his colleagues (for example, Dunning and Lundan, 2008a). Among these insightful theories and views, Dunning's eclectic theory of international production is such a classic framework for analyzing the motivations and the strategic choices of international production and investment activities of multinational firms. Below we briefly lay out the main pillars of Dunning's OLI paradigm that have been developed up to date, and discuss the potential linkages with state institutions. By doing this we aim to incorporate the role of the state into the OLI paradigm for analyzing Chinese firms' internationalization.

2.1.1. The ownership advantage (O)

The ownership advantage (O) (or firm specific advantage) refers to the advantage that is exclusive to firms in other countries. It suggests that the superior productivity is managerially related, such as the knowledge-related and relationally related assets (the ownership-specific effect), as "the productivity differences were presumed to rest on the spatially transferable intangible assets of the parent company" (Dunning, 2001: 174). These are usually the advantages generated from monopolistic intangible assets, such as proprietary technologies, brand names, corporate cultures, etc. Through O-advantages firms could achieve economies of scale, broader access to financial capital throughout the multinational enterprise organization, and advantages from international diversification of assets and risks. According to the O-advantage, as one example, MNEs should invest and set operation in industries that could to a larger extent leverage their parent firm capacities in the domestic market, such like firms with more low-cost labor advantage (as the case in China) may choose to transfer this advantage to their overseas subsidiaries. Similarly, MNEs may tend to employ consistent managerial practice in their overseas operation.

2.1.2. The location advantage (L)

The location advantage (or the country-specific advantages) describes the *location* specific component of any productivity differential – the non-transferable characteristics of a country's economy, which comprise the host country advantageous factors. Cost of labor, market potential and government policies of host countries are crucial parts to decide the locations for OFDI. It generally predicts that MNEs are more likely to invest in more institutional-friendly countries, usually with better regulations and legal systems, higher investor protection mechanisms as well as lower entry barriers. Of course the institutionally related location advantages of countries are likely to be highly situational and to differ considerably among different countries (Dunning and Lundan, 2008a). At the same time, the firm must use some host-country "foreign factors" in combination with its native firm specific advantages in order to earn full rents on these location advantages.

2.1.3. The internalization advantage (I)

The internalization advantage is about how firm- and country-specific institutions have conditioned foreign market entry mode depending on the motivation for firms to invest outside. The internalization factors explain the firm's propensity to internalize cross-border structural or endemic imperfections in the intermediate goods market (Dunning & Lundan, 2008a; Dunning, 1980). To minimize the cost of internalization, multinational firms have several choices of entry mode, ranking from the market (arm's length transactions and sell or buy decisions) to the hierarchy (intra-firm coordination and the wholly owned subsidiary decision). Transactional advantage generated from firms' capabilities to manage both internal and external relationships (Rugman and Verbeke, 1992; Rugman, 1996).

Multinational firms are the outcome of substituting imperfect and poorly functioned market where transactions expenses of the external route are high. It helps explain why such firms choose to generate or exploit their O-specific advantages internally rather than to acquire them through the open market, thus explains the scope and geography of value-added activities by MNEs (Dunning, 2001). It proposes that to reduce operational risks and transaction costs, MNEs from less developed economies with relative incapability of handling international transactions should start from minority joint-ventures in their OFDI. Also, a strong trade surplus (deficit) should decrease (increase) domestic firms' outward investment activities, viewing exports and OFDI as substitutive choices by the firm[6]. Of course MNEs vary their way to internalize according to different situations where institutions play a major role in determining the complementarities or substitutability of the different organizational modes.

2.1.4. The OLI paradigm incorporating an institutional view

Drawing from the work by Douglass North, the most recent study by Dunning & Lundan (2008) has further extended the building blocks of the OLI paradigm by incorporating institutional analysis into the framework. Their work taps on the emergence of the Asian network MNEs which exemplify the new organization forms, and tries to bridge both the macro and micro levels of analysis, and encompassed both formal and informal institutions, thus advances our understanding of contemporary MNEs. They suggest that the design and implementation of incentive structures and enforcement mechanisms, which originate from specific external institutional arrangement, affect all three parts of the OLI paradigm. When it turns to China's case, we believe the strong involvement of the state will influence firms' international investment through specific incentive structure and enforcement mechanisms. Hence, further extension of the OLI framework will be centering on institutional drivers and the underlying incentive mechanisms shaped by the state.

2.2. The organizing principle, incentive structure and enforcement mechanisms in a formal economy

When incorporating the institutional perspective to explain the Chinese OFDI phenomenon, it is important to identify the specific institutional settings that may

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[6] OFDI and export are usually seen as two major forms of a firm's internationalization strategy. See, for example, Lu and Beamish (2008).

complement the traditional OLI paradigm. To delineate the institutional environment and China's economic structure within which Chinese firms are embedded, Yasheng Huang discovered that there exist two Chinas. One is from not so long ago, vibrant, entrepreneurial and rural, which we consider as an informal economy; the other is today's China, urban and controlled by the state, which we consider as a formal economy (Huang, 2008).

The formal economy is majorly SOEs or state-related economic sectors, which are still dominant in the country, largely relying on and being closely tied to the policy and state command. Comparatively, the private and entrepreneurial economies are more informal and freely established in the market or in the gray economy system. It is widely recognized that China is a state-led capitalism with a reliance on creaking state companies rather than more efficient private ones dominates the economy (*The Economist*, October 2008)[7]. This situation even sustains after the massive (but incomplete) privatization of the SOE sector (*The Economist*, September 2011)[8]. Thus, in China, the SOEs are still dominating key sectors of the economy. It is argued that this is partly due to that "the Chinese Communist party wants to remain the primary control over dispenser of resources and business opportunities which are significantly related to the political power." (*The Economist*, September 2011).

For the informal economy, according to Huang's observation and on closer inspection, even the private companies (the core part of the informal economy) conducting the OFDI are either not really Chinese or not really private (*The Economist*, October 2008). For example, Lenovo, a computer group, has succeeded because it was controlled, financed and run not from mainland China but from Hong Kong. The subsidiaries of Haier, a white-goods maker, were also put out of reach of mainland bureaucrats early on. Wahaha, a food producer, Galanz, a maker of microwave ovens, and many others all depended on foreign protection and capital to grow and escape state strictures.

What is the relationship between these formal (the state-led) and informal (the market-led) economy to Chinese firms' OFDI? What does matter to Chinese firms' OFDI, in the respective formal and informal economic sectors? The above description seems to suggest

[7] The Economist: "Chinese Capitalism: The Long March Backwards": http://www.economist.com/node/12333103?story_id=12333103
[8] The Economist: "Privatisation in China: Capitalism Confined": http://www.economist.com/node/21528262

that Chinese firms' foreign investment behaviors have unique features characterized as either state-led or foreign-related, while the state-led part of OFDI is dominant. Let's focus on the formal economic sectors' OFDI behaviors and the underlying enforcement mechanism first.

Definitely, what caused the Chinese SOEs' going global and going so rapidly? Are the motivations and behavioral patterns of the OFDI in the formal economic sector a direct product of the State's influence, and how? We argue that the state is able to offer direct coercion and exert strong enforcement on a major part of the OFDI, particularly, the SOE-related OFDI. To achieve her influence, the state establishes obligatory incentive mechanisms of managers and directors of major SOEs, to influence their decision making and economic activities. The incentive mechanisms accompany a special personnel arrangement within which managers and directors of SOEs are directly appointed by the state and lay their career on political cadre promotion. This institution even holds after the massive (but incomplete) privatization reform.

Consequently, they carry out state wills in their OFDI strategies, which are either political objectives or economic ones. Economic objectives focus on profitability of the firm, the industry and the country in general; while political objectives focus on using the firm as a vehicle to benefit the state and its politicians or parties, which are not necessarily in alignment with the economic profits of the firm, the industry and the country. First, the state control insulates inefficient management from the market principle of profit maximization. Second, managers with a strong political bond may work to serve the political goals of the politicians, rather than the economic goals of the business activity itself. Furthering the discussion with a shareholder economy perspective, managers act deviating from pursuing profits are considered as inefficient and the agency problem arises.

Indeed, we can define the above mentioned state-firm or state-manager relationship generating a mechanism or system in contrast to the market for corporate control which is well-established in the capitalist economy. We define this system a 'state for corporate control' system – a result of socialist planned economy that help shape the Chinese formal economic sector. We suggest that this is the fundamental difference between the capitalist economy and China. In the former case, institutions and transactions are created following a market side rules, yet in the later, created following a command side rules. This difference will surely influence China's OFDI. One salient consequence is that under this system, the OFDI business activities may go beyond the traditional economic profit maximization view shaped under different OLI. It renders greater room for more alternative view incorporation such as the political power maximization within the country, thus calls for better explanations on why Chinese firms go abroad.

2.3 A state-stewardship view on Chinese firms' OFDI

Having discussed the institutional setting of Chinese firms, we then would like to ask: how would the state influence and the state-shaped incentive structure and enforcement mechanisms relate to Chinese firms' OLI? How do Chinese MNEs internationalize and operate in the international market imprinting with the state influence? We need to further define the state influence and the state-shaped incentive structure and enforcement mechanisms on the managerial motives and behaviors of the SOEs, and then analyze how would that influence Chinese firms' OLI-specific advantages or disadvantages in the international market. Borrowing from the "stewardship" concept – a theoretical basis for manager and shareholder philosophical alignment (for example, Donaldson and Davis, 1989, 1991), we propose a "state-stewardship" view to describe a state and manager philosophical alignment relationship.

Specifically, we use the term "state-stewardship" to describe the fact that in principle the SOE managers are responsible to the state. They actually act like the "stewards" of the state, and work to fulfill both the economic objectives of the country (not necessarily the firm) and the political ones of the state. We define such "state-stewardship" being shaped by three institutional building blocks: the organizing principles, the incentive structures, and the enforcement mechanisms. The organizing principles can be simply understood as state involvement in every level of the economic and social development of the firm, it could be further classified as an organizing principle (P) and an organizing principle (E).

For the organizing principle (P), P is for political power, it requires that the SOEs' varieties of activities shall be fundamentally state-driven, aligned with the goals such as enhancing political power and conforming to ideological requirements. For the organizing principle (E), E is for economic power, it requires that the SOEs' varieties of activities shall be able to help achieve the state-related sectors' economic growth and power. The reason that we classify as above follows Marxism about the dynamic relationship between "economic foundation" and "superstructure". As both are important, for current China, maintaining the mutual balance and pursuing for both are the fundamental considerations of the communist party.

What deserves to note is that managing such a balance is hard for both the state and the SOE per se. As some political command from the state to SOEs are destroying the enterprises' competitiveness (such as allying with a nearly-bankrupt SOE partner), and some economic decision makings may not necessarily help build political coherence (such as refusing the above command but shift to merge with a more efficient private partner firm). This suggests that we have to pay attention to the incentive structures and enforcement mechanisms. Hence, how the SOEs and the managers, i.e. the state-stewards are motivated to help build the above foundation? And what fundamental limitations of the above organizing principles may generate through a hard to manage incentive structure and enforcement mechanisms to the whole system?

First, the coexisting organizing principles (the P-E principle) will determine the incentive structures that are used to motivate the state stewards to pursue for the state's long term goals. In particular, they help generate a dual track incentive structures. The political organizing principle requires motivate the state-stewards to maximize the political benefits of the state. And the economic organizing principle requires motivate the stewards to maximize the economic ones. The state needs to make sure these state-stewards in line with the state's interests, hence, their managerial behaviors and firm activities can maximize both of the state's political and economic benefits.

The state uses many methods to achieve this interest alignment. The first method is to set a stratification structure to group the SOE sector, amongst which, the centrally controlled and locally controlled SOEs (or the different industrial SOEs and the different regional SOEs) enjoy different benefits such as in governmental support of essential resources and opportunities. The second method is to set a political cadre promotion system where the SOE managers can pursue for their career advancement over the ladder step by step or via a big jump. Within such ladder, different levels of cadres are equipped with different set of benefits, but by nature, all are entitled as government officers, enjoying the miscellaneous political and economic remunerations.

The first incentive structure can help enhance the effect of the second. If a SOE is classified in the top-tier level in the economy, the peculiar SOE managers will be rewarded the most higher incentive at the aforementioned aspects. But for these SOEs and their managers, satisfying the dual track goals (under the political and the economic organizing principles) will be more demanding and challenging.

Finally, the enforcement mechanisms are mainly relying on the coercive power of the state in punishing the state-stewards (the SOEs and the managers) when they violate the state's will or when their status and works are perceive as less satisfactory. The punishment goes with either lower a SOE's status or removing a manager's political cadre position. There are various kinds of such enforcement mechanisms, however, all centering on enforcing the state-stewards to be good stewards of the state. There is the particular administrative governance system there to help operationalize how the SOEs or managers may be strongly enforced in a positive (or negative) way (Ren, *et al*, 2011).

Referring to China's OFDI, the SOEs' managers may conduct such activities overseas to pursue for political objectives shaped, motivated and enforced by the political side. For example, they go to Africa to help build bridges. They provide help to the poorly managed financial state, etc. They may also conduct economic business activities overseas for pursuing for economic objectives, shaped, motivated and enforced by the economic side. For example, they go to overseas markets to extract natural resources and acquire brands and technologies for building future economic competence. The economic side deserves further note. SOEs conduct overseas investment to seek new market opportunities, lower transaction costs, and enhance profitability and increase shareholder value. At the personal level, the state-stewards have to strongly solidify their political career and getting SOEs' economic goals achieved. However, some time, these stewards paid much more attention to their promotion in the political cadre system than to the economic value they made, suggesting that such economic structure mixed with the political ones suffer in nature the second type of inefficiency (the inefficiency of the state for corporate control in relative to the inefficiency of the market for corporate control).

Table 1 summarized the three key aspects of the state-stewardship concept and its corresponding functioning mechanisms to Chinese firms' OFDI.

[Insert Table 1 about Here]

2.4. Revisiting the OLI paradigm for Chinese multinational firms

We believe that more elaborative studies shall be conducted based on a revisited OLI paradigm, hence, explaining what kind of institutions matter and how do they matter to firms' internationalization. Peng *et al*. (2005) argued that institutional change at the national level might change the parameters of the feasible behavior of firms, and specifically how institutional change might affect their optimal product scope and geography. With strong state involvement, Chinese MNEs have formed OLI advantages or disadvantages under a conducive country ambition. In our earlier work (Ren *et al.*, 2011), we already applied an institutional perspective to study the role of the state in shaping Chinese firms' OFDI activities, and we identified five institutional determinants, namely the formal institutions as policy, bureaucratic administration, and government ownership, as well as the informal institutions as state ideology and national pride. Later we will discuss how these five institutional aspects play a role in shaping Chinese firms' OLI advantages. However, we feel those are far from exhaustive; it is plausible to extend our scope and examine the state roles from more concrete perspectives, and see how they actually function to impact Chinese firms' unique OLI advantages or disadvantages. Therefore in this paper we further look at the impact of direct FDI policies, the impact of macroeconomic policies (particularly the exchange rate policies and interest rate policies), and the OFDI of Chinese financial intermediations.

2.4.1. Direct OFDI policy schemes

The state deliberately designs policy schemes in favor of its steward firms (SOEs) to carry out its political and economical strategies globally. As in the regime of OFDI, it is seen that a state-controlled mode has led to efficient and relatively successful deals conducted by Chinese firms globally. At the time, it is obvious that Chinese OFDI firms' motivations and strategies are influenced by the strong central-level policy scheme. Our earlier work has already devoted a lot of context to elaborating on what specific policies they are, and how these policies evolve over time. Chinese firms that intend to go abroad also seek to obtain those preferential policy treatments to lower costs while boost profits. Following up with that work, we further identify recent policies aiming at releasing capital control, such as the "Cancellation of Deposits Guaranteeing Profits from Investments Abroad" (SAFE, November 2002), "Simplifying Foreign Exchange Administration Relating to OFDI"[9] (SAFE, March 2003), "Guiding Directories of Target Nations and Industries for OFDI"[10] (MOFCOM, July 2004; MOFCOM, October 2005; MOFCOM, January 2007), "Information on the adjustment of foreign exchange management policy of foreign investment"[11] (SAFE June 2006). The time points of issuing these specific policies coincide with the dramatic surges of OFDI flows (as in Figure 1), which implies the strong effect of those direct capital control policies on Chinese firms' international investment behaviors.

Policies from state controlled economies like China naturally enjoy high policy-consistency and policy-discrimination (Murtha & Lenway, 1994). As what Murtha & Lenway suggest, policy consistency refers to governments' capabilities to commit themselves, to consistent courses of action over time. This is because: (1) Chinese government constitutes these policies deliberately under the complex bureaucratic system. Every piece of policies would not be issued without thorough examination and approval (a detailed description of the examination and approval process of China's OFDI could be found in our earlier work); (2) Chinese government has strong enforcement to "order" companies to follow these policies; (3) Although China lacks well-established legal framework and clear property rights protection

[9] This policy contains two main points: 1. SAFE will only investigate domestic foreign exchange sources; 2. foreign exchange obtained from a source outside of mainland China will no longer be inspected.

[10] It provided industry and country information for enterprises to conduct investment encouraged by the state through preferential treatment concerning funding, tax collection, foreign exchange, customs and others.

[11] This policy stresses on two key issues: 1. SAFE no longer checks and ratifies purchasing quota of foreign exchange for overseas investment of its branches; 2. Domestic investors are able to pay upfront costs associated with overseas investment projects via foreign exchange, purchase foreign exchange with RMB or domestic foreign currency loans with the approval of local branch of SAFE and Foreign Exchange Management Department, after investors submit application to the relevant authorities for overseas investment projects or intentions but haven't got formal approval.

which would weaken policy constancy, China has its unique administrative governance to enhance the constancy of policies.

Policy discrimination means that the policy-makers could isolate the policy target such as certain industry or even a specific firm and make discriminated policy for it without disturbing the others[12]. This is because resources are largely at the mercy of the state. The government is able to allocate resources to the target it wants as well as to prevent the others from utilizing them. Both of the two characters of policies in China would help strengthen the effect of them and make the targets (firms, industries, etc) willingly to obey those policies. Those policy discrimination and consistence, along with ownership, bureaucratic system and other formal institutional regimes as proposed in our earlier work, are closely tied to the state-centered political system. They jointly influence the resource allocation and residual claim of the economy and enterprises, which in turn shape the expectation of politicians and managerial agents thus their political and managerial behaviors in OFDI.

2.4.2. Indirect macroeconomic policy schemes

We also look at other "indirect" policy schemes, which, in theory, might affect firms' motivation and strategic choice of international investment and the aggregate OFDI flow, while in practice, are not deliberately designed by the state in guiding firms' OFDI. These indirect policy schemes include macroeconomic policies such as exchange rate policies, interest rate policies and monetary policies. Since change of macroeconomic policies can be regarded as a risk for firms, the positive risk will encourage firms to go out while the negative ones make them think twice before taking actions.

Interest rate policy

Bank interest rates in China are regulated. Increases of loan interest rate often result in less credit borrowing for investment, including investment in other countries. However, since the mid-1995, China's central bank has continuously raised bank loan rate to combat inflation, though mostly at a decreasing acceleration rate. This period also witnessed continuous surge

[12] This point is also proposed in our earlier work (Ren et. al, 2011) which suggests a stratified structure of the OFDI policy implementation.

of China's OFDI, as shown in Figure 1 depicting their interaction over the 18 years[13]. A striking increase in the end of 2007 also did not correspond to the seemingly flat interest rate change.

[Insert Figure 1 about Here]

Exchange rate policy

China recently faces world-wide reproach of manipulating its exchange rate policies by the state. This has turned exchange rate into a substantial risk for FDI firms. Chinese government expects the exchange rate for RMB to increase at a slight pace as the government leaders announced, in order to maintain a stable export growth level. It is widely accepted that export and OFDI are two substitutive forms of a firm's internationalization (Lu & Beamish, 2008), depending on the firm's choice between international market (export) and international organization (OFDI). As RMB becomes relatively more expensive, export will be hampered and OFDI should be preferred as a substitute to reduce costs of internationalization and exchange rate risk. Thus theoretically there should be a positive relationship between OFDI and exchange rate level. Such indirect policy mechanism should matter more for private firms with exporting business.

[Insert Figure 2 and Figure 3 about Here]

Figure 2 plots the OFDI flow and export volume, and Figure 3 plots change of OFDI flow versus exchange rate. There seems to be no clear substitutive effect between OFDI and export, and no clear relationship between OFDI change and exchange rate. The growth rate of OFDI varies heavily from year to year and has several extreme points which can hardly be achieved by natural development. We therefore bring in the state institution to explain such pattern. The rate rises and drops with extreme statistics largely coincide with major policy adoption for artificial stimulation during the evolution of OFDI policies as shown in our

[13] We focus on loan rate instead of deposit rate as it measures the credit constraints of firms' financial activities thus have more implication to their outward investment. We use the nominal interest rate to draw a rough picture to illustrate the trend of interest without taking into account of other real interest rate factors such as inflations.

earlier work (Ren *et al.*, 2011). Consequently, once state has been involved in OFDI via policy, administration and ownership arrangement, it exerted strong influence on forming Chinese firms' ownership advantages. This is achieved through strong execution power and policy tilts, as well as isolating these firms from exchange risks through policy discriminations towards certain industries. Such observation might be due to the fact that the direct OFDI policy impact dominates the indirect macroeconomic policy impact, both controlled by the state. Direct OFDI policies as overwhelming orders enforced by the state decision-makers are the peculiarity of Chinese firms' OFDI (Ren *et al.*, 2011), they normally have much stronger influence than the indirect policies that serve as induction factors, though it is not clear which one of them is stronger.

It is worth noting that interest rate and exchange rate policies matter more for private firms with exporting businesses. That is to say, private firms are vulnerable to change of these macroeconomic policies. Meanwhile, due to discriminatory policy support and financial support, SOEs are isolated from these policy variables in their OFDI. Thus the majority presence of SOEs in the OFDI markets makes the overall OFDI flow seem uncorrelated with the interest rate and exchange rate changes.

2.4.3. The role of Chinese state-owned financial intermediaries

A new compelling observation of China's OFDI is the OFDI by Chinese financial intermediaries, such as policy banks, commercial banks, investment banks, insurance companies and the sovereign wealth fund -- China Investment Corporation (CIC). Regarding the motivations of these financial intermediaries' OFDI, many explain from a "Western view", that the expansion of China's financial services overseas is mainly to utilize the wealth of the Chinese diaspora, learn advanced techniques and diversify earnings sources.

We distinguish between internally- and externally-driven motivations. The above reasons are mainly internally-driven motivation that Chinese banks implement a classic "follow your customer" strategy. We acknowledge that such profitability motive is indeed salient, but we argue more for the externally-driven motivations which are imposed by the state. The OFDI of financial intermediaries on one hand aims to enhance the their own global competence (internally-driven motivation), while on the other hand aims at facilitating the capital channel and services of those Chinese industrial MNEs' OFDI in the host countries, an objective of and imposed by the state (externally-driven motivation). While China's resource and construction companies have moved aggressively into new markets, its financial institutions generally have been slow to follow. Similar to other industrial sector firms, Chinese banks aim to obtain advanced management skills and seek international market shares. Another important motive as mentioned above is to facilitate the Chinese government's big plan such as assisting the non-financial sector firms' long-term international strategy in the overseas market.

The majority OFDI industrial parties are in strong need of financial services and support in overseas markets. However, due to politically sensitive concerns and high costs of borrowing from host country banks, they are usually lack of financial sources in host country. From a country level perspective and adopting the institutional and political view, the motivation of Chinese financial intermediaries' going abroad together with their industrial clients might also result from the state's will and intervention. There are two possible mechanisms. One, the Chinese government might pay close attention to whom their major SOEs work with in terms of financial service, consultancy, and others in their international operations. To avoid the SOE sectors to be captured or controlled by foreign financial intermediaries, the state may try to promote those Chinese state-owned banks to go abroad to take that important place. Second, the state might intentionally position their financial sectors' operations in different foreign locations in order to support and smooth their country-level specific strategies adopting by the major SOEs such as acquiring essential raw materials and strategic asset owners. Both aspects are possible given that the Chinese state is politically and strategically manipulating her economy more successful in a state-centered economy. Furthermore, it is worth pointing out that although the state does not completely own those Chinese banks, it has absolute control power on them. For example, by some measures the world's largest bank, Industrial & Commercial Bank of China Ltd. is 70% owned by Chinese government. This actually would accelerate the pace of Chinese banks' development.

It is remarkable that China has begun to push its banks into global stage and those banks, much different from non-financial companies, choose to internationalize by seeking minority ownership shares[14]. For example, China Minsheng Bank Corp., in 2008, attempted to take a 9.9% stake in San Francisco lender UCBH Holdings Inc., the holding company for United Commercial Bank. Also, Industry & Commercial Bank of China (ICBC), in 2008, invested $5.5 billion for a 20% stake and two board seats in Johannesburg-based Standard Bank, Africa's largest lender. These regions that state-backed Chinese banks invest in are usually coincident with the destinations of other non-financial firms' OFDI as mentioned in our previous study).

However, it is interesting to notice that the approach that Chinese banks choose to internalization is much different from the companies belonging to other industries who mainly adopt outward M&A. Wary of provoking political controversy, Chinese banks are more likely to seek minority ownership stakes rather than full acquisitions, as financial industry is usually considered as vital for national economic security. Furthermore, under China's specific state-controlled institution arrangement, OFDI-decision of its banks may be accompanied with strong state strategies which may easily alerts regulators in host countries. In addition, minority ownership stakes are usually an outcome of managing risks in an environment with higher institutional distance and possible discrimination, or an ownership control battle. Hence, rationally, Chinese banks would prefer not to use full acquisition or majority ownership acquisitions which involve high resource commitment and high potential risks management.

We argue for two reasons for Chinese financial intermediaries' fast and successful internationalization in the recent years. First, contractual joint venture approach is relatively a mild way which does not grant complete control power to Chinese banks compared with direct "buy". Naturally, the "ally" approach will appease the unwelcome mood in regulators' mind. Second, the success of internalization cannot be achieved without the endeavor of Chinese government, even at the cost of compromising interests. For example, it took almost two years for ICBC to get the approval from the Federal Reserve to open its New York branch, which has so far focused on commercial lending. That green light was given shortly before President George W. Bush's trip to Beijing for the Summer Olympics in 2008. Also, in

[14] Wall Street Journal January 31, 2011:
http://online.wsj.com/article/SB10001424052748704832704576114032994273502.html

Europe, China has worked hard to overcome European suspicions. Chinese leaders have won praise from European officials for their pledges to support and invest in struggling euro-zone countries such as Greece, Portugal and Spain. Concrete Chinese help for the euro zone, such as major government-bond purchases, has begun to respond. These acts have paved the road for Chinese non-financial MNEs to enter these developed markets more smoothly.

At this very time, Chinese financial intermediaries' investment may be an aid to some troubled banks in western countries. As across Europe, plentiful opportunities exist for eager acquirers or investors to pick through the wreckage of the continent's banking boom and bust. Some European governments such as Ireland, Greece and Spain are actively courting outside aid. This earns Chinese financial intermediaries much credibility and influence worldwide, further paving the road for further more aggressive OFDI by Chinese industrial firms into these markets. This state push also echoes with RMB's internationalization, which would enhance internalization advantages for Chinese MNEs operating in foreign markets, thus helps reduce significant transaction costs.

However, the OFDI of Chinese financial intermediaries may take a long way before being able to substantially create internalization advantage. Concerns have arisen regarding Chinese firms' inability to sustain its internalization advantage. Many have criticized the distorted capital structure and investment are propelled by the governance structure of large SOEs, such as it fails to effectively promote managerial incentives of seeking higher profitability and efficiently monitoring and controlling managerial opportunistic and empire building behaviors.

To summarize, China's recent OFDI surge is likely a manifestation of specific state-oriented direct policies, the vast presence of SOEs carrying out state wills, and the OFDI of the state-controlled Chinese financial intermediaries in support of other non-financial Chinese MNEs' internationalization. In the following analysis we try to incorporate such role of the state into the OLI paradigm within the institutional framework, especially from a "state-stewardship" view, to further examine how the state has reshaped Chinese firms' OFDI advantages and strategies.

3. DISCUSSIONS

3.1. Explaining Chinese MNEs' OLI advantages from a state-stewardship view

The above analysis, along with the theoretical framework on formal and informal institutions raised in our previous work, join together to offer an in-depth look into the determinants of OLI advantages or disadvantages. To synthesize the above discussions, we argue that Chinese MNEs enjoy the following specific OLI advantages.

The specific-ownership advantages include strong political and economic execution power boosting firms to invest abroad, policy tilts/discriminations towards (privileged) SOEs carrying out national goals, policy consistency at both the country and the firm level to ensure top-down enforcement, being isolated from domestic interest rate and exchange policy risks, managers' unique incentive structure and ideological compliance to the state will, etc. The factors that create these specific ownership advantages include the vast presence of state ownership in OFDI, the design and implementation of the obligatory dual-incentive structure of those state-steward managers of SOEs and the enforcement mechanisms granted by the state.

The specific-location advantages include preferential policies towards certain regions and industries with strategic assets, shortened institutional distance between home and host countries, and more experience with incomplete and indulge institutional features (so more capable in handling unfavorable regulations and navigating around the obscure political constrains)[15], etc. The factors that create these specific location advantages include the national-level political and economic institutions that are in line with Chinese state's development strategy, the political relationship with China, and the easiness of the market for Chinese financial intermediaries to enter.

The specific internalization advantages include capability of tackling with complex entry modes such as M&A, capability of tackling with post-acquisition integrations, huge domestic markets absorbing internalized productions, internationalized financial

[15] Locations such as the western market with a democratic system will not be a suitable choice due to that both of the higher order and lower order organizing principles and that the incentive structures are different from theirs. Therefore it would be hard for Chinese firms to find collaborators, investors, suppliers and customers, and local government's support.

intermediary-backed capital advantages, etc. The factors that create these specific internalization advantages include the assistance of Chinese state-controlled financial intermediaries to provide easier financing channels, the favorable policy discrimination to reduce transactional costs in overseas deals especially mergers and acquisitions, and the powerful execution of these policies by the state's top-down enforcement mechanism that help smooth post-merger integration.

Under the new OLI framework, we suggest that Chinese firms especially SOEs could effectively leverage their state-stewardship relationship, strong domestic market power and capital advantages (backed both by direct capital injection from parent companies and by Chinese internationalized financial intermediations), granted by the state privilege policies, dominant ownership controls, and debt relation with their state-controlled lenders on CEO behaviors to form their unique ownership advantages. Such strategic assets include natural resources that could fulfill China's national competence strategies, as well as advanced technologies and managerial skills that domestic Chinese firms usually lack of.

With the strong state-privileged power, Chinese firms could implement more complex entry modes to acquire these assets, regardless the transaction costs involved. The unique internalization advantages are manifested by the vast presence of "buy and ally" entry modes (especially direct acquisition), as the state intervention could help Chinese firms more effectively integrate with their foreign counterparts through strong execution powers.

The location advantages are obtained through shortening institutional distance enforced by the state political and cultural relationship through policy influence and ideological influence, to orient Chinese firms' OFDI towards the destinations that could more favorably serve the state's needs. However, such location distribution could also be "distorted" due to the state's incentive mechanism that induces Chinese CEOs to invest in tax heavens and other regions with institutional voids. It is hard to tell which advantages under the state influence would be stronger and more significant, but it's worth pointing out their relative functioning regimes. These unique OLI advantages of Chinese multinational firms discussed in our two papers could be summarized in Table 2.

[Insert Table 2 about Here]

Having analyzed how the state influence changes Chinese firms' OFDI, it's naturally to show real-world justifications. We look into how the Chinese companies utilized their state-influenced OLI advantages as discussed above for better shaping their own core competence.

Chinese firms had vast experience in navigating complex bureaucracies, while on the other hand mature markets have relatively well established institutional environment which are not compatible with Chinese firms' weak competence. Also, Chinese government grants FDI firms with national goals to seek strategic assets and resources. These help explain why instead of Europe, Japan, or North America, targets of China's OFDI are mainly in Southeast Asia, Africa and Latin America where the institutional environment remain incomplete and abound in resources. Of course the vast investment especially in recent years from China to developed countries such as countries in Europe and North America, including investment in financial industry and non-financial industry such as business services and information technology (Ren et al., 2011), also manifest the economic incentives of Chinese firms aside from the political ones: to obtain technologies, better manage skills, to broaden international markets and opportunities that Chinese firms carry with.

In other regimes, China is now expanding its power to the world in all rounds which brings a series of changes to the state influence. First, the exchange rate policy is starting to function to affect export and stimulate value-chain-upgrade. Meanwhile, to heal the inflation and control problems in real estate realm, the interest policy has turned to be more flexible. Since these are new trends in the country where market economy still remains in progress, the changes can be risks for companies. However, China's special institutions have distinguished OFDI firms when faced with these risks. Unlike companies in other countries, Chinese firms' OFDI volume does not reveal a negative trend with loan rate. Such evidence has already been shown in the earlier section (referring to figure 1, 2 and 3). The state-firm relationship indeed insulates Chinese MNEs from macroeconomic risks and supports them with various direct policy discrimination and consistency.

3.2. How should we perceive China's state-oriented OFDI?

So far we have discussed how the state helps form Chinese firms' OLI advantages through special institutional arrangement to build conducive environment and facilitate their OFDI activities. But it might be too fast to jump into the optimistic mood to favor the positive roles of the state, while ignoring the institutional disadvantages associated with it. A major concern raised is that, *are we really talking about "conducive" advantages and environment*? Or put it in another way: although numerous attentions have been paid to the rise of China's OFDI wave and its ambitious strategies, one also needs to consider whether such state-oriented institutional advantages are sustainable. However, these crucial aspects are usually ignored by Chinese economics and business scholars when discussing China's OFDI.

One concern is regarding the political instability in the host countries. With the increase of Chinese firms' investment to the other countries, the risk faced by these firms also get higher, especially in countries in middle east where warship, secession, religious conflicts happen from time to time. Recently, what happened in Sudan (In Beijing just as in Khartoum and elsewhere in east Africa) on whether to separate from the rest of the country makes Chinese firms' investment in the region in a swing situation. As the biggest foreign investor in Sudan, China finds itself caught in the middle of the country's visceral internal divide (*Wall Street Journal* March, 2011). This tests Chinese firms' (especially SOEs') ability in tackling foreign political risks, and more importantly, the capability of Chinese government to protect the interest of Chinese firms while commit its words not to intermeddle other countries' affair – a great challenge for Chinese government. The state, not only the firms (especially SOEs), need to prove their capability to protect the property of those firms in the political swing, and produce a positive effect in calling for OFDI of Chinese firms.

Host country's political resistance also posits great challenge to Chinese firms' successful OFDI and Chinese government's credibility in making foreign policies. For example, besides the aforementioned resistance on Chinese financial intermediations' aggressive investment, Huawei's bid on buying 3Com in the U.S. was recently turned down by CFIUS with the reason that Huawei's founder Mr. Ren Zhengfei has military and political backgrounds[16]. Similar cases that always make Wall Street Journal and Financial Times

[16] "Huawei contests U.S. stance", *The Wall Street Journal* February 25, 2011: http://blogs.wsj.com/chinarealtime/2011/02/25/huawei-executives-open-letter-to-the-u-s/

headlines include China's investment in Burma and Pakistan[17] with political appeals and terms added. Australian government's resistance in Chinese firms' buying of the Australian ore coal mountains from BHP and Rio Tinto further manifests this concern[18]. Such concerns have questioned the sustainability of Chinese firms' aggressive OFDI. One may even ask whether the state influence is really advantage that shapes Chinese firms' OLI? This leads to substantial responsibility of Chinese scholars in relevant fields, especially in economics and business research, to discover the true mechanism of China's state influence in firms' capability and external social influence and how should host countries respond, to make this important judgment.

Decades of research on FDI and MNE mainly focus on MNEs' technological, financial, and managerial capabilities, and have underappreciated the role of institutions—both at home and abroad (Peng, Sun &Blevins, 2011). We believe that, merely focusing on economic returns of Chinese firms' OFDI ignores the institutional context of China's international business and trade environment, thus may shy away from the real driving forces of the state-controlled economy under transition. Taking into account of strategic-asset-seeking motivations of the state might partially unveil the truth of the state-oriented economic growth pattern, but is still subject to further examination on the statistical data and scientific analysis results with reasonable econometrical treatments. Moreover, relying too much on the data can sometimes be misleading, as a lot of hidden information is "behind the scene" but crucial in judging the real motivations, strategies, and consequences of China's international investment, such as data on GDP growth and executive compensation in the financial reports of listed companies and from the National Bureau of Statistics. In general, studying China's OFDI and the role of the state under an institutional-based view (Cantwell, Dunning, and Lundan 2010; Dunning and Lundan 2008; Peng, Wang, and Jiang 2008) and supported with many complementary data sources and scientific analysis is definitely more reasonable. At the same time, Chinese economists' and management experts' advocates on collecting and revealing economic data scientifically and completely are always necessary in pushing the truth-telling

[17] "Beijing and troubled nations: Signal of a shift", *Financial Times* Janurary 20, 2011: http://www.ft.com/cms/s/0/426c3912-24c8-11e0-a919-00144feab49a.html#axzz1I0xv9bo5

[18] "No escape from China for Rio Tinto", *The Wall Street Journal* April 8, 2011: http://online.wsj.com/article/SB123911954518297263.html

progress of the government. These are our social responsibility that we could not simply shy away from. Thinking about Japan's boom in 1990s but its later recession, one has to be cautious in optimistically arguing China's rise.

IV. CONCLUSION

4.1. Contributions of this paper

This paper complements the theoretical framework of our earlier work that applies an institutional perspective in analyzing the role of the state in Chinese multinationals' OFDI. In that priori work, we proposed that both formal institutional factors such as policy impact, bureaucratic system and state ownership (SOE), as well as informal institutional factors such as national pride and state ideology, would significantly influence Chinese firms' OFDI motivations and strategies. In this paper we supplement our existing framework with new aspects such as the role of direct FDI policy scheme, macroeconomic policy scheme, and China's state-backed financial intermediaries. More importantly, we propose a state-stewardship view on Chinese firms' OFDI to integrate these two conceptual theoretical papers by modifying the classic OLI paradigm. Moreover, the potential concerns on political conflicts and resistance that might affect the sustainability of China's overseas investment are further elaborated on.

Taking these aspects into account helps us complete our conceptual framework on the role of the state in China's OFDI from an institutional perspective. Specifically, by applying Dunning's OLI paradigm in a new setting, we look at how the state reshapes Chinese firms' ownership, location and internalization advantages through policy trajectory, ownership trajectory, and ideological trajectory. The new OLI advantages under the state influence help explain the movement and patterns of Chinese firms' OFDI activities to a greater extent.

4.2. Future research directions

As our second paper in discussing China's OFDI, This paper aims at filling in the spaces left in our earlier work. So far we are still at the intermediate stage in exploring the institutional content of China's OFDI, and therefore our next step would be empirically looking into the institutional driving forces behind these international investments – This would be our third leg of the "role of the state" trilogy. However, some concerns arise regarding the precise measurement of those factors. In particular, informal institutional factors such as state ideology and national pride, as well as the indirect impact of ownership arrangement and ideological influence are difficult to be proximated. Furthermore, some proposed hidden driving factors such as the round-trip money issues are hard to find evidence. Nevertheless, it is worth taking a brave step forward in proposing them and seeking for plausible proxies. We hope our institutional perspective and the state-stewardship view could help practitioners and academia in further understanding China's overseas expansion and rationally viewing the rise of the new China power in the world arena.

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APPENDIX

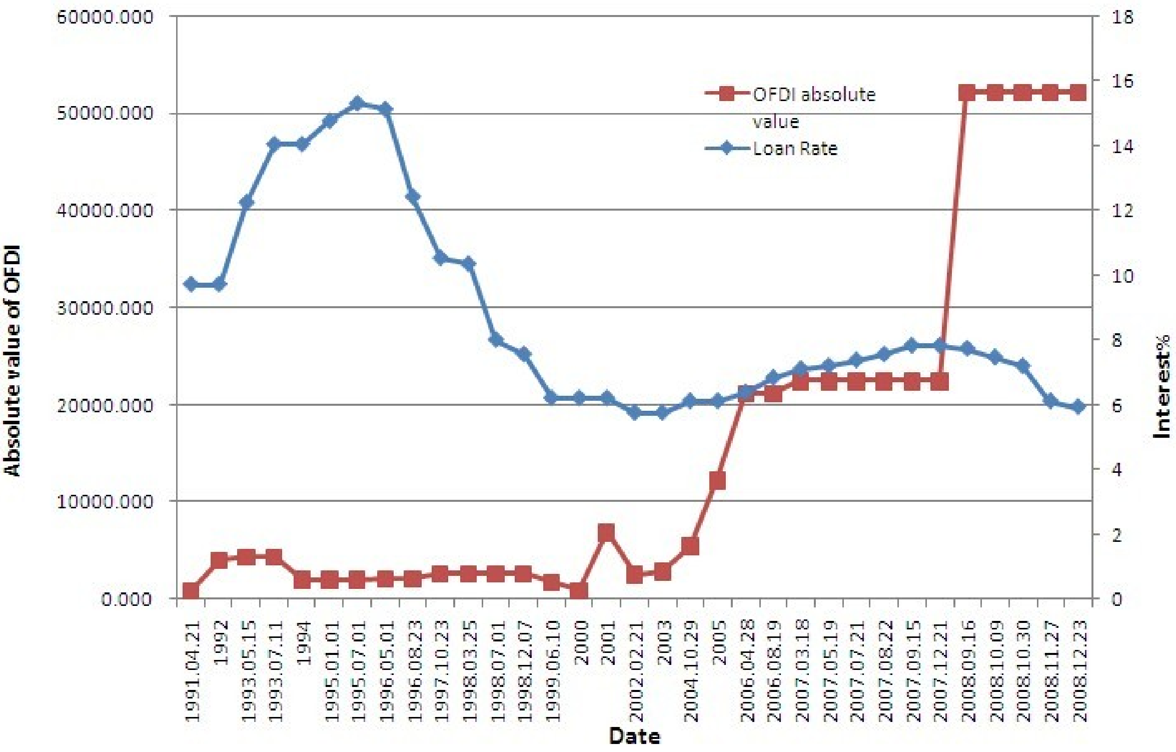

Figure 1. Interaction of OFDI Volume and Interest Rate Change

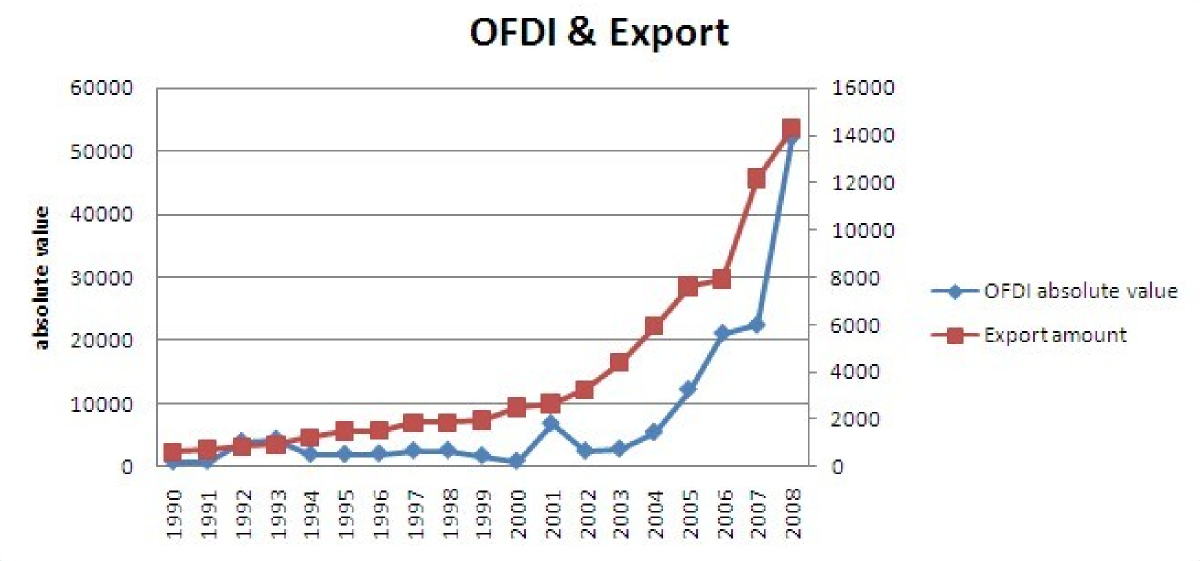

Figure 2. OFDI Flow v.s. Export Flow

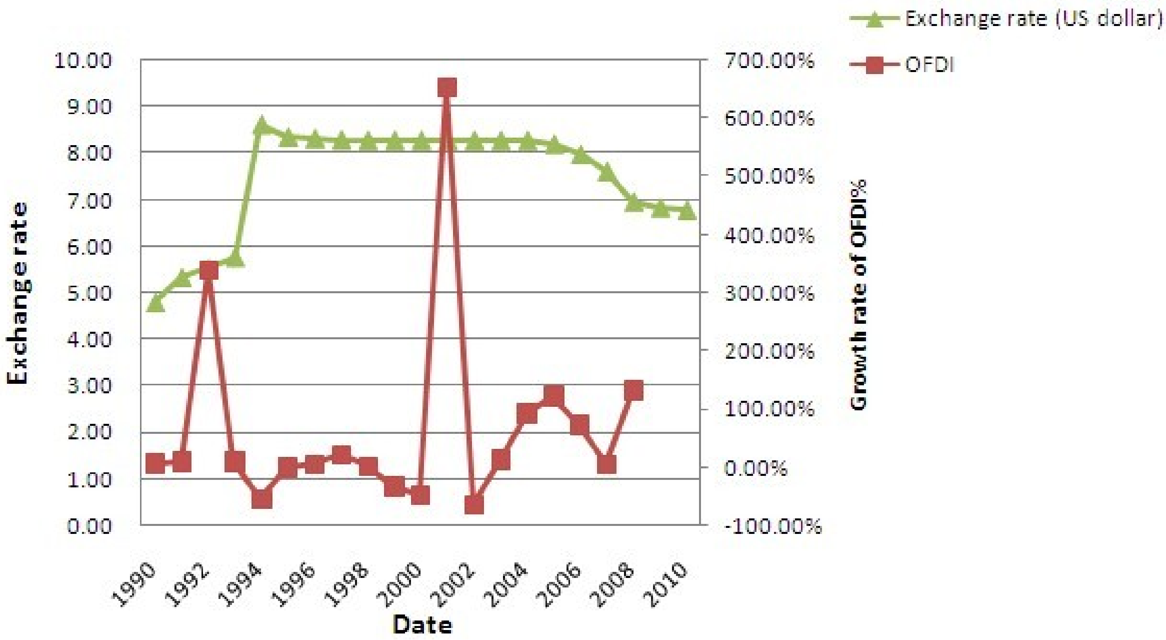

Figure 3. Growth of OFDI v.s. Exchange Rate

Table 1. The State-Stewardship Relationship

The Organizing Principles	The Incentive Structures	The Enforcement Mechanisms
➢ Higher-order organizing principles: ● State-driven country-level goals such as serving for political objectives and conforming to ideological requirements and helping to achieve the country-level economic benefits ➢ Lower-order organizing principles: ● State-driven firm-level process on the firm's strategic planning	➢ Dual incentives of the firm: ● Political incentives to fulfill state goals; ● Economic incentives to improve firm profitability. ➢ Personal incentives of state-steward managers: ● Political cadre promotion system; ● Individual political career aspirations.	➢ High-level control and monitor mechanism under administrative governance; ➢ The state's strong execution power on the implementation of the firm's strategies.; ➢ etc.

Table 2. The OLI Advantages of Chinese Multinationals under State Influence

Ownership Advantages	Location Advantages	Internalization Advantages
➢ Strong political and economic power and indulged home country/domestic administration skills; ➢ The state-driven country image and consumer stock; ➢ Policy discriminations towards SOEs; ➢ Policy consistency at both the country and the firm level; ➢ Isolated from domestic interest rate and exchange policy risks; ➢ Ideological compliance to the state will; ➢ Unique incentive mechanisms;	➢ Preferential policies towards certain regions and industries with strategic assets; ➢ Shortened institutional distance between home and host countries; ➢ More experience with incomplete and indulge institutional features (so more capable in handling unfavorable regulations and navigating around the obscure political constrains)	➢ Capability of tackling with complex entry modes such as M&A; ➢ Capability of tackling with post-acquisition integrations; ➢ Huge domestic markets absorbing internalized productions; ➢ Internationalized financial intermediations-backed capital advantages;