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FACTORS AFFECTING FOREIGN DIRECT INVESTMENT (FDA) FROM CHINA TO U.S.?

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1. Introduction

In the next decade, the two sides of the Pacific Ocean will have the strongest economic growth (Fernald and Jones, 2014), the strongest military strength (Fravel, 2008), and the closest trade links (Friedberg, 2005). The economic and political relations between China and the United States are the core of world affairs (Xgyhys1212, 2017). Studying the flow of capital between China and the United States has become very important for the financial world.

Research from the Rhodium Group (https://rhg.com/) shows that in the first five months of 2018, China's foreign direct investment (FDI) in the United States, achieved through acquisitions and other transactions, fell to a negative value. However, in the area of loosely regulated venture capital, China's venture capital investment in the United States reached nearly $2.4 billion dollars between January and May 2018, which is close to its full-year investment record set in 2015. China's capital is flowing to the cutting-edge technology of the United States at a record rate this year.

From 2000 to May 2018, China participated in more than 1,300 rounds of financing for US start-ups, with an estimated total investment of about $11 billion dollars (Hanemann et al. 2018). In 2017, there were 126 examples of Chinese capital investment in the United States and 13 mergers and acquisitions involving a total amount of approximately 16.88 billion dollars (RMB 116.32 billion), accounting for nearly 30% of the total investment M&A events of Chinese capital overseas.

The relationship between China and the U.S. has entered a new stage. Researchers need to understand what factors affect capital flows between China and the United States. Since data on the capital flow between China and the United States is difficult to find, this paper only collects data on China and the United States' foreign direct investment (FDI), and only considers the FDI from China to U.S.

This paper investigates the impact of a set of domestic and global factors on the level and volatility of FDI from China to U.S. A panel dataset is used between China and U.S. to measure the impact and significance of **financial** and **non-financial variables.** A simple linear regression model was established to choose the variables which affect the Chinese's direct investment to U.S. After that, we used PCA to combine the variables into two groups in an attempt to reduce the number of dimensions.

2. Literature Review

There are numerous empirical studies dealing with the determinants of capital flow. Some have examined internal and external factors that cause capital flows to surge or drop in market economics (Reinhart et al., 1993). A growing body of literature also focuses on the determinants of different types of capital flows (Taylor and Sarno,1997). We therefore research a number of economic and social factors.

a. Military expenditures

As governments increase their spending on military, they are stimulating the economic engine of the country, known as Military Keynesianism (Custers, 2010). Alptekin and Levine (2012) conducted a meta-analysis of military expenditures and economic growth and stated that although there is a positive net combined effect of military expenditure on economic growth, the magnitude is very small. However, variations in the findings across studies were a result of sample size and varying time periods which could have been affected by geopolitical situations. Hassan et al. (2003) has also shown more specifically that military expenditure has a significant positive impact in economic growth equation, but a negative impact on FDI.

b. High-technology exports

Kogut and Chang (1991) indicated that Japanese-U.S. joint ventures appear to be motivated by the sourcing of U.S. technology. Gilboy (2004) concluded that business and political leaders in the United States feared China's growing shared world exports, especially of high technology and industrial goods, signals, although exports of high-technology had benefits. Competition among the major countries has strongly increased in high technology industries, and their competitive positions have been significantly altered, since high technology industries play a key role in a country's long-term economic performance. Thus, competitive positions between United States, Japan and the EU has changed during the past decade, as changes in the economies and each countrie geopolitical strategies have changed (Archibugi and Michie, 1998).

c. GDP growth

Alvarado et al. (2017) showed FDI has a positive and significant effect on product in high-income countries, while in upper-middle-income countries the effect is uneven and non-significant. However, the effect on lower-middle-income countries is negative and statistically significant (Alvarado et al. 2017). While FDI plays an important role in contributing to economic growth, the level of development of local financial markets is crucial for these positive effects to be realized. (Alfaro et al., 2004)

d. Trade Openness

Neary (2002) showed some relationship between trade-related variables such as tariffs and FDI, which was shown to be a weaker correlation when considering the effect of internal tariffs. Along with Taylor (2000), the authors found that openness to trade and FDI is positively correlated in manufacturing only. Adhikary(2011) concluded that the degree of trade openness shows negative influence on GDP growth rates and further showed that the volume of FDI has significant positive effect on the real GDP's change.

e. Human capital

Noorbakhsh and Paloni (2001) concluded that human capital is a statistically significant determinant of FDI inflows and one of the most important determinants. They suggest human capital's importance becomes more important through time. The authors highlighted the importance of human capital found that it is not only the most important determinant, but also has a greater influence over time.

Borensztein et al. (1997) suggested that FDI is an important vehicle for the transfer of technology. Compared to domestic investment, FDI contributed more to growth. Only when the host country has a minimum threshold stock of human capital, FDI can produce higher productivity for FDI holds. Thus, FDI contributes to economic growth only when a sufficient absorptive capability of the advanced technologies is available in the host economy (Borensztein et al., 1997). Cleeve et al. (2015) showed that all measures of human capital have a significant influence on FDI, but counter argued the notion of its importance on FDI over time.

f. Financial openness / Economic Markets

It is apparent that the health of an economy and the free flow of money could be essential to the perceptions of FDI. Fratzscher et al. (2004) concluded, the size of FDI inflows and the sequencing of the liberalization process are important driving forces for growth in the medium to longer term, while, financial openness has little effect on the size of FDI flows.

Prior research demonstrates how acquisitions and greenfield investments affect competition. Globerman and Shapiro (2009) believed that FDI by acquisition accelerated competition facilitates broader economic aspects across larger geographic areas than greenfield investments. Proper FDI investment being from greenfield investments or acquisition can benefit the host country in different ways through efficiencies and knowledge transfers (Globerman and Shapiro, 2009). The authors further suggest that in more developed countries, foreign acquirers benefit the host country, such as the United States, since acquisition if quicker and easier in an open style economy. Thus, for a Chinese company investing, the economic benefits and advantages can be gained using a simpler investment strategy such as acquisition as opposed to larger more complicated entry such as greenfield investments. This argument is further explained due to the political environment and freedom in the US economy. The legislation and regulations in an economy such as the US are more known and thus the costs and are well known and the risks can be quantified easier (Globerman and Shapiro, 2009).

g. Research Question

Based on the literature, we seek to find a better understanding of the key variables that can be an indicator of Foreign Direct investment. Data is widely available from sources such as the World Bank. In order to assist practitioners in their investments and help policy regulators in countries create or modify policies to encourage proper investments to benefit their country. Thus, identifying the key factors can help simplify analysis and further identify

possible confounding factors. Using the research above, our goal therefore is stated in the following research question:

RQ: What factors might be indicators of increased Foreign Direct Investment (FDI) from China to the United States.

3. Methodology

3.1. Data and Descriptive Statistics

A dataset was constructed from datasets obtained from the Bureau of Economic Analysis and world bank for the empirical analysis. The variable of interest is the FDI from China to U.S. 2002-2015. Figure 1 presents an annual chart of FDI from China to the US.

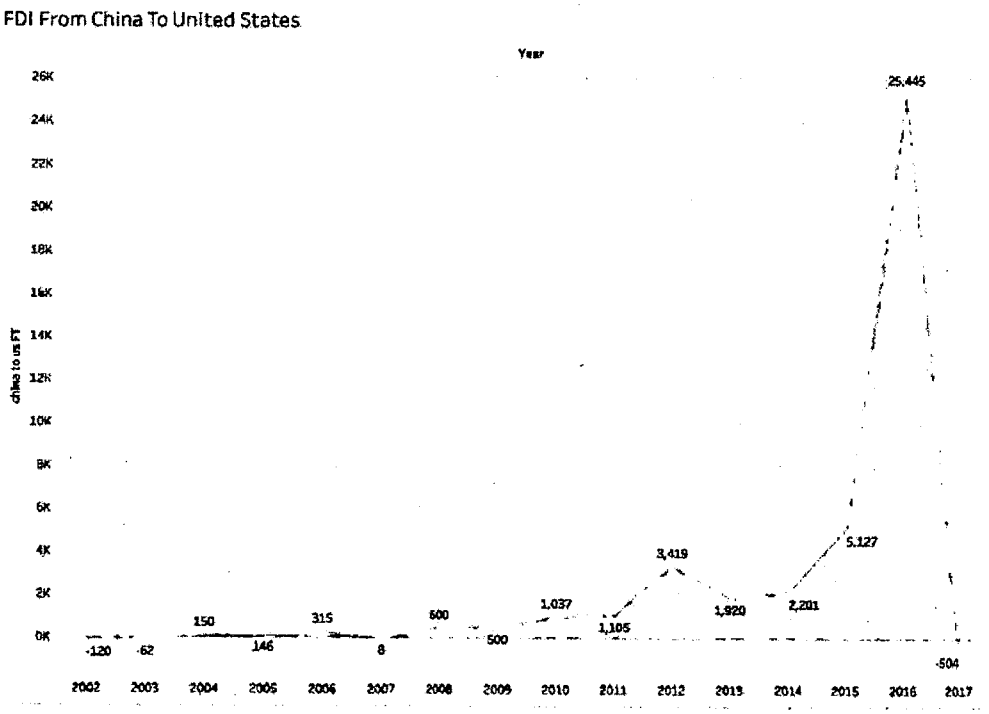

Figure 1: FDI flow from China to U.S., 2002-2017, (Millions of dollars), Financial transactions without current-cost adjustment
Source: https://www.bea.gov/international/di1fdibal

Capital flow increased dramatically from China to U.S beginning around 2015 (5127 millions of dollars), but decreased in 2017 (-504 millions of dollars). It is believed that Beijing's policy on "Make China rich and strong" (Allison, 2017) is the cause of the increase of 2015. In 2015, the One Belt- One Road Campaign, enacted by the central government in February 2015, established ocean direct investment promotion agencies to facilitate cross-border trade and investment (European Parliament, 2016). More than 20 provinces out of 31

province-level administrative areas expressed strong interest to invest overseas in their governments' annual work reports. (European Parliament, 2016). Much of the decline in 2017 was attributable to Beijing's regulatory crackdown on outbound capital flows. But the growing regulatory hurdles in the US was the second main reason suppressed Chinese investors (Hanemann and Rosen, 2018). Figure 2 shows the precipitous decline of investments beginning in 2017.

Our data collection provides for a number of different variables. This paper examines a number of independent variables including China and U.S.'s economic and social factors (see Table 1), with respect to Foreign Direct Investment (FDI). However, the primary challenge stems from the limited number of observations, since the measures are annual. This complicates the analysis in terms of the various methodologies that can be utilized.

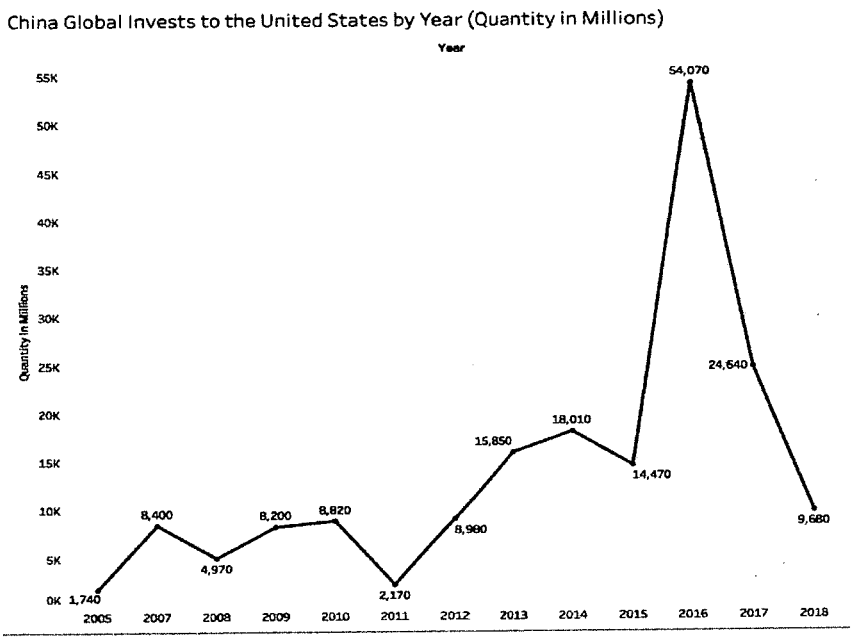

Figure 2: Investment flow from China to U.S., 2005-2018, (Millions of dollars)
Source: http://www.aei.org/china-global-investment-tracker/

3.2 Simple Linear Regression

We built a series of linear regressions to determine which variables might be significant. Since we only have 13 observations, we cannot consider all variables simultaneously. Research suggests that the minimum number of observations is based on the ratio of observations to variables, ranging from 30 to 1 to as little as 10 to 1 (Bujang et al., 2017). Therefore, we conducted individual linear regressions to assess each variable's effect. However, simple linear regression might not show the relationship between independent

variables, which multivariate linear regression might indicate. The dependent variable in each of the regressions is FDI from China to the United States, and thus simple linear regression models were created to isolate possibly significant independent variables.

We have broken down the items into two groupings non-financial items and financial items. Table 1 provides the results of the linear regression for non-financial items, which constitute those items that are economically driven, but not directly part of the financial system. Each column is the coefficient and significance of the simple linear regression conducted for that particular item. In this case, electronic power consumption was significant (China - p= .000, US- p = .014) for both countries as a measure of FDI, although in opposite directions. Second, the high technology exports was significant (p=.004) only in the negative direction for the US, and was not significant in China; however, our results showed the inverse for industry value added, whereby the Chinese variable was significant (p=.001). It is worth noting that military expenditure of China (p=.066) was not significant at the .05 significance level, therefore, we did not find support for Hassan et al. (2015); however support would be given at the .10 significance level. The lack of significance is most likely due to the small sample size.

Table 1: Linear Regression for Non-financial items

	China	U.S.
Electric power consumption (kWh per capita)	**0.9882** (0.0002 ***)	**-2.4732** (0.0138 *)
High-technology exports (% of manufactured exports)	-245.1 0.244)	**-176.81** (0.004167 **)
Industry (including construction), value added (annual % growth)	**-472.5** (0.001202 **)	74.34 (0.6345)
Military expenditure (% of GDP)	-7009 (0.0658 .)	-506.3 (0.597)

(coefficients are in the table and p-values are in parentheses)
Source: World bank

Table 2 provides the results of the linear regressions for the financial items. For the financial items, we found GDP for both countries were significant (China - p=.000 and US - p = .0002) for increased FDI, as well as for Broad Money for both countries (China - p=.00 and US - p= .01). Interestingly, the GDP growth for China was significant (p=.005) and negative for theUnited States (p=.628), however, we believe this is also related to the smaller sample size.

Table 2: Linear Regression for Financial items

	China(p-value)	U.S.(p-value)
GDP (current US$)	**3.870e-04** (6.12e-05 ***)	**3.870e-04** (0.000298 ***)
Broad Money	**71.85** (6.18e-05 ***)	**126.87** (0.0103 *)
Trade openness	**-11847** (0.01907 *)	26273 (0.0509 .)
GDP growth (annual %)	**-523.5** (0.00525 **)	131.6 (0.628)
Total Share Prices for All Shares (index 2015=100)	23.58 (0.190)	**61.55** (0.0133 *)
Market capitalization of listed domestic companies (% of GDP)	7.757 (0.646)	19.96 (0.353)
Real Broad Effective Exchange Rate	**98.61** (1.93e-05 ***)	-61.29 (0.204)
Population in the largest city (% of urban population)	-12549 (0.707)	**-5177** (0.000509 ***)
Difference of Interest Rates between China and U.S.	438.7 (0.0519)	

(coefficients are in the table and p-values are in parentheses)
Source: World Bank.

Trade openness was found to be significant (p=.019) in the negative direction for China, while positive for the US, but only at the .10 significance level (p=.0509). This provides some support, although not conclusive, the Demirhan and Masca's (2008) conclusion that degree of openness is positive and statistically significant.

Alfaro et al. (2004) concluded that the development of financial markets is pivotal for positive contribute to economic growth to increase FDI inflow. However, our conclusion is that market capitalization of listed domestic companies is not statistically significant both in China and the United States (p-value = 0.646 and 0.353, respectively), providing support to the Fratzscher et al. (2004) results that capital openness has little effect on the size of FDI flows. Further, the lack of support by the real broad effective exchange rate of the United States (p-value= 0.204) may provide additional evidence to Fratzscher et al. (2004).

3.3 Principal Component Analysis

Due to the limitations of the number of observations available for regression, we used Principal Component Analysis (PCA) to derive key components and reduce the number of dimensions. PCA can correspond the variables to directions of maximal variance in the data. This can be performed via a singular value decomposition of the data matrix or through an eigenvalue decomposition if the matrix is a covariance matrix (Aspremont et al.2005).

The principal components analysis can identify a set of variables and synthesize most of the total information to a few factors, usually two or three, which is the latent basis of the variables inter collinearity (Kulcsar, 2010).

Olawale and Garwe (2010) use principal component approach to investigate the obstacles to the growth of new small and medium-sized enterprises in South Africa. The principal component analysis was used to reduce the variables into five clusters: Financial, Economic, Markets, Management, and Infrastructure from originally thirty variables which were identified as obstacles.

Jalil et al. (2010) asserted that principal components are a powerful method to examine the links between growth and financial development, when they re-examined the finance-growth nexus in China, using principal components analysis and Autoregressive Distributed Lag Method to cointegration.

PCA allows us to determine the key variables in each dimension. Table 3 provides abbreviations for the variables in the analysis for ease of review. After running the PCA, we found that 89.7% of the variance (see Table 5) can be explained by two dimensions.

Table 3: Abbreviations of the variables

cu	China to U.S. Financial Transactions	indc	Industry (including construction), value added (annual % growth) in China
astous	Asia and Africa to U.S.	milexc	Military expenditure (% of GDP) China
dir	Difference of interest rate between U.S. and China	epc	Electric power consumption (kWh per capita) China
rbeerc	Real Broad Effective Exchange Rate for China	hteu	High-technology exports (% of manufactured exports) U.S.
bmc	Broad money of China	poplu	Population in the largest city (% of urban population) U.S.
bmu	Broad money of United States	cgdpg	GDP growth (annual %) China
tou	Trade openness of U.S.	epsu	Electric power consumption (kWh per capita) in U.S.
cgdp	China GDP (current US$)	toc	Trade openness of China
ugdp	U.S. GDP (current US$)	tspu	Total Share Prices for All Shares for the United States

Table 4 provides a summary of the principal components after rotation, where 2 dimensions are sufficient, since the eigenvalues Dim.1 and Dim.2 are greater than 1, and the respective "cumulative proportion" is 49.02% and 89.66%. Since over 80% of the cumulative variance was explained by the two dimensions we can ignore the other dimensions in the PCA (Kulcsar, 2010).

Table 4: Values of the components and the variance explained

	No Rotation		Varimax Rotation	
	Dimension 1	Dimension 2	Dimension 1	Dimension 2
Standard deviation	3.324	1.815	7.872	6.473
Proportion of Variance	0.691	0.206	.492	.405
Cumulative Proportion	0.691	0.897	.492	.897

After rotation we attempt to describe the principal components. The rotated loadings are found in Table 5. First, we have 2 variables that appear to have overlapping loadings, which is a problem for orthogonality. We assign the variables to the principal component with the highest loading. This assigns 10 variables to principal component 1 and 6 variables to principal component 2. Figure 2 shows how the variables are aligned to the dimensions and each other in the PCA graph. Principal component 2 seems to be related to much broader economic/policy measures, but also heavily weighted with variables related to China's growth such as trade openness and GDP growth financial measures such, while principal component 1 may be more reflective of the broader economy.

Table 5: Rotated loadings

	PC1	PC2
Difference of interest rate between U.S. and China		-0.907
Real Broad Effective Exchange Rate for China	0.616	-0.759
Broad money of China	0.669	-0.644
Broad money of United States	0.751	
Trade openness of U.S.	0.957	
China GDP (current US$)	0.824	
U.S. GDP (current US$)	0.950	
Industry (inc. construction), value added (annual % growth) China		0.833
Military expenditure (% of GDP) China	-0.936	

Electric power consumption (kWh per capita) China	0.894	
High-technology exports (% of manufactured exports) U.S.	-0.773	
Population in the largest city (% of urban population) U.S.	-0.904	
GDP growth (annual %) China		0.927
Electric power consumption (kWh per capita) in U.S.		0.900
Trade openness of China		0.944
Total Share Prices for All Shares for the United States	0.866	
SS Loadings	7.872	6.473
Proportion Var %	.492	.405
Cumulative Var %	.492	.897

We conducted a secondary analysis of the principal components by removing the variables which had overlapping loadings, specifically the broad money variables. Table 6 shows the new loadings without the two variables and has no overlapping loadings. The cumulative variance for both components is now 90.3%.

Table 6: Rotated loadings after removed bmc and bmu.

	PC1	PC2
Difference of interest rate between U.S. and China		0.912
Real Broad Effective Exchange Rate for China		-0.765
Trade openness of U.S.	0.962	
China GDP (current US$)	0.821	
U.S. GDP (current US$)	0.946	
Industry (inc. construction), value added (annual % growth) China		0.847
Military expenditure (% of GDP) China	-0.940	
Electric power consumption (kWh per capita) China	0.889	
High-technology exports (% of manufactured exports) U.S.	-0.760	
Population in the largest city (% of urban population) U.S.	-0.896	
GDP growth (annual %) China		0.936
Electric power consumption (kWh per capita) in U.S.		0.893
Trade openness of China		0.941
Total Share Prices for All Shares for the United States	0.876	
SS Loadings	6.833	5.811
Proportion Var %	48.8%	41.5%
Cumulative Var %	48.8%	90.3%

Using the principal components, we create two new variables based on the values of the individual observations, in an attempt to rerun our linear regression. The values are derived as a function of the linear combinations. Thus, the two linear functions are:

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PC1 = .257 * dir + 0.607 * rbeerc + .973 * tou + .820 * cgdp +.932 * ugdp - .255 * indc - .971* mirexc + .892 * epc - .811 * hteu - .910 * poplu - .155 * cgdpg - .190* epsu - .018 * toc + .766 * tspu.

PC2 = - .887 * dir - .701 * rbeerc - .096 * tou - .496 * cgdp - .237* ugdp + .930 * indc + .006 * mirexc - .365 * epc + .429 * hteu + .321 * poplu - .979 * cgdpg + .735 * epsu + .810 * toc + .099 * tspu.

From these new variables we build two linear regression models. Due to the limited number of observations, we create two simple linear models

$$FDI_1 = \beta_0 + \beta_1 PC_1$$

$$FDI_2 = \beta_0 + \beta_1 PC_2$$

The results of the linear regressions are shown below in Table 7.

Table 7: Principal Component Regression Model Results

Model	Model 1 (FDI_1)	Model 2 (FDI_2)
Intercept (B_0)	-2816 (p=0.000)**	-1859 (p= 0.003)**
PC_1 (B_1)	.0002 (p=0.000)**	
PC_2 (B_2)		-.00046 (p = 0.000) **
Adj R^2	0.7068	0.7283
F-statistic	29.93 (p = 0.000)*	33.16 (p = 0.000)*

** - significant at p <.05, ** - p <.01*

4. Limitations

Due to the limited number of observations, yearly data points, we ran a number of simple linear regressions to determine the predictive effects of each variable. This method might not show the complex relationship between the independent variables when using multivariate regression model. Also, the components which affect the FDI from China to the United States are complex and varied, we cannot list all the variables and the political situation between the two giant countries.

In addition, world economic measures and stability might also affect capital flow and need to be monitored. Our aim in the future would be to examine these metrics as a factor of investment. However, the data on the other important determinants, like labor costs and the capital flow flight to the United States may be considered as another limitation of our study. Thus, the limitations above can be further examined by future research to improve upon these models as more data becomes available.

In addition, a number of psychological factors may impact investment decisions (Bucciol and Zarri, 2015). The psychological factors can range from personal life events to attitudes surrounding geopolitical situations. Chinese investors attitudes toward the United States and the economy as a whole may increase investments. Chinese investors might be more willing to invest in the United States since America's products mean higher quality, better environment and differing education system, also a desire to learn from America, especially modern management (Deng, 2004; Li, 2007). Additionally, further research into the difference in the internal industry economics and attitudes are a necessary consideration in examining the flow of FDI into the United States from China.

5. Conclusion

This paper focuses on the drivers of FDI from China to the United States, as the speed of Chinese capital flows accelerates. We used simple linear regression model to remove the variables which are not significant to the dependent variable, and then used the PCA method to reduce the number of independent variables which could then be used in a subsequent regression model. While we were unable to adequately name the components, the results are interesting. The results showed surprising loadings of variables that seems more integrated across national boundaries.

From the indicators provided, we found both components were significant in predicting the foreign direct investment from China to the United States. A stable macroeconomic environment, such as low and stable inflation can attract investors, while better financial institution of foreign direct investment may not be statistically significant.

As our analysis indicates, high-technology is an important situation to attract capital flow to the United States. Military expenditures were theorized to be significant, however, our results found no support for this. As tensions between the two nations increase, and military budgets expand we should see no direct impact on FDI from China to the United States. In the next ten years, China will continue to invest heavily in military power, high-tech companies, such as planes, large warships, semiconductors, aerospace systems and artificial intelligence, in order to enhance the "national hard power", and therefore, this should not affect investments in the United States. However, the geopolitical situation and economic conflict may impact the investments by constricting the trading environment between the two

nations. It will be interesting to see how some of these factors play out over the next few years as the two governments engage in trade talks and reciprocal trade barriers. Therefore, the FDI flow from China to the US could be severely impacted by the changing political winds in either direction.

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APPENDIX A: DATASETS USED

Capital account openness index taken from Chinn-Ito Index
http://web.pdx.edu/~ito/Chinn-Ito_website.htm

Direct Investment by Country and Industry, 2017https://www.bea.gov/data/intl-trade-investment/direct-investment-country-and-industry

FDI from China to US:
https://datacatalog.worldbank.org/dataset

Human capital index
https://datacatalog.worldbank.org/dataset/human-capital-index

Interest Rates, Discount Rate for China
https://fred.stlouisfed.org/series/INTDSRCNM193N#0

Real exchange rate

https://fred.stlouisfed.org/series/RBCNBIS
Stock market capitalization
https://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS?view=chart