

# A Study on the Impact of Host Country Political Risk on China's OFDI

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**Abstract:** Using the panel data of China's OFDI in 107 host countries from 2010-2021, this paper explores the impact of host country political risk on China's OFDI by constructing an expanded gravity model, and on this basis, introduces the interaction term between host country political risk and economic system quality, and discusses the effect of economic system quality on the relationship between political risk and China's OFDI. The moderating effect of the impact between political risk and OFDI in China is discussed. It is found that the political risk of host countries can significantly inhibit China's OFDI to them; the investment motivation of China's OFDI to host countries with different levels of political risk varies, and the quality of economic system inhibits China's OFDI in host countries with low political risk. It is beneficial for China to understand and prevent political risks in host countries and to differentiate investment strategies according to countries with different levels of risks.

**Keywords:** political risk; OFDI; gravity model; quality of economic system; moderating effect

## 1. Introduction

Since China's accession to the World Trade Organization in 2001, the level of economic development and the degree of openness to the outside world have been increasing. According to the Statistical Bulletin on China's Outward Foreign Direct Investment in 2020<sup>1</sup>, China ranked first in the world in outward FDI flows for the first time, reaching \$153.71 billion. Investment in countries along the "Belt and Road" has grown steadily, with direct investment of \$22.54 billion in 2020, making it an important global investment force and source of capital.

However, in recent years, due to the existence of uncertainties such as international trade frictions and geopolitical integration, the political risk of countries has increased, and the political risk of host countries for OFDI is also growing. Most of the countries along the "Belt and Road" are developing countries with high political risk, and the social and political instability in some countries such as Afghanistan and Iran has increased the risk of China's direct investment there.

In addition, although China's outbound investment has made remarkable achievements, there are still problems such as uneven regional and industrial distribution and low revenue efficiency.

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<sup>1</sup> Source: Website of the Central People's Government of the People's Republic of China  
<http://www.gov.cn/>

Take the Belt and Road Initiative countries as an example, most of the countries that have signed the Belt and Road cooperation document with China are developing countries or even extremely underdeveloped countries. The objective economic factors are bound to affect the efficiency of China's foreign investment.

## 2. Literature Review

With the rapid development of China's economy and the expansion of outward investment, the issue of OFDI in China has also aroused the attention of scholars at home and abroad. Studies on the risk of China's OFDI mainly focus on the institutional risk of the host country. In a related domestic empirical study, Qi and Zou (2013)[1] used China's outward FDI data to 51 host countries and found that higher institutional quality of host countries can significantly promote outward FDI. Internationally, Asiedu (2006)[2] also support the view that host country institutional quality is positively related to FDI inflows.

In terms of political factors, the host country's own social stability and bilateral political relations with other countries seriously affect the risk of investment. Yang and Liu et al(2016)[3] find that bilateral political conflicts have a significant inhibitory effect on corporate investment, while friendly bilateral political relations can not only expand the scale of corporate outbound investment, but also help promote diversification and the success rate of corporate outbound investment; Zhang and Jiang (2012)[4] also support the view that bilateral friendly relations can effectively promote OFDI, and pointed out that bilateral diplomatic activities can escort some sensitive and important investments.

On the economic front, the level of economic development of the host country and the level of uncertainty in its economic policies are important factors affecting OFDI. Xu et al. found that the level of digital economy development can promote the increase of outward FDI by enhancing innovation capability through studying the relevant data of RCEP partner countries. Yang, and Li(2018)[5] found that the scale of China's outward FDI in host countries is significantly and negatively related to the level of economic policy uncertainty in host countries.

Buckley (2007)[6], using the regression of China's OFDI data from 1984-2001, firstly suggests that China's outward investment has the characteristic of institutional risk preference. Song and Wu (2018)[7] proposed that China's outward investment has institutional risk preference characteristics after adding the level of host country risk. However, some scholars suggest that the "risk appetite" characteristic of China's OFDI is actually an artifact. Yang, Wang et al (2015)[8] find that the positive relationship between China's OFDI and host country risk is no longer significant after adding natural resources as a control variable in the regression.

In summary, the shortcomings of the existing studies are: first, focusing on whether there is a "risk preference" characteristic of OFDI in China, few studies have analyzed the heterogeneity of OFDI in China over time, and there is no unified conclusion on the findings. Secondly, regarding the impact of host country risk on OFDI, domestic and foreign studies are basically limited to institutional risk, but do not pay much attention to the interrelationship between political risk, economic risk, etc. on the impact of OFDI.

The main contributions of this paper in the previous study are: (1) Selecting regime stability, government efficiency and corruption control from the Worldwide Governance Indicators

(WGI)<sup>2</sup> to measure the political risk of host countries. (2) Incorporating the quality of economic system into the comprehensive framework of the impact of political risk on China's OFDI, and exploring the effect of the quality of economic system on China's OFDI under different levels of political risk, in an attempt to make up for the shortcomings of previous research perspectives.

### **3. Theoretical analysis and research hypothesis**

#### **3.1. Political risk and location choice**

In neoclassical economics, the sole purpose of the firm is to maximize profits. Therefore, according to the traditional theoretical predictions, China's OFDI should flow more to countries with lower political risks.

From the perspective of regime stability, political stability is the basic guarantee of economic operation. If there is internal struggle or external conflict in the host country, there will be no order in its society and multinational enterprises will not be able to operate or have to withdraw from the country. From the perspective of government efficiency, the management efficiency of the government will affect the efficiency of the government's management will affect the efficiency of dealing with major emergencies, which in turn will affect the stability of the local the stability of the local market From the perspective of corruption control, the Corruption hinders the formation and development of fair and efficient markets.

In summary, this paper proposes that:

Hypothesis 1: Host country political risk is an important factor inhibiting OFDI in China.

#### **3.2. Quality of economic system, political risk and OFDI**

It is still inconclusive as to how the quality of economic institutions affects OFDI, Deng (2012)[9] point out that Chinese OFDI tends to flow into countries with good quality economic institutions, while Tian and Li et al. (2018)[10] obtain through empirical tests that Chinese OFDI has a preference to flow into host countries with poor quality economic institutions.

According to Institution-based View, institutional quality is an important factor affecting the location choice of a country's OFDI. Host countries with low quality economic institutions often face problems such as large fiscal deficits and high inflation rates, and excessive deficits and high inflation will trigger social panic and thus increase a country's political risk, while an important part of Chinese OFDI is investment by state-owned enterprises, and one of their investment motives is to expand political relations, so they will be interested in host countries with low quality economic institutions and high political risk "giving a helping hand". Second, countries with high political risk tend to have low levels of economic development, and according to the economic pull effect of OFDI, OFDI will have a catalytic effect on host country economic growth, so such countries will introduce more preferential policies to attract foreign investment inflows.

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<sup>2</sup> Source: World Bank database <https://www.worldbank.org/>

In summary, this paper proposes that:

Hypothesis 2: China's OFDI tends to flow to countries with low quality economic systems.

## 4. Data and model setting

### 4.1. Sample selection, data source and processing

After discarding the sample of countries with too many missing values, a linear interpolation method is used to complete the data to obtain panel data for 107 countries and regions worldwide from 2010 to 2021, and the study is conducted accordingly.

In terms of data sources, the stock of Chinese OFDI is obtained from the National Bureau of Statistics of China. Host country political risks (including regime stability, government efficiency, and corruption control) and the degree of rule of law are from the Worldwide Governance Indicators compiled with World Bank Institute economists Kaufman et al. GDP per capita, labor force participation rate, and metal ore exports as a percentage of merchandise exports were obtained from the World Bank database. The quality of the economic system is selected to be measured by the Index of Economic Freedom, with data from the Heritage Foundation. The entropy method processes the subindex of the degree of rule of law in the WGI with the subindex of the degree of property rights protection in the Worldwide Economic Freedom Index to obtain the strength of property rights protection in the host country, and the raw data before processing are obtained from the World Bank Institute and the Heritage Foundation, respectively.

### 4.2. Variable selection and description

#### 1. Explained variable (OFDI).

Data are obtained from the National Bureau of Statistics of China<sup>3</sup>. To eliminate the effect of heteroskedasticity, it is logarithmized.

#### 2. Core explanatory variable (Risk).

Since this paper focuses on the impact of host country political risk on the scale of China's outward FDI, only three WGI sub-indicators, namely regime stability, government efficiency and corruption control, are selected as the arithmetic mean to measure the level of political risk in the host country.

#### 3. Control variable

First, a large literature such as Hajzler (2014) finds that the abundance of natural resource endowments in the host country may change the choice of investment for institutional quality. Therefore, this paper adds the ratio of metal ore exports to commodity exports in the econometric model  $Resource_{it}$  and labor force participation rate  $Labor\_Participation_{it}$  as control variables.

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<sup>3</sup> National Bureau of Statistics [www.stats.gov.cn](http://www.stats.gov.cn)

Second, according to the neoclassical theory predicts that capital will flow from developed countries with relatively high capital intensity to developing countries with relatively low capital intensity to obtain higher investment returns, this paper adds GDP per capita to the econometric model  $C\_GDP_{it}$  to control for the capital intensity of the host country.

Other control variables include the intensity of property rights protection  $Property\_Rights_{it}$  and the degree of rule of law  $Rule\_law_{it}$ .

### 4.3. Model setting

1. Benchmark model. To test the specific impact of host country political risk on Chinese OFDI behavior, this paper constructs a model based on the trade gravity model with host country political risk  $Risk$  as the independent variable, Chinese OFDI stock  $OFDI$  as the dependent variable, and considers other factors affecting Chinese OFDI as follows eq 1:

$$\ln OFDI_{ijt} = \alpha_0 + \alpha_1 Risk_{it} + \alpha_2 \ln C\_GDP_{it} + \alpha_3 \ln Quality\_Economic_{it} + \alpha_4 Property\_Rights_{it} + \alpha_5 Labor\_Participation_{it} + \alpha_6 Resource_{it} + \alpha_7 Rule\_Law_{it} + e_i \quad (1)$$

where  $i$  denotes the host country,  $j$  denotes China,  $t$  denotes the year ( $t=2010, 2011, 2012, \dots, 2021$ )

## 5 Empirical analysis

### 5.1. Descriptive statistics

Table 1 presents the results of descriptive statistics of the relevant variables. From Table 1, it can be seen that the standard deviation of China's OFDI stock to different host countries after taking the natural logarithm is 2.613, which indicates that China's OFDI stock varies widely among countries. The mean value of political risk in host countries is 0.091, which is somewhat different from the median -0.099, indicating the tendency of Chinese enterprises to invest in low political risk locations.

**Table 1** Descriptive statistics

VARIABLES	Mean	Std. Dev.	Min	Med	Max
lnOFDI	10.36	2.613	2.996	10.60	18.89
Risk	0.091	0.866	-1.918	-0.099	1.986
lnC_GDP	8.828	1.503	5.379	8.772	11.80
lnQuality_Economic	4.133	0.164	3.065	4.135	4.502
Property_Rights	0.503	0.054	0.323	0.498	0.718
Labor_Participation	69.88	10.42	41.53	71.81	90.34
Resource	9.834	14.86	0	3.531	80
Rule_Law	0.136	0.931	-1.842	-0.115	2.125

## 5.2. Baseline regression results

This paper uses stata17.0 based extended gravity model to conduct regression analysis on panel data for 107 countries and regions worldwide, 2010 to 2021. The natural logarithm is taken for OFDI, GDP per capita, and quality of economic system to eliminate the heteroskedasticity problem, and the original hypothesis is rejected by Hausman test, and a fixed effects model is used.

Table 2 presents the model estimation results. First, the results show that the regression coefficient of host country risk is -1.016 and is significant at the 1% level, indicating that China's OFDI will prefer to flow to host countries with lower levels of political risk when controlling for other factors, and hypothesis 1 is verified. Second the regression coefficient of economic system quality is significantly negative, which proves that China's outward FDI is characterized by "low economic system quality preference" and hypothesis 2 is verified.

**Table 2** Baseline regression results

VARIABLES	(1)	(2)	(3)	(4)	(5)	(6)
	lnOFDI	lnOFDI	lnOFDI	lnOFDI	lnOFDI	lnOFDI
Risk	-0.742** (0.296)	-1.163*** (0.290)	-1.115*** (0.290)	-0.965*** (0.277)	-1.054*** (0.272)	-1.016*** (0.272)
Rule_Law	1.017*** (0.288)	0.872*** (0.279)	0.867*** (0.278)	0.982*** (0.266)	1.094*** (0.261)	1.205*** (0.268)
lnC_GDP		1.752*** (0.194)	1.720*** (0.194)	1.546*** (0.186)	1.415*** (0.184)	1.445*** (0.184)
Resource			-0.009** (0.00388)	-0.010*** (0.00371)	-0.011*** (0.00364)	-0.011*** (0.00363)
Labor_Participation				0.182*** (0.0172)	0.161*** (0.0171)	0.163*** (0.0172)
Property_Rights					4.715*** (0.674)	5.073*** (0.702)
lnQuality_Economic						-1.175* (0.656)
Constant	10.29*** (0.0430)	-5.124*** (1.709)	-4.752*** (1.712)	-15.98*** (1.950)	-15.72*** (1.911)	-11.48*** (3.043)
R-squared	0.011	0.076	0.081	0.162	0.196	0.198
Number of countries	107	107	107	107	107	107

Standard errors in parentheses

\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

## 6. Mechanism Analysis

Through the above analysis, host country political risk can have a significant and important causal effect on China's OFDI. Based on the theoretical analysis in the previous section, the following regression equation 2 is constructed by constructing the interaction term F after centralizing the level of host country risk  $Risk_{it}$  with the quality of the economic system  $Quality\_economic_{it}$ :

$$\ln OFDI_{ijt} = \beta_0 + \beta_1 Risk_{it} + \beta_2 \ln C\_GDP_{it} + \beta_3 \ln Quality\_economic_{it} + \beta_4 Property\_Rights_{it} + \beta_5 Labor\_participation_{it} + \beta_6 Resource_{it} + \beta_7 Rule\_law_{it} + \beta_8 F_{it} + e_i \quad (2)$$

Table 3 shows the regression results of the moderating effect of economic system quality, and the results show that the regression coefficient of the logarithmic economic system quality is -2.502, which is significant at the 1% level, and the regression coefficient of the logarithmic economic system quality and host country political risk interaction term is -1.665, which is significant at the 5% level, indicating that the economic system quality exacerbates the host country political risk on China's OFDI inhibitory effect.

For the result that the quality of economic system reinforces the political risk of the host country on the inhibiting effect of China's OFDI, this paper argues that there are the following reasons: firstly, the quality of economic system acts on political risk by affecting a country's fiscal situation, inflation rate, etc., which in turn inhibits China's OFDI. Second, with the strong support of Chinese government, state-owned enterprises dominate important foreign economic cooperation, and their OFDI takes more into account the policy direction of the country, cooperates with the implementation of national policies.

**Table 3** Results of moderating effects

VARIABLES	lnOFDI
Risk	-0.853*** (0.296)
lnQuality_Economic	-2.502*** (0.862)
F	-1.665** (0.654)
Constant	-5.842 (3.864)
Observations	1,265
Number of countries	107
R-squared	0.198

Standard errors in parentheses

\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

## 7. Heterogeneity analysis

### 7.1. Estimated results by country category

Due to the large number of countries where China conducts OFDI and the large differences in income levels among different host countries (Xie, Zhang et al,2017)[11]. Therefore, this paper divides the full sample of 107 countries or regions into two subsamples of high-income countries or regions (36) and low- and middle-income countries or regions (71).

Table 4 presents the results of the regressions by country category. The host country political risk is significantly negative in both the low- and middle-income country groups and the high-income country group, which verifies that Chinese OFDI in both low- and middle-income countries and high-income countries have political risk aversion characteristics, which strongly supports the paper's conclusion that host country political risk inhibits China's OFDI.

The differentiated characteristics of the sample results for different categories are as follows:

First, the inhibiting effect of political risk on China's OFDI is significantly higher in high-income countries than in low- and middle-income countries. This can be attributed to the fact that China's OFDI to low- and middle-income countries tends to reflect a more pronounced non-commercial trend, and the purpose of investing in them is more focused on the expansion of political relations.

Second, natural resource abundance is not significant in high-income countries, but  $\ln$ Quality\_Economic, which represents the quality of economic system, is significantly higher than that in low- and middle-income countries. It can be seen that the motivation of Chinese OFDI differs between high-income countries and low- and middle-income countries.

**Table 4** Estimation results by country category

VARIABLES	Low and middle income	High-income
	$\ln$ OFDI	$\ln$ OFDI
Risk	-0.512* (0.276)	-2.441*** (0.604)
$\ln$ Quality_Economic	-0.419 (0.630)	-7.131*** (1.797)
Resource	-0.015*** (0.00371)	-0.004 (0.00653)
Constant	-5.018* (3.035)	2.809 (7.664)
Observations	836	429
R-squared	0.217	0.374
Number of countries	71	36

Standard errors in parentheses

\*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$



## 8. Endogeneity analysis

The political risk of the host country can not only affect the location choice of Chinese OFDI, but also may be changed by the inflow of Chinese OFDI. For example, foreign capital inflows can make up for fiscal deficits to reduce social fears and thus reduce political risk. Therefore, there may be a reverse causal relationship between Chinese OFDI and political risk in the host country. Therefore, this paper uses a systematic GMM approach for estimation. The results are shown in Table 5.

Since the current period Chinese OFDI cannot affect variables such as the level of political risk in the host country in the previous period, the corresponding lagged period OFDI is used as the corresponding instrumental variable. The obtained results indicate that all variables are consistent with the baseline regression results, except for the control variable, intensity of property rights protection, which has the opposite sign of the baseline regression coefficient.

**Table 5** Dynamic Panel SYS-GMM

VARIABLES	lnOFDI
Risk	-0.107*** (0.0264)
L.lnOFDI	0.838*** (0.00536)
L.lnC_GDP	-0.438*** (0.0157)
Property_Rights	-0.669*** (0.0805)
Constant	2.127*** (0.452)
AR (1)	0.000
AR (2)	0.424
Sargan test	0.997

Standard errors in parentheses

\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

## 9. Conclusion and Insight

Using panel data on Chinese OFDI from 2010-2021, draws the following main conclusions: First, Chinese enterprises' OFDI has "political risk aversion" characteristics. Second, there are differences in the investment motives of China's OFDI to host countries with different levels of political risk, and the quality of the economic system inhibits China's OFDI in host countries with low political risk.

Based on the above study, this paper makes the following recommendations:

First, understand and prevent political risks. Enterprises should conduct in-depth research on the host country before investing, such as site visits, to clarify the current political situation and

form of the host country. At the same time, the government can develop risk prevention and control models suitable for Chinese enterprises and improve the commercial insurance system for foreign investments to further reduce the possibility of losses due to high political risks.

Second, we should make differentiated investment strategies for host countries with different investment environments and achieve a reasonable global layout in the industrial chain. For high-income countries with generally good institutional environment and low political risk, we should base on long-term investment mechanism. For low- and middle-income countries with average institutional environment and relatively high political risks, we should base on short-term investment.

Finally, Chinese firms should invest mainly in host countries with high quality economic systems in order to maintain market equity and promote the healthy development of OFDI.

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