Research on the Location Selection of China's OFDI in Southeast and South Asian Countries

—*From the Perspective of Institutional Distance*

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Abstract—**In the context of the Belt and Road Initiative, the scale of China's OFDI continues to expand. Based on the perspective of institutional distance, this paper selected the developing countries along the "One Belt and One Road" route and located in southeast Asia and South Asia as the research objects, established the investment attraction model, and empirically tested the influence of institutional distance on China's OFDI location choice from two aspects of regulatory institutional distance and normative institutional distance .The study found that the greater the regulatory distance between China and developing countries in Southeast Asia and South Asia, the less attractive it is to China's OFDI. The greater normative institutional distance ,the greater the attractiveness to China's OFDI. When conducting foreign investment, Chinese enterprises should pay more attention to the gap between the normative institutional and the regulatory institutional of the host country.**

Keywords: institutional distance, OFDI, location selection

I. INTRODUCTION

With the development of economic globalization and regional integration, the economic and trade cooperation among countries has become increasingly close .As the second largest economy in the world, China's capital globalization is accelerating and its outward foreign direct investment (OFDI) is developing rapidly .At the same time, under the background of "One Belt and One Road" initiative, economic and trade exchanges between China and countries along the Belt and Road have been pushed forward to a deeper and broader level .Most of the countries along the Belt and Road route are emerging economies and developing countries with broad markets and great development potential. Due to the demand for economic development, on the whole, these countries generally adopted more favorable policies for foreign investment. Southeast Asian and South Asian countries ,as an important part of One Belt and One Road, indicate that China will further expand investment cooperation and economic and trade exchanges with it. According to the 2017 Statistical

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Bulletin of China's Outward Foreign Direct Investment, China's OFDI investment in the Asian region was $110.04 billion, accounting for 69.5% of the foreign direct investment flows of the year. Among them, the investment in ASEAN countries was $14.12 billion, up 37.4% year-on-year, accounting for 12.8% of investment in Asia. However, although China is adjacent to Southeast and South Asian countries, there are also many differences in political and legal institution. If the institutional environment of the home country is quite different from that of the host country, it means that the multinational enterprises will spend higher costs to adapt to the environment that different from the home country when investing in the host country, which is not conducive to enterprises' rapid acquisition of local resources and short-term profits. Therefore, the institutional distance plays an important role in the process of location selecting of foreign direct investment of enterprises.

Along with the rise of new institutional economics, in addition to the traditional factors affecting foreign direct investment such as market size, infrastructure construction, and trade policy, scholars began to introduce institutional quality and institutional distance into OFDI research. Under the background of the "One Belt and One Road", how to help and promote Chinese companies to invest in countries along the line and to make effective location choices is of great theoretical and practical significance. Therefore, this paper chooses the institutional distance as the research perspective, and takes the developing countries in Southeast Asia and South Asia as the research object, trying to clarify the influence mechanism distance on China's OFDI selection in this region.

II. THEORETICAL BACKGROUND

A. OFDI

At the end of the 20th century, Dunning put forward the eclectic theory of international production, which has a good explanatory power for China's OFDI .Dunning summarizes the three most basic elements that determine the international direct investment of enterprises ,namely, ownership advantage,

location advantage and internalization advantage [1]. It is concluded that the location selection of foreign investment by transnational enterprises can be divided into market seeking type, resource seeking type, strategic asset seeking type and efficiency seeking type. Based on the data of transnational enterprises in China, Yan revealed several factors that determine the location choice of enterprises' OFDI [2] .In terms of location advantage, the market potential, labor cost and resources of the host country will affect the intensity of foreign investment. In point of institution, the economic institution has a greater influence, while the political and legal system has a relatively weak influence. Enterprises are even willing to invest in regions with higher risks. In the matter of culture, enterprises would prefer to invest in countries with similar cultural environment. In other aspects, the service industry, openness and communication capacity of the host country all have important influences on OFDI location selection. Taking countries along the Belt and Road route as research samples, Sui et al. found that China companies tends to invest in countries with high GDP growth rate, and the more perfect the infrastructure of the host country, the more China's OFDI can promote [3]. Based on China's investment experience in 57 countries from 2006 to 2014. Cui et al. pointed out that transnational enterprises tend to invest in countries with large investment markets, low living standards and regional trade agreements [4].

B. Institutional distance

North defined institution as a social game rule that regulate people's behavior[5].According to North's definition of institution, Scott argues that institution is composed of three aspects: regulatory pillar, normative pillar and cognitive pillar [6]. The regulatory pillar reveal existing laws and regulations within the national environment, which restrict certain behaviors while encouraging certain practices. Normative pillars reflect the values, beliefs, norms, and assumptions associated with human behavior and nature in the national environment. The cognitive pillar display the social knowledge and cognitive structure Shared by people in the national environment, and also involves cultural elements. Kostova[7] defined institutional distance as the difference between countries in the regulatory, normative and cognitive institutional environment. However, from the perspective of actual OFDI activities, the distinction between normative distance and cognitive distance is slightly, so scholars [8] [15] put them into a category called normative distance. Many scholars also proposed different classification standards based on their own research objects. For example, Liu classified institutional distance as economic institutional distance and legal institutional distance[9].

C. OFDI and Institutional distance

The institutional differences between the home country and the host country form an institutional distance ,which allowing direct investment from abroad have to spend additional costs such as familiarity with the local market, searching for local markets and interpersonal behavior, communicating and negotiating, and ensuring contract performance. The associated additional costs increase the risk of cross-border investment and influence the location choice of foreign direct investment

by multinationals. At present, more and more scholars are beginning to study the issues related to OFDI from the perspective of institutional distance. Different conclusions are drawn from the different division of institutional distance. For example, Liu divides the institutional distance into economic and legal institution distances[9].The results show that the economic institution distance between China and the countries along the "One Belt and One Road" had little impact on China's OFDI, while the legal institution distance had a significant negative effect.

Some scholars have classified the institutional distance into formal and informal institutions [10] [11], such as Qi et al. empirical tests: the better the formal institutional environment of the host country, the more attractive the Chinese capital inflow[11], but the informal institutional distance hinders China enterprise's OFDI. Jiang believe that China's OFDI is generally more inclined to those countries or regions with great difference from their own institutional environment, and the greater the difference in system, the larger the investment scale[12]. Wang found that China's OFDI in developed countries or countries with better institutional quality had obvious characteristics of institutional bias and institutional risk aversion [13]. In developing countries, countries with poor institutional quality and countries related to "One Belt One Road", the investment shows certain characteristics of institutional risk preference and institutional similarity. These scholars demonstrated that for developed and developing countries along the Belt and Road, institutional distance has different influences on China's OFDI location choice.

Another part of scholars divided institutional distance into regulatory institutional distance and normative institutional distance, maintaining that the larger gap between normative institutional distance and normative institutional distance, the smaller the scale of China's OFDI. The greater the distance between regulatory institutions, the larger the scale of China's OFDI [14] [15].However, Zhang hold that both regulatory institutional distance and normative institutional distance have significant negative effects on the location selection of Chinese enterprises[15].

In general, the existing literature does not agree with the conclusion on how the host country system affects the location choice and flow direction of China's OFDI. Combining the theories and viewpoints of the above scholars, this study also divided institutional distance into regulatory institutional distance and normative institutional distance, and selected developing countries in Southeast Asia and South Asia as research objects to further explore the influence of regulatory distance and normative distance on China's OFDI.

Hypothesis1: The institutional distance between the home country and the host country affects the location of the China's OFDI;

H1a: The greater the regulatory distance between China and Southeast Asian and South Asian countries, the less attractive it is to China's OFDI;.

H1b: The greater the regulatory distance between China and Southeast Asian and South Asian countries, the less attractive it is to China's OFDI;

III. METHODS

A. Data and Measures

Based on the data of China's OFDI flow from 2007 to 2017, the sample countries selected in this paper are the developing countries in Southeast Asia and South Asia, which are an important part of the Belt and Road. By referring to previous empirical studies on panel data [9] [15], fixed effect regression was adopted. Due to the lack of relevant statistical data in some countries, 14 countries were finally identified as the analysis samples. The 14 countries included Vietnam, Laos, Cambodia, Thailand, Myanmar, Malaysia, Indonesia, Brunei, Philippines, Nepal, India, Pakistan, Bangladesh, Sri Lanka.

1) Dependent variable

In this paper, China's OFDI flow to countries along the "One Belt and One Road" from 2007 to 2017 is selected as the explained variable. In the statistics of China's OFDI to Southeast Asia and South Asia, some data are missing, so the time span chosen in this paper is 2007-2017, and the annual OFDI flow does not lag behind, which is more effective in explaining the economic development and changes of the current period. Moreover, flow data can be used to understand the investment location selection preference of Chinese transnational enterprises to these countries. Therefore, this paper chooses flow data to describe the location selection behavior of Chinese enterprises to Southeast Asia and South Asia countries, instead of stock data. Due to the large volume of OFDI flow data, in order to reduce the heteroscedasticity of the model, its logarithm was taken in this paper and defined as LnOFDI, with the unit of $ 10,000. The data were obtained from the statistical bulletin of China's OFDI from 2007 to 2017 issued by the Ministry of Commerce.

2) Explanatory variable

This paper divides the institutional distance into a regulative distance (RD) and a normative distance(ND), which is used to measure the institutional environmental difference between China and the Southeast Asian and South Asian countries along the Belt and Road Initiative so as to test the impact of institutional distance on the location choice behavior of Chinese enterprises in this region. In the specific measurement, Kaufmann and Kraay adopted the six institutional indicators of each country integrated by the Global Governance Indicators (WGI), namely government efficiency (GE) ,regulatory quality (RQ), rule of Law (RL), control of corruption (CC), voice and accountability (VA), and political stability (PS) [16]. The RD was measured by GE, RQ, and RL, and the ND was measured by CC, VA, and PS. This article will follow this measurement method. In the calculation of the RD and the ND, we followed the measurement method proposed by Kogut & Singh in 1988 [17]. "KS" method is universally recognized by the international community , and truly, objectively and comprehensively reflect the indicators composed of different dimensions. The formula is as follows:

$$Distance_{ij} = \frac{\sum_{k=1}^{n} \frac{(I_{ik}-I_{jk})^2}{V_k}}{n} \qquad (1)$$

Distance$_{ij}$ represents the institutional distance between country I and country j, I_{ik} is the index value of indicator k of country I, I_{jk} is the index value of indicator k of country j, V_k is the overall variance of indicator k, and n is the number of indicators.

3) Control variables

a) The host country's economic development level (ENV). In this paper, the per capita GDP of the host country was selected to represent the economic development level of the host country. Generally speaking, high per capita GDP indicates that the country has strong economic vitality, great market potential and can well attract foreign investment. To reduce the heteroscedasticity, we took its logarithmic form. The data came from the WDI database of the World Bank.

b) Overseas Demonstration Effect (EX), the more China exports to the host country, the more favorable it is for China to understand the cultural customs and business environment of the host country. And exports help the two sides to establish close cooperation, which lays a good foundation for China's OFDI. The demonstration effect reduces the range of investment risks brought about by institutional factors. This article selected China's exports to Southeast Asian and South Asian countries to express this demonstration effect, and takes the logarithm and records it as LnEX. The data is compiled from the China Statistical Yearbook from 2007 to 2017, with a unit of $10,000.

c) The degree of opennessof the host country (OD) . If the host country is more open to the outside world, it is easier to attract foreign direct investment. In this article, the host country's openness to foreign investment is measured by the proportion of foreign direct investment stock in GDP every year. The data comes from UNCTAD STAT;

B. Model

In 1962, Tinbergen put forward a relatively complete and simple economic model — gravity model by using gravity related knowledge, which made some economic problems well verified. This paper through expanding the traditional trade gravity model and introducing the institutional distance, constructs the investment gravity model. Finally, the empirical model was concluded as follows:

$$\ln OFDI_{it} = \beta_0 + \beta_1 RD_{it} + \beta_2 ND_{it} + \beta_3 \ln ENV_{it} + \beta_4 OD_{it} + \beta_5 \ln EX_{it} + \mu_{it} \quad (2)$$

In the equation(2) ,the subscripts I and t represent the investment host country and the specific year respectively ;RD stands for regulatory institutional distance, ND stands for normative institutional distance, ENV represents host country's economic development level, OD is host country's openness to the outside world, EX stands for host country's export volume. β_0 is a constant term; β_n represents the regression coefficient of the corresponding variable; μ_{it} is the error term.

TABLE I. DESCRIPTIVE STATISTICS AND CORRELATION MATRIX

Variables	Mean	SD	1	2	3	4	5	6
1.OFDI flow	32903.55	40816.26	1					
2.Regulative Distance	1.61	1.02	-0.25**	1				
3.Normative Distance	0.68	0.78	-0.05	-0.22**	1			
4.Environment	0.5	0.93	-0.04	0.16*	0.07	1		
5.Open degree	26.93	19.12	0.47**	-0.50**	0.13	0.25**	1	
6.Export	16037E6	1.73556E6	0.49**	0.26**	-0.38**	0.046	0.10	1

Indicates correlation significance at the $p \le 0.10$ (* $p \le 0.05$; ** $p \le 0.01$; *** $p \le 0.001$) level of confidence (two-tailed test).

IV. RESULT

According to the descriptive statistics of the variables in Table I, the variance of outward foreign direct investment flows of the explanatory variables was large, which indicated that China's investment in developing countries in Southeast and South Asian fluctuated greatly. The mean and standard deviation of the explanatory variables RD and ND was relatively close. It was owed to the global governance indicator database adopted in this paper. The values of each sub-indicator were between -2.5 and 2.5. The smaller the RD and/or ND, the smaller the RD and/or ND between China and the host country of the OFDI investment. Since there were some high correlations between explanatory variables, variance inflation factors (VIFs) were calculated to test for multicollinearity. The mean VIF obtained in the full model was around 1.46, and the maximum VIF was 1.75. Both are substantially below 10, which is suggested as the rule-of-thumb cutoff [18], minimizing multicollinearity concerns .

TABLE II. REGRESSION RESULTS OF INSTITUTIONAL DISTANCE TO OFDI SELECTION

Variable	Coefficient	Std. Error	t-Statistic	Pr(>|t|)
RD	-0.996047***	0.283818	-3.509454	0.0006
ND	0.616837**	0.269183	2.291515	0.0235
LnEnv	1.438528**	0.562669	2.556613	0.0117
OD	0.023692*	0.013384	1.770215	0.0789
LnEx	0.469541*	0.27892	1.683423	0.0946
R-squared				0.782270
Adjusted R-squared				0.753239
F-statistic				121.2583
Prob(F-statistic)				0.000000

Indicates significance at the $p \le 0.10$ (* $p \le 0.05$; ** $p \le 0.01$; *** $p \le 0.001$) level of confidence (two-tailed test).

Table II shows the regression results obtained by using Eviews8 measurement software. The correlation coefficient of LnOFDI to RD is negative, and it has passed the test at a significant level of 0.1%, indicating that the RD is negatively correlated with the OFDI flow, i.e, Chinese enterprises tend to invest in southeast Asian and South Asian countries with similar control systems. Consistent with the hypotheses . The larger gap between the host country's legal system and government efficiency and China's, the smaller the scale of China's investment in the host country will be. If the distance between RD is small and the institutional environment is superior, the host country can attract Chinese enterprises' OFDI.

Specifically, this may be because the closer the host country and China's laws and regulations are, the more familiar Chinese companies are with the host country's system of contract implementation and property protection. Therefore, the enthusiasm of Chinese enterprises for foreign investment is higher. Moreover, the better the quality of public services provided by developing countries and the better the quality of supervision, the more willing Chinese enterprises are to carry out OFDI. This shows the risk aversion characteristics completely consistent with the mainstream international capital flow theory.

The correlation coefficient of LnOFDI to ND is positive, and it has passed the test at the significance level of 1%,

indicating that there is a positive correlation between the distance between normative institution and OFDI flow. In other words, the larger the normative distance is and the worse the normative institution is, the higher the willingness of Chinese enterprises to invest in this country. This is the opposite of the hypothesis1b.In general, studies have found that multinationals tend to avoid riskier and politically unstable regions. However, China's OFDI in Southeast Asia and South Asia reflects a certain institutional risk preference. This may be due to the complex political situation and the rent-seeking behavior induced by corruption in the host country. Enterprises can achieve rapid investment and financing in the host country by establishing a good "relationship" with the authorities. It is also possible that enterprises want to avoid the risks of the home country's normative institution by make use of the immature normative institution environment of the host country.

The regression structure of the three control variables is consistent with the theoretical expectation, indicating that these factors play an important role in the location selection process of OFDI. The regression coefficient of the host country's economic environment (ENV) is positive and has passed the test at a significant level of 1%, indicating that China's OFDI tends to those countries or regions in Southeast and South Asia with good economic environment and high market potential. OD passed the test at a significant level of 5%, indicating that the higher the openness of the host country, the easier it will be to attract foreign direct investment. The demonstration effect of overseas investment (LnEX) passed the test at a significant level of 5%, indicating that the frequent export links between the home country and the host country become an important way for enterprises to understand the host country's market, common business routine, culture and other factors. The accumulation of business experience in the host country's market makes the national characteristics of the investor country increasingly important in the choice of the enterprise's OFDI location.

V. Conclusion and Discussion

By analyzing China's OFDI in 14 developing countries in Southeast and South Asia from 2007 to 2017, this paper draws the following conclusions: First, institutional distance is a key factor in determining the scale of China's OFDI. Second, the different dimensions of institutional distance have different effects on China's OFDI. On the one hand, China's OFDI in developing countries——located in Southeast Asia and South Asia tends to enter countries or regions with poor normative institution, and has certain characteristics of "normative institution risk appetite". That is, the greater the normative distance between these countries and China, the more they can stimulate Chinese companies to invest in these countries. On the other hand, host countries with large differences in regulatory institution are less attractive to Chinese companies. It shows that Chinese companies tend to operate OFDI in countries with similar regulatory institution to seek market resources.

Based on the above conclusions, it is necessary to pay attention to the investment operations of Chinese companies abroad. First of all, Chinese companies cannot ignore the importance of the gap between the normative institution and

the regulatory institution when conducting foreign investment. The administration further improve the risk report on investment country, so that multinational enterprises can familiarize with the host country's institutional environment as much as possible, especially the host situation about the control of corruption, voice and accountability political efficiency and regulatory quality, etc, which will prompt the investment effect of enterprises. Second, according to the size of the institutional distance, the corresponding strategy is adopted to meet different types of investment needs. Specifically, for countries in South and Southeast Asia, Chinese enterprises can choose countries with similar regulatory systems to carry out OFDI so as to expand the market scale, e.g. Thailand and Myanmar. Selecting developing countries with relatively different investment system environment to obtain scarce resources e.g. Indonesia, the Philippines, Vietnam and so on.

It is worth noting that the different divisions of the institutional distance dimension and the calculation of different measurement methods may lead to differences in research results. Secondly, in terms of sample selection, this paper only studied the developing countries located in Southeast Asia and South Asia, not all developing countries along the Belt and Road. Therefore, the research conclusions have certain limitations, and subsequent research can expand to all the developing countries in the Belt and Road.

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