Manufacturing Outward Foreign Direct Investment and Regional Value Chains Construction under the Belt and Road Initiative

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Abstract: In the context of economic deglobalization and the reconstruction of global value chains, the survival and development of the manufacturing industry has encountered multiple difficulties. This paper will discuss how Chinese private enterprises in the manufacturing industry can build regional value chains by effectively investing in countries along the "Belt and Road" through OFDI, and complete their own transformation and development as well as enhance their value chain positions through the construction of regional value chains.

Keywords: The Belt and Road, Regional Value Chains, Outward Foreign Direct Investment, Private Enterprises.

1. Introduction

Outward Foreign Direct Investment (OFDI) by Chinese enterprises is not only a way to circumvent trade barriers, open up new markets and acquire advanced technology, but also an important way to enhance China's position in the value chains. With the continuous enhancement of China's international competitiveness and the construction of the Belt and Road Initiative, OFDI by Chinese enterprises has maintained a rapid growth momentum. However, in recent years, due to the investment restrictions and suppression by developed countries, the wave of deglobalization and the reconstruction of global value chains, the total amount of Chinese OFDI, the structure of investment industries and the location of investment have all changed. Local private enterprises are one of the key players in China's OFDI. In 2020, the OFDI of local enterprises reached US$80.75 billion which is a 16.4% year-on-year growth and accounts for 73.3% of total OFDI in the same period. Now a major dilemma of local private enterprises is that they are facing the double pressure of "returning the high-end" to developed countries and "diverting the middle and low-end" to developing countries in the global value chains dominated by developed countries. The survival and development of private enterprises has encountered multiple difficulties. This paper will discuss in the context of the Belt and Road Initiative how private enterprises can build regional value chains through OFDI, and complete their own transformation and development as well as enhance their value chain status through the construction of regional value chains.

2. Literature Review

2.1. FDI

According to the International Monetary Fund's definition, foreign direct investment (FDI) is an investment in a foreign company with the objective to acquire a 'lasting interest' in the foreign country, and the investment involve a long-term relationship and significant control of the company [1]. FDI includes mergers and acquisitions of an existing company in a foreign country and greenfield direct investment [2]. There are various theories to explain FDI activities. According to Stephen Hymer's monopolistic advantage theory, to participant in FDI, multinational firms should have firm-specific advantages in manufacturing, products, brands, technology, finance and distribution networks which are not possessed by local firms, to overcome extra costs and disadvantages in unfamiliar environment [3]. Vernon (1966) introduced the product life cycle (PLC) theory which argues that a new product is initially introduced in the developed countries to service the local market and then export abroad; finally the production would be relocated abroad at low-cost location and exported back into the developed countries [4]. This theory considers FDI as a stage of product life cycle, in product's late growth phase and mature phase, firms will undertake FDI [5]. With the presence of market imperfection in the external market, internalization theory suggests making a market inside firm to internalize production [6]. Dunning's OLI paradigm is an analytical framework of FDI's determinants including ownership-specific advantages (O), location-specific advantages (L) and internalization advantages (I) [7]. O includes natural endowments, technology, marketing networks, managerial skills and firm's experience from geographically dispersed cross-border activities. L is countries' locational attractions including country's immobile, natural or created endowments, as well as legal and political environment. I is advantages from conducting production within internal hierarchies rather than external arm's length markets which cause transaction and coordination costs.

2.2. Global Value Chains，GVC

Porter refers to a series of value-creating activities such as design, production, sales and after-sales service as a value chain. According to Gerefii's global value chain, in the context of economic globalization, the various production activities in the value chain are completed across national borders, with one or more enterprises participating in the division of production and cooperating in the entire production process to achieve value creation. The UN World Investment Bulletin points that OFDI by enterprises can increase the participation of home countries in global value chains and the value added of production. Through OFDI, enterprises of developing countries can effectively adjust their industrial structure and enhance their position in global value chains. Capital- and technology-intensive enterprises can improve their technological capabilities and shift to higher value-added segments such as R&D and design through the reverse technology spillover effect of OFDI. Labor-intensive enterprises, on the other hand, achieve value chain appreciation through the marginal industrial transfer effect of OFDI.

2.3. Regional Value Chains，RVC

Regarding regional value chains, Wei and Wang (2016) defined it as a regional cross-enterprise network organization in which emerging countries and regions with strong industrial complementarity and geographic proximity aim at industrial upgrading, and link raw material inputs, production, sales, and after-sales services to create and realize the value of goods or services [8]. It is found that the value chains of global products is mainly composed of the four "giants", namely the China, United States, Germany and Japan, other countries around these four countries are actively embedded in the production networks of the value chains where these four "giants" are located. In terms of leading regional value chains, many researchers argued that China has the advantage to lead the Belt and Road regional value chains. Wei and Wang (2016) analyzed the industrial competition and complementarity between China and the countries along the Belt and Road and suggested that the complementarity is strong, while the competition is weak[8]. The existence of industrial complementarities and the mastery of core competencies make Chinese enterprises capable of leading the Belt and Road regional value chains.

3. Reasons for Building Regional Value Chains along the Belt and Road

3.1. Investment Prospects

Since 2000, when China proposed its "Going Out" strategy, China's OFDI has grown rapidly. With the introduction of the Belt and Road Initiative in 2013, China has entered the implementation stage of comprehensively promoting the construction of the Belt and Road. In 2021, China's OFDI in countries along the Belt and Road reached a record high of US$24.15 billion, with a year-end stock of US$213.84 billion. The Belt and Road Initiative straddles three continents which are Europe, Asia and Africa, and there are huge investment opportunities in these countries, which provides a broad investment prospect for Chinese OFDI.

In addition, the countries along the Belt and Road have enormous market potential. With large market size, firms can achieve economies of scale, whereby the average total cost lowers as the quantity of output increases, thus achieving their corporate goals of profit maximization [9]. The market along the Belt and Road is characterized by its under development and great potential. Under development refers to the limited domestic supply and lack of competition, thus facilitating the entry of foreign investors into the market with low cost and quick recovery of initial investment. Great potential signifies that the rapid economic development, together with rising purchasing power is liable to stimulate the increasing demand, hence providing more business opportunities and bolstering Chinese enterprises’ confidence to invest in the countries along the Belt and Road. Foremost, the countries along the Belt and Road, which account for more than 60% of the world’s population and about 30% of the global economy, definitely appeal to foreign investors, as the huge population and GDP mean the large potential market demand and consumption.

Labor cost is one of the factors to attract foreign investors in some countries along the Belt and Road. Labor cost measured by wage is generally believed to have a negative correlation with FDI. Researches show that foreign investors tend to invest in low wage countries, because they can achieve cost competiveness and profit maximization with low labor cost. The study about the labor costs of countries along the Belt and Road concludes that labor costs are high in developed economies such as Singapore, Israel and Bahrain, and low in less developed economies such as Indonesia, Pakistan and Tajikistan [10]. China, as a developing emerging economy, has a medium to high labor cost position [10]. Therefore, these less developed countries have attractiveness for Chinese firms engaging in labor-intensive activities or firms with export-oriented objectives.

Furthermore, preferential policies have a positive effect on FDI. As of July 2022, China has signed more than 200 cooperation documents with more than 140 countries and 30 international organizations to build the Belt and Road. For instance, in the area of financial support, from 2015 to 2020, Bank of China followed up more than 600 major overseas projects along the Belt and Road and provided credit support of more than USD 185.1 billion to countries and regions along the Belt and Road.

3.2. Background of Value Chains Reconstruction

Since the global financial crisis in 2008, trade protectionism has been on the rise, and many countries have promoted trade protectionism and unilateralism in order to take the lead in the global value chains. The global COVID-19 epidemic in recent years has led to the most serious global economic recession since World War II, and has also brought a huge impact on the global value chain as well, various activities of value chain such as manufacturing, product distribution, services and researches have affected to varying degrees. Many Chinese local private enterprises are only embedded in the global value chains dominated by developed countries, but do not really occupy the core sectors of global value chains. With the rising labor costs and the approaching risk of "low end lock" in the global value chains, it is necessary for private enterprises to build their own dominant value chains.

3.3. Potential for Regional Value Chain Construction

Gereffi (1999) suggests that if a country wants to dominate a value chain, it must have a core competence in that industry, or at least a core ability in a particular production activity [11]. Compared to the countries along the Belt and Road, China has greater international competitiveness in the textile, footwear, and machinery and equipment manufacturing industries. Meanwhile, the industrial systems and resources of countries along the Belt and Road have a good basis for cooperation, as well as the complementary advantages of resource endowments [12]. Furthermore, the countries along the Belt and Road also have location advantages in terms of market demand, labor costs and geographic location which are very beneficial to Chinese enterprises in building the regional value chains.

4. Construction of Regional Value Chains

This section will choose the examples of the electrical, garment, footwear and auto parts industries which are representative of Wenzhou's manufacturing industry and analyze how Wenzhou enterprises in these industries can build regional innovative technology-based value chains, labor efficiency-seeking value chains and market resource utilization value chains through OFDI to countries along the Belt and Road.

4.1. Innovative Technology-Based Value Chains

In the past decades, enterprises from developing countries usually acquire existing companies in developed countries to access technology and market. Through acquiring, outward investment from developing countries can solve problems of latecomer disadvantages and technological changes. For specifically, firstly, when private enterprises invest in developed countries, they embed themselves in specific high value-added industrial segments in the host country through R&D cooperation with host country enterprises to improve their own R&D level through imitation, absorption and innovation, meanwhile they can acquire various production factors such as talents, patents, brands and management systems in the host country [13]. After obtaining technology spillover, private enterprises apply technological innovation to relevant industries in their home countries, promote technological upgrading and improve the production. Finally the overall level of the industry will be promoted and the global value chain status of enterprises in their home countries will be improved. Therefore, through reverse technology spillover, the acquisition of advanced technology in overseas operations by Chinese enterprises drives the advancement of domestic production technology, and further promotes the optimization of industrial structure and enhances China's position in the global value chain of certain industries.

After acquiring advanced strategic assets and moving into the higher value-added sectors of value chains, the parent company can build a new regional value chain which can be named as ‘an innovative technology-based value chain’. Based on its own strengths, the parent company can carry out OFDI in countries along the Belt and Road to transfer production, services and sales to the investment host country, while the domestic parent company focuses on technological innovation and product development. This part will take CHINT, a representative of Wenzhou's electrical industry, as an example. CHINT is one of the world's leading intelligent energy solutions provider for the whole industrial chain. Over two decades of global expansion, CHINT’s business network covers more than 140 countries worldwide in areas of low-voltage, power transmission and distribution, water, gas and electricity metering, green energy like solar and more. In the early years of overseas investments, through equity participations, mergers and acquisitions in Europe and the establishment of several global R&D centers, CHINT acquired advanced technology, manufacturing experience and management methods. Then, through reverse technology spillover, CHINT drives the advancement of its domestic production technology and promotes the optimization of industrial structure. After enhancing its position in the global value chain of the electrical industry, CHINT uses the advanced technologies it has acquired and accumulated to carry out OFDI in countries along the Belt and Road, such as establishing industrial manufacturing bases, constructing ground-mounted photovoltaic power stations and power transmission and transformation projects etc. to build innovative technology-based value chains. The profits from production and operation activities in overseas markets flow back to CHINT’s parent company, which can be further used in research and development to improve the technology level. In addition to building a full industrial chain in the field of new energy and power equipment manufacturing, CHINT has also actively promoted its "one cloud, two networks" strategic layout, including Big Data Cloud, Industrial Internet of Things and Energy Internet of Things, so as to deeply integrate big data and artificial intelligence with the manufacturing industry and consolidate its position in the regional value chains.

4.2. Labor Efficiency-Seeking Value Chains

Efficiency-seeking FDI focuses on labor cost, environmental resources and assets which are productivity relevant, to achieve cost advantages, economies of scale and scope. Country differences in natural or created factor endowments and labor cost motivate companies of high-wage countries to conduct export oriented manufacturing in low-wage countries. The importance of labor cost is magnified, particularly for firms engaging in labor-intensive activities or firms with export-oriented objectives.

For the Wenzhou manufacturing industry, after the labor dividend has passed, a large number of low-end processing manufacturing industries and marginal industries with backward production capacity are gradually losing their comparative advantage in the country. The structural transformation of economy and the rising wage levels will make labor-intensive manufacturing industries moving to counties with labor cost advantage. The garment and footwear industries are traditional industries representative of Wenzhou's private economy. The garment and footwear industries have high dependence on labor, however the demographic dividend disappears and the cost of labor in China continues to rise. With industrial restructuring and economic transformation, these low-tech and labor-intensive industries are at a position with competitive disadvantage. While, most of the countries along the Belt and Road are developing countries with relatively underdeveloped economies, where labor is plentiful and the overall level of manufacturing wages is lower than that in China, such as Indonesia, Thailand, Vietnam, Cambodia, the Philippines and other Southeast Asian countries, as well as African countries. Therefore, enterprises in the garment and footwear industries can build labor efficiency-seeking regional value chains in above-mentioned countries. Through increasing industrial investment in such countries, private enterprises can make use of the labor factor endowments of the relevant countries along the Belt and Road, transfer the production activities of garment and footwear to the host countries, achieve the orderly transfer of low value-added manufacturing industries. Furthermore, by transferring certain production activities to other centuries, garment and footwear manufactures can release the production factors they occupy at home, so that their domestic parent company can focus on product design, technological innovations, branding and marketing.

4.3. Market-Based Resource Utilization Value Chains

Market-seeking FDI establishes overseas subsidiaries to protect or expand a foreign market. In recent decades, many emerging markets in developing countries with sufficient and potential consumer purchasing power attract oversea investment. Additionally, adapting and customizing products to local special tastes and demand also is a motivation of market-seeking FDI. This part will take the Wenzhou auto parts industry as an example and analyze how enterprises can use the market location advantages of countries along the Belt and Road to build the market-based resource utilization value chains by using market resources through OFDI. The impact of global COVID-19 epidemic on overseas vehicle market has weakened from the second half of 2020, the demand of automobiles in Europe and America is gradually recovering. With the low inventory of overseas automobiles and rebounding demand, the export of a number of Chinese component companies has achieved accelerated growth. On the other hand, in the long run, the growth rate of global new car sales may slow down in the future, the demand for auto parts OEM (Original Equipment Manufacturer) may slow down, but with the growth of global car ownership and the increase in the age of cars, the demand for auto components brought by car repair and maintenance will maintain a good growth trend. As suppliers of automotive driveline components that supports one-stop purchasing needs, Wenzhou automotive parts industry manufacturers produce constant velocity joints, drive shafts, hub assemblies, rubber-to-metal parts as well as steering and suspension parts for the worldwide aftermarket. In oversea production, Wenzhou automotive parts manufacturers can directly choose host countries whose existing or potential market is large. Most of the countries along the Belt and Road are developing countries with huge market consumption potential. Depending on their own product range and the relevant market demand in the host countries, automotive parts enterprises can establish production bases in the host country through OFDI to get closer to the host market and bring native products to each local market. On the other hand, the current international trade environment is becoming increasingly complex, the trade frictions occurs constantly between countries, and the United States and many European countries restricting the export of goods to their countries through various policies such as tariffs and non-tariff trade barriers. In order to maintain the existing market share of auto parts in Europe and the United States, Wenzhou auto parts enterprises can conduct OFDI in countries with relevant trade facilitation policies and use these host countries' trade facilitation policies overcome policy barriers. In order to build the market-based resource utilization value chains, Wenzhou automotive parts enterprises can choose some countries along the Belt and Road with lower production costs, closer to the final consumption markets in Europe and the United States, and which have signed the International Trade Reciprocity Agreement with the United States and the European Union to conduct OFDI. For instance, enterprises can choose to set up production bases in Africa and the Middle East, which have signed International Trade Reciprocity Agreements with the United States and the European Union. In this value chain, Wenzhou auto parts enterprises not only facilitate access to the European and American markets, but also reduce production costs and effectively expand into high value-added sales sector of value chain.

5. Conclusion

Along with the global economic recession and the wave of economic deglobalization initiated by some developed countries, the global value chains have accelerated their restructuring. In order to better participate in the division of labor in the value chains and change the situation from "low-end lock-in" to "high-value-added end", the manufacturing industry can build and dominate regional value chains through OFDI in countries along the Belt and Road. This paper analyzed Wenzhou's representative electrical, garment and footwear, and automotive parts and equipment industries as examples. Combining the background of value chain restructuring and the potential of regional production division of labor reorganization in countries along the Belt and Road, this paper found that manufacturing enterprises with advanced strategic assets and relative competitive advantages can build innovative and technology-based value chains through OFDI, the enterprises in labor-factor-intensive manufacturing industries can build labor efficiency-seeking value chains through OFDI, and the market-seeking enterprises can build market-based resource utilization-oriented value chains through OFDI. After forming regional value chains with countries along the Belt and Road, the position of China's manufacturing industry in the value chains will tend to be more towards the middle and high end of the value chains, and the overall level of manufacturing industry will be improved.

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