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"Political Ties as a Substitute for Property-Protecting Institutions, Explaining China's Foreign Direct Investment to Africa"
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Political Ties as a Substitute for Property-Protecting Institutions

Explaining China's Foreign Direct Investment to Africa

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(Note: This is the earlier version. The author is still revising this paper and may make some important changes. Please do not circulate without permission.)

Abstract: China's expanding economic engagement in African countries has captured enormous attention from the academic and the policy community. This paper seeks to offer a novel explanation of the spatial variation of China's foreign direct investment (FDI)-a credible measure of economic involvement- across African countries. We argue that political ties between African countries and China serve as a substitute for property-protecting institutions and play a vital role in attracting China's FDI. We developed two imperfect but defensible measures of political ties: the time duration of diplomatic relations and the number of the front page articles reporting a particular African country on *People's Daily*, the mouthpiece of the Chinese Communist Party (CCP). Our empirical results suggest that close political ties with China lead to greater levels of China's FDI in African countries during 2003-2010 and the effect of political ties on FDI diminishes as the level of democracy increases. China's FDI is found to be attracted by mineral resources instead of oil as suggested by many policy analysts.

"Trust and sincerity between the two sides are more valuable than gold. China and Africa have similar historic experiences and development tasks and I believe we also share bright prospects for development."

— *China's President Xi Jinping, August 2013*

Introduction

As China becomes an emerging global powerhouse, it has been expanding its economic and political footprints across the world particularly in developing countries. One notable case is China's increasing economic involvement in African continent. To be sure , trade volume between China and Africa increased substantially from $10 billion in 2000 to $114 billion in 2010, surpassing the U.S. as the Africa's largest trading partner in 2009 (*Wall Street Journal* 2011). In addition, China's outward FDI flows in Africa surged significantly from $74.8 million in 2003 to $2.1 billion in 2010, a more than 28-fold increase (Ministry of Commence 2011).

Indeed, China's aggressive economic engagement into Africa has attracted a great deal of attention from the academic and the policy community. One camp of policy analysts and scholars tend to be preoccupied with the negative consequences of China's economic penetration in Africa. They contend that China's economic expansion was intended to grab resources especially oil to fuel its growing economy and fostered illiberal regimes in African continent (e.g. Alden 2007; Marysse and Geenen 2009; Taylor 2004 2006; Tull 2006). As the former US Secretary of State Hillary Clinton implies, China's investment in Africa is "new colonialism" in nature(Huffington Post 2011).The other camp of observers paints a rosy picture of China's economic

involvement into Africa. They highlight the mutual benefits between China and African countries and portray China's engagement as business opportunities for African countries and political leverages over western countries (e.g. Brautigam 2003 2009; Men 2010; Sautman and Yan 2008). In fact, China paved the way for Africa's economic development by building a great number of infrastructure projects including roads, dams, bridges and so forth. More importantly, China has brought its own development experience to African countries and offered an alternative development model characterized by "Beijing Consensus" (Ramo 2004).

Nevertheless, these debates shed limited light on one fundamental puzzle: Given the fact that FDI, a credible measure of economic engagement in a particular country, is vulnerable to the threat of expropriation or more subtle government interventions due to time inconsistency problem, what drives the explosive rise of China's FDI in Africa where the formal institutions for protecting property rights are typically weak or even absent? Relatedly, what accounts for *the spatial or regional variations* of China's FDI in Africa? Exploring the rationale of China's FDI in African countries has implications for understanding how multinational corporations (MNCs) live with the potential political risks in regions without strong institutions credibly committing against expropriation, for delving into the inflows of FDI of developing countries broadly, and for envisioning the future of Sino-African relations and reassessing the impact of China's international reemergence and expansion.

The prevailing view in the literature suggests that democratic institutions can reassure fearful foreign investors and reduce expropriation risks, thereby contributing to greater levels of FDI inflows (e.g., Feng 2001; Jensen 2003 2006). The checks and

balances in democratic systems impose institutional constraints on host governments, leading to political stability and policy predictability (Henisz 2000; Tsebelis 1995). Meanwhile, democratic leaders suffer from "audience costs" and thus are less likely to renege on commitments with foreign investors (e.g., Cowhey 1993; Fearon 1994; Gaubatz 1996). Yet, recent work also notes that preferential treatment and selective protection of property rights provided by authoritarian regimes and international agreements can constitute alternative avenues for attracting FDI inflows (e.g., Li and Resnick 2003; Zheng 2013; Büthe and Milner 2008 2009).

Since a substantial portion of African countries cannot be seen as fledgling democracies, it is dubious that the positive effect of democracy on FDI still holds in the case of China's FDI in Africa. Even if the degree of democracy also matters for promoting investment (Jensen, Malesky and Weymouth 2013), we still need to understand how China's MNCs mitigate potential political risks in countries with lower levels of democracy. The argument concerning preferential treatment and selective protection of property rights gives insight into alternative ways of attracting FDI. Yet, few studies have explored why some host countries tend to offer preferential policies to investors of a particular country or sign international treaties with that country.

In this paper, we argue that political ties between African countries and China serve as a substitute for property protecting institutions guaranteed by democratic systems. On the one hand, close political ties allow Chinese MNCs to gain more information about host countries and thus reduce potential risks surrounding investment. On the other hand, African countries with closes political ties to China are more likely to

offer preferential policies and to some extent provide selective property protection to Chinese investors.

We developed two imperfect but defensible measures of political ties: the time duration of diplomatic relations and the number of the front page articles reporting a particular African country on *People's Daily*, the mouthpiece of the Chinese Communist Party (CCP). Our empirical findings suggest that African countries with close political ties to China tend to attract more FDI from China. Put concretely, one-year difference in the time span of diplomatic relations corresponds to an expected positive difference of approximately 7 % in China's FDI. In addition, 1% change in the number of newspaper reports of African countries on the front page of *People's Daily* corresponds to 1.4 % change in China's FDI. We lend support to the positive effect of democratic institutions on FDI inflows and also find that the effect of political ties on China's FDI diminishes as the level of democracy in African countries increases, indicating a substitutive relationship between democratic institutions and political ties in terms of protecting property rights. The "resource-grabbing" thesis is only partly buttressed by our empirical results in the sense that instead of extracting oil resources, suggested by conventional view, mineral resources turn out more attractive to China's FDI.

This study contributes to the exiting scholarship in several important aspects. First, we offer two novel measures of political ties and identify the effects of political ties on African countries' ability of attracting China's FDI. Second, our findings substantiate the traditional wisdom that high levels of democracy contribute to greater levels of FDI and further show that political ties can play a more important role in attracting FDI when the democratic institutions are weak. Third, while most of previous studies examine the

determinants of the overall FDI flows across countries, our research focuses on FDI flows from China, an emerging economy and rising global power, and thus shed light on "South-South FDI flows" (Aykut and Ratha 2004). Finally, from the angle of China's FDI in Africa, our study provides an empirical test of China's economic engagement in African countries and has important implications on ongoing debates on Sino-African relations and China's rising in international arena.

The reminder of this paper proceeds as follows. The first section examines the existing literature on the determinants of FDI flows and lays out our hypothesis. The second section assesses the competing hypotheses and tests our hypothesis empirically. The third section provides a discussion of potential causal mechanisms linking the strength of political ties with China to higher levels of FDI flows in African countries. The final section discusses the theoretical and policy implications of our findings.

Theoretical Foundations and Testable Hypotheses

Foreign direct investment (FDI) has become an integral dimension of globalization. FDI serves as a driving force of economic growth especially in developing countries in the sense that it plays an essential role in injecting physical and human capital, creating new job opportunities and facilitating technology diffusion in host countries. The preponderance of theorizing about FDI has focused on one fundamental question: Why some countries are able to attract more FDI than others? Put differently, what are the determinants of variations of FDI inflows?

The earlier scholarship that tries to explain the variations of FDI inflows across the world has typically focused on economic factors including the market size, the level of

economic development as well as economic growth rate. Of primary importance in this strand of literature is OLI framework that highlights the role of ownership, location, internalization advantages and thus gives insight into the economic rationale of multinational corporations (Dunning 1981).

It is worth noting that aside from special tariffs, transportation costs and cheap factor prices, location advantages also include the existence of natural resources. After all, natural resources like oil, natural gas or mineral resources are immobile and location-specific. Yet, the extant empirical studies on the effects of natural resources on FDI flows reach inconclusive results. While natural resource endowments are found to allow host countries to attract more FDI and to some extent mitigate the effects of institutional weakness (Jenson 2003; Aleksynska and Havrylchyk 2013), the presence of natural resources may also crowd out non-resource FDI and thus result in the fall of aggregate FDI (Poelhekke and van der Ploeg 2013).

In the case of China's FDI in Africa, although the "resource-grabbing" thesis tends to attribute China's economic involvement in African continent to the motivation of extracting natural resources to fuel China's economy, yet to the best of our knowledge there is little quantitative comparative analysis of the relationship between the natural endowments of African countries and China's FDI. The present research attempts to offer a cross-country empirical test of the "resource-grabbing" thesis. Thus, we derive the following hypothesis:

Hypothesis 1: *China's FDI tends to target on resource-rich countries in Africa.*

Nevertheless, the extraction of natural resources generally requires an initial large-scale capital intensive investment, which renders institutional protection necessary. Not

only does resource-related FDI need institutional guarantees, non-resource FDI also demands institutional constraints to reduce political risks because of the inherent nature of FDI. The "obsolescing bargain" between MNCs and host governments constitutes the primary political risk of FDI (Vernon 1971). FDI is mobile *ex ante* but immobile *ex post* such that once multinational investments have been made, the relative bargaining power shifts to the host government over time. Even if host governments can benefit from FDI in the long run and have the incentive to attract more FDI to facilitate economic growth, they are also tempted to exploit or even expropriate the assets of foreign investors when short-term benefits overweight the long-term costs.

In this light, aside from a host of economic factors, political economists have devoted a great deal of attention to the role of political institutions in guarding against expropriation. Much of the vast literature on institutions and economic performance suggests that property-protecting institutions are conductive to promoting private investment and fostering economic growth (e.g., Acemoglu, Johnson and Robinson 2001; North 1990; North and Weingast 1989; Olsen 1991). Implicitly or explicitly, this strand of literature suggests that democratic institutions are associated with strong property-protecting mechanism and better economic performance. In the same vein, democratic regimes are arguably superior to authoritarian regimes in terms of reducing expropriation risks and attracting FDI (e.g., Feng 2001; Li, 2009; Jensen 2003 2006). One important mechanism linking democracy to high levels of FDI inflows is the number of veto players in democratic political systems. Multiple veto players imply institutional constraints of host governments and thus lead to the predictability of policy and high levels of FDI inflows (e.g., Henisz 2000; Tsebelis 1995). In addition, democratic regimes are less

likely to renege on promises because democratic leaders suffer from audience costs (e.g., Cowhey 1993; Fearon 1994; Gaubatz 1996). Concerned with electoral backlashes, democratic leaders are held accountable and are forced to make credible commitments to foreign investors. In short, democratic regimes are more likely to credibly commit against predatory behaviors of host governments and protect property rights of MNCs.

Yet, most of African countries by no means are fledgling democracies. To be sure, a substantial portion of them can be seen as hybrid regimes (Levitsky and Way 2002, 2010; Diamond 2002; Van de Walle 2002). In this case, the *degree* of democracy may still matter for attracting FDI. Quasi-democratic institutions in authoritarian regimes-political parties and legislatures in particular- can also serve as commitment mechanisms that can constrain predatory behaviors and boost economic growth (Gandhi and Przeworski 2007 ; Gandhi 2008; Wright 2008; Gehlbach and Keefer 2011). From the perspective of contracting institutions, authoritarian legislatures can also contribute to representation of divergent private economic actors and thus constrain the ability of corporate insiders to expropriate investors, leading to high levels of investment and economic growth (Jensen, Malesky and Weymouth 2013). The main implication of the above discussion is the following hypothesis:

Hypothesis 2: *African countries with relatively high level of democracy tend to attract more FDI from China.*

An important caveat of aforementioned findings is that democratic institutions may affect FDI in a complex way (Li 2009; Li and Resnick 2003). Under certain circumstances, democracies may discourage foreign investors in that democratic institutions may weaken the ability of MNCs to exploit their oligopolistic and

monopolistic positions, facilitate protection-seeking activities of indigenous business due to wide political participation and easy access to elected politicians, and perhaps more importantly prevent host countries from offering preferential financial and fiscal policies to MNCs (Li and Resnick 2003). Indeed, the collusion of authoritarian leaders and MNCs also help non-democracies attract foreign capital (Evans 1979; O'Donnell 1978 1988). Because authoritarian governments are able to offer preferential treatment and selective protection of property rights to foreign investors in some cases, the relationship between political institutions and FDI in developing countries likely exhibits an inverse U-shaped curve: too many or too few veto players are less attractive for foreign capital (Zheng 2013). Put in another way, there exists a tradeoff between policy credibility and flexibility. In a nutshell, an alternative key mechanism of attracting foreign capital other than establishing credible democratic institutions is to provide preferential policies or and selective protection of property rights to MNCs.

Beyond domestic politics, another alternative mechanism comes from international agreements. International trade agreements like GATT/WTO and preferential trade agreements (PTAs) can boost FDI inflows because international institutions facilitate dissemination of information about noncompliance and increase monitoring such that a country can commit to open markets and liberal economic policies by signing trade agreements (Büthe and Milner 2008). In addition, bilateral investment treaties (BITs) can also lead to higher levels of FDI flows in the sense that BITs, one the one hand, allow investment-seeking governments to signal their true intention to protect investment, and on the other hand, provide foreign investors with a wide range of protective policies including provisions on national treatment, most-favored nation status, the right to

transfer profits in hard currency to the home country, and international arbitration of disputes between the investor and the host country (Allee and Peinhardt 2011; Büthe and Milner 2009; Egger and Pfaffermayr 2004; Haftel 2010; Neumayer and Spess 2005). To sum up, international agreements provide an alternative avenue of attracting FDI because international agreements can reveal information of host countries and lead to a wider array of preferential policies to MNCs.

Taken together, aside from democratic institutions, preferential treatment and selective protection of property rights offered by authoritarian regimes or international agreements contribute to greater levels of FDI inflows. In our analysis of China's FDI in African countries, the key question we need to address then becomes: Why some African countries are more likely to offer preferential policies and protect Chinese investment? From a novel perspective, we argue that political ties between China and African countries can serve as a substitute for property-protecting institutions enforced by democratic institutions and thus lead to greater levels of Chines FDI in some African countries. [2]

Political ties can reassure Chinese investors through two channels. First, in the face of enormous risks surrounding foreign investment, political ties help reveal more information about host countries. If an African country maintains close political ties with China, Chinese investors are more likely to receive credible information from Chinese embassies and people who had experience in that country. Second, political ties also contribute to preferential policies and selective property protection of Chinese investment. We will elaborate these two points in subsequent sections of this article.

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[2] Li and Liang (2012) find that bilateral relations especially international cooperation between China and other countries lead to higher levels of China's FDI during 2003-2005. We posit that international cooperation is the outcome of historical political ties.

Hypothesis 3: *African countries with close political ties to China can attract more FDI from China.*

Since political ties, as we argue, serve as a substitute of property-protecting institutions provided by democratic regimes, we expect that the effect of political ties on China's FDI will decrease in countries with higher levels of democracy. Put differently, assuming that democratic institutions are inherently linked to strong property-protecting institutions, political ties can exert greater effects in countries with relatively weak institutions for protecting property rights, whereas their effect diminishes as institutions become stronger. Therefore, we have the following hypothesis:

Hypothesis 4: *The marginal effect of political ties on China's FDI decreases as the degree of democracy increases*.

Empirical Strategy

Data and Model Specification

Since China's FDI outflows to a specific country are volatile from one year to the next year and the independent variables we are interested in are either unable to explain this volatility or fixed at a single point in time, we average the panel over the period from 2003 to 2010 and employ cross-sectional ordinary least squares (OLS) with White's correction for heteroscedasticity to estimate the determinants of China's FDI flows to African countries. This practice is in accordance with Dreher and Fuchs' (2012) research on China's foreign aid allocation.

The cross-sectional regression is:

$$Ln(Net\ FDI\ Inflows_{2003-2010})_i = \alpha + \beta(Economic\ Control\ Variables_{2003-2010})_i +$$
$$\gamma(Natural\ Endowments\ Variables)_i + \delta(Political\ Variables)_i + \varepsilon_i$$

The dependent variable in our model is the average of net China's FDI outflows to each recipient country in Africa from 2003 to 2010. A country with positive FDI inflows is attracting investment from China, while a country with negative FDI inflows is undergoing an outflow of China's investment capital. In addition, we transform the values at the current year into constant (2000) dollars. The data comes from *2010 Statistical Bulletin of China's Outward Foreign Direct Investment*, available on the website of China's Ministry of Commerce. This variable is logged to reduce skewedness. China had not been an active global investor until the "go global" policy was formalized in 2002 when Ministry of Commence began to collect Chinese Outward FDI data in accordance with Organization for Economic Cooperation and Development (OECD) definitions and IMF's balance- of- payments guidelines (Cheng and Ma 2010).As noted at the beginning of this article, China's FDI in Africa increased more than 28 folds from 2003 to 2010 so that China's FDI outflows before 2003 can be seen as a miniscule, if not negligible. In this sense, the FDI data from 2003 onward serve as a natural window through which to investigate the outward investment of an emerging economic power.

Following Büthe and Milner (2008), we include market size, level of economic development, and economic growth as economic control variables in our model. Market size is measured by the logarithm of the recipient country's population. Level of economic development is measured by the logarithm of per capital GDP in constant (2000) dollars. Economic growth is the percentage change in the country's real GDP

from the previous year. The data of these three economic variables can be found in *World Development Indicator Dataset 2011*.

In order to test if China has invested more in resource-rich countries especially oil-rich economies, we include a recipient country's (log) oil production as a proxy of natural resource endowment in our model. The data of oil production come from BP Statistical Review of World Energy (2011). In addition to oil, our model also includes "metal index", a variable that captures a country's strategic metals (bauxite, copper, iron, manganese, uranium, and nickel) production as a percentage of world production (averaged across the six metals). The relevant data is drawn from Kastner and Saunders (2012)'s research. To show the robustness of the results, we use a host of other variables to measure the resource endowment of African countries. The detailed information about these variables is reported in Appendix 1.

Political variables consist of a few governance indicators and variables that measure political ties between China and African countries. We use two different variables, including dummy variables (Cheibub et al. 2010) and Polity2 Score to measure democracy. Drawing on Keefer(2013)'s Database of Political Institutions, we include the variable "veto points", a proxy for checks and balance, to test the effects of veto players on China's FDI. In addition, we also test the statistical significance of four governance indicators including rule of law, political stability, government effectiveness, and regulatory quality, all of which are provided by the World Bank (2011).

According to our hypothesis, political ties between China and African countries have played a critical role in attracting China's FDI. We use the United Nations General

Assembly (UNGA) voting alignment to measure the political ties between China and each African country in our sample, as previous literature has suggested (Alesina and Dollar 2000; Barro and Lee 2005; Kilby 2009, 2010, 2011). As far as this study concerned, this measurement has a few limitations as we discussed in the empirical finding section. Therefore, we developed two alternative measures of political ties between China and African countries. One proxy is the time span of diplomatic relations between China and each African country. We assume that the earlier one African country established diplomatic relations with China, the stronger the political ties have been. The other proxy is (log) the number of front-page articles of a specific African country in the *People's Daily*, the mouthpiece of Chinese Communist Party, from 1990 to 2002. Methodologically, we use the previous information (1990-2002) to avoid potential simultaneity.

Equally important is the justification of this measurement in a political sense. Because of Tiananmen incident in 1989 and the end of Cold War, China was in an isolated diplomatic position in the 1990s (Alden and Alves 2008). For example, up until the September 11 2001 attacks in the US, there were a lot of tensions – including the 1995–1996 Taiwan Strait Crisis, the U.S. bombing of the Chinese embassy in Belgrade in 1999 and the Hainan Island incident in 2001 – between China and the United States. If one country had maintained close ties with China during this period (1990-2002), that would be a credible signal of having close political ties with China. It is also important to note that, in general, the articles on the front page of *People's Daily* report the political activities of China's political leaders, especially the regular exchange of high level visits between China and other countries (as shown in Figure 1). Despite the fact that China's

newspapers tend to report a lot about Japan, Taiwan, and the United States to attract more audience and foster nationalism, the coverage of China's foreign relations with countries other than the big three has little media publicity (Shirk 2007: 84). As such, the more frequently one African country's name appears on the front page of *People's Daily*, the more likely the high-level visits between China and this specific country have taken place. In turn, the frequency of high-level visits can be a proxy for strong political ties between China and an African country.[3] The data sources and definitions as well as descriptive statistics are reported in Appdeix1 and Appendix 2 respectively.
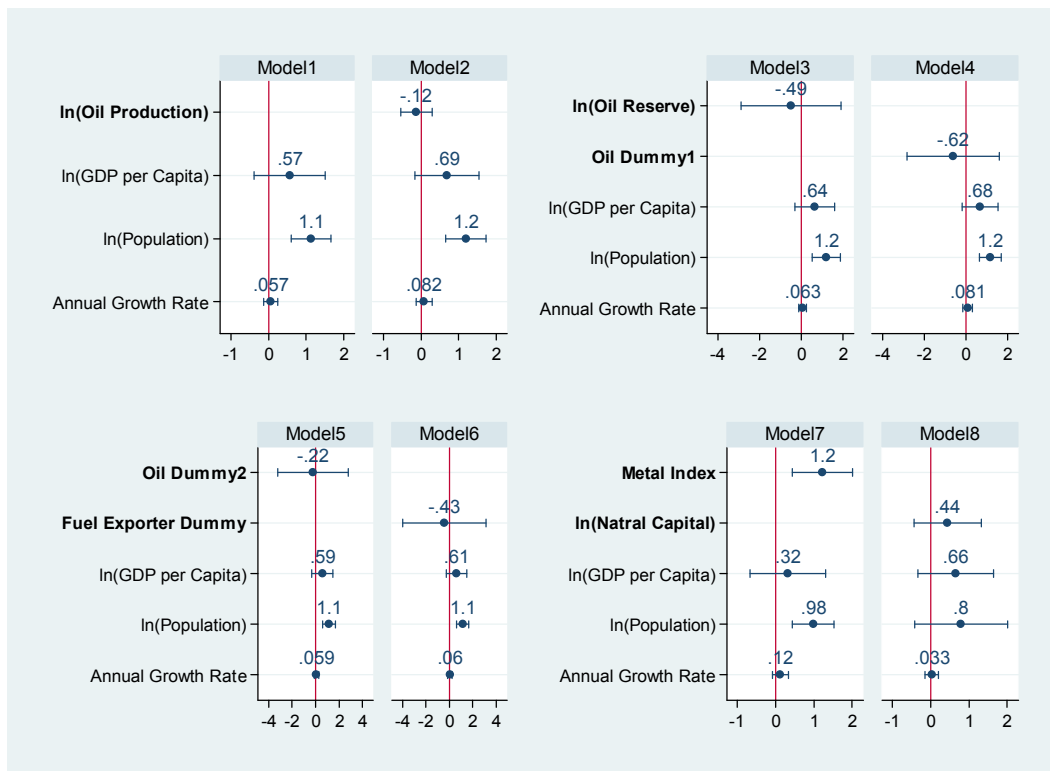
Empirical Results

China's FDI and Natural Resources Endowments in African Countries

As illustrated in Figure2, Model 1 is our baseline model, which only includes the economic control variables. It is not surprising that the market size measured by the logarithm of the recipient country's population is significant in our model, given that our dependent variable is not in per-capita terms. The variables level of economic development and economic growth rate are not statistically significant, indicating that economic situations of an African country are unlikely to fully account for the investment

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[3] In the coding process, a few important procedures were followed: First, the country name "Central Africa" and the abbreviation of "China and Africa" have the same expression (Zhongfei) in Chinese. Therefore, we search for the news reports including "the Central African Republic (Zhongfei Gongheguo)" instead of "Central Africa (zhongfei)." Second, the country name "Guinea-Bissau (Jineiya bishao)" includes another country name "Guinea (Jineiya)". Thus, we first count the number of articles with "Guinea-Bissau (Jineiya bishao" and "Guinea (Jineiya)" respectively. Then, we use the difference between the former number and the latter number as the number of news reports on "Guinea". Finally, some countries changed their names during this period. For example, when we count the number of articles with "Democratic Republic of the Congo (gangguo minzhu gongheguo)," we also count for the number of articles with "Zaire (zhayier)" and add these two numbers together.

behaviors of Chinese MNCs. In Model 2, we add oil production variable to the baseline model and find that this variable is insignificant. In Model 3, the independent variable is oil reserve instead of oil production and it is not statistically significant either. In Model 4 and Model 5, we use oil exporter dummy variables to measure the natural resources endowment of a country. [4] In Model 6, we include fuel exporter dummy as the independent variable. As it turns out, none of these three dummy variables is significant.

Figure 2: China's FDI and Natural Resources Endowments

Notes: 95% confidence interval (calculated by heteroskedasticity-robust standard errors) is shown in the above figure.

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[4] Based on BP Statistical Review of World Energy (2011) oil exporter dummy 1 is coded as 1 if oil is produced in a recipient country. Otherwise, it is coded as 0. Oil exporter dummy 2 and fuel exporter dummy were constructed and employed by Papaioannoua and Siourounis (2008).

In model 7, we find that the variable "metal index" is statistically significant. Substantively, this result suggests that one standard deviation (SD) increase in metal index increases China's FDI by 81.6 %. In Model 8, the effect of "natural capital", a variable defined as the sum of crop, pasture land, timber, non-timber forest, protected areas, oil, natural gas, coal, and minerals (World Bank 2010), is indistinguishable from zero.
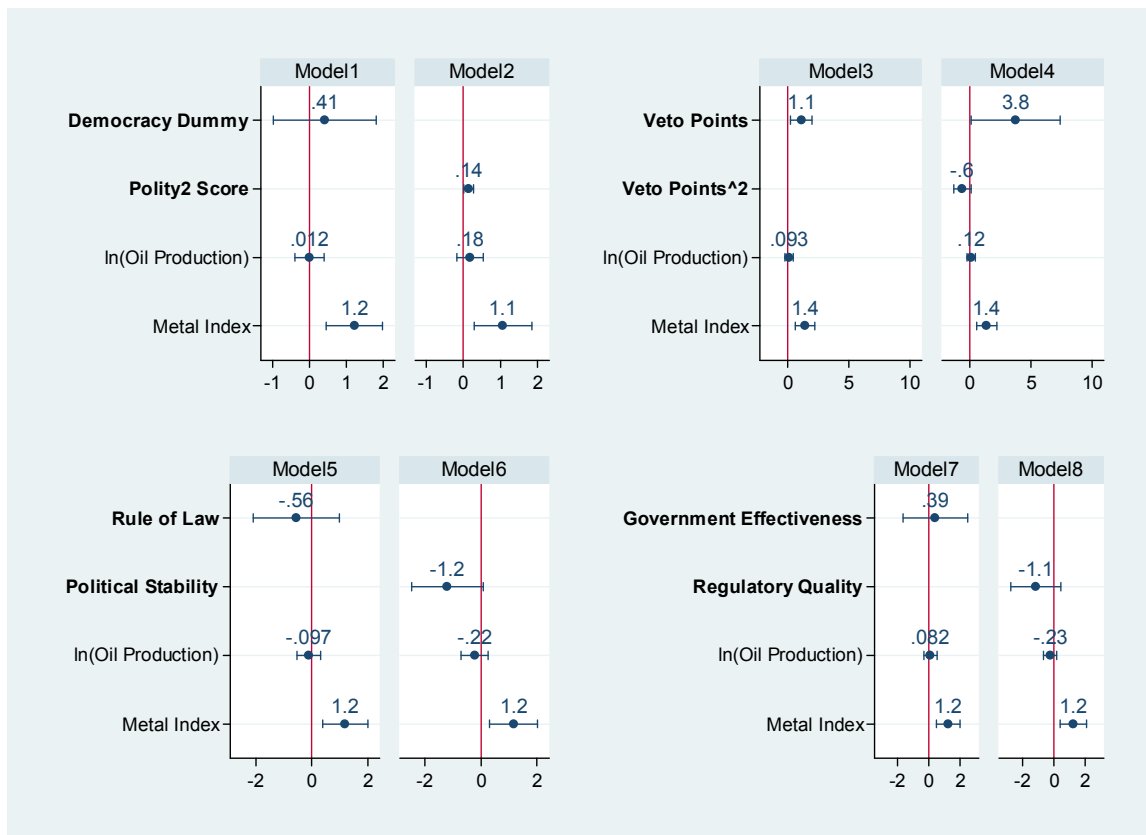
Overall, none of the variables regarding on oil resources endowment are significant in our model. This result is similar to Dreher and Fuchs (2012)'s finding that China's foreign aid allocation is not concentrated on oil-rich countries. Our finding disconfirms the conventional view that China's economic involvement with African countries is primarily driven by the need to extract oil to feed China's massive industrial production. Nevertheless, we find some evidence that Chinese MNCs are more interested in mineral resources in African countries and the resource-grabbing thesis is not completely unfounded.

China's FDI and Governance Indicators in African Countries

Figure3 reports OLS regression results with a set of governance indicators as the main independent variables. Because these variables are highly correlated, we include them one by one in the model to avoid potential multicollinearity problems. Model 1 shows that the democracy dummy, constructed by Cheibub et al (2009), is not significant. Yet, the dichotomy between democracy and dictatorship may be problematic in the sense that a large portion of African countries are hybrid regimes (Levitsky and Way 2002, 2010; Diamond 2002; Van de Walle 2002). Therefore, we employ Polity2 score to

measure the degree of democracy in African countries. Model 2 suggests that the degree of democracy has a significantly positive effect on attracting China's FDI. One SD increase in the degree of democracy boosts China's FDI by 73.5 %. [5] Thus, Hypothesis 2 is supported by our empirical evidence, which is in accord with previous findings democratic governments tend to attract more FDI flows (eg.Feng 2001; Jensen 2003 2006). We find little evidence that China's investment activities have perpetuated illiberal regimes in Africa.

Figure 3: China's FDI and Governance Indicators

Notes: 95% confidence interval (calculated by heteroskedasticity-robust standard errors) is shown in the above figure. Economic variables are controlled but not reported.

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[5] We also use Freedom House Score to measure the degree of democracy and find that it is significant at 10% significance level. One SD increase in the degree of democracy increases China's FDI by 69.9%.

In Model 3, we focus on the effect of veto points. As Zheng(2013) suggests, the relationship between veto points and FDI inflows may exhibit a non-linear relationship, and we add the squared term of veto points in Model 4. Whereas the result of Model 3 shows that the number of veto points is positively significant, the evidence of Model4 presents an inverted-U shape between the number of veto players and FDI inflows. China's FDI reaches the highest level when the number of veto players is around three.

Model 5-8 show the OLS regression results of four indicators of governance provided by World Bank (2011). Model 6 shows that political stability is negatively significant at 10% level. One possible explanation is that this indicator may not capture the perception of Chinese investors because some countries can provide selective protection of property rights to them. Other governance indicators including rule of law, governance effectiveness and regulatory quality are not statistically significant.
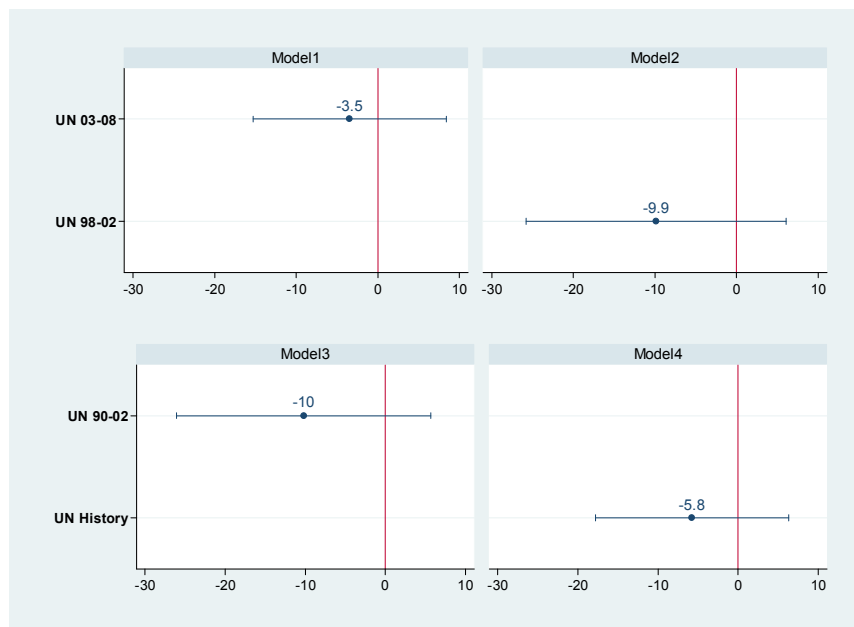
China's FDI and Political Ties

As we hypothesize, the political ties between China and African countries are likely to be an important explanatory variable in accounting for the variations of China's FDI across African countries. Previous research has employed the United Nations General Assembly (UNGA) voting alignment to measure the strength of political ties between two countries (Alesina and Dollar 2000; Barro and Lee 2005; Kilby 2009, 2011). In the same way, we use the UNGA voting alignment with China as the proxy for political ties between China and African countries.

In Model 1, the average of the UNGA Voting alignment during 2003-2008 is the independent variable and it is not statistically significant. In Model 2-4, we use the

average of UNGA Voting alignment during 1998-2002, during 1990-2002, and of all historical periods as the independent variables respectively and find that the effect of these three variables are not distinguishable from zero. In addition, we also include oil production and polity as control variables in the regression and find that the results remain the same.

Figure4: China's FDI and UNGA Voting Alignments

Notes: 95% confidence interval (calculated by heteroskedasticity-robust standard errors) is shown in the above figure. Economic variables are controlled but not reported.

The UNGA voting alignment is not a good proxy for political ties between China and African countries. China and the overwhelming majority of African countries are developing countries such that they have some common interests in international politics and therefore are more likely to vote for the same issues at the UN. Therefore, voting alignment with China does not necessarily mean that the political ties with China are
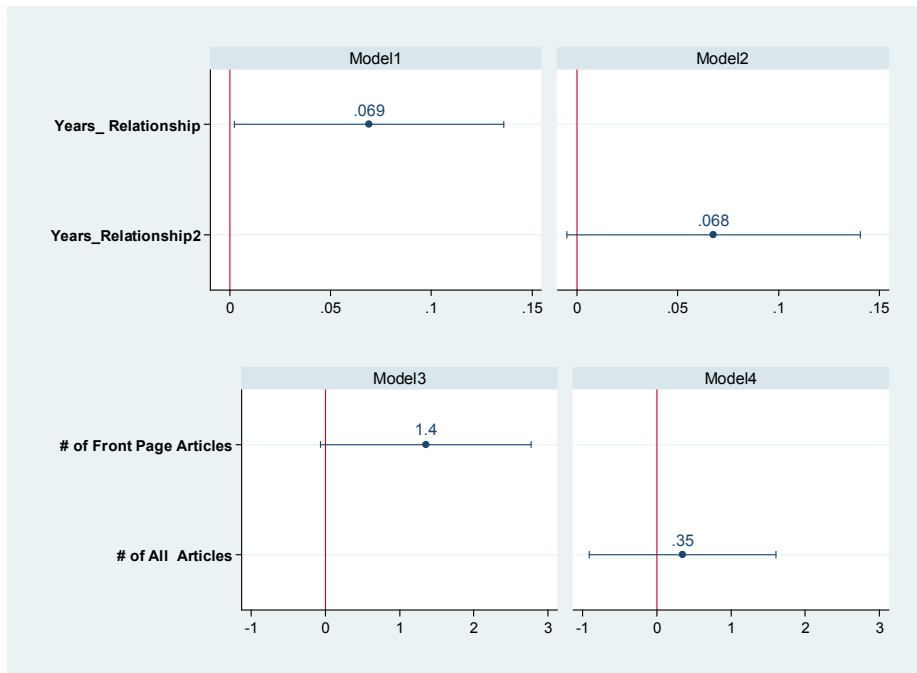
strong. Moreover, it is also difficult to disentangle the effect of UNGA voting alignment on FDI from vote buying strategically employed by China. For example, Flores-Macías and Kreps (2013) find that higher volumes of bilateral trade between China and developing countries in Africa and Latin America lead to converge on issues of foreign policy, measured as the UNGA voting alignment on human rights issue. Our empirical evidence shows that the UNGA voting alignments during different periods are all insignificant, suggesting that unlike trade, the foreign policy consequences of China's FDI are indiscernible.[6]

Due to the limitations of the UNGA voting alignment measurement, we construct alternative proxies for capturing political ties between China and African countries. First, we use the time-span of diplomatic relations between China and one African country to measure the strength of political ties. In model 1 of Figure5, the time span of diplomatic relations between China and an African country has a significant positive effect on China's FDI inflows during 2003-2008. Because a few African countries broke off diplomatic relations with China and then restored full diplomatic relations. Thus, we subtract the number of years in which one country did not maintain diplomatic relations with China and construct a corrected indicator. Model 2 shows that this variable is positively significant at 10% level. Substantively, one-year difference in the time span of diplomatic relations corresponds to an expected positive difference of about 7 % in China's outward FDI.

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[6] The existing literature suggests that UN Security Council (UNSC) membership has a positive effect on the amount of foreign aid one country has received (Dreher etal 2009; Kuziemko and Werker 2006). For strategic reasons, China may have invested more capital in countries that rotated on the UN Security Council (UNSC) during 2003-2010. We also test this hypothesis and find little evidence to support it.

Secondly, we use the number of front-page articles in the *People's Daily* covering an African country during the period 1990-2002 as a proxy for political ties. As mentioned previously, the front page of the *People's Daily* typically reports the important activities of China's political leaders at home and abroad. Thus, it is reasonable to assume that the more frequently the name of an African country appears, the closer the political ties between China and that particular country. After Tiananmen Massacre in 1989, the relationship between China and western countries soured. During 1990-2002, if an African country maintained close relationships with China, the friendship must be very credible.
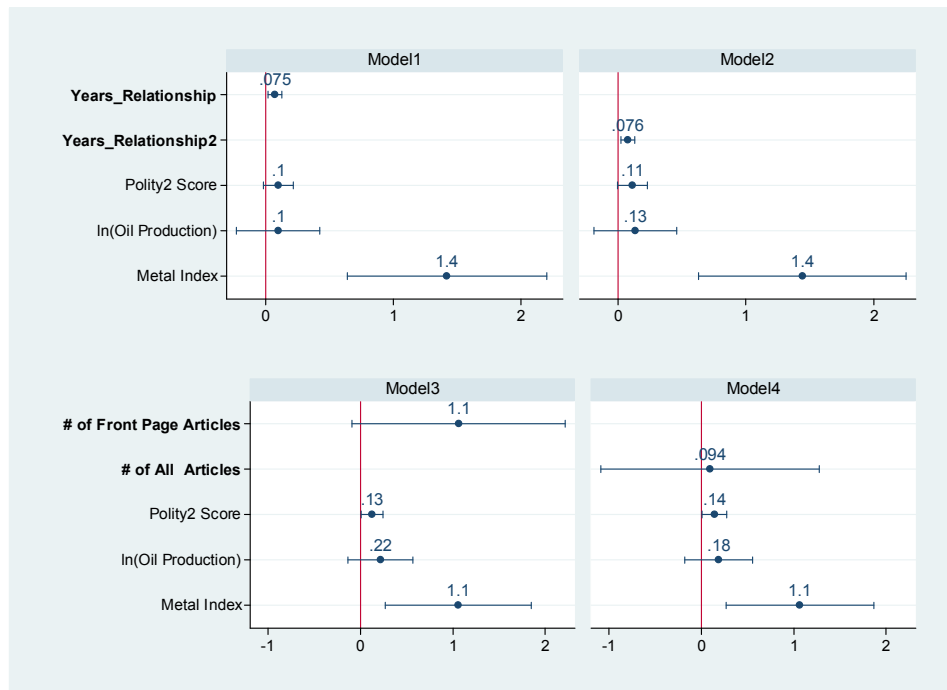
Figure 5: China's FDI and Political Ties

Notes: 95% confidence interval (calculated by heteroskedasticity-robust standard errors) is shown in the above figure. Economic variables are controlled but not reported.

As Model 3 illustrates, this new indicator is statistically significant at 10% level, which means that 1% change in the number of newspaper reports on the front page of *People's Daily* corresponds to 1.4 % change in China's outward FDI. However, if we use the number of articles on *all* the pages of *People's Daily* rather than the front pages as a proxy, this variable turns out to be insignificant, as Model 4 shows. Aside from the front page, *People's Daily* may cover some news that are irrelevant to the Sino-African relations, including domestic crises of African countries in the international pages, the African Cup of Nations soccer competition in the sports pages and so forth. Thus, it is reasonable to focus on the number of front-page articles rather than the articles in all the pages of *People's Daily.*
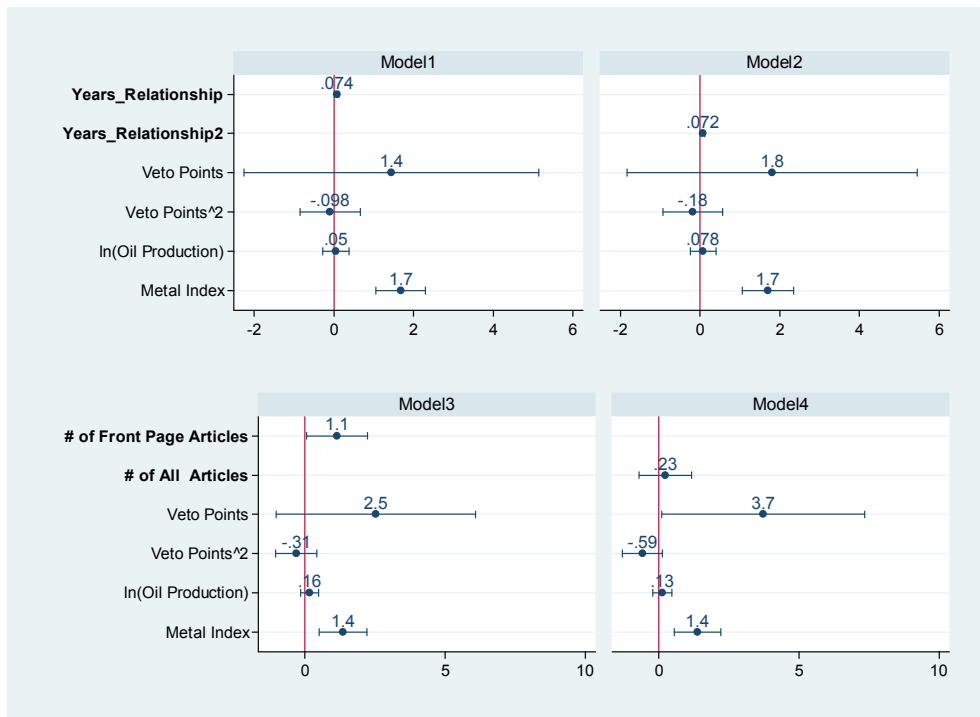
Figure 6: China's FDI and Political Ties (Robustness Check)

Notes: 95% confidence interval (calculated by heteroskedasticity-robust standard errors) is shown in the above figure. Economic variables are controlled but not reported.

In addition, to test the robustness of the above results, we include oil production, metal index and Polity2 Score as control variables in the model 1-4 of Figure6. To be sure, we find similar results. It is worth noting that Polity2 Score and metal index remain significant, while oil production is still insignificant. Additionally, we also include veto points and its squared term instead of Polity2 Score in the regression and find that the effect of veto players becomes statistically insignificant when taking into account the effect of political ties, as illustrated in Figure7. Overall, our empirical analysis supports Hypothesis 3 that African countries with close political ties to China are more likely to receive high levels of FDI from Chinese investors.
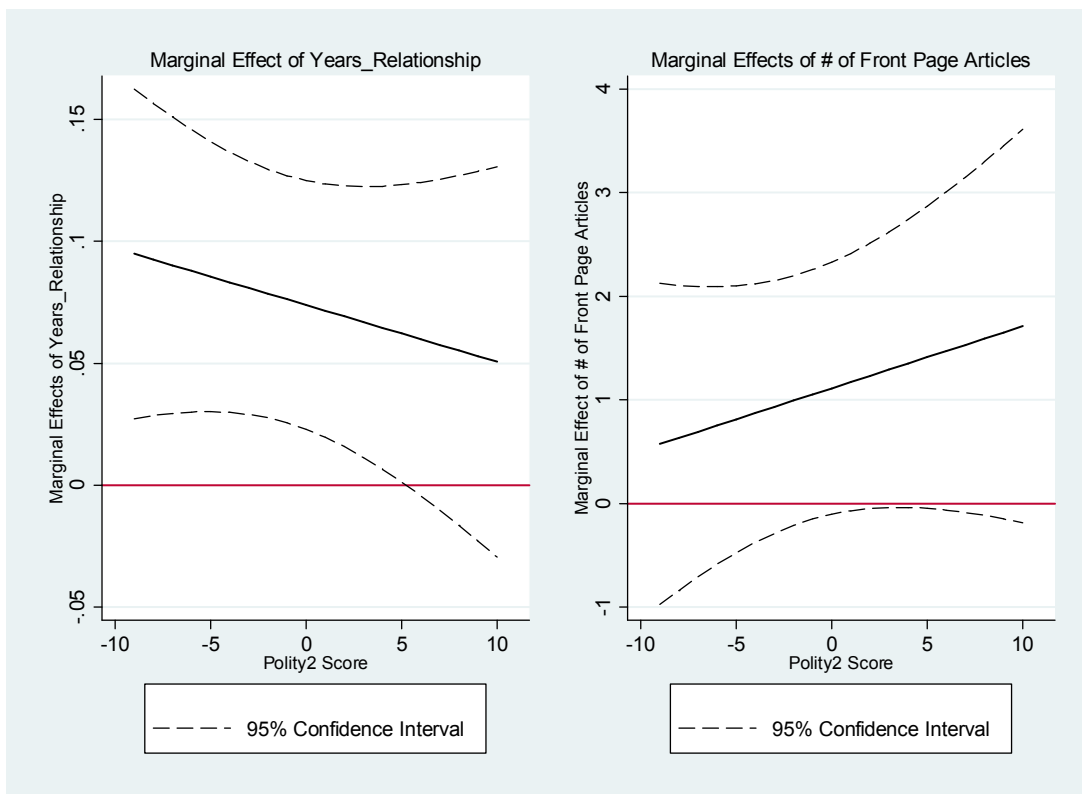
Figure 7: China's FDI and Political Ties (Robustness Check)

Notes: 95% confidence interval (calculated by heteroskedasticity-robust standard errors) is shown in the above figure. Economic variables are controlled but not reported.

Furthermore, we test if there is a substitutive relationship between political ties and strong institutions for protecting property rights. We include the interaction term of Polity 2 Score and two measures of political ties in the model and find some evidence that the effect of the time-span of diplomatic relations becomes smaller as the degree of democracy increases, even though the marginal effect of the other measure based on news reports on *People's Daily* is not significant, as Figure8 presents. When Polity2 Score reaches as high as 5 or above, the marginal effects of the time-span of diplomatic relations are indistinguishable from zero. This finding leads support to Hypothesis 4 and indicates that political ties serve as an alternative to strong formal institutions of protecting property rights.

Figure 8: The Marginal Effects of Political Ties on China's FDI

Discussion of the Mechanism

The above empirical analysis has shown that African countries with strong political ties to China tend to receive higher levels of China's FDI. There are two major mechanisms, I argue, that can link political ties to China's FDI.

From the Chinese side, close political ties to African countries facilitate information flows and enable Chinese investors to obtain relatively more information about host countries with the help of Chinese government, embassies as well as diasporas, thereby reducing potential risks surrounding investment. The major barrier for foreign investors is that they typically lack of general knowledge of market opportunities and potential risks in other countries. Information gap results in considerable transaction costs and less incentive to invest.

Chinese governments and embassies in African countries have played a pivotal role in bridging the information gap by distributing valuable information to Chinese investors. For instance, the department of West Asia and African Affairs of Ministry of Commerce (MOC) provides useful information concerning the local economic, political and legal environments in African countries to Chinese MNCs (Gill and Reilly 2007:42). As the local MOC representatives of in Africa, Economic and Commercial Counselor's Offices (ECCO) in Chinese embassies pay close attention to the local conditions of African countries and deliver information to Chinese companies (Institute of Developing Economies 2009:24). Chinese diasporas, who usually maintain personal connections with their families and friends in their home countries, also convey information about investments and trade opportunities to Chinese companies (Bräutigam 2003, Broadman 2007: 249). More importantly, Chinese embassies in African countries and local Chinese

businessmen interact frequently and offer information, legal counsel and other assistances Chinese investors (Michel and Beuret 2009: Ch2). Furthermore, the Chinese government has set up ten "investment and trade promotion" centers in Sub-Saharan African countries including China's old friends Tanzania and Zambia to offer business consultation services as well as simplified procedures to Chinese companies investing in Africa (Broadman 2007: 244). According to a survey, when Chinese investors made their original investment decision in Africa, the important sources about market opportunities in Africa came from central government, Chinese embassies in Africa, and also local Chinese business and community networks in both China and the African countries (Gu 2009).

From the African side, countries with strong political ties to China are more likely to provide preferential policies and selective protection of property rights to China. For example, seven China's special economic zones were constructed in African in six African countries including Egypt, Zambia, Nigeria, Ethiopia, Algeria, and Mauritius which generally maintain close diplomatic relations with China. These host governments typically provide incentive packages-including tax holidays, [7]waivers on import tariffs for raw materials and inputs, restrictions on strike activity and so forth-to Chinese investors (Bräutigam and Tang 2011). It is worth mentioning that the China-Egypt Suez Economic and Trade Cooperation Zone sheltered Chinese enterprises and ensured people's safety even during the recent political unrest (*People's Daily online* 2013). In fact, only one special zone is related to mineral mining, and the other six are mainly

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[7] For example, the special economic zone in Zambia offers the following incentives to the Chinese enterprises: (1) Zero percent tax rate on dividends for 5 years from year of first declaration of dividends. (2) Zero percent tax on profits for 5 years from the first year profits are made. For year 6 to 8 only 50 percent of profits are taxable and in years 9 and 10 only 75 percent of profits are taxable.

focusing on manufacturing, suggesting that China's economic engagement is not merely targeting on natural resources especially oil (Bräutigam and Tang 2011).
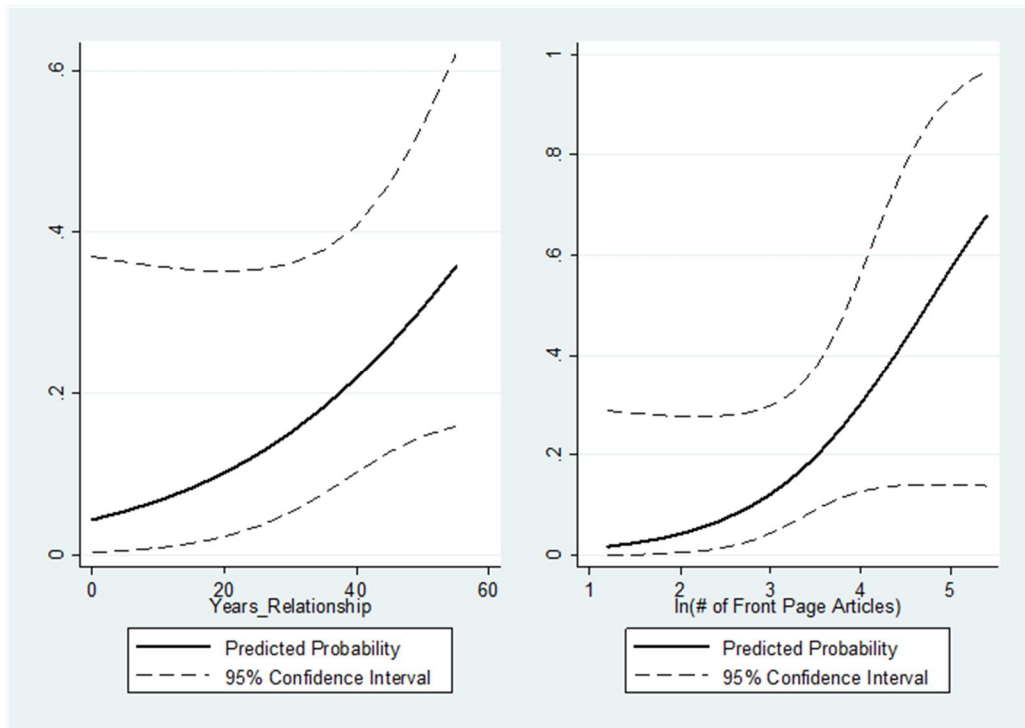
In addition to special economic zones, China had signed and ratified bilateral investment treaties (BITs) with 15 African countries by 2010. BITs may vary case by case but they typically offer substantive investment protections including fair and equitable treatment, national treatment standard, most favored nation standard, free transfer of funds relating to investment, and perhaps most importantly protection against expropriation. For instance, the clauses in almost all BITs between China and African countries stipulate that "investment and activities associated with investments of investors of either Contracting Party shall be accorded fair and equitable treatment and shall enjoy protection in the territory of the other Contracting Party" and these treatment and protection "shall not be less favorable than that accorded to investment and activities associated with such investments of investors of any third state". [8] The distinctive feature of BITs is the resolution of investment disputes that enables the investor bring a claim before the International Centre for Settlement of Investment Dispute (ICSID) or a tribunal established under the Arbitration Rules of the United Nations Commission on International Trade Law. While the consents to investor-state arbitration may differ in terms of the range of disputes they cover, [9]they at least provide a way of protecting the investment interests and reduce the potential risks substantially. One strand of burgeoning literature has shown that the number of BITs a country has signed is associated with higher level FDI inflows (e.g. Allee and Peinhardt 2011; Büthe and Milner 2009; Egger

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[8] The documents of BITs can be found at: http://www.unctadxi.org/templates/DocSearch.aspx?id=779

[9] Some BITs(like the BIT between China and Egypt) stipulate that only disputes concerning on the amount of compensation for expropriation can be submitted to an international arbitration tribunal, while others (like the BIT between China and Ethiopia) include all the disputes arising from investment.

and Pfaffermayr 2004; Haftel 2010; Neumayer and Spess 2005). We further argue that the likelihood of signing BITs between two countries can be predicted by their political ties. We specify a logit model to examine how political ties between China and African countries affects the likelihood of signing BITs and find that other things being equal, political ties to China can boost the probability of signing BITs with China. As Figure9 illustrates, for example, when the timespan of diplomatic relationship increases from 20 to 40 (years), the probability of signing BITs increases by approximately 10%.

Figure 9: The Expected Probability of Signing BITs with China

Concluding Remarks

As is clear from the quotes by Chinese President Xi Jinping at the beginning of this article, the trust between China and Africa is more valuable than gold. Our research shows that the trust between two sides is valuable because long-established political ties have brought Chinese "gold" to African continent.

Our study on China's FDI in Africa substantiates canonical theories that democratic institutions matter for attracting FDI inflows. More importantly, when democratic institutions are relatively weak, political ties constitute an important alternative to strong institutions of protecting property rights. The behavior of Chinese investors abroad is understandable when we take China's economic development experience in account (McNally 2012). After all, China has achieved impressive economic growth in the last three decades in the absence of strong formal institutions for protecting property rights. Informal business network and political connections to the state enable Chinese firms to overcome the weakness of formal property-rights protection institutions (e.g. Tsai 2002; Li, Meng, Qian, and Zhou 2008)

In this light, it is hard to believe that Chinese MNCs invest in some countries with weak institutions merely because they are risk-seeking. It is also overstated that the investment decisions of Chinese MNCs have bearing on fostering illiberal regimes or supporting "rogue states" in spite of potential political risks. The concern that China's rise in the international system may present "threat" to the liberal order is not supported by our findings. With respect to China's economic engagement in African and Sino-African relations broadly, a more nuanced analysis is needed instead of the good-bad dichotomy. As Wild and Mepham (2006:4) rightly notes, the question is less does Africa

gain or lose from China, "but rather, which Africans might gain or lose, in which countries or sectors, and in which circumstances".

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Figure 1: The Front Page of People's Daily

Notes: This is an example of the front page of People's Daily. On March 25,2013, the front page of People's Daily reports China's President Xi Jinping's visit in Tanzania. The left picture shows that China's President Xi Jinping and Tanzania's President Jakaya Kikwete were walking on the red carpet, while the right one shows that President Kikwete welcomed President Xi at the airport.

Appendix1: Sources and Definitions

Variable	Description	Source
Dependent Variable		
FDI inflows from China	the logarithm of the average FDI inflows from 2003 to 2010 in constant 2000 US$	Ministry of Commerce (2011)
Control Variables		
Market Size	the logarithm of the recipient country's population, average	World Development Indicator Dataset 2011
Economic Development Level	the logarithm of per capital GDP in constant 2000 US$, average	World Development Indicator Dataset 2011
GDP Growth	the percentage change in the country's real GDP from the previous year, average	World Development Indicator Dataset 2011
Natural Resource Endowment		
Oil production	the logarithm of Oil production in millions of barrels per day, average	BP(2011)
Oil reserves	the logarithm of Oil reserves in barrels, average	BP(2011)
Oil Dummy1	1 if oil is produced in a recipient country	BP(2011)
Oil Dummy2	1 if a country is a main oil producer	Papaioannoua and Siourounis (2008)
Fuel Exporter	1 if a country is a fuel exporter	Papaioannoua and Siourounis (2008)
Metal Index	A country's strategic metals (bauxite, copper, iron, manganese, uranium, and nickel) production as a percentage of world production (averaged across the six metals).	Kastner and Saunders(2012)
Natural Capital	the logarithm of Natural capital in constant 2000 US$, average	World Bank (2010)
Governance Indicators		
Democracy	1 if the regime qualifies as democratic, average	Cheibub et al. (2010)
Polity2 Score	Score ranging from -10 to 10 with higher values corresponding to high level of democracy, average	Marshall and Jaggers(2010)

Freedom House Score	The average value of political rights rating and civil liberties rating ranging from 1 to 7 with high values corresponding to low level of democracy, average	Freedom House(2012)
Veto Points	Score ranging from 1 to 6 (most cases) with higher values corresponding to more veto points, average	Keefer(2012)
Political stability	Index ranging from -2.5 to 2.5 with higher values corresponding to better governance, average	World Bank(2011)
Rule of Law	Index ranging from -2.5 to 2.5 with higher values corresponding to better governance, average	World Bank(2011)
Government effectiveness	Index ranging from -2.5 to 2.5 with higher values corresponding to better governance, average	World Bank(2011)
Regulatory quality	Index ranging from -2.5 to 2.5 with higher values corresponding to better governance, average	World Bank(2011)
Political Variables		
UNGA 0308,	UNGA voting alignment between China and an African country from 2003 to 2008, average	Gartzke(2010)
UNGA 9802	UNGA voting alignment between China and an African country from 1998 to 2002, average	Gartzke(2010)
UNGA 9002	UNGA voting alignment between China and an African country from 1990 to 2002, average	Gartzke(2010)
UNGA History	UNGA voting alignment between China and an African country in all historical periods, average	Gartzke(2010)
UNSC Membership	1 if a country was a member of UNSC during 2003-2010	Dreher et al.(2009)
Time Span of Diplomatic Relations	2010 minus the year of establishing diplomatic relations	Ministry of Foreign Affairs. (2011)
Time Span of Diplomatic Relations2	2010 minus the year of establishing diplomatic relations and the time span of suspending diplomatic relations	Ministry of Foreign Affairs. (2011)
ln(People's Daily News)1	the logarithm of the number of front-page articles of one country on People's Daily from 1990 to 2002	People's Daily online database 1946-2003

ln(People's Daily News)2	the logarithm of the number of articles of one country on People's Daily from 1990 to 2002	People's Daily online database 1946-2003

Appendix 2: Descriptive Statistics

Variable	OBS	Mean	Std. Dev.	Min	Max
Dependent Variable					
ln(Net FDI Inflows)	53	7.35	3.26	0.68	13.28
Control Variables					
ln(GDP Per Capita)	51	6.39	1.19	4.53	8.94
ln(Population)	51	8.94	1.53	4.46	11.89
Annual GDP Growth Rate	51	4.72	2.82	-4.50	12.67
Natural Resource Endowment					
ln(Oil Production)	53	2.09	2.20	1	7.74
ln(Oil Reserve)	53	1.12	0.65	-0.58	3.76
ln(Natral Capital)	46	23.79	1.78	18.74	27.35
Oil Dummy	53	0.21	0.41	0	1
Oil Dummy2	53	0.11	0.32	0	1
Metal Index	53	0.23	0.68	0	4.01
Fuel Exporter Dummy	53	0.09	0.30	0	1
Governance Indicators					

Democracy Dummy	53	0.32	0.46	0	1
Polity IV	51	1.47	5.25	-9	10
Freedom House Index	53	4.33	1.59	1	7
Political Stability	53	-0.49	0.93	-2.92	1.22
Rule of Law	53	-0.70	0.64	-2.42	0.93
Government Effectiveness	53	-0.76	0.59	-2.25	0.69
Regulatory Quality	53	-0.67	0.70	-2.45	1.61
Veto Points	51	2.31	0.91	1	4
Political Affinity					
UNGA 0308	53	0.87	0.06	0.65	0.95
UNGA 9802	53	0.83	0.05	0.69	0.94
UNGA 9002	53	0.84	0.05	0.70	0.91
UNGA History	53	0.85	0.04	0.68	0.91
UNSC Membership	53	0.25	0.43	0	1
Time Span of Diplomatic Relations	53	31.42	16.40	0	54
Time Span of Diplomatic Relations2	53	33.89	14.29	0	54
ln(People's Daily News)1	53	3.39	0.92	1.39	5.39
ln(People's Daily News)2	53	6.07	0.98	3.78	8.44