



Diplomacy and investment – the case of China

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Abstract

Purpose – The purpose of this paper is to analyze the impact of diplomatic activities on outward foreign direct investment (OFDI).

Design/methodology/approach – The paper first develops a set of hypotheses drawing insights from politics, international business and institutional theory. It then tests these hypotheses by estimation of Panel Corrected Standard Error models, using the data of Chinese OFDI flow to 131 countries over the period of 2003-2010.

Findings – The main findings are: friendly bilateral diplomatic activities help OFDI in general; bilateral diplomatic activities provide effective support to some sensitive and important investments; and bilateral diplomatic activities play an important role in host countries where institutions are absent or poor in quality.

Practical implications – Friendly bilateral diplomatic activities provide strong support to multinationals investing abroad.

Originality/value – The paper incorporates a neglected but important factor, diplomacy, into a model to analyze its influences on OFDI. It investigates not only the direct impact of diplomatic activities on OFDI but also their moderating effect on other OFDI determinants, such as economic and institutional factors.

Keywords China, Institution, Moderating effect, Outward foreign direct investment, Diplomatic activities

Paper type Research paper

1. Introduction

During Premier Wen's visit to Italy in October 2010, China announced ten commercial investment agreements worth \$2.5 billion, including, among others, the solar energy sector. During President Hu's visit to France in November 2010, France and China signed commercial agreements of \$22.8 billion in total value. During President Hu's visit to Portugal in November 2010, Portugal and China signed several commercial agreements, including a joint construction of optical fiber networks by Huawei and Portugal Telekom and a banking cooperation between Millennium and Industrial and Commercial Bank of China (Mihalakas, 2011). These stories show the importance of diplomatic activities in foreign investment and trade.



JEL Classification — F21

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However, scholarly literature on the influence of diplomacy on foreign direct investment (FDI) from emerging economies is scarce. Past FDI determinant studies that build on the Dunning's ownership-location-internationalization (OLI) analytical framework have largely focussed on firm characteristics, such as R&D and experience (e.g. Morck and Yeung, 1992), orexogenous macroeconomic factors, such as exchange rate (e.g. Kogut and Chang, 1996), taxes (e.g. De Mooij and Ederveen, 2003), and trade protection (e.g. Blonigen, 2002). Recent studies pay attention to the quality of institutions (e.g. Buckley *et al.*, 2007; Kolstad and Wiig, 2012). This study aims to extend the literature by analyzing the effect of international diplomacy on outward FDI (OFDI) using the case of China.

FDI from emerging economies has gradually increased with the globalization process. Multinational enterprises (MNEs) from emerging economies need unique competitive advantages to enhance their international expansion, but the origins of such advantages are less well understood (Kumar, 2007). As these firms in developing countries differ considerably from MNEs in developed countries when it comes to competitive advantages and international experiences (Mathews, 2006; Buckley *et al.*, 2007; Dunning, 2000; Dunning *et al.*, 1998; Gammeltoft *et al.*, 2010), traditional theories may not be adequate or appropriate for explaining the investment behaviors of MNEs from emerging economies. For one, Dunning's (1993) OLI analytical framework is challenged, as booming MNEs from developing countries obviously lack ownership advantages, which are deemed crucial preconditions for cross-border investment. Therefore, new views and models have emerged, such as Mathews's (2006) linkage-leverage-learning framework and institutional-based views (Peng, 2002; Scott, 2002; Mudambi and Navarra, 2002; Wright *et al.*, 2005; Peng *et al.*, 2008), that specifically account for MNEs from developing countries. Dunning also adapts his early OLI framework to explain the new phenomenon (Dunning and Lundan, 2008a, b; Cantwell *et al.*, 2010). In general, scholars tend to extend institutional theory to the field of FDI, which is capable of explaining outward direct investment from developing countries by emphasizing the role of government. On the empirical front, there is some research examining the impact of institutional quality or institutional distance between host and home countries on direct investment of MNEs (see e.g. Buckley *et al.*, 2007; Kolstad and Wiig, 2012). Some studies emphasize the positive role of home governments (Rasiah *et al.*, 2010; Holtbrügge and Kreppel, 2012). Despite this trend, studies on the relationship between international diplomacy and direct investment are limited. In particular, the relationship between international political relations and Chinese OFDI has not been well examined. Some scholars have extended institutional theory to international relationship studies (Jönsson and Tallberg, 2005; Goldstein *et al.*, 2007), but there are no studies to date integrating institutional theory, politics, and international business in a framework. This paper attempts to fill this gap. In particular, we focus on examining the direct effect of international diplomatic activities on OFDI and analyzing how diplomatic activities moderate the direct effect of economic and institutional factors on FDI.

Specifically, this paper addresses four issues. First, do bilateral diplomatic activities, such as senior visits, improve outward investment? On the other hand, do diplomatic conflicts hinder OFDI? Second, do bilateral diplomatic activities benefit sensitive and important direct investment, such as resource-seeking investment? Third, can diplomatic efforts compensate for disadvantages associated with the host countries' poor institutions, such as political instability and the absence of bilateral investment treaty (BIT)? In line with these issues, we develop a set of hypotheses

drawing insights from politics, international business and institutional theory. We test our hypotheses with a Panel Corrected Standard Error (PCSE) model, using the data of Chinese OFDI flow to 131 countries over the period of 2003-2010.

This paper is structured as follows. Section 2 briefly reviews the relevant literature and develops hypotheses. Section 3 describes the data and variables, and then presents the data and estimation methodology. Section 4 presents the estimation result. Section 5 summarizes our findings.

2. Literature review and hypotheses

Various theories try to explain the phenomenon of FDI. The eclectic paradigm (Dunning, 1993) is the dominant analytical framework that takes into account the determinants and activities of FDI. The eclectic paradigm suggests that MNEs conduct FDI on the premise of ownership, internalization, and location advantages. The former two advantages are related to the capacities and market structures for the MNEs themselves: the possession and exploitation of monopoly power, the competency of managers, the possession of scarce and sustainable resources; while the latter originates from the host countries' investing environment, including political, economical, and institutional factors. In fact, these factors interact with FDI, too. Extant theories are captured from the experience of north-north or north-south investment flows, which cannot fully explain south-north or south-south investment flows. Nevertheless, MNEs from developing countries are active. With great changes in MNEs development, Dunning has constantly amended the OLI paradigm and extended the concept of ownership advantages. In particular, Dunning introduced enterprise-specific institutional advantages to the framework of ownership advantages. The institutional advantages come from the enterprises' cultural or external values and norms (Dunning and Lundan, 2008a,b). Country specific advantages include country institutional and politic advantages, industrial advantages dependent on factor endowment, market advantages determined by country economic situation, etc. These theories suggest it is important to examine institutional and political factors while studying FDI from developing countries (Peng, 2002; Peng *et al.*, 2008; Buckley *et al.*, 2007; Cantwell *et al.*, 2010).

Accordingly, we argue that the effect of politics cannot be neglected. One of the basic arguments in political economics is that politics is crucial to economic development, whether improving or constraining economic growth. Institutional factors cannot completely explain the reasoning of FDI, though it is closely relative to politics. Therefore, it is necessary to analyze the effect of political behaviors on FDI – from the perspective of political science – to fully understand direct investment. A body of literature in the fields of economy and politics has investigated the effects of international relationship on FDI. The majority of the research demonstrates that a good relationship between home and host countries facilitates FDI (Nigh, 1986; Bandelj, 2002; Gupta and Yu, 2009; Zhang, 2005; Zhang *et al.*, 2011; Desbordes and Vicard, 2009; Desbordes, 2010; Fornes and Butt-Philip, 2011). A few studies find that a deteriorating international relationship cannot influence MNEs' investment decision due to the effect of sunk cost (Davis and Meunier, 2011). Other studies find that whether international political relations have an impact on direct investment depends on other factors, such as economic development level, institutional quality, etc. (Li and Vashchilko, 2010; Desbordes and Vicard, 2009). However, the extant studies are biased toward FDI from developed countries and have largely neglected that from developing

countries. Meanwhile, the existing approaches to weigh international relations are only measured by some comprehensive indices, and the concrete role of diplomatic activities is rarely investigated. To fill the gaps in the literature, this paper studies the effect of diplomatic activities on OFDI by using the case of China. In so doing, both the direct and indirect effects are investigated.

2.1 The direct effect of diplomatic activities on OFDI

Diplomatic activity is an important aspect of international relations. The friendly diplomatic interaction may lead to a good investment environment for MNEs, and hence influence MNEs' location decision. The main missions of China's diplomacy are: "to safeguard national sovereignty, to create favorable external environment for building a well-off society and accelerating socialist modernization, and to actively promote world peace and development[1]." Thus, one main objective of China's diplomatic activities is creating good external environments for economic development and to improve international economic cooperation through economic diplomacy. Nevertheless, there are conflicts between countries due to different national interests. We next analyze the effect of diplomatic activities on FDI in both peace and conflict.

Public interest is the set of private interest, and diplomatic activities are driven by both national and private interest (Lee and Hudson, 2004). The traditional diplomatic systems emphasize political exchange but neglect economic exchange, while the modern diplomatic system regards business diplomacy as a main goal. Governments have re-allocated diplomatic activities to concentrate more on business activities and extend the diplomatic business scope (Lee and Hudson, 2004). Governments are likely to become business cooperators. To some degree, senior political visits are spatial extensions of the political power of overseas investors from the home country to host country. The home country's political influence on the host country is an important way for overseas enterprises to gain business advantages in the host country (Transparency International, 2002). It also enforces contracts and protects the property rights of foreigner investors (Desbordes and Vicard, 2009). Therefore, the home government provides a good institutional arrangement for its MNEs through bilateral political visits, which originate from bilateral political negotiations or pressure. Bilateral senior visits are friendly signals that help investors in home country trust the host country. MNEs always follow the flag of bilateral political relations to avoid political risks, and they prefer to invest or increase investment in host countries that have good relations with their own country. Moreover, MNEs from emerging economies tend to be more attuned to government priorities and preferences (Gammeltoft *et al.*, 2010). This implies that the governments' political preference can influence MNE's investment decisions. Put concretely, when a government prefers a country, bilateral visits increase, which in turn send an encouraging signal to investors, leading MNEs to invest in the country. With respect to the host country, bilateral senior visits improve the awareness of, or foster the positive sentiment toward, the investing country, creating a more friendly investment environment for foreign companies to overcome the liability of foreignness. This friendly environment is also favorable for MNEs to invest in the host country. These arguments lead to:

- H1.* Bilateral senior visits between China and a host country promote Chinese OFDI flow to that country.

Overseas MNEs face two types of political risks: domestic systematic risk and risk related to political ideology. The former is due to the poor quality of domestic institution, which affects all MNEs in the host country equally; the latter scenario is related to the bilateral diplomatic risk between host and home countries (Desbordes and Vicard, 2009; Desbordes, 2010). This paper mainly discusses the latter risk. Host country's officials do not distinguish foreign investors from their government, and foreign investors are regarded as extensions of the home government or informal agents of their home country (Robert *et al.*, 1978; Cuervo-Cazurra *et al.*, 2007). Meanwhile, FDI is a long-term investment, and it is less likely to escape evacuation. Host countries can easily penalize the home country for political conflicts by shifting the cost of political conflicts to MNEs. The host government can capture investors' surplus by outright expropriation, strict regulation, heavy taxation, rigorous entry barriers, visa requirements, or selective law enforcement (Büthe and Milner, 2008; Kastner, 2007). Rising political tensions lead governments to adopt policies that reduce investment interdependence and encourage investors to transfer investment to other partners (Davis and Meunier, 2011). In addition, MNEs' products are constrained by the host consumers' public choices. Consumers' cognition and demand propensity toward different countries may be different. Consumers express goodwill or solidarity toward those they identify as friends, but nationalist feelings lead them to shun, punish or boycott those they perceive as foes (Pollins, 1989). Therefore, bilateral political conflicts result in reduced expected return of *ex ante* investors, and lower the probability of re-investment due to damage in *ex post* investors' property rights. As a consequence, MNEs are reluctant to invest in the countries with diplomatic conflicts with their home country. In other words, bilateral diplomatic risks lead to lower investment. These arguments lead to:

- H2. Political conflicts between China and a host country have a negative impact on Chinese OFDI to that country.

2.2 Moderating effects of diplomatic activities

The OLI paradigm explains how national characteristics (L-specific advantages) determine MNEs' location choice, including the host's economic environment (such as size and scope of market, quantities and qualities of the factors of production, technology and trade cost, etc.) and institutions (such as political stability, government policies, and agreement, etc.) (Dunning *et al.*, 1998; Dunning, 2009; Cantwell *et al.*, 2010). In this study, we examine how diplomatic activities moderate the effects of these national characteristics on MNEs' location choice by focussing on following two aspects.

Moderating effect on economic factors. A host country's resource abundance, market size, cost, and technology are major factors attracting FDI (Dunning, 2000). Due to data availability, this paper mainly discusses resource and market-seeking FDI in the context of China.

Many studies find that direct investment from developing countries, in particular countries like China and India with constrained natural resources, is motivated by wanting to secure resources for their rapid economic growth (e.g. UNCTAD, 2006; Lall, 1983; Guillen and García-Canal, 2009). Since the start of Reform and Opening, China's economy has grown at an annual rate of 8 percent for 30 years. Such high-speed growth has increased demand for fuel, ore, and metal resources. Supplies from domestic market cannot meet the huge demand, which has to be supplied with

imports. FDI is an effective strategy for securing a sufficient supply of resources (Kolstad and Wiig, 2012; Ramasamy *et al.*, 2012). Many Chinese MNEs exploit resources in Australia, Canada, Africa, Eastern, and Central Asia (Buckley *et al.*, 2008). However, MNEs confront various institutional obstacles when they conduct resource-seeking activities. Host governments may raise the entry threshold higher for foreign investors or even prevent direct access to entry for the sake of national security. Host countries with rich natural resources may have serious corruption and rent (Kolstad and Wiig, 2009; Frankel, 2010), such that the exchange of natural resources does not follow the principle of maximizing economic profit. Bilateral diplomatic activities enhance the success of negotiation, especially when seeking large-scale rent or economic interests. Home governments can gain the ownership and exploit right of some large resource trade and development projects through strong political and economic power, but private enterprises are unable to access to these projects. Konings (2007) points out some African countries demand additional projects when they sell their resources. For example, China's government provides cash and soft loans to these host countries or help build infrastructures of host countries when obtaining ownership and exploration rights. In addition, political interest may be embedded in the exchange of natural resources. Many politicians prefer to sell resources to countries with fewer or no disagreements over political ideology. China's diplomatic policies follow the principle of seeking common ground while putting aside differences with a policy of non-interference on states' sovereignty and freedom from ideological hegemony. Thus, diplomatic activities reduce prejudices and modify how the host countries' political leaders see and regulate China's investors. Therefore, we argue that bilateral political visits provide favorable political conditions for China's enterprises to gain ownership and exploitation rights of host countries' natural resources. Following this logic we posit:

H3a. Friendly diplomatic activities between China and host countries benefit Chinese OFDI in resource-abundant countries.

According to a UNCTAD (2006) survey of MNEs from developing countries, more than 50 percent of these firms are market seeking. Previous empirical studies demonstrate, too, that China's OFDI is attracted to host countries with a large market (Buckley *et al.*, 2007; Ramasamy *et al.*, 2012). Market-seeking OFDI faces both external and internal uncertainty (Erramilli and D'Souza, 1995; Armstrong, 2009; Anderson and Gatignon, 1986). Internal uncertainty originates from a MNE's lack of relevant market information and knowhow (Erramilli and D'Souza, 1995) as well as political distance between the two countries (Armstrong, 2009). External uncertainty stems from instability in the host country market (Anderson and Gatignon, 1986). External and internal uncertainties increase transaction cost, reduce confidence of managers and investors, and dilute ownership advantages of enterprises (Kogut and Singh, 1988; Armstrong, 2009); hence, they have negative effect on investment. Friendly diplomatic activities help reduce bilateral political distance. Political and economic talks as well as cooperation between leaders of host and home countries facilitate the exchange of information and knowledge (Stark and Brusz, 1998). In addition, friendly diplomatic activities reduce the host government's interference with enterprises from the investing country, enabling overseas MNEs to gain licenses, contracts, and special business permits. Moreover, host governments are likely to support MNEs with consulting organizations or experts and provide local market information, reducing the enterprises'

liabilities of foreignness and costs. All of these factors facilitate the market expansion of MNEs. These pieces of arguments induce:

H3b. Friendly diplomatic activities between China and host countries benefit Chinese OFDI in countries with large markets.

Moderating effect on institutions. Institution is a broad concept. North (1990) defines institutions as the rules of a game that are devised to shape human interaction. Institutions promote economic exchange and cooperation by establishing order and reducing uncertainty (North, 1990), and they are important structures for providing different incentives to enterprises (Baumol, 1993). These rules can be formal constraints including political and judicial rules, economic rules, and contracts, or informal rules, such as codes of conduct, norms of behaviors, and conventions embedded in culture and ideology. Countries with good institutional qualities have low uncertainty in economic activity, as institutions are developed by societies to create order and reduce uncertainty in promoting economic exchange and cooperation (Williamson, 1985; North, 1990, 1991). The quality of institution is often assessed from the following aspects: political stability, regulatory quality, government effectiveness, democratic accountability, rule of law, control of corruption, absence of violence. In this study, we focus on the two aspects of political institutions: political stability and BIT.

Political stability is widely acknowledged as an important institutional factor in explaining FDI flows (e.g. Buckley *et al.*, 2007). BITs are signed between two countries in order to encourage, promote, and protect investments between them (UNCTAD, 2000). They are formal economic institutional arrangement, including fair and equitable treatment, protection from expropriation, free transfer of means and full protection and security. Studies found that the implementation of a BIT increases the FDI (Neumayer and Spess, 2005; Egger and Pfaffermayr, 2004).

The institution-based view suggests good institutions promote economic activity, since good institutions are associated with a favorable business environment as well as lower uncertainty and complexity (Globerman and Shapiro, 2002). In line with many empirical results from developed countries, countries with good institutions are more likely to attract foreign investment (Garcia-Canal and Guillen, 2008; Daude and Stein, 2007). However, that does not mean foreign investment is less likely to flow toward host countries with poor institutions. In the empirical literature on MNEs from emerging economies, poor institution in a host country seems not to be a barrier, and some authors even regard it as an environmental advantage for MNEs from emerging economies (Cuervo-Cazurra and Genc, 2008; Quer *et al.*, 2012). In the case of China, evidence indicates that Chinese firms are investing in countries with poor institutions, endowed with natural resources (Kolstad and Wiig, 2012; Sanfilippo, 2010). In fact, political influence strongly impacts economic activities countries where laws, rules, and market mechanisms are lacking. Investing firms can thus maintain their economic benefits through political power. The institutional gap can be remedied by friendly bilateral diplomatic activities. A host country's political preference toward firms from certain countries is enhanced by friendly bilateral diplomatic relations. Firms from these countries are given more investing priorities and supplied with favorable obligatory institutional arrangements. This arrangement is also selective and exclusive, only being offered to MNEs from preferred countries. Firms from preferred countries can access economic resources and gain more contracts and developing opportunities. Friendly bilateral diplomatic relations between investing and host

countries therefore create a new institutional advantage for foreign firms. This new institutional ownership advantage may substitute or complement the existing institutional advantage. In many cases, political leaders are more influential in the countries with weak institutions than those with strong institutions. One can expect the weaker the institutions, the stronger the influence of politician's diplomatic activities. Therefore, we argue that friendly diplomatic activities between China and host countries can overcome institutional weaknesses in host countries. In other words, there is a substitution effect between diplomatic activities and institutional quality.

This argument leads to:

H4a. Friendly diplomatic activities between China and host countries have a substitution effect on political stability, which means that the diplomatic activities play more important role in a high-risk country than in a stable country.

H4b. Friendly diplomatic activities between China and host countries have a substitution effect on BITs, which means that the diplomatic activities play more important role in a country that has BITs with China than in a stable country.

3. Data and method

To test our hypotheses, we use the data of Chinese OFDI flow to 131 countries between 2003 and 2010. The variables and data sources are described below.

3.1 Dependent variable

Dependent variable is Chinese OFDI. It is measured by the value of FDI flow. This sample is collected from the CEIC database[2].

3.2 Key explanatory variables

In line with hypotheses above, we choose the following two key explanatory variables.

Visit captures the number of senior leader's visits in a certain year. It is measured as the total number of bilateral visits, which are weighted as follows: two for a visit by top national leaders, and one for a visit by other leaders. The data are created by using descriptive information from the official web site of Foreign Ministry of China, the subpage of "Countries and Regions[3]."

Conflict defines political conflicts between China and the host country. It is measured by the total counts of conflict events weighted as follow: two for serious conflict, and one for general conflict[4]. The data are created by using descriptive information from the official web site of Foreign Ministry of China, the data source are the same as the variable above.

3.3 Control variables

We choose variables to control for host country economic and institutional factors. Our host country economic factors include three variables: host country GDP, GDP growth (GG), and natural resources; while institutional factors contain two variables: host country social stability and BIT.

GDP is used to capture host country market size. Generally speaking, countries with a large market attract FDI.

GG defines market growth of the host country, measured as growth rate of GDP. Economic theory states that faster market growth results in more FDI.

Resource captures the abundance of the host country's nature resources. It is measured by the export of host country's fuels, ores and metals as share of GDP. Economic theory shows host countries with more resources attract more FDI.

All of the data for GDP, GG, are derived from the World Bank World Development Indicators, 2011.

Social stability indicates the degree of political risk in the host country. It is measured by the index of Political Stability and Absence of Violence/Terrorism (Kaufmann *et al.*, 2010), derived from databank Worldwide Governance Indicators[5]. The indexes range from about -2.5 to 2.5, with higher values corresponding to better social stability. There is a lower economic cost to foreign investors investing in environments with lower political risk. Hence, we expect firms to be more willing to invest in countries with social stability.

BIT captures whether China and the host country have signed a BIT. It is a dummy variable, with a value of 1 if bilateral investment agreements have taken effect, and with a value of 0 otherwise. The data are collected from UNCTAD's report on total number of BITs published in June 2011. We expect that a BIT can benefit or protect a Chinese firms' investment, having a positive impact on Chinese OFDI in host countries.

Diplomacy indicates length of time that the bilateral central diplomatic relations have been established. The data are obtained from the official website of Foreign Ministry of China: www.fmprc.gov.cn/chn/gxh/tyb/. The longer the establishment of diplomatic relations, the more perfect the rules, and the more secure the investors' benefits. Investors are also more capable of adapting to the host country's institutions and adjusting their investment behaviors accordingly. With deeply embedded institutions, foreign investors can even duplicate the environment of their home country to exploit comparative advantages (Erdener and Shapior, 2005), enhance their linkage, leverage, and learning ability (Mathews, 2006). Empirical research demonstrates there is a positive relationship between long-term bilateral diplomatic relations and China's FDI inflow (Zhang, 2005). We expect the *Diplomacy* has positive influence on OFDI.

City defines the sister-city relations. It is measured by the total number of sister-city pairs established by local governments between the two countries. The data are obtained from the official web site of Foreign Ministry of China. A sister-city relation provides enterprises from the partner city with advantages in new institutional ownership, market information, resources, and management; reduces transaction cost; improves their investing decision; and motivates them to act. Hence, under the driving force of vested institutions and compulsory institutional creation, a rational choice investor may increase investments in a partner city. We expect the sister-city relationships positively influence OFDI.

In addition, two dummy variables are introduced to control for regional characteristics. One is *Asian*, and another is *Europe*. *Asian* takes the value of 1 if a host country is an Asian country, and 0 otherwise; *Europe* take the value of 1 if a host country locates in Europe and 0 otherwise.

3.4 Interaction terms

In line with *H3a*, we create an interaction term of senior leader visits and natural resources, called *Visit_Resource*, to assess the possible moderating effect of friendly diplomatic activities between China and the host country on China's natural resource-seeking OFDI.

Implied by *H3b*, we generate the interaction term of bilateral senior leader visits and host country's market size, termed *Visit_GDP*, to examine the possible moderating

effect of the friendly diplomatic activities between China and the host country on China's market-seeking OFDI.

To conceptualize the institutional constructs, we choose both host country social stability and BIT as two-dimensional institutional variables. Hence, two interaction terms related to senior leader visits and host country institutions are included to investigate the possible moderating effect in *H4a* and *H4b*: one is the multiplication of senior leader visits and host country social stability, which is termed *Visit_Stability*; another is the multiplication of senior leader visits and BIT, which is termed *Visit_BIT*.

3.5. Model

We use the following model for estimation:

$$\begin{aligned}
 FDI_{it} = & \beta_0 + \beta_1 Visit_{it} + \beta_2 Conflict_{it} + \beta_3 Resource_{it} + \beta_4 GDP_{it} \\
 & + \beta_5 GG_{it} + \beta_6 Stability_{it} + \beta_7 BIT_{it} + \beta_8 Diplomacy_{it} + \beta_9 City_{it} \\
 & + \beta_{10} Asia + \beta_{11} Europe + \varepsilon_{it}
 \end{aligned}$$

where *i* represents a certain host country, and *t* stands for a certain year. We use PCSE estimator, which is commonly applied in politics. Beck and Katz (1995) point out this estimator can solve the problems of contemporaneous correlation, heteroscedasticity, and serial correlation, in addition to getting robust standard errors.

The estimated coefficient of the interaction terms is often used to judge the moderating effect. However, Friedrich (1982) and Brambor *et al.* (2006) point out this approach is not proper. When interaction terms are introduced into the equation, the nature of model changes, and the coefficient of interaction terms should be interpreted differently from similar terms in a linear-additive model. Therefore, to assess the effect and significance of moderating variables, one should combine the coefficient' variance, covariance of the corresponding variable and interaction, and the value of moderating variable. We use a previously introduced approach (Friedrich, 1982; Brambor *et al.*, 2006) to assess the effect and significance of moderating variables.

Before proceeding to estimation, we calculate correlations between the independent variables to check for potential multicollinearity problems. As shown in Table I, all of the correlations are below the commonly recognized threshold of 0.7. Furthermore, all of the values of VIF in the Models 1 and 2, far below the commonly used threshold of 5, suggesting that multicollinearity is not an issue in all models below.

| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 |
|-------------|--------|--------|--------|--------|--------|--------|-------|--------|--------|--------|----|
| 1 Visit | 1 | | | | | | | | | | |
| 2 Conflict | 0.159 | 1 | | | | | | | | | |
| 3 Resource | 0.019 | -0.016 | 1 | | | | | | | | |
| 4 GDP | 0.417 | 0.472 | -0.107 | 1 | | | | | | | |
| 5 GG | -0.024 | -0.023 | 0.335 | -0.126 | 1 | | | | | | |
| 6 Stability | -0.008 | 0.008 | -0.210 | 0.101 | -0.161 | 1 | | | | | |
| 7 BIT | 0.058 | -0.049 | 0.064 | -0.035 | 0.060 | 0.064 | 1 | | | | |
| 8 Diplomacy | -0.138 | -0.026 | -0.171 | 0.005 | -0.107 | -0.012 | 0.047 | 1 | | | |
| 9 City | 0.083 | 0.000 | -0.170 | 0.107 | -0.126 | 0.206 | 0.039 | 0.097 | 1 | | |
| 10 Asia | 0.048 | -0.001 | 0.304 | -0.008 | 0.218 | -0.176 | 0.378 | -0.128 | -0.002 | 1 | |
| 11 Europe | 0.190 | -0.037 | -0.269 | 0.047 | -0.216 | 0.434 | 0.091 | 0.168 | 0.327 | -0.340 | 1 |

Table I. Correlation analysis

4. Result and discussion

The PCSE model estimation results are presented in Table II. Model 1 includes the constant and control variables with full sample. Model 2 presents the results with two key explanatory variables and two variables reflecting existing diplomatic relation *Diplomacy* and *City*. Models 3-6 show the results with different interaction terms, using the multiplications of senior leader visits and *resource*, *GDP*, *social stability*, and *BI*, respectively. Models 1 and 2 are used to assess the direct effect of key explanatory and control variables on Chinese OFDI. Models 3-6 are used to examine the indirect effect of bilateral senior leader visits on others variables.

In Model 2, *Visit* has a positive and significant sign at the confidence level of 1 percent, which strongly confirms *H1*, suggesting senior leader visits send a signal of legitimacy, creating business advantages, and confidence for the home country's firms.

| | Model 1 | Model 2 | Model 3 | Model 4 | Model 5 | Model 6 |
|-----------------|----------------------|----------------------|----------------------|----------------------|----------------------|----------------------|
| Visit | | 4.016*** (0.828) | 3.146*** (0.949) | 4.084*** (0.964) | 3.551*** (0.954) | 4.885*** (0.832) |
| Conflict | | -12.8 (20.470) | -13.68 (19.970) | -13.04 (20.500) | -13.23 (18.610) | -13.06 (18.060) |
| Visit_Resource | | | 0.0382** (0.019) | | | |
| Visit_GDP | | | | 0.000 (0.001) | | |
| Visit_Stability | | | | | -1.221 (0.791) | |
| Visit_BIT | | | | | | -0.137 (0.13) |
| Resource | 0.153*** (0.033) | 0.305*** (0.063) | -0.079 (0.118) | 0.305*** (0.065) | 0.297*** (0.062) | 0.302*** (0.066) |
| GDP | 0.0339*** (0.004) | 0.0225*** (0.007) | 0.0261*** (0.008) | 0.0246* (0.014) | 0.0248*** (0.007) | 0.0214*** (0.006) |
| GG | -3.411*** (0.424) | -3.382*** (0.585) | -3.432*** (0.596) | -3.365*** (0.656) | -3.371*** (0.591) | -3.528*** (0.534) |
| Stability | 12.84 (10.220) | 10.31 (9.662) | 11.26 (9.483) | 10.37 (9.305) | 14.8 (9.942) | 11.48 (9.275) |
| BIT | 28.41*** (5.123) | 21.75*** (5.161) | 20.92*** (6.308) | 21.66*** (5.470) | 22.21*** (5.104) | 27.89*** (7.466) |
| Diplomacy | | 0.479** (0.197) | 0.547*** (0.196) | 0.480** (0.204) | 0.537*** (0.199) | 0.511*** (0.194) |
| City | | 3.569*** (0.458) | 3.631*** (0.451) | 3.559*** (0.508) | 3.622*** (0.471) | 3.587*** (0.464) |
| Asia | 22.75*** (5.314) | 8.655* (4.904) | 5.265 (4.861) | 8.341** (4.193) | 7.918 (5.849) | 10.38* (6.027) |
| Europe | 5.666 (18.500) | -39.49* (20.310) | -37.19** (18.390) | -40.22** (16.930) | -41.44** (20.030) | -42.98** (19.350) |
| Constant | 36.11*** (1.470) | 2.532 (6.012) | -9.643 (6.275) | 2.277 (6.961) | 1.881 (6.156) | 0.0522 (6.477) |
| Observations | 1029 | 989 | 989 | 989 | 989 | 989 |
| Number OFDI | 131 | 126 | 127 | 126 | 126 | 126 |
| Wald χ^2 | 179943.7 | 117529.4 | 248131 | 387898.7 | 33336.72 | 3388.73 |
| Prob > χ^2 | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 |

Table II.
Estimates of China's
OFDI 2003-2010

Notes: Standard errors are shown in parentheses. * $p < 0.1$; ** $p < 0.05$; *** $p < 0.01$

Therefore, bilateral political visits between China and a host country are positively associated with Chinese OFDI to this country.

The coefficient of *Conflict* is negative, which states that bilateral political conflict prevents Chinese OFDI. However, the coefficient is insignificant. Hence, the empirical evidence fails to fully support *H2*. In fact, the result is consistent with recent literature, such as Brada *et al.* (2006), Davis and Meunier (2011). Generally, bilateral political tension negatively influences bilateral economic activities. For example, during the 1960s, the deteriorated political relations between China and the Soviet Union resulted in large-scale capital flow out of China. However, this study chooses a sample from 2003 to 2010. During this period studied, there were no serious tensions between China and host countries; a relatively normal political relation can still be maintained in the face of less tensions. Therefore, the argument of sunk cost effect works, resulting in stable, and continuous cross-border investment decisions.

Control variables *Resource* and *GDP* have positive and significant coefficients at the confidence level of 5 percent in both Models 1 and 2, which are consistent with our expectations.

However, *GG* is negative, which is unexpected. This suggests host countries' potential *GG* has not fostered Chinese OFDI at present. The reason may be that development of Chinese OFDI is still in the early stage, as most Chinese companies have just started to invest abroad. When they make location decisions, they may consider the existing market size to be preferable over market growth potential. In addition, although market-seeking is one motivation of Chinese OFDI, knowledge-seeking, and resource-seeking are also important motivations (China Council for the Promotion of International Trade, 2011). The destinations for the knowledge-seeking and resource-seeking FDI, such as USA, EU, Canada, and Australia are low-growth developed countries.

Stability has a positive but not significant sign in all models, which does not fully confirm previous speculation. In other words, host social stability does not significantly improve Chinese OFDI. This result is in line with extant studies (e.g. Kolstad and Wiig, 2012; Cheung and Qian, 2009).

BIT is always positive and significant at the 1 percent level in all specifications, which suggests institutionalization of bilateral economic relations improves Chinese OFDI.

Diplomacy has a positive and significant sign at a confidence level of 5 percent, confirming our speculation that Chinese OFDI tends to flow into host countries with longer time of diplomatic ties to China.

City has a positive and significant sign at a confidence level of 1 percent, indicating that host countries establishing more sister-to-sister cities with China attract more Chinese OFDI.

In order to assess different moderating effects of senior leader visits on other economic and institutional variables, we include the interaction terms in Models 3-6. Using the variance and covariance obtained from Models 3-6, we calculate the moderating effect of visits on Chinese OFDI. The results are shown in Figures 1-4.

Figure 1 shows the marginal effect of host country's resource on OFDI and its 95 percent confidence interval, as a function of bilateral senior leader visits. Figure 1 demonstrates that the positive effect of host country's resource on Chinese OFDI depends on the bilateral senior leader's visits between China and the host country. In general, *Visit* has a positive moderate effect (seen from the positive slope of the solid line). When the number of *Visit* is larger than 5.1, the positive effect is statistically significant at the 5 percent level (seen by both dashed lines being above zero).

Figure 1.
Marginal effect of
resource, conditional
on political visit

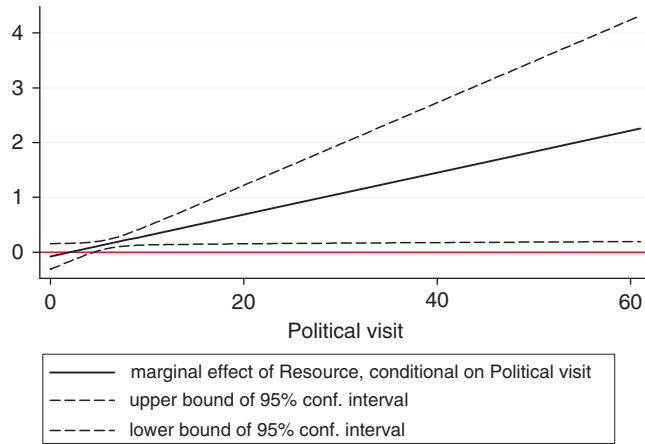


Figure 2.
Marginal effect of
market, conditional on
political visit

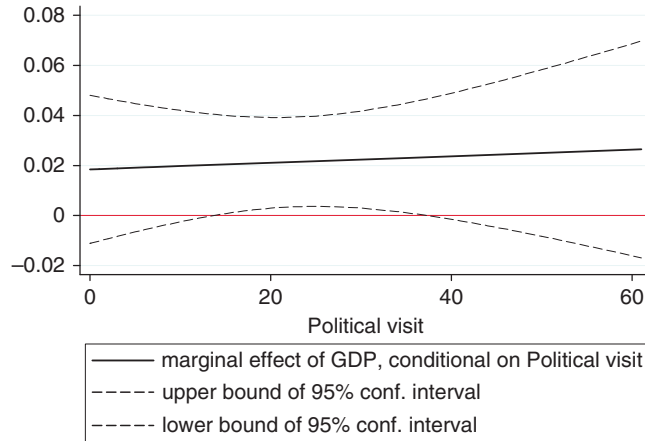
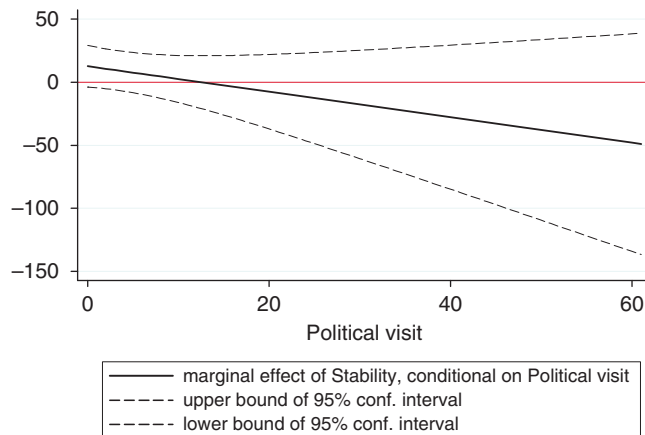


Figure 3.
Marginal effect of
stability, conditional on
political visit



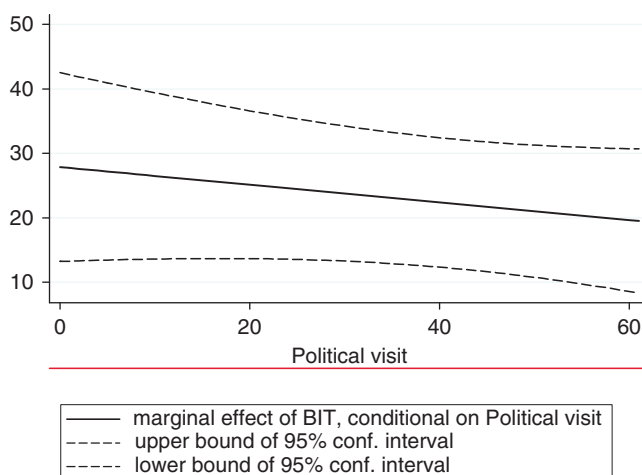


Figure 4.
Marginal effect of
BIT, conditional on
political visit

This result suggests bilateral senior visits help resource-seeking OFDI, and such positive moderating effect become significant only if the visits reach a certain number. This evidence conditionally supports *H3a*. Figure 2 shows the relationship between *Visit* and the marginal effect of market size on OFDI. As seen from the slope of the solid line, the moderating effect of senior visits is almost zero and significant only in a very narrow range (between 14.5 and 36.5). This evidence fails to support *H3b*. Figure 3 shows how senior visits moderate the effect of the explanatory variable *Stability*. Seen from the slope of the solid lines, senior visits have a negative moderating effect on *Stability*. This result implies senior visits have a substitute effect on host's political stability. However, the moderating effect is not significant. We do not have enough evidence to support *H4a*. Figure 4 shows how senior visits moderate the effect of the explanatory variable *BIT*. Seen from the slope of the solid lines, senior visits have a negative moderating effect on *BIT*. This result implies senior visits have a substitutive effect on *BIT*. This substitutive effect on *BIT* is statistically significant. The result supports *H4b*.

With its rapid and extensive economic growth, China sees securing natural resources abroad as imperative for sustaining development. Previous studies demonstrate that one of the main motivations of Chinese OFDI is natural resource seeking. Our empirical evidence indicates diplomatic activities (senior visits) benefit resource-seeking investment. Resource is a sensitive issue in most countries. Host country may treat it especially cautiously when it comes to foreign investment because resources are related to national economic security. Even in the high-level market economies, such as USA, Canada, Australia, natural resource investing is not fully dependent on economic factors, but still under the strong influence of government or political power. In this case, diplomatic activities facilitate the investing activities.

Market is also one of determinants of OFDI from developing countries (Guillen and García-Canal, 2009). Our empirical evidence proves that larger market size attracts more FDI. However, we cannot find sufficient evidence to support the idea that such positive effect of market size is moderated by diplomatic visits. This may reflect the fact that market is more an economic factor than a political one, on which government influence is limited. Additionally, government is less motivated to interfere with market.

Good institutions in the host country attract FDI (Daude and Stein, 2007). Our evidence supports this view. We find BIT improves direct investment. More importantly, we also find the substitution effect between bilateral diplomatic visits and local institutional arrangement. That is, as the quality of institutions in host countries decreases, friendly bilateral diplomacy can offset the negative impact from such institutional imperfection. Chinese diplomatic activities not only directly foster Chinese OFDI, but also improve the investment environment in host countries for Chinese overseas firms.

5. Conclusion

MNEs from developing countries differ considerably from MNEs in developed countries (Dunning *et al.*, 1998). They do not possess a set of firm-specific advantages as those from developed countries, such as managerial capabilities and technology. Scholars explained the rise of OFDI from developing countries by analyzing the country specific advantages (Sun, 2009) or institutional advantages (Dunning and Lundan, 2008b). This study extends this line of research by examining the impact of diplomacy on OFDI.

Drawing on political, institutional, and economic theories, this study argues that diplomatic activities are important for MNEs from developing countries competing in the global market. The activities have direct and indirect effects on the OFDI. By using the data of Chinese OFDI flow to 131 countries over the period of 2003-2010, we found evidence to support our hypotheses and answered the four questions raised in the introduction. We summarize our findings as follows.

First, friendly bilateral diplomatic activities are positively related to Chinese OFDI. Our empirical evidence suggests that senior visits create good opportunities for Chinese direct investment.

Second, friendly bilateral diplomatic activities benefit some sensitive and important investments, such as resource-seeking investment. Our empirical result suggests that resource is a determinant of Chinese outward investment. However, the realization of resource-seeking outward investment depends on the Chinese government's diplomatic efforts and power.

Third, bilateral diplomatic activities can compensate for some disadvantages associated with the host country's lack of good-quality institutions. The empirical evidence demonstrates that the bad institutional environment in a host country is disadvantageous to Chinese OFDI, but it can be improved by proactive diplomatic activities.

In addition, the empirical evidence indicates that the longer the diplomatic relations between China and a host country and the more sister-to-sister cities between China and a host country, the more likely the Chinese OFDI expands in that host country. This implies that establishment of formal political institutions between governments helps cross-border investment.

Although the current study extends the literature by analyzing the relationship between OFDI and diplomacy, it is characterized by a number of limitations that point the way for future work. For example, the study only uncovers the correlation between the OFDI and diplomatic factors. The causality can run in both directions: Good diplomatic relations may lead to more OFDI, and more OFDI may cause more diplomatic activities. Future research might focus on the causality analysis.

Notes

1. Source: available at: www.fmprc.gov.cn/chn/gxh/zlb/zcwj/t24782.htm (accessed February 2012).

2. CEIC is the preeminent authority on Asian, Chinese and Emerging Market macro-economic, industrial and financial time-series data. CEIC databases have been developed by experienced and professional specialists and researchers, leveraging on well-established relationships and direct data distribution arrangements with the prime national and regional statistical agencies and major industrial data issuing organizations of each country covered. CEIC China Premium Database provides 286,000 series, FDI data are part of them. See more information at: www.securities.com/products/ceic.html
3. The descriptive information is derived from the web page: www.fmprc.gov.cn/eng/gjhdq/ (accessed February 2012).
4. The serious conflicts include events such as non-military sanction and serious protests; the general conflicts include events such as declining a proposal raised by a host government and normal complaints and protest.
5. http://info.worldbank.org/governance/wgi/sc_chart.asp (accessed January 2012).

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