

Reversal of Fortune

Solving the Puzzle of Emerging Economy ODI

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Abstract—Since the surge of the outbound direct investment (ODI) of the emerging economies, the limitations of the traditional Ownership-Location-Internalization (OLI) paradigm of foreign direct investment were exposed. The main puzzle is how to interpret emerging economy ODI when the fundamental buildingblock of OLI, firm specific ownership advantages, barely existed. Focusing on the case of China, an integrated theory based on the reversal of fortune of China and the reversal of the role of ownership advantages is proposed. The new framework adds home advantage and institutional support to OLI while reversing the role of the “O”, generalizing the “L”, and strategizing the “I”.

Keywords-China, the eclectic theory, emerging economies, foreign direct investment, institutional support, outbound direct investment

I. INTRODUCTION

Foreign direct investment (FDI) has been an important topic in international business during the past five decades [1]. As multinational enterprises (MNEs) and globalization evolved, scholars continued to wonder about the future of FDI [2].

A widely accepted theory of FDI is Dunning’s Eclectic Theory [3][4][5]. While it has five versions as summarized by Eden and Dai [6], it has been crystallized as the Ownership, Location, and Internalization Paradigm (OLI). It provides a framework for understanding FDI: MNEs doing FDI must have firm specific Ownership advantages (technology, brand and management) that they can transfer abroad; they will choose an attractive Location (seeking natural resources, market, efficiency and strategic assets); and when FDI is chosen as the preferred entry mode, it is because Internalization of the above advantages incur lower transaction costs than alternative modes.

While OLI has been criticized for the interdependent nature of O, L, and I [7], it is still a popular analytical tool for FDI. We may interpret OLI as an attempt to answer the following three FDI questions:

- What firm specific advantages (FSA) does the firm own?
- Which location is the best place to go?
- Why is FDI the best entry mode?

OLI evolved and matured during the age of globalization when the developed world expanded their businesses all over the world through FDI. It has long been recognized that the ownership of FSA is a necessary condition for FDI [8][9]. But since the rise of the emerging economies and with the surge of

their overseas investments, especially the outpouring of Chinese outbound foreign direct investment (ODI) in the 21st century, the limitations of the OLI paradigms were exposed.

The main puzzle that academicians have been struggling with is how to interpret emerging economy ODI when the fundamental buildingblock of OLI, firm specific ownership advantages, barely existed within their MNEs. Many scholars such as Buckley et al [10], Huang and Wang [11], Sun et al [12], and Andreff and Balcer [13], to name just a few, have attempted to address this question from various angles but so far there is no generally accepted answer.

The purpose of this paper is to propose an integrated theory for emerging economy ODI to solve the puzzle. Given China’s dominating role in emerging country ODI, our illustration and analysis will be based on the case of China. The new framework may be applicable to other emerging economies.

The solution to the puzzle lies in the “reversal of fortune” (Figure. 1) of China – from a relatively poor country short in foreign exchange, to the world’s second largest economy with a thriving domestic market (deep market) and long in foreign exchange reserves (deep pocket). And decades of FDI pouring into China was indeed an important contributor to the economic miracle. The deep market and deep pocket enabled Chinese MNEs to acquire desired FSA through ODI; the “O” in OLI was skipped!

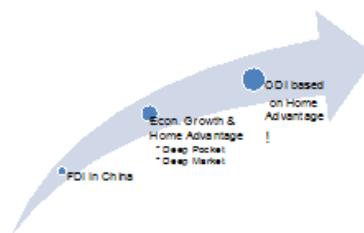


FIGURE I. THE REVERSAL OF FORTUNE

II. AN INTEGRATED CHINESE ODI FRAMEWORK

A thorough analysis of the Chinese ODI trends and patterns is beyond the scope of this conceptual paper. But it might be useful to note that KPMG and China International Contractors Association [14] reported recently that while Asia is still the leading destination of Chinese ODI, Europe and North America have enjoyed significant growth during the past few years. Chinese investments in Europe have been growing at an annual

rate of 111% between 2008 and 2011, and those in North America at 90%. The key sectors for Chinese ODI have been overseas engineering and contracting projects, energy and mining, household appliances, automotive, and financial services.

They also reported that in 2012, the total value of ODI made by Chinese non-financial enterprise reached \$77.2 billion – a 44% compounded annual growth rate since 2003. As well, overseas acquisitions have risen at an annual growth rate of 31% between 2005 and 2012.

With the rapidly expanding Chinese ODI in mind, the integrated theory adds home advantage and institutional support to OLI. It also reverses the role of “O”, generalizes the “L”, and strategizes the “I”. The solution to the Chinese ODI puzzle lies in the reversal of fortune of China and the reversal of roles of Chinese MNEs. Below is a brief explanation of each component of the new framework.

A. *Reversal of Fortune: Home Advantages*

After decades of rapid economic growth and trade surplus, in part due to voluminous inbound FDI, China has experienced a reversal of fortune. The Chinese economy has been transformed from a less developed one with a severe foreign exchange shortage to the fastest growing in the world. It boasts to be the second largest economy worldwide and possesses the highest foreign exchange reserves.

Such a profound transformation, never seen in economic history, should serve as a backdrop of a theory for Chinese ODI. While China is still a developing country and its MNEs may not have transferrable FSA, they do have home country advantages at the macro level that the OLI paradigm did not cover.

The two most striking advantages are the abundant foreign exchange reserves and the huge domestic market with potential for further growth. The deep financial capability of the state enables Chinese MNEs to go on a shopping spree globally at a lower cost of capital to buy FSA from foreign firms to compensate for their competitive weaknesses. The deep domestic market not only provides customers for their products and natural resources but also lowers their market risk. Thus the advantages of the Chinese MNEs are not firm-specific but rather country-specific: lower capital cost and lower market risk.

B. *Institutional Support*

The Chinese institutional environment has had a profound influence on its ODI. This is indeed a “Chinese characteristic” that distinguishes Chinese ODI from the rest of the world. To begin with, the waves of FDI pouring into China during the past three decades were one of the results of the states “Reform and Opening Up” strategies since 1978. Then the surge of Chinese ODI after entering into the 21st century was the direct outcome of the game-changing “Go Global” policy announced in 2001. To support “Go Global”, not only did the state identify strategic ODI goals, such as natural resources, technology, and managerial capabilities, there was a spectrum of pro-ODI policies to support ODI, including financing, foreign exchange, and risk management. Given the top-down political system and the SOE dominated MNE sector, the whole package of support,

well documented by Luo et al [15], proved to be very powerful in launching Chinese firms onto the global stage.

C. *Reversal of Roles of Chinese MNEs: Acquisition of Ownership Advantage*

Equipped with home country advantages and institutional support, Chinese MNEs were able to go on a global “shopping spree” to compensate for their weaknesses in competitiveness. They skipped the “O” in OLI and acquired the FSA of foreign firms through M&A and other modes. Understanding such a reversal of roles, from a recipient of foreign FSA through FDI to a buyer of foreign FSA is key to establishing a theory for Chinese ODI.

D. *Generalized Location Advantage*

Rugman and Verbeke have thoroughly reviewed location, strategic and MNEs in international business [16]. For Chinese ODI, given the cultural emphasis on personal connections and trust, confidence gained through a vibrant local Chinese community is definitely a factor when choosing a location. Similarly, Chinese executives, compared to their Western counterparts, may feel more at ease with developing or socialist countries because the social/economic/political distances between China and these countries are shorter. Thus location for Chinese ODI should include both physical and non-physical distance in addition to the four traditional advantages listed in the Introduction. We shall this expanded view of location “Generalized Location Advantage”.

E. *Strategic Internalization*

Pioneered by Buckley and Casson [17], internalization based on transaction cost consideration is a basic construct of OLI and plays an important role in international business [18]. But one of its restrictions is that it only considers transaction costs [19]. We argue that when choosing an entry mode, the strategic benefits should be taken into consideration besides cost efficiency. For example, cross-border M&A has been a main form of Chinese ODI. One of the reasons is that M&A is more time-effective than green field investment. This is particularly true when competing for scarce strategic resources globally [20]. Thus transaction costs alone do not fully explain the choice of entry mode. We shall call this broadened entry mode selection “Strategic Internalization”, which encompasses strategic benefits and transaction cost considerations.

III. CONCLUSION

Based on the above discussion, we may start to delineate a Chinese ODI theoretical framework. “The Reversal of Fortune” theory is rooted in the Chinese home country advantages, the deep pocket and the deep market. The pursuit of ODI activities is strongly supported by a spectrum of pro-ODI policies since the 2001 strategic shift to “Going Global”. Equipped with the above, Chinese MNEs are able to acquire competitive advantages that they did not own. When choosing a location, a non-physical social/economic/political distance is also considered in addition to physical distance and traditional location advantages. When they choose ODI as an entry mode, benefits they intend to internalize include strategic benefit as well as transaction cost efficiency. Figure 2 contrasts OLI and the integrated Chinese ODI framework. Further research needs

to be conducted to determine if such a theory may be applicable to or modified for other emerging countries.

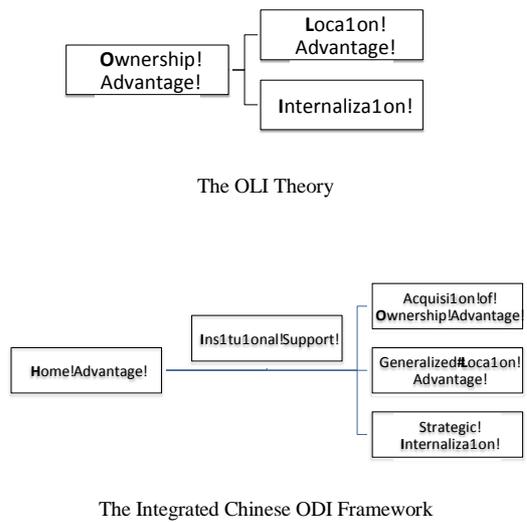


FIGURE II. FROM OLI TO THE INTEGRATED FRAMEWORK

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