International Journal of Business Marketing and Management (IJBMM)
Volume 6 Issue 3 March 2021, P.P. 20-28
ISSN: 2456-4559
www.ijbmm.com

The Influence of Interstate Economic Relation on OFDI: A Study of China OFDI

[1]Xing Fan, [2]Lei Wang

[1]PhD candidate at Glorious Sun School of Business and Management Donghua University, Shanghai, China No.1882, West Yan'an Road, Changning district, Shanghai, 200051, Email: 13636608916@163.com
[2]PhD, Professor at Glorious Sun School of Business and Management Donghua University, Shanghai, China No.1882, West Yan'an Road, Changning district, Shanghai, 200051, Email: wanglei7296@dhu.edu.cn Tel: +86 2162373621

***Abstract**: Our research is to discuss the influence of interstate economic relation on MNCs' (MultiNational Company) OFDI (outward foreign direct investment) location choice. Although there are many researches about the effect of interstate bargaining tier on OFDI location choice, most of them focuses on interstate bargaining power from political aspects. We argue that with economic globalization, the role of interstate economic relation is more and more important during interstate negotiation. In the only several interstate economic relation researches, the authors discuss interstate economic relation separately from interstate political relation. We argue that in the interstate negotiation, host government won't consider home country's interstate economic power separate from interstate political relation. So in this paper we mainly discuss the effect of the interaction between interstate political relation and interstate economic relation on OFDI location. We use China's country-level OFDI data to test our hypothesis. This paper contributes new insights to interstate bargaining tier literature and China's OFDI location choice literature.*

***Keywords:** OFDI; interstate bargaining tier; China.*

I. Introduction

In IB literature, the influence of interstate bargaining tier on MNCs' OFDI location has attracted many scholars' attention in a long time. Ramamurti (2001) found that due to deepen globalization, home government could use its interstate bargaining power to negotiate with host government for its MNCs' overseas investment condition. In his two bargaining tier model, interstate government bargaining tier influences OFDI just as traditional MNEs-host governments bargaining tier. Ramamurti(2001)'s two bargaining tier model is based on experience of MNCs from industrial countries investing in developing country. After rapid internationalization of emerging country corporations, many scholars start to focus on the effect of interstate bargaining power on MNCs' overseas investment from developing countries, especially focus on China's OFDI (Buckley et al., 2007; Luo et al., 2010; Ramasamy et al., 2012; Liu et al., 2016; Clegg et al, 2016; Zhang et al,2014; Li et al, 2018, Duanmu,2014). The effect of the interstate bargaining tier on OFDI in existing literature is mostly analyzed from political aspects, for example, political event (Nigh,1985) , dyadic military conflict and security alliances (Li, Vashchilko, 2010) , bilateral diplomatic activities (Zhang et al,2014); bilateral political relation(Duanmu, 2014; Han et al, 2018); political affinity (Bertrand, 2016); diplomatic relations (Li et al., 2018). But recent world-wide trade war show us that the interstate economic relation is more and more important during interstate negotiation.

Although the effect of interstate relation on OFDI has discussed by many researchers, the research about effect of interstate economic relation on OFDI is still limited. Only a few scholars mentioned the effect of interstate economic relation on OFDI. Duanmu (2014) argue that, with new context of deepening economic globalization, home government also could use economic coercion dissuade host government's expropriation for its OFDI. The soft power such as economic coercion may more effective to negotiate with another country than interstate political factors. Han et al(2018) divided interstate relation into interstate political relation and interstate economic relation, and discuss the moderating effect of interstate relation on the influence of home financial support on MNE overseas performance separately. Li et al(2018) use bilateral economic relations as control variables when discussing the effect of bilateral diplomatic relation on OFDI location choice. In these researches

mentioned above, interstate political relation and interstate economic relation was discussed separately. We argue that when home government negotiate with host government, host government will consider bilateral political relation and bilateral economic relation together instead of separately. Interstate bargaining tier is influenced by many kind of macro variables (Ramamurti, 2001). When we measure one country's general interstate bargaining tier, we should take interstate political aspect and interstate economic aspect into consideration together. The interaction of interstate political relation and interstate economic relation should be researched. Until now we find few researches discussing the interaction effect between interstate political relation and interstate economic relation on OFDI location choice. In this paper we want to discuss one question: will interstate economic relation positively or negatively moderate the effect of interstate political relation on OFDI? Namely, will interstate economic relation substitutes or complements interstate political relation.

We choose China's OFDI as our research subject. China's international position is special. The world has different opinion on China's rise because of political view. China's rise is viewed by some countries as peaceful but by others as a threat that might challenge the existing order (Womack, 2015). Unlike traditional theory, China OFDI has special location pattern. China OFDI especially from SOE will suffer more complicated institution pressure in developed countries with advanced technology and sound legal system (Meyer et al., 2014). This is a discrimination based on ideology, which seldom discussed in tradition literature and hard be measured. China's OFDI receives very different treatment around the world (Li et al., 2018). China' OFDI suffers political pressure in developed countries, meanwhile get support in developing countries (Cui, Jiang., 2012). So we divide our sample into developed country and developing country. Using country-level OFDI data, we prove our hypotheses. Our research contribute to China OFDI literature and interstate bargaining tier literature.

II. Theoretical foundation and Hypothesis

Interstate bargaining tier is influenced by many kind of macro variables (Ramamurti, 2001). The interaction effect of different kinds of macro variables remain under-discussed. In this paper we want to research the interaction of interstate economic relation and interstate political relation when they influence OFDI location choice. In current literature. The scholars focus on interstate economic relation from very different aspects. For example, Han et al. (2018) focus on bilateral economic treaties. Duanmu (2014) focuses on economic dependence of host country on home country. We need to discuss the different underlying mechanism of the two aspects.

III. Bilateral Economic Treaties

Bilateral economic treaties is a main reflection of interstate economic relation. Han et al. (2018) use the bilateral investment treaties (BITs) and double taxation treaties (DTTs) to represent interstate economic relations. Li et al.(2018) use BITs and free trade agreement to measure interstate economic relations. Bilateral economic treaties at interstate level allow governments to identify their common interests and compromise on an acceptable scale. As a specific institutional link between the home and host countries, interstate economic treaties may enhance EMNEs' treatment and performance through defining legal rights, reducing uncertainty, and providing reliable information. Consider that the most prevalent and important interstate economic treaties to China's OFDI are bilateral investment treaties(BITs)(Han et al.,2018; Zhang et al.,2014; Li et al.,2018). Emerging economy governments have actively signed BITs with other countries in order to promote OFDI. We mainly analyze BITs to represent bilateral economic treaties for China's OFDI.

BITs provide effective protection for firms with regard to dispute settlement, which reduces uncertainty facing EMNEs when operating in the host country(Sauvant & Sachs, 2009). BITs typically include a "national treatment" clause that entitles foreign firms from signatory countries to be treated equally in comparison with domestic firms. Such a clause creates institutional conditions through which EMNEs are better able to be embedded in the local context, thus reducing the liability of foreignness. It confers EMNEs with the legal rights of participating in the host-country's financial market and receiving financial support from host-country FDI promoting agencies, which reduce the costs of accessing overseas assets by Chinese MNEs. And most BITs have specific clauses to govern disputes between investors and the host-country government, they have enabled firms to seem arbitration without the need to involve the home-country government in the process (Jandhyala & Weiner, 2014). As a result, the risk-safeguard mechanism provided by home-government support can be replaced by well-defined bilateral economic treaties for Chinese firm's overseas performance. From over

analysis, we could find that BITs are treaties to reduce political negotiation. The establishment of BITs is a replacement of interstate political relation. Hence, we hypothesize:

H1：the interaction effect of BITs and interstate political relation on OFDI is negative.

Economic Dependency of Host Country on home country

Duanmu (2014) uses economic coercions from export dependence to represent interstate economic relation. Home government bargaining power should be considered in a dyadic asymmetrical economy relationship between the home and host countries. Duanmu (2014) finds theory foundation from political science. Political science has a long history of studying how nation states could deploy their economic power to constrain the behavior and decisions of other countries(Beron, Murdoch & Vijverberg, 2003). He uses export dependence to represent interstate economic relation because with the deepening globalization of economy, the level of economic dependence of the host country on the home market are become more and more effective for home country government to get bargaining power (Drezner, 2003). He researched the effect of the interstate economic relation on moderating host country expropriation risk.

He mentioned the China economic gunboat diplomacy. We agree that export dependence is one very important aspect of interstate economic relation. Recent worldwide trade war shows that export dependence could be one crucial economic coercion to negotiate with other countries. USA use export dependence to help lift investment restriction of host country for its MNCs. To China's OFDI, we argue that the effect of trade dependence and the effect of interstate political relation are overlapped. We argue that they can replace with each other. Thus, we hypothesize:

H2：the interaction effect of export dependency and interstate political relation is negative

The effect of Traditional interstate bargaining tie is limited. The effect of interstate bargaining tier is lift OFDI barrier, set macro investment rule to reduce political risk in literature based on developed country MNC's OFDI experience (Ramamurti, 2001). But recent researches show that the effect of interstate bargaining tie could offer different kinds of resources. According to the existing literature, the interstate influence of China could push some host country to provide some kind of non-regular resource to give China's MNCs competitive advantages in developing countries. China's aid in Africa make Africa countries give China's companies the natural resource exploitation license (Li et al., 2013). Host country also could offer preferential treatment in taxation, foreign loans, exchange rates, and procurement of materials, which could become competitive advantage (Frynas et al., 2006). We argue that each country has different capability to offer resources. For example, the developed countries has mature law system and government has the low intervene economy ability, so it only can provide limit resource for OFDI. The developing country government has the high intervene economy ability. They have concentrated power and can provide much more resources, some are even non-regular resource. So we argue that the interaction effect of interstate political relation and interstate economic relation will be different in developed country and in developing country. In developing countries, the bargaining position of the Chinese government and Chinese firms may have been further strengthened vis-à-vis governments in those host countries that attract only modest amounts of investment from the industrialised nations (Buckley et al., 2007). The national treatment clauses including in BITs are different among countries. In developing country, BITs could has more effect than interstate political relation. For same reason, the effect of export dependence may be very different from interstate political relation in developing country considered that developing country can provide much more resource than developed country. we thus reach the following, three-way interaction hypotheses:

H3a：interaction of export dependence and interstate political relation is greater in developed countries than developing country.

H3b：interaction of BITs and interstate political relation is greater in developed countries than developing country.

IV. Methods and Data

We use random-effect regression estimation method by our panel data because fixed effect regression estimation cannot be used in our model because there are two time dummy variables in our model (Buckley et al.,2007; Kang, Jiang, 2012). After LM test, we find random effect regression estimation is more suitable for our model than pooled ordinary least squares estimation.Following above discussion, our model equation is:

OFDI(stock)=β1BITs+β2ExportDependence+β3PoliticalRelations+β4Developed+β5BITs*PoliticalRelations+β6ExportDependence*PoliticalRelations+β7ExportDependence*PoliticalRelations*Developed+β8BITs*PoliticalRelations*Developed+ControlVariables+εi

Dependent Variable: We choose China's country-level OFDI stock in each host country to represent China's OFDI location choice as our dependent variable because OFDI stock data is more accurate than OFDI flow data (Kang, Jiang, 2012). We get China's OFDI stock data from different editions of Statistical Bulletin of China's Outward Foreign Direct Investment (SBCOFDI), which is published by MOFCOM, National Bureau of Statistics of the People's Republic of China and State Administration of Exchange Control of China every year since 2003. Our final Chinese OFDI stock data is from 2003 to 2018.

Explanatory Variables: Through above discussion, we choose BITs and export dependence to represent interstate economic relation. We use dummy variable of BITs. The dummy equals 1 if China sign BITs with host country and 0 if otherwise. Following Duanmu(2014), we use the ratio of the country's export to China with its total export to the world to measure export dependence. We draw export to China data from China national database and draw total export to the world from World Bank. As most existing literature, we use the similarity of united nations(UN) general assembly voting between host country and China to measure interstate political relation (Bertrand et al.,2016; Duanmu, 2014; Li et al., 2018; Han et al., 2018). The UN general assembly voting data is from Harvard dataverse (Bailey, Strezhnev & Voeten, 2017). We use another dummy to divide sample into developed country and developing country, The dummy equals 1 if host country is developed country and 0 if otherwise.

Control Variables: Following traditional IB theory, We pick our control variables. The main characteristics of host country influence OFDI in OLI theory is host country's market size, natural resource, technology level and efficiency. We use host country's GDP to show its market size. The GDP data is from world bank database (Kolstad, Wiig, 2012; Buckley et al.,2007). We use GDP per capita to measure efficiency of host country. Same from world bank database. We use Total natural resources rents (% of GDP) to measure host natural resources (Li et al., 2018; Kolstad, Wiig, 2012), and the data is also from World Bank. Total natural resources rents are the sum of oil rents, natural gas rents, coal rents (hard and soft), mineral rents, and forest rents. It is the most comprehensive indicator to measure the richness extent of natural resource of one country. We use the the number of application of patents to measure one country's technology level (Buckley et al.,2007).

We add three more control variables according to current researches: cultural distance, institutional quality, geographical distance. We use the Kogut and Singh's (1988) cultural distance measurement. We use worldwide governance indicators (WGI) to measure institutional quality (Kolstad, Wiig, 2012; Ramasamy et al., 2012; Liu et al.,2016). The WGI Index scale is from-2.5 to 2.5, the higher index means lower institutional quality. Geographic distance is the distance between the capital of China and the capital of host country. The data of geographic distance is from the French Research center in International economics database. Considering the availability of data, our final example of countries is 71. Our measurement of each variable and their source are represented in Table 1.

Table 1. Variables, Measurement and Source of data

Variables	Measurement	Source
OFDI	China's OFDI stock in a host country each year	The Statistical Bulletin of China's Outward Foreign Direct Investment (2003-2018)
BIT	If China signs BIT with host country or not	http://tfs.mofcom.gov.cn/article/Nocategory/201111/20111107819474.shtml

ED(Export Dependence)	The ratio of the country's export to China with its total export to the world.	China national database and World Bank Development lndicator (2018)
PR (Political relation)	The similarity of united nations general assembly voting between host country and China	United nations general assembly voting data from Harvard Dataverse (Bailey, Strezhnev & Voeten, 2017).
GDP(market size)	GDP of host country each year	World Bank Development lndicator (2018)
NR（Natural resource）	Total natural resources rents (% of GDP) of host country	World Bank Development lndicator(2018)
Patent (Technology)	The number of patents (resident + non-resident)	WIPO report (2018)
GDP per capita(efficiency)	GDP per capita of host country each year	The Worldwide Governance Indicators(2018)
IQ (Institution quality)	Arithmetic mean sum of six related WGI items	The Worldwide Governance Indicators(2018)
CD (Culture distance)	We use Kogut and Singh's (1988) measure method	Hofstede's cultural distance data
GD (Geographical distance)	Distance from China's Capital to the capital city of host country	French Research center in International economics database(www.cepii.fr)
Developed(developed country)	If host country is developed country or not	IMF

Source: compiled by the authors.

V. Results

Table 2 presents the descriptive statistics and correlation matrix for the variables used in our sample. The results of the variance inflation factor(VIF) test suggest that all VIF values are below the recommended benchmark of 10. So multicollinearity is not a problem in our analysis (Chatterjee *et al*., 2000).

Table 2. Correlation matrix and Variance inflation factor test

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
(1)OFDI	1.000											
(2)PR	-0.330***	1.000										
(3) ED	0.143***	0.122***	1.000									
(4) BIT	0.031	-0.140***	0.088***	1.000								
(5) GDP	0.591***	-0.517***	0.002	-0.066**	1.000							
(6) GDP percapita	0.278***	-0.620***	-0.095***	0.243***	0.372***	1.000						

(7) NR	-0.067**	0.449***	0.261***	0.012	-0.169***	-0.136***	1.000					
(8) Patent	0.467***	-0.411***	0.108***	-0.124***	0.892***	0.293***	-0.150***	1.000				
(9) CD	0.167***	-0.745***	-0.139***	0.335***	0.274***	0.676***	-0.411***	0.195***	1.000			
(10) IQ	0.180***	-0.677***	-0.120***	0.230***	0.296***	0.794***	-0.424***	0.236***	0.767***	1.000		
(11) GD	-0.037	0.057**	-0.096***	-0.342***	-0.019	-0.092***	-0.067**	-0.102***	-0.005	0.008	1.000	
(12) Developed	0.210***	-0.754***	-0.100***	0.203***	0.369***	0.769***	-0.422***	0.312***	0.759***	0.798***	-0.130***	1.000
VIF		3.69	1.26	1.27	7.16	4.73	1.61	6.35	3.73	5.05	1.43	4.90

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

Table 3 reports the results for our hypotheses. First Model 1 tests the direct effect of each variable on OFDI. The results of Model 1 show that Both BITs and export dependence have a significantly positive effect on OFDI stock. It means interstate economic relation will promote OFDI. Political relation is positive but not significant. Model 2 tests the interaction effect of BITs and interstate political relation on OFDI. The result is negative and significant, our hypothesis1 is testified. which means the increase of interstate political relation will reduce the effect of BITs on OFDI. BITs is a mean to replace interstate political relation or interstate political negotiation. Model 3 tests the interaction effect of export dependence and bilateral political relation on OFDI. The result is negative and significant. We find support for hypothesis 2. We reach our conclusion: interstate economic relation and interstate political relation are substituted relation. The results of model 4 and model 5 are negative and significant. It means the interaction effect of interstate economic relation and interstate political relation are greater in developed countries. So our hypothesis 3a and hypothesis 3a are testified.

Table 3. the result of regression, dependent variable: China's OFDI stock

	Model 1	**Model 2**	**Model 3**	**Model 4**	**Model 5**
Export dependence	1.209e+10*** (1.968e+09)	1.211e+10*** (1.949e+09)	1.514e+11*** (1.116e+10)	1.197e+10*** (1.938e+09)	4.960e+10** (2.029e+10)
GDP	0.000*** (0.000)	0.000*** (0.000)	0.000*** (0.000)	0.000*** (0.000)	0.000*** (0.000)
NR	-8,338.227*** (3,076.943)	-6,228.339** (3,080.685)	-- 6,031.739** (2,662.052)	-6,389.742** (3,112.525)	-4,912.517** (2,503.919)
technology	-2.936*** (0.759)	-2.943*** (0.755)	-5.011*** (0.651)	-3.013*** (0.751)	-3.618*** (0.652)
Political risk	-39,407.795 (56,858.848)	-38,999.985 (56,539.972)	-37,493.135 (47,210.776)	-40,881.250 (56,615.210)	-54,655.890 (43,366.919)
BIT	115,606.067** (52,354.672)	1123198.539*** (203,210.367)	97,330.410** (45,451.970)	349,869.431 (554,651.237)	77,439.143* (42,356.585)
Cultural distance	-21,025.800 (55,081.497)	-26,305.752 (54,934.899)	53,500.665 (44,396.953)	-13,656.337 (55,510.921)	20,252.513 (40,270.473)
GDP per capita	7.569*** (2.136)	6.514*** (2.128)	2.215 (1.889)	5.963*** (2.122)	2.162 (1.753)

Poliitcal relation	5,088.565 (232,178.682)	787,782.609*** (275,689.979)	1316719.183*** (232,675.567)	7,216.253 (523,491.891)	198,617.800 (321,931.124)
Developed country	-362,861.915*** (118,844.299)	-360,830.873*** (118,489.978)	-235,159.699** (95,399.287)	-1598963.233*** (562,474.909)	-2069923.527*** (345,700.490)
Geographical distance	-5.748 (8.120)	-5.541 (8.101)	-13.420** (6.481)	-6.188 (8.085)	-10.358* (5.874)
BIT×Poliitcal relation		-1282525.633*** (250,311.857)			
Exportdependence× Political relation			-1.665e+11*** (1.317e+10)		
BIT×Poliitcal relation×developed country				-2452072.160*** (814,320.025)	
Exportdependence× Political risk×Developed country					-3.809e+11*** (4.241e+10)
Adjusted R^2	0.3994	0.4095	0.5045	0.3981	0.4385
No. of countries	71	71	71	71	71
No. of observations	998	998	998	998	998

Source: compiled by the authors.
Note: Standard errors in parentheses.
***, **and*indicate that the coefficient is significant at the 0.1, 0.05 and 1% levels, respectively.

VI. Discussion

Our paper discussed the interaction effect and interstate economic relation and interstate political relation on OFDI. We divide interstate economic relation into BITs and export dependence based on the prior research work. We test our hypotheses by using China's country-level OFDI data in 71 countries from 2003 to 2018. We find support for our hypotheses in our analysis. Interstate economic relation and interstate political relation substitute each other in influencing OFDI. We are the first to empirically examine interaction effect of interstate political relation and interstate economic relation and the difference of them in developed country and developing country. Our finding contributes to interstate bargaining tier literature and furthers the analysis of the effect of interstate relation on OFDI location choice. Our research provides some important implications for managers and policymakers to make a strategic decision. The export dependence of host country will not promote OFDI if the host country already has close political relation with China. Our study has several limitations. Interstate economic relation should include official aids and finance dependence. And when take the effect of interstate relation on OFDI into consideration, we should not neglect international organization such WTO, world bank and IMF.

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