DETERMINANTS OF FDI INFLOWS TO CHINA: 
An Empirical Analysis of Source Country Characteristics

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ABSTRACT
Although the importance of China in the FDI study has been increasing, there is a limited literature that directly tests how source country characteristics are likely to affect the FDI inflows to China and how firm characteristics influence firms’ decision on investment to China. In this paper, we examine how intellectual property rights (IPRs) protection along with other possible macro variables in source countries may affect FDI inflows to China from 18 major source countries during 1989-2006. The results indicate that source countries with higher export ratio, depreciation of real exchange rate, lower borrowing cost, lower GDP per capita, higher relative labor cost, strong IPR protection and higher volatility in its exchange rate tend to invest more to China.

JEL classification: F21; F23; O53
Keywords: Foreign direct investment (FDI); intellectual property rights (IPRs); source country characteristics

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1. INTRODUCTION

According to World Investment Report 2006 released by the United Nations Conference on Trade and Development (UNCTAD), China (excluding Hong Kong and Macau) is the world's third largest foreign direct investment (FDI) recipient and the largest FDI destination of all developing countries, receiving 72.4 billion U.S. dollars of FDI in 2005. Although the importance of China in the FDI study has been increasing, there is a limited literature that directly tests how source country characteristics are likely to affect the FDI inflows to China and how firm characteristics influence firms’ decision on investment to China.

To our best knowledge, there are only five empirical studies in the literature directly testing how source country characteristics may affect the amount of FDI inflows to the host country. Among these studies, Grosse and Trevino (1996) is the first paper studying this issue. By using FDI inflow data from 23 source countries to the U.S. over the period 1980-1991, they find that (1) bilateral trade, source country GDP, and the exchange rate are important determinants of FDI inflow, (2) culture distance and geographic distance are significantly negatively related to the FDI inflow, and (3) political risk of the source country is weakly positively correlated with FDI inflow.

In a similar study, Thomas and Grosse (2001) utilize a panel data of 11 source countries over the period 1980-1995 to study the determinants of FDI inflows to Mexico based on source country characteristics. Different from using the relative rate of return in Grosse and Trevino’s (1996) study that emphasizes on the higher capital

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1 There are some other papers discussing the relationship between FDI inflow and some specific source country characteristics. For example, Cushman (1985, 1988), Froot and Stein (1991) are Klein and Rosengren (1994) focus on the role of exchange rate and Tallman (1988) centers on the role of political risk. However, our goal is to build a more comprehensive empirical model that includes most of possible source country characteristics, thus the value of those studies to this paper is limited and we decide to exclude those papers from our discussion here.
return in the U.S. than in its source countries, they introduce the variable of relative labor cost (wage cost differential) to portray the attractiveness of Mexico to the source country in terms of cheaper labor cost. They conclude that bilateral trade, source country GDP, political risk, geographic distance and exchange rate are related to FDI inflow to Mexico. Relationship between FDI and source country characteristics, such as market size and culture distance that have previously in research on FDI inflow to large, developed countries (e.g. Grosse and Trevino, 1996) do not hole in the same way in the developing countries.

Pan (2003) studies the impacts of country-specific factors on FDI inflows from 30 source countries to China during 1984-1996. Instead of using the source country political risk as one of the independent variables, Pan use the host country political risk as a dummy variable to explain the huge drop in FDI inflow to China due to the 1989 Tiananmen Square incident. He argues that a substantial portion of FDI inflow to China has been aimed at penetrating China’s market, so some of source country characteristics do not play their expected role in his study. For example, exchange rate may not be critical since foreign firms are not planning to take profits out of China in the short run. Hence, the appreciating currency is not associated with a larger amount of FDI inflow to China. Also, when foreign firms aims at penetrating China’s market, reducing transportation costs becomes an incentive for distant source countries to establish more investments in China.

Zhao (2003) examines the impact of eight variables in threes sets of country factors, i.e. market condition, risk and financial factors, on FDI inflow to China based on data from 21 source countries over a period of 17 years (1983-1999). By using the political risk index along with an operating risk index, which has not been used in the previous
studies, measured by the difference between the risk scores of source countries and that of China published by Business Environment Risk Index (BERI), Zhao concludes that the market-condition variables and the appreciation of source country currency positively influence FDI inflow to China, while the relative borrowing cost and political and operating risks in China negatively affect FDI inflow to China.

Kimino, Saal and Driffield (2007) investigate whether and to what extent a broad set of source country characteristics have influenced FDI inflows to Japan during the period 1989-2002. They argue that previous empirical studies have failed to employ panel-based techniques on taking unobservable country-specific heterogeneity into account. Their empirical results show that several source country characteristics, such as market size, exchange rate and labor costs, are no longer supportive to the hypotheses in the previous studies. On the other hand, relative exchange rate fluctuation, relative borrowing cost and the stability of business environment are all strong incentives for inducing FDI inflows to Japan. The export performance, by contrast, is found to have a negative influence on FDI inflows to Japan.

In this paper, we will examine how the possible macro variables in the source countries suggested by past studies may affect FDI inflows to China from 18 major source countries during 1989-2006. Our paper, however, differs from the above studies in the following ways. First, different from past studies investigating FDI inflow to China, Pan (2003) and Zhao (2003), we effectively reduce the number of source countries to 18 by excluding some “free port” countries, such as Virgin Islands, Cayman Islands and Western Samoa, that receive a lot of funds from the third country on their FDI to China. Including these free port states may generate biased estimation.
Second, we drop “geographic distance” and “culture distance” from our variable list. Previous studies have claimed that both geographic and culture distances are important determinants of FDI flows. Nevertheless, the geographic distance between two countries is usually measured by the spatial distance between the capitals of these countries and this may provide some misleading information to our estimation. For example, the true transportation cost between the U.S. and China should be calculated based on the distance between major ports, Los Angeles and Shanghai, instead of political centers, Beijing and Washington D.C.. Without an objective measure of geographic distance force us to give up using this variable. On the other hand, the culture distance is often used as a proxy of transaction cost caused by culture distances. Yet, as Brouthers and Brouthers (2001) and Cho and Padmanabhan (2005) point out, the construction of such culture distance variable, e.g. Hofstede’s index (1980 and 2001), usually has theoretical and methodological glitches. Kimino, Saal and Driffield (2007) also find that the inclusion of the geographic and culture distance variables does not improve the results and “the distance variables themselves are at best only borderline significant”.

Third, different from Pan (2003) and Zhao (2003), we consider “relative labor cost” in our empirical model based on the reason that FDI may be attracted to a developing country due to its lower labor cost. Both Pan (2003) and Zhao (2003) neglect this variable in their studies on FDI inflows to China. Fourth, with the increasing importance of intellectual property rights (IPRs) in the literature of international trade and investment, we also consider how IPRs may affect the FDI flows. Finally, regarding the panel-based technique utilized in this paper, in addition to the traditional OLS (and with fixed effect or random effect) method used in previous studies, we will try to implement some up-to-date techniques, such as the System
GMM approach, in our study. The results form these new techniques which considers the endogeneity problem can be compared to past studies.

The remainder of this paper is structured as follows. The following section provides the theoretic hypotheses on the potential macro determinants of FDI which are later tested in our empirical framework. Section 3 introduces the specifications of our empirical model and the sources of data. Section 4 presents the empirical results from our model. The final section briefly concludes this paper.

2. THEORETICAL HYPOTHESES

In this section, we discuss the possible macro determinants that may influence FDI inflow to China based on the previous literature. The determinants discussed in detail shortly below are: source country market size, bilateral trade, relative exchange rate, exchange rate volatility, relative borrowing costs, relative labor costs, source country risk and IPRs protection.

Past studies have proposed that there is a positive relationship between source country market size and FDI (Grosse and Trevino, 1996; Moshirian, 1997; Thomas and Grosse, 2001; Walkenhorst, 2004). Larger countries are regarded to have many more competitive multinational corporations (MNCs) which are capable to invest abroad. Besides, larger countries also have higher levels of physical and intangible assets to invest overseas. Therefore, when the source country market size is larger, the FDI inflow from the source country to China is higher.
Export is regarded as a better means to serve an unfamiliar foreign market than FDI since the latter has a sunk cost to build the plant. It is rationale to assume that a source country with more export experience has better knowledge on the foreign markets and thus has stronger incentives to invest abroad. Therefore, we expect a positive relationship between the export performance of the source country and its outward FDI to China.

The relationship between relative exchange rate and FDI is also disputed. Froot and Stein (1991) argue that appreciation of the source country currency relative to that of the host country currency will reduce the relative cost of capital and enable MNCs to invest more abroad relative to MNCs in countries with depreciated currency. On the contrary, if the host country is an export platform of MNCs, i.e. FDI and bilateral trade are complements, the depreciation of the source country currency should increase MNC’s investment abroad. Hence, the relationship between relative exchange rate and FDI is ambiguous.

There is no concrete conclusion on the impact of exchange rate volatility on FDI, either. It was once said that short-run real exchange rate volatility may accelerate outward FDI by risk-aversion MNCs (Goldberg and Kolstad, 1995). Besides, FDI may be favored than exports as a method to serve foreign market under exchange rate uncertainty (Cushman, 1985). In opposition, Amuedo-Dorantes and Pozo (2001) find a significantly negative relationship between exchange rate volatility and outward FDI. Likewise, Crowley and Lee (2003) find the impact of exchange rate volatility on FDI to be weak. As a result, the relationship between exchange rate volatility and FDI is unclear.
For MNCs that invest in China for cheaper labor costs, higher wage rates in the source country may encourage more outward FDI to China. Although higher wages may signal higher productivities in the high-tech industries, we assume that FDI inflows to China are basically attracted to labor-intensive industries. Under this assumption, we expect there is a positive relationship between the wage rate in the source country and the outward FDI to China.

When the borrowing cost is lower in the source country relative to that in the host country, MNCs have the cost advantage on raising capital to establish affiliates abroad than the local firms in the host country. Therefore, outward FDI will rise when the cost of borrowing is relatively lower in the source country. However, there is some possibility that MNCs raise capital in the host country instead of the source country if the interest rate in the host country is lower. In that case, a smaller amount of FDI will flow into the host country. This indicates a negative relationship between the borrowing cost in the source country and the outward FDI to China.

Source countries with less risky investment climate or political instability are believed to be able to attract more FDI inflow (Schneider and Frey, 1985; Loree and Guisinger, 1995). In addition, Tallman (1988) shows that domestic conflicts in the source country will stimulate outward FDI to relatively stable countries. Pan (2003) also indicates that the level of FDI into China increases as the risk conditions in China improve. Thus, we expect that as the country risk of the source country increases, the outward FDI to China increases.
Source countries with stronger IPRs protections are usually larger developed economies, thus they are able to make more investment to China as discussed above. In addition, IPRs protection can preserve R&D incentives. Hence, firms in countries with stronger IPRs protections can make profits through keeping R&D activities at home and moving their productions to the hosts which provide cheaper inputs. China is a good destination country in this view because it provides cheaper labors to MNCs. Therefore, we expect a positive relationship between the IPRs protection of the source country and the outward FDI to China.

Based on the discussion above, we develop eight hypotheses regarding the macro determinants of FDI inflow to China:

**Hypothesis 1:** Source countries with higher GDP per capita have higher levels of FDI in China.

**Hypothesis 2:** Source countries with higher export ratio have higher levels of FDI in China.

**Hypothesis 3:** Source countries with an appreciating currency have either higher or lower levels of FDI in China.

**Hypothesis 4:** Source countries with larger currency volatilities have either higher or lower levels of FDI in China.

**Hypothesis 5:** Source countries with higher wage rates have higher levels of FDI in China.

**Hypothesis 6:** Source countries with lower lending rates have higher levels of FDI in China.
Hypothesis 7: Source countries with higher country risks have higher levels of FDI in China.

Hypothesis 8: Source counties with stronger IPRs protection have a higher level of FDI in China.

3. ANALYTICAL FRAMEWORK

3.1 The empirical model

As suggested by Grosse and Trevino (1996) and Kimino, Saal and Driffield (2007) and the theoretical hypotheses discussed in the previous section, our benchmark model can be constructed as a simple regression as follows,

\[
\ln FDI_{it} = \ln \alpha_i + \beta_1 \ln GDP_{it} + \beta_2 EX_{it} + \beta_3 RE_{it} + \beta_4 EV_{it} + \beta_5 \ln RL_{it} + \beta_6 RB_{it} + \beta_7 \ln CR_{it} + \beta_8 IPR_{it} + \nu_{it},
\]

\[
(i = 1, 2, 3, \ldots, 18; t = 1989, 1990, 1991, \ldots, 2006)
\]

\[
\nu_{it} = u_{it} + \epsilon_{it}
\]

where FDI is annual FDI inflows to China, and subscripts \(i\) and \(t\), respectively, index cross-section units of a specific source country varying from 1 to 18 and time starting from 1989 to 2006. GDP is GDP per capita of the source country representing the source country market size, EX is export ratio of the source country measure by the volume of exports over GDP, RE is the relative (bilateral) exchange rate, EV is the volatility of the relative exchange rate, RL is relative unit labor cost in manufacturing, RB is relative borrowing cost, and CR is the country risk rating of the source country.

In addition, we use the IPR index reported by Ginarte and Park (1997), IPR, to proxy the relative IPRs protection between the source country and China (i.e. \(IPR_{source}\))
Traditional panel data analysis with either fixed effect or random effect ignores the endogeneity problem, thus we decide to apply the recently developed System Generalized Method of Moments (System GMM) approach to estimate our panel data if the endogeneity is found. The System GMM approach is believed to be able to solve the endogeneity problem by applying appropriate instrument variables in its estimation.

3.2 Data
The major source countries studied in the paper include: Hong Kong, Taiwan, Singapore, South Korea, Thailand, Philippines, Malaysia, Indonesia, Macau, Japan, United States, United Kingdom, Germany, France, Italy, Netherlands, Australia and Canada. These countries are selected because they are ranked at the top of the source country list according to the dollar value of FDI to China. Data on FDI inflow to China (FDI) can obtained from the OECD/MOFTEC database constructed by China’s Ministry of Foreign Trade and Economic Cooperation (MOFTEC), export performance (EX), relative exchange rate (RE), exchange rate volatility (EV), relative borrowing cost (RB) are collected and calculated from the International Monetary Fund’s (IMF) International Financial Statistics (IFS) and World Bank’s World Development Indicator (WDI) database. Relative labor cost (RL) is obtained and calculated from U.S. Bureau of Labor Statistics. The IPR index is collected from Ginarte and Park (1997) for the period 1980-1995 and provided by Dr. Walter G. Park for the year 2000. Country risk (CR) is collected from Euromoney. The sample period, 1989-2006, is decided by the deregulation of Taiwanese investment to China. Table 1 provides the summary statistics of variables used in our study.
Table 1 Summary statistics

<table>
<thead>
<tr>
<th>Variable</th>
<th>Observations</th>
<th>Mean</th>
<th>Standard Deviation</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>FDI</td>
<td>306</td>
<td>184847.6</td>
<td>391233.6</td>
<td>64</td>
<td>2067721</td>
</tr>
<tr>
<td>GDP</td>
<td>324</td>
<td>16983.05</td>
<td>10299.52</td>
<td>572.0027</td>
<td>39824.11</td>
</tr>
<tr>
<td>EX</td>
<td>320</td>
<td>1.7034</td>
<td>2.022168</td>
<td>0.0604</td>
<td>14.4054</td>
</tr>
<tr>
<td>RE</td>
<td>312</td>
<td>1.0839</td>
<td>0.4058</td>
<td>0.4547</td>
<td>4.0576</td>
</tr>
<tr>
<td>EV</td>
<td>324</td>
<td>0.1837</td>
<td>0.1742</td>
<td>0.0715</td>
<td>1.2567</td>
</tr>
<tr>
<td>RB</td>
<td>317</td>
<td>1.1551</td>
<td>0.6205</td>
<td>0.174</td>
<td>5.032</td>
</tr>
<tr>
<td>RL</td>
<td>213</td>
<td>91.8743</td>
<td>17.3303</td>
<td>45.3807</td>
<td>137.4</td>
</tr>
<tr>
<td>CR</td>
<td>306</td>
<td>81.8601</td>
<td>16.0532</td>
<td>27.2</td>
<td>100</td>
</tr>
<tr>
<td>IPR</td>
<td>306</td>
<td>1.5730</td>
<td>0.5965</td>
<td>0</td>
<td>3.1128</td>
</tr>
</tbody>
</table>

4. EMPIRICAL RESULTS

Tables 2 and 3 report the correlation matrix and VIF test and confirm there is no strong correlation between any two variables, thus no multicollinearity problem is found in our model. We also conduct the panel unit root test to see if the panel data is stationary or not. The Levin, Lin and Chu (LLC) test (not reported here) confirms that the panel data passes the panel unit root test, i.e. the panel data is a stationary system. We then perform the endogeneity tests. Both Wu-Hausman $F$ test and Durbin-Wu-Hausman chi-square (DWH) (not reported here) indicate an endogeneity problem between $\ln FDI$ and $IPR$ at 1% significance level. Therefore, we must estimate the model by the System GMM approach.
Table 2 Correlation matrix

<table>
<thead>
<tr>
<th></th>
<th>lnFDI</th>
<th>EX</th>
<th>RE</th>
<th>RB</th>
<th>lnCR</th>
<th>lnGDP</th>
<th>lnRL</th>
<th>IPR</th>
<th>EV</th>
</tr>
</thead>
<tbody>
<tr>
<td>lnFDI</td>
<td>1.0000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EX</td>
<td>0.3591</td>
<td>1.0000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>RE</td>
<td>-0.3218</td>
<td>-0.0284</td>
<td>1.0000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>RB</td>
<td>-0.3264</td>
<td>-0.0527</td>
<td>0.0355</td>
<td>1.0000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>lnCR</td>
<td>-0.2704</td>
<td>0.0222</td>
<td>0.2006</td>
<td>-0.2871</td>
<td>1.0000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>lnGDP</td>
<td>0.2356</td>
<td>0.3428</td>
<td>-0.1809</td>
<td>-0.2232</td>
<td>0.5148</td>
<td>1.0000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>lnRL</td>
<td>-0.1074</td>
<td>0.2918</td>
<td>0.3412</td>
<td>-0.1111</td>
<td>0.4723</td>
<td>0.2813</td>
<td>1.0000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>IPR</td>
<td>-0.5139</td>
<td>-0.2257</td>
<td>0.1089</td>
<td>0.0646</td>
<td>0.4408</td>
<td>0.1910</td>
<td>0.2277</td>
<td>1.0000</td>
<td></td>
</tr>
<tr>
<td>EV</td>
<td>0.4160</td>
<td>0.0952</td>
<td>-0.5491</td>
<td>-0.1007</td>
<td>-0.5198</td>
<td>-0.1040</td>
<td>-0.4209</td>
<td>-0.3567</td>
<td>1.0000</td>
</tr>
</tbody>
</table>

Table 3 VIF test

<table>
<thead>
<tr>
<th>Variable</th>
<th>VIF</th>
</tr>
</thead>
<tbody>
<tr>
<td>lnCR</td>
<td>2.56</td>
</tr>
<tr>
<td>EV</td>
<td>2.20</td>
</tr>
<tr>
<td>lnGDP</td>
<td>1.85</td>
</tr>
<tr>
<td>RE</td>
<td>1.68</td>
</tr>
<tr>
<td>lnRL</td>
<td>1.65</td>
</tr>
<tr>
<td>EX</td>
<td>1.46</td>
</tr>
<tr>
<td>IPR</td>
<td>1.44</td>
</tr>
<tr>
<td>RB</td>
<td>1.26</td>
</tr>
</tbody>
</table>

Mean VIF 1.76

Table 4 shows the results from the System GMM model with three lags of lnFDI. The estimates of constant and lag terms are omitted to save space. These significant results pass the Sargan test, i.e. the overidentifying restrictions are valid. The impact of source country market size (lnGDP) on FDI inflow to China is significantly negative which is opposite to our expectation. The existing literature has provided many empirical evidences on a positive relationship between source country size and outward FDI. However, the FDI inflow to China seems to be a different story. Zhang (2005) points out that the investment from Hong Kong and Taiwan (small economies)
accounts for more than half of FDI inflow to China during 1979-2001, while that from OECD countries (larger economies) accounts for less than a quarter.\(^2\) Thus, as smaller economies contribute to a larger share of FDI inflow to China, traditional wisdom on the impact of source country size on FDI needs to be reconsidered in our study.

We find that the countries with higher export ratio (\(EX\)) tend to invest more in China. This meets our expectation in Hypothesis 2. In addition, it may imply that MNCs use China as an export platform. This is quite consistent with the fact that most MNCs from Hong Kong and Taiwan invest in China in order to obtain cheaper labor cost and export their products outside China. Such a reality can also help to explain why a depreciation of real exchange rate (\(RE\)) in the source country will increase its investment to China. Besides, source countries with higher volatility in it exchange rate seem to invest more in China from our observation. This may be due to the risk-aversion behavior of MNCs as mentioned in Section 2.

Source countries with relatively higher labor costs and relatively lower borrowing costs do invest more in China as expected in Hypotheses 5 and 6. These results reflect the facts that most FDI inflows to China are attracted cheaper labor cost and MNCs may raise most of their capital in their home countries instead of the host country, China. Furthermore, source countries with strong IPR protection tends to invest more which confirms Hypothesis 8. However, the impact of country risk on FDI is insignificant, so we are unable to verify Hypothesis 7.

\(^2\) This can be attributed to the so-called “Ethnic Chinese Networks”. See Gao (2003) for more discussion.
<table>
<thead>
<tr>
<th>Variable</th>
<th>Estimate</th>
<th>Standard error</th>
</tr>
</thead>
<tbody>
<tr>
<td>lnGDP</td>
<td>-0.2673**</td>
<td>(0.1162)</td>
</tr>
<tr>
<td>EX</td>
<td>0.0222*</td>
<td>(0.0132)</td>
</tr>
<tr>
<td>RE</td>
<td>-0.5085***</td>
<td>(0.1866)</td>
</tr>
<tr>
<td>RB</td>
<td>-0.2503***</td>
<td>(0.0683)</td>
</tr>
<tr>
<td>lnRL</td>
<td>0.4461***</td>
<td>(0.1665)</td>
</tr>
<tr>
<td>IPR</td>
<td>0.1055*</td>
<td>(0.0628)</td>
</tr>
<tr>
<td>EV</td>
<td>3.9607***</td>
<td>(1.0408)</td>
</tr>
<tr>
<td>lnCR</td>
<td>-0.0043</td>
<td>(0.4506)</td>
</tr>
</tbody>
</table>

Sargan test

Chi-square(245) = 248.9533

$P$-value = 0.4177

Note:

1. Standard errors are in parentheses.
2. *** denotes 1% significance level; ** denotes 5% significance level; * denotes 10% significance level.
5. CONCLUSIONS

In this paper, we use the data from 18 source countries during the period of 1989-2006 to examine the possible source-country determinants of FDI inflow to China. We find that source countries with higher export ratio, depreciation of real exchange rate, lower borrowing cost, lower GDP per capita, higher relative labor cost, strong IPR protection and higher volatility in its exchange rate tend to invest more to China.

This paper may contribute to the literature in the following aspects. First, we use the recently developed System GMM approach to solve the potential endogeneity problem, thus our estimate is believed to be more precise than past studies. Second, with the increasingly importance of IPRs, we add the IPRs protection in our model as a potential macro determinate of FDI inflow and provide some explanations on its impact on FDI. Third, we find that the positive relationship between source country market size and FDI suggested by the existing literature needs to be carefully revised when studying the FDI inflow to China. Of course, further in-depth work can be done if the firm-level data is available to distinguish different purposes (efficient-seeking or market-seeking) and types (greenfield or mergers and acquisition, M&A) of FDI inflow to China.
REFERENCES


