

# A Review of Research on the Impact of Financial Development on China's Outward Foreign Direct Investment

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**Abstract:** China's outward foreign direct investment continues to expand, and varying levels of financial development in host countries present differing degrees of risk to Chinese enterprises' overseas investments. This paper employs a literature review methodology to examine domestic and international approaches for measuring financial development indicators, revealing that no unified standard has been established for such measurements. It then analyzes the factors influencing China's foreign direct investment from the perspectives of host countries, home countries, and bilateral relations. Finally, it examines the impact mechanisms of financial development on China's foreign direct investment from both home country and host country viewpoints. Addressing shortcomings in existing literature, the paper offers corresponding research recommendations.

**Keywords:** Financial Development, Outward Investment, Influencing Factors.

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## 1. Introduction

Data from the Statistical Bulletin on China's Outward Direct Investment shows that China's outward direct investment flows increased from \$2.855 billion in 2003 to \$177.29 billion in 2023. In 2023, the figure grew by 8.7% compared to 2022, accounting for 11.4% of the global total and ranking third among all countries worldwide. China's outward investment continues to expand in scale, extend into new sectors, and diversify geographically. However, disparities in financial development among host countries have increased the costs and risks associated with China's outward direct investment to some extent, posing challenges for enterprises engaging in overseas investment. A well-developed host country financial system not only reduces information asymmetry and lowers the risks and costs associated with outbound foreign direct investment for enterprises but also enhances capital utilization efficiency. By facilitating capital aggregation and redistribution, it enables large-scale capital flows, thereby expanding financing channels for enterprises and reducing their financing costs. Therefore, the level of national financial development is a key factor influencing enterprises when conducting OFDI.

Currently, numerous scholars have conducted extensive research on the relationship between financial development and foreign direct investment. This paper employs a literature review methodology to organize, summarize, and analyze relevant studies. It examines domestic and international research across three key areas: financial development, factors influencing foreign direct investment, and the relationship between financial development and China's foreign direct investment. The analysis explores the impact mechanism through which a nation's financial development influences its foreign direct investment, aiming to provide theoretical and literature references for subsequent research.

## 2. The Development of Financial Development Theory and Its Measurement

### 2.1. A History of Financial Development Theory

For a long time, there has been theoretical disagreement within the academic community regarding the causal mechanisms linking finance and economic development. Since the late 1960s, Western scholars have made breakthrough progress in the field of research on the relationship between financial development and economic growth. Goldsmith established a framework for analyzing financial structures, systematically elaborating the concept of financial development for the first time. He asserted that "financial development is the transformation of financial structures" and introduced the concept of the "Financial Interrelations Ratio" to measure the level of financial development. This framework revealed the dynamic evolution patterns of financial structures during the process of economic financialization. This research marked the beginning of the creation of financial development theory and systematic studies on the relationship between financial development and economic growth<sup>[1]</sup>. Shaw, drawing on the theory of financial repression, argued that interest rate controls imposed by government intervention distort financial market pricing mechanisms. He advocated for interest rate liberalization reforms to enhance the efficiency of financial resource allocation<sup>[2]</sup>. McKinnon, from the perspective of financial deepening, demonstrated the inhibiting effect of excessive government regulation on financial structural transformation. He emphasized the crucial role of financial liberalization policies in promoting capital formation and balanced economic development<sup>[3]</sup>. Shaw and McKinnon expanded the meaning of financial development from an institutional perspective, arguing that financial development constitutes the process of financial deepening. Their theory marked the formal formation of financial development theory and exerted a profound influence on financial policy

formulation and institutional reform practices in developing countries.

## 2.2. Research Progress on Financial Development Theory and Measurement

Regarding the determination and measurement methods for the level of financial development, the academic community has yet to establish a unified standard. Early measurements of financial development primarily relied on single indicators. Such single-indicator approaches have inherent limitations, as they can only partially reflect the level of development in a specific area and struggle to comprehensively capture the complexities of the financial system. In *Financial Structure and Financial Development*, Goldsmith pioneered the use of the ratio of private sector credit to GDP as a measure of a country's financial development, laying the groundwork for subsequent research on financial development indicators. McKinnon and Shaw analyzed the economic development trajectories of developing countries and proposed using the ratio of broad money to gross domestic product as an indicator to measure financial deepening, reflecting the degree of monetization in a nation's economy. As research deepens, scholars have begun exploring the use of multiple indicators to measure the level of financial development, thereby addressing the limitations of relying on a single metric. King and Levine pioneered a dual-dimensional approach to measuring financial development from the perspective of financial system functionality. By employing private sector credit/GDP and current liabilities/GDP as dual dimensions, they opened new horizons in financial development research and broadened the range of indicators available for assessing financial development<sup>[4]</sup>. Beck and Levine proposed using the relative scale of equity financing versus bank financing as an indicator of financial size to measure the level of financial development<sup>[5]</sup>. Svirydzenka developed a financial development indicator system based on financial institutions and markets, innovatively constructing a composite metric encompassing pension fund assets, mutual fund assets, and private sector credit to provide a quantitative analytical framework for China's financialization process<sup>[6]</sup>.

At present, most scholars constructing national financial development indices predominantly adopt the standard methodology of the International Monetary Fund, measuring financial development through depth, scale, and efficiency. Yi Gang employed the ratio of China's total financial assets to gross national product to measure financial deepening, exploring the relationship between financial development and economic growth. Other scholars have also referenced Goldsmith's methodology, applying financial ratios to assess regional financial development by measuring the relationship between a specific region's total financial assets and its corresponding economic output<sup>[7]</sup>. As research continues to deepen, many scholars have adopted composite indicators to measure the level of financial development. Li Mei evaluates the level of financial development by considering both scale and efficiency. She measures the scale of development using the ratio of total credit extended by financial institutions to GDP, and assesses development efficiency through the proportion of total private sector credit to GDP<sup>[8]</sup>. Zhang Chengsi and Zhu Yueteng measure the level of financial development through financial scale, financial efficiency, and the degree of competition, applying this framework to research the relationship between China's degree of opening up and its financial development<sup>[9]</sup>. Jiang Guanhong and

Zhang Xinyue systematically measure the level of financial development across countries based on five dimensions: depth of financial development, efficiency, scale of the banking system, financial stability, and size of the securities market<sup>[10]</sup>. Xu Zhangyong constructed a financial development level measurement system based on five dimensions: financial scale, financial structure, financial efficiency, financial function, and financial stability<sup>[11]</sup>. Zhang Kuan and Huang Lingyun used the following indicators to measure the level of financial development: Year-end deposit and loan balances of regional banks as a percentage of GDP, representing financial scale; Year-end loan balances of regional banks as a percentage of GDP, representing financial depth; Year-end loan balances of regional financial institutions as a percentage of year-end deposit balances, representing financial efficiency<sup>[12]</sup>.

## 3. Factors Influencing China's Outward Direct Investment

Research by scholars both domestically and internationally has revealed that the home country, host country, and bilateral factors all exert varying degrees of influence on the scale, efficiency, and location choice of foreign direct investment.

Host countries primarily analyze the impact on China's outward foreign direct investment from various dimensions, including institutional environment, trade openness, resource endowment, investment facilitation, and market size. Regarding the institutional environment, scholars both domestically and internationally have yet to reach a consensus<sup>[13]</sup>. Some scholars argue that Chinese foreign direct investment tends to favor host countries with weaker institutional environments. A weaker institutional environment implies deficiencies in the host country's regulatory and legal frameworks, coupled with higher levels of government corruption. Driven by motivations such as accessing natural resources and reducing investment costs, enterprises often prefer to invest in host countries that offer abundant resources and lower labor costs despite their weaker institutional environments<sup>[14][15]</sup>. Another group of scholars believes that a favorable institutional environment in host countries promotes China's outward foreign direct investment<sup>[16]-[18]</sup>. The host country's robust institutional environment ensures that the investing country can conduct investments within a stable and fair market framework, thereby mitigating potential risks during the investment process and attracting foreign investment into the host nation. Regarding resource endowments, Song Weijia and Xu Hongwei<sup>[19]</sup>, Wang Yongqin<sup>[20]</sup>, and others empirically verified through econometric modeling that the abundance of host country resources exerts a significant positive influence on China's outward foreign direct investment. Moreover, this effect exhibits heterogeneity across developing and developed nations. In terms of market size, Duan Xiufang's research found that factors such as the market scale and infrastructure levels of RCEP member countries have played a promotional role in Chinese enterprises' outward direct investment<sup>[21]</sup>. Research findings generally indicate that the more developed the host country's institutional quality and financial sector, the greater its ability to attract direct investment from China.

At the same time, factors such as the host country's level of economic development, currency internationalization, exchange rates, and institutional policies also influence

enterprises' decisions regarding foreign direct investment. Di Yuna and You Linqing selected China's GDP at constant 2010 prices as an indicator of China's economic development level to analyze the primary factors influencing China's investment location choices. Their research found that a 1% increase in China's economic growth leads to a 2.79% increase in the scale of investment in host countries. In contrast, a 1% increase in host country economic growth results in only a 0.22% increase in investment scale. This indicates that China's economic growth exerts a greater influence on China's outward foreign direct investment than host country economic growth does<sup>[22]</sup>. Fu Shaojun pointed out that the internationalization of the renminbi promotes China's outward foreign direct investment through three channels: reducing exchange rate risks in cross-border investments, broadening financing channels, and advancing domestic financial reforms<sup>[23]</sup>. Chen et al. constructed a game model and found that appreciation of the home country's currency leads to a relative increase in labor costs domestically, prompting the home country to shift production activities abroad and thereby promoting foreign direct investment<sup>[24]</sup>. However, Liu, Chen, and Wu analyzed foreign direct investment data from 92 countries and reached the opposite conclusion. Their research revealed that RMB appreciation increases the risks associated with foreign direct investment, thereby suppressing China's outward foreign direct investment<sup>[25]</sup>. Chen Yinmo et al. point out that increased uncertainty in home country tax policies can suppress corporate foreign direct investment, with the dampening effect being particularly pronounced for small-scale and newly established enterprises<sup>[26]</sup>.

Beyond host country and home country factors, scholars both domestically and internationally have also examined the impact of bilateral political relations, institutional distance, cultural distance, and geographic distance on foreign direct investment. Generally speaking, bilateral geographical, institutional, and cultural distances tend to be negatively correlated with the scale of foreign direct investment. That is, home countries are more inclined to invest in nations that share similar institutional, cultural, and geographical characteristics. However, Wang, Hongshu et al. found that the promotion of bilateral political relations can mitigate the negative effects of institutional, cultural, and geographical distance on foreign direct investment. This effect is particularly pronounced in host countries with high humanistic indices<sup>[27]</sup>. Sound bilateral political relations can provide a solid political foundation for the expansion of Chinese enterprises' outward direct investment scale and diversification of investment types, thereby boosting their enthusiasm for outward direct investment and enhancing investment success rates<sup>[28]</sup>.

## **4. The Impact of Financial Development on China's Outward Foreign Direct Investment**

### **4.1. The Impact of Home Country Financial Development on Outward Foreign Direct Investment**

Dunning's International Production Compromise Theory posits that the scale and pattern of a firm's foreign investment are primarily determined by three types of advantages: ownership advantages, location advantages, and

internalization advantages. Unlike the emphasis on internalization advantages inherent to the firm or industry itself and location advantages tied to host country conditions, ownership advantages place greater emphasis on the influence of the home country environment<sup>[29]</sup>. The impact of home country financial development on China's foreign direct investment can be categorized into two aspects: direct effects and indirect effects.

#### **4.1.1. Direct Impact**

The direct impact of home country financial development on China's outward foreign direct investment manifests primarily in three aspects: alleviating financing constraints, enhancing financing efficiency, and reducing investment risks<sup>[30]</sup>.

First, unlike traditional exports, foreign direct investment requires establishing overseas branches or executing cross-border acquisitions. Such projects are characterized by substantial upfront capital requirements, extended investment cycles, and slow return on investment. In recent years, China has enhanced the scale and efficiency of its capital markets through measures like deepening financial reforms. However, the country's financial landscape remains predominantly bank-centric<sup>[31]</sup>. Securing funds from banks not only involves cumbersome and stringent lending requirements, but the financing terms are also relatively short-term. Moreover, banks tend to favor investments in large enterprises such as state-owned companies, making it significantly more challenging for private enterprises and other businesses to obtain bank financing. This creates difficulties in corporate financing, thereby increasing the complexity of enterprises expanding overseas. The difficulties enterprises face in securing financing reflect the inadequacies of financial institutions and the insufficient level of financial development. Therefore, enhancing the financial development level of the home country can alleviate financing constraints by providing multiple financing channels, thereby promoting enterprises' outward foreign direct investment. Chinese banks establishing overseas branches can alleviate financing constraints<sup>[32]</sup>, influence export trade and market size thereby promoting China's foreign direct investment<sup>[33][34]</sup>, and this impact varies across countries or regions at different levels of development. Second, as the level of financial development increases, it also enhances financial efficiency and reduces investment risks. On one hand, by improving the savings conversion rate and optimizing capital allocation, it provides enterprises with greater access to funds, thereby promoting their outward direct investment. On the other hand, the advancement of financial development also enhances financial institutions' capabilities in acquiring and processing information. This helps alleviate issues arising from information asymmetry in outward direct investment, such as inadequate credit supply and distorted credit allocation, thereby further facilitating enterprises' outward direct investment<sup>[35]</sup>.

#### **4.1.2. Indirect impact**

In terms of technological innovation, robust financial markets can provide timely funding for corporate R&D. When a country develops a new technology, it will increase its foreign direct investment to seize market opportunities promptly. The application of new technologies in overseas subsidiaries not only expands corporate scale and reduces production costs but also brings technological innovation to host countries. However, corporate R&D for technological innovation requires substantial financial backing. In such

cases, the parent country's advanced financial development enables enterprises to secure necessary funds through direct and indirect financing channels for technological R&D investments. Crucially, innovation projects typically carry high risks, and enterprises can leverage their home country's financial markets to distribute these risks among a broader investor base<sup>[30]</sup>. Additionally, the well-developed financial markets and sound financial systems in the home country mitigate overseas investment risks by providing overseas investment insurance services and investment information consulting services. This enhances risk resilience and expands the scale of investors' foreign direct investment<sup>[36]</sup>.

## **4.2. The Impact of Host Country Financial Development on Outward Foreign Direct Investment**

Research findings on the relationship between host country financial development and the impact of outward foreign direct investment are substantial. Studies reveal that host country financial development exerts a positive and promoting effect on OFDI<sup>[37]-[39]</sup>. Furthermore, host country financial development enhances the efficiency and scale of OFDI through three channels: alleviating corporate financing constraints, improving resource allocation efficiency, and reducing business operational risks<sup>[40]</sup>.

### **4.2.1. Relieve financing constraints on enterprises**

The host country's advanced financial development implies a robust financial system and abundant financial resources. A sound financial system facilitates cross-regional capital flows, expands the pool of available credit to meet overseas financing needs of investment enterprises, and alleviates financing constraints faced by companies in foreign investment. Abundant financial resources broaden financing channels for enterprises, thereby enhancing the scale and efficiency of their outward investment<sup>[41]</sup>. Therefore, a well-functioning financial market in the host country can alleviate corporate financing constraints.

### **4.2.2. Enhance the efficiency of resource allocation**

The host country's financial development can channel capital toward high-yield investment projects through robust capital markets, thereby driving industrial upgrading. A well-developed financial market can reflect diverse information about invested enterprises through price mechanisms, enhancing corporate transparency. It also mirrors the host country's macroeconomic trends, thereby guiding capital allocation. Furthermore, financial institutions conduct comprehensive analysis and evaluation of investment projects, selecting those with high investment value and directing capital toward ventures with promising returns. This indirectly enhances the efficiency of foreign direct investment<sup>[42]</sup>. Therefore, sound financial development in host countries can enhance the efficiency and scale of China's outward foreign direct investment by improving resource allocation efficiency.

### **4.2.3. Reduce business operational risks**

Due to geographical, cultural, and institutional factors, China faces information asymmetry issues with host country governments and markets during its outward investment process, which increases investment risks. Well-developed financial systems in host countries provide robust financial markets and diverse financial service intermediaries. Investment enterprises can utilize various financial instruments to diversify and mitigate investment risks,

thereby reducing risks during the investment process and enhancing investment efficiency in host countries<sup>[43]</sup>. Therefore, sound financial development in host countries can enhance the efficiency of China's outward foreign direct investment by reducing business operational risks.

## **4.3. The Impact of Financial Synergy Between Home and Host Countries on Outward Foreign Direct Investment**

Currently, there is limited literature examining the impact of bilateral financial cooperation on China's outward foreign direct investment. However, Yu Cheng and Huang Qifan found through analyzing the number of new international syndicated loan connections established between countries from 1990 to 2014 that establishing bilateral banking connections helps enterprises reduce information friction costs and alleviate financing constraints, significantly promoting the scale of China's direct investment in host countries.<sup>[44]</sup> Moreover, the trade-investment complementarity effect generated by bilateral banking ties indirectly promotes China's outbound foreign direct investment.

## **5. Literature Review and Outlook**

Currently, research on the impact of financial development on China's outward foreign direct investment is already quite extensive. However, studies examining the influence of financial development on China's outward FDI still require further in-depth investigation. First, existing literature has relatively insufficient consideration of financial environment factors. Specifically, financial innovation indices and digital finance development indicators have not yet been incorporated into analytical frameworks. Furthermore, no unified standards have been established for selecting financial development level indicators. Different scholars employ varying criteria for selecting these indicators, leading to conclusions with varying degrees of bias. Second, most studies rely on static panel models, failing to effectively distinguish between the short-term marginal effects and long-term dynamic impacts of financial development. Finally, systematic research on the mechanism through which financial development levels influence China's outward foreign direct investment remains insufficient, particularly lacking empirical support for the synergistic development effects between the financial systems of the home country and host country.

Therefore, future research on financial development and China's outward foreign direct investment will focus on the following issues: First, further exploration is needed on how to scientifically construct an evaluation index system for regional financial development levels. Existing literature primarily uses national-level financial development indicators as the basis for evaluation systems. However, assessments of financial development differ between the national and regional levels, necessitating distinct evaluation frameworks. Additionally, evaluation indicators involve multiple dimensions. Further exploration is needed on how to determine the weighting ratios among different dimensions and indicators, as well as how to scientifically establish control variables and moderating variables. Second, actively explore the impact of the short-term marginal effects and long-term dynamic influences of financial development on China's foreign direct investment. While improved financial

development levels can increase accessible capital for enterprises in the short term, whether the long-term effects on enterprises' foreign direct investment align with the short-term effects requires further research. Third, in today's complex and volatile international trade environment, in-depth analysis is needed on how the financial development level of the home country and bilateral financial coordination influence China's foreign direct investment.

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