

# Study of the Construction of Regional Value Chains by Private Enterprises through Outward Foreign Direct Investment

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**Abstract:** In the context of economic structural transformation and global value chains reshaping, the space for survival and development of private enterprises has encountered multiple difficulties. Taking the countries along the Belt and Road and RCEP member countries as examples, this paper will study how Wenzhou private enterprises can build regional value chains through outward foreign direct investment (OFDI) activities according to the characteristics of the host countries, and complete their own transformation and development as well as enhance their value chains status through the construction of regional value chains, so as to provide suggestions for the development of private enterprises.

**Keywords:** Regional Value Chains, Outward Foreign Direct Investment, Private Enterprises.

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## 1. Background

Outward Foreign Direct Investment (OFDI) by Chinese enterprises is not only a way to develop new markets, bypass trade barriers and acquire advanced technologies, but also an important way to enhance the status of Chinese enterprises value chains. In 2021, China's OFDI flow was US\$178.82 billion, up 16.3% from the previous year, ranking among the top three globally for the tenth consecutive year. At the end of 2021, China's OFDI stock was US\$2.79 trillion, ranking among the top three globally for the fifth consecutive year. In the outward foreign direct investment activities of Chinese enterprises, local enterprises are active, with US\$87.73 billion which is 57.7%, of outbound non-financial investment by local enterprises in 2021. By the end of 2021, China had set up more than 11,000 enterprises in countries along the Belt and Road, accounting for about 1/4 of China's total overseas enterprises. In November 2020, 15 countries, including China, ten ASEAN countries, Japan, South Korea, Australia and New Zealand, officially signed the Regional Comprehensive Economic Partnership (RCEP). The signing of RCEP marked the official establishment of the world's most populous and largest free trade area in terms of economic and trade scale. In recent years, the Belt and Road Initiative has promoted the connections between countries in policy communication, infrastructure interconnection, trade and investment, cross-border capital flows and humanities and science and technology exchanges. In the future, the Belt and Road Initiative and RCEP will promote each other and develop together, which provides enterprises with broad overseas investment prospects.

However, in recent years, due to the investment restrictions and suppression by developed countries in Europe and the United States, the rise of the wave of deglobalization and reconstruction of global value chains, Chinese private enterprises are now facing a serious dilemma of "returning the high-end" to developed countries and "diverting the middle and low-end" to developing countries in the global value chains which are dominated by developed countries. This paper will focus on how Chinese private enterprises can build regional value chains through OFDI in countries along the

Belt and Road and RCEP member countries, and complete their own transformation and development through the construction of regional value chains, as well as enhance the status of the value chains and move towards the two ends of the value chain with high added value.

## 2. Literature Review

### 2.1. Foreign Direct Investment

According to the IMF's definition, foreign direct investment (FDI) is an overseas investment of a company in the foreign country which involves a long-term relationship [1]. There are two forms of FDI, which are mergers and acquisitions of an existing company in a foreign country and greenfield direct investment [2]. Many researchers explain the reasons of companies to conduct OFDI. In monopolistic advantage theory, Stephen Hymer pointed that with participating in FDI, multinational companies should have specific advantages in products, technology, manufacturing, brands, finance and distribution networks which are not possessed by local firms, to overcome extra costs and disadvantages in unfamiliar foreign environment [3]. With the product life cycle theory, Vernon argued that a new product is initially introduced in the developed countries to service the local market and then export abroad; then in product's late growth phase and mature phase, firms will undertake OFDI at low-cost location and exported back into the developed countries [4][5]. In Dunning's research of FDI, it is found that there are three determinants of FDI which are ownership-specific advantages, location-specific advantages and internalization advantages [7]. Ownership-specific advantages include technology, natural endowments, managerial skills, marketing networks and firm's experience from cross-border activities[7]. Location-specific advantages refer to countries' locational attractions including country's immobile, natural or created endowments, as well as legal, political and economic environment[7]. Internalization advantages are advantages from conducting production within internal hierarchies rather than external arm's length markets which cause transaction and coordination costs[7].

## 2.2. Value Chains

Porter refers to a series of value-creating activities such as design, production, sales and after-sales service as a value chain. In the background of globalization, Gereffi proposed the global value chain which means the various production activities in the value chain are completed across national borders, with one or more companies participating in the entire production process to achieve value creation. Through OFDI, multinational companies can enhance their status in global value chains. 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. Through the marginal industrial transfer effect, labor-intensive enterprises achieve value chains appreciation through conducting OFDI in countries with lower labor cost. In the research area of regional value chains, Wei and Wang (2016) defined it as a regional cross-enterprise network in which countries with industrial complementarity and geographic proximity aim at industrial upgrading to connect raw material inputs, production, sales, and after-sales services [8]. If the industrial complementarity between countries is strong, while the competition is weak, the enterprises with core competencies can construct and lead the regional value chains [8].

## 3. Value Chains Restructuring

### 3.1. Accelerated Restructuring of Global Value Chains

After the outbreak of the global financial crisis in 2008, the world economy fell into a downturn, trade protectionism rose, and in order to take the lead in the global value chains, many countries promoted trade protectionism which made the wave of deglobalization become more and more serious. In recent years, the global COVID-19 epidemic and the Russia-Ukraine conflict have further pushed the global value chains into a period of deep adjustment. On the other hand, with the development and application of technology, such as artificial intelligence, new energy, 3D printing, etc., the original production pattern has changed dramatically, the intermediate production process have gradually become shorter, and the global value chains tend to become shorter. For example, a study by UNCTAD shows that the number of suppliers of new energy vehicles is small, while the suppliers of traditional energy vehicles are often in the thousands, compared with traditional energy vehicles, the industrial chain of new energy vehicles is significantly shorter [9]. Furthermore, the global value chains accelerate localization and regionalization. In recent years, the United States, the European Union, Japan and other economies have introduced certain plans to enhance the supply capacity of local or domestic industry chains. It is claimed that in the future, a number of regional value chains characterized by regional center countries controlling core sectors and neighboring countries supporting production may replace the previous global value chains [10]. Many Chinese private enterprises are only embedded in the global value chains led by developed countries, but do not really occupy the core parts in the global value chains. With the rising labor costs and the approaching risk of "low-end lock" in the value chains, it is necessary for private enterprises to build their own leading value chains.

### 3.2. Potential of Regional Value Chain Construction

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, and by the end of 2021, China has established more than 11,000 overseas enterprises along the Belt and Road. In 2021, China's direct investment 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 spans three continents, Asia, Europe and Africa which involves more than 60 countries, 4.4 billion people and a GDP of about US\$21 trillion, accounting for 62% and 29% of the world respectively. The investment space in countries along the Belt and Road is huge, which provides broad investment prospects for the OFDI of Chinese companies. The industrial systems and resources of the countries along the Belt and Road are complementary to the development status of China's relevant industries and resource endowments, and there is a good basis for cooperation [11]. At the same time, these countries also have location advantages in terms of labor cost, trade policies, market demand, and geographical location which are attractive to enterprises to conducting OFDI and build the regional value chains.

Besides the Belt and Road Initiative provides a potential of regional value chains construction, the RCEP also brings a prospective opportunity of constructing the regional value chains. As the world's largest free trade area covering about 30% of the world in terms of population, GDP and import and export of goods [12], the implementation of RCEP will help the creation and development of regional value chains. In the 1990s, the two major regions, North America and Europe, signed large free trade agreements, including the North American Free Trade Agreement (NAFTA) and the European Union Treaty (EU Treaty), but similar institutional arrangements were lacking in the Asian region. Prior to the signing of RCEP, there are various types of FTAs existed among the 15 RCEP members which to some extent increased the cost of intra-regional trade and investment[13]. RCEP is an integration of the original trade and investment rules in the region, and as a unified and high-standard FTA in the region, the implementation of RCEP will provide institutional guarantee for achieving a higher level of regional integration[13].

According to RCEP's regional cumulative rules of origin, as long as the regional value component contained in a country's exports reaches 40%, it can enjoy the corresponding preferential tariff treatment, which will guide enterprises to keep more product orders and values within the RCEP member countries. The regional accumulation rules of origin significantly reduce the cost of flow of raw materials, intermediate goods and other resource factors in the region of member countries, which will be conducive to promoting the free flow of production factors in the RCEP region and encourage multinational enterprise to construct regional industrial chains from the perspective of the overall regional industrial chains. In addition, RCEP member countries have their own characteristics of resource endowment, degrees of economic development, and industrial complementarity, in the context of regional cumulative rules of origin, enterprises can give full play to their competitive advantages, layout production in the RCEP region, and improve the efficiency of the division of labor[13].

## **4. Construction of Regional Value Chains**

### **4.1. Natural Resource-Intensive Value Chains**

Resource-seeking FDI is to gain access to natural resources, such as minerals, metals, oil and agricultural commodities and then export them to home countries without servicing the local markets [7]. Resource-seeking FDI allows resource-based enterprises with high demand for raw materials to set up factories in the investment host countries of the relevant resource and then export the processed intermediate products back to China. The countries along the Belt and Road and the RCEP member countries are rich in various natural resources, but in recent years many countries have set up a series of export bans or increased export tariffs to restrict the export of related natural resources. Therefore, Chinese enterprises with high demand for related natural resources can build natural resource-intensive regional value chains and bypass trade barriers by directly setting up factories in related countries for natural resource extraction and processing, and occupy important value chain segments such as extraction and processing.

### **4.2. Innovative Technology-Based Value Chains**

With strategic asset-seeking OFDI, enterprises from developing countries usually acquire existing companies in developed countries to access technology that helps them to solve problems of latecomer disadvantages, technological changes, domestic institutional constraints. After acquiring advanced strategic assets and entering the production stage of higher value-added products and services, the parent company can build a new regional value chain with its own advantages and carry out OFDI in the countries along the Belt and Road and RCEP member countries and transfer production to the investment host countries. The domestic parent company will focus on technological innovation and product development to realize the construction of the innovative technology-based value chains. At the same time, Chinese private enterprises can strengthen the technology-intensive industrial cooperation with Japan, South Korea and Singapore, and build a high value-added production network system on this basis, which will help improve the efficiency of resource allocation among members and give full play to China's role as a hub in the Belt and Road and RCEP regional value chains.

### **4.3. Labor Efficiency-Seeking Value Chains**

A large number of private enterprises are concentrated in low-end manufacturing industries with backward capacity and these industries have benefited from the labor dividend in the past decades. As the development of China's economy and the disappearance of demographic dividend, the cost of labor in China continues to rise and these low-end manufacturing industries gradually lose their comparative advantage in the country. The transformation of the economic model and the rising labor costs have forced these labor-intensive manufacturing enterprises to move to countries with cheaper labor. Most of the developing countries along the Belt and Road and RCEP regions are relatively underdeveloped, and the labor force in these countries is abundant and low cost, such as the neighboring Indonesia, Thailand, Vietnam, Cambodia, the Philippines and other Southeast Asian countries, as well as the overall level of manufacturing wages

in African countries is lower than that in China. The ten ASEAN countries are densely populated and rich in human resources, and the local governments give priority to the development of labor-intensive industries with fast capital turnover[14]. Meanwhile, the commitment to reduce the tariff on goods of each RCEP member country will significantly reduce the trade cost among member countries, which is conducive to the optimal production layout arrangement of private manufacturing enterprises in the whole RCEP region. Due to the reduction of potential trade cost, the production segments of these labor-intensive manufacturing enterprises which are originally laid out in the country can carry out OFDI through the cumulative rules of origin and following the profit maximization principle. The construction of labor efficiency-seeking regional value chains transfer the production of enterprises to countries with labor cost advantages, and the resources they occupied previously can be effectively released, so that the domestic parent company can focus on high value-added sectors such as product design, technology development, brand management and marketing.

### **4.4. Market-Based Resource Utilization Value Chains**

Due to the emerging markets with the potential consumer purchasing power in developing countries, multinational enterprises conduct market-seeking FDI by establishing oversea subsidiaries. Moreover, adapting and customizing products to local special tastes and demand also is a motivation of market-seeking FDI. When laying out production abroad, private enterprises can directly choose host countries with large existing or potential markets for investment and build market-based resource utilization value chains. 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 have huge market consumption potential. RCEP member countries account for about 30% of the world's population, total economic volume and total trade is the world's most populous, largest economic and trade scale, the huge population and GDP mean the large potential market demand and consumption. Private enterprises can establish production bases in the host country through OFDI according to their own product categories and the relevant market demand of the host countries. Furthermore, the current international trade environment is becoming more and more complex, and trade frictions between countries are constantly occurring, OFDI can help private enterprises use regional trade agreements and bypass trade barriers with investment. By conducting production in counties with EU free trade zone treatment, private enterprises can not only broaden the survival and development of enterprises, avoid trade barriers, but also solve the local employment problem to achieve both economic and social benefits[14]. Meanwhile, investment in the host countries which are closed to the European market can help enterprises quickly access market supply and demand information, this will help them to develop their own brands and high value-added products which finally enhance their positions to the high value-added end of the industrial value chains[14].

## 5. Industry Analyses of Regional Value Chains Construction

### 5.1. Mining Industry

Among the countries along the Belt and Road and RCEP member countries, Russia has the world's largest reserves of minerals, including coal, iron, manganese, copper, lead, zinc, nickel, cobalt, vanadium, titanium, chromium, etc. Mongolia has rare earth, coal, copper, iron, fluorite, molybdenum, gold, silver, uranium, zinc, phosphorus, etc. and the Erdenet copper-molybdenum mine is one of the world's top ten copper-molybdenum mines. Australia, a member of RCEP, is very rich in mineral resources, with bauxite reserves ranking first in the world, accounting for about 35% of the world's total reserves. Besides bauxite, Australia also has many other mineral resources including cobalt, lead, nickel, mineral sands, tantalum, uranium, coal, copper, diamonds, gold, iron ore, etc. Indonesia in Southeast Asia has huge reserves of nickel and iron ore.

In recent years, many countries have implemented a ban on the export of raw minerals and banned the export of relevant minerals in their countries. With certain technical advantages, Chinese enterprises can make resource-based investments in resource-related industries in the host countries, build the natural resource-intensive value chains in these regions. In order to ensure the supply of raw materials for the relevant domestic production sectors, Chinese enterprises can acquire the mining rights of mineral resources in the host countries, and invest in ore extraction, smelting and export industries, thus mastering the production sectors of the energy extraction and processing.

### 5.2. Timber industry

Among the countries along the Belt and Road, Russia has the world's largest forest reserve, with more than one-fifth of the world's forest area. With more than 8.6 million square kilometers of forests, Russia has a reserve of 80.7 billion cubic meters of forest timber. Russia has many varieties of trees, including larch, white pine, red pine, willow, basswood, white birch, larch, poplar, etc. The Chinese market has a high demand for timber, but China's forest resources are limited, therefore the import demand of timber is huge. In recent years, Russia has increased log export tariffs several times to encourage the development of domestic wood processing industry. These export tariffs have raised the import price of logs which increased the import costs of foreign enterprises. Therefore, to bypass the increased log export tariffs, the relevant Chinese wood processing companies and furniture manufacturers can choose to establish wood processing bases in Russia by OFDI and then export the processed wood back to China.

### 5.3. Dairy Industry

Australia and New Zealand in Oceania have well-developed animal husbandry and are famous for their high quality milk sources worldwide. New Zealand is the world's largest exporter of dairy products. With the rapid expansion of the domestic dairy consumption market in China, the demand for raw milk is huge. Therefore, Chinese dairy companies can acquire the excellent local farming and animal husbandry resources by building factories in New Zealand and Australia through resource-seeking OFDI, and eventually obtain high quality milk sources to enhance their product quality.

### 5.4. Apparel and Footwear Industry

Many countries have the location characteristics of sufficient labor force and low labor cost, such as the neighboring Indonesia, Thailand, Vietnam, Cambodia, the Philippines and other Southeast Asian countries as well as African countries. The overall level of manufacturing wages of these countries is lower than that of China. In Vietnam, for example, the labor force is abundant with nearly 60 million people of working age, and in 2005 manufacturing labor cost in China was 0.8 USD/hour, and in 2018 it reached 4.44 USD/hour, an increase of 455%, while the average wage of Vietnamese workers was about 0.81 USD/hour in 2018 which was the same as China's labor cost in 2005 [15]. The apparel and footwear industries are labor-intensive industries, especially in the garment processing industry, the labor costs account for more than 80%. Therefore, in the background of the demographic dividend disappearing and the cost of labor in China increasing continually, the private enterprises in the apparel and footwear industries have a strong willingness to conduct OFDI in countries with lower labor cost. One usual mode of Chinese private textile and garment enterprises is manufacturing base layout mode, such as investing in local factories for production, which is mainly located in Southeast Asia and South Asia. In addition to labor advantages, the United States, the European Union and more than 20 other countries have given some ASEAN countries, such as Cambodia and Vietnam, Generalized System of Preferences (GSP) treatment and some lenient quotas and exemptions from import tariffs[15]. Therefore, private enterprises can transfer low-end production and processing to countries with lower labor costs, build regional value chains, and their domestic parent companies focus on product development and innovation. Finally, by constructing labor efficiency-seeking value chains through OFDI, the apparel and footwear enterprises can upgrade themselves from OEM processing production to independent R&D and brands.

### 5.5. Electrical Industry

Private enterprises in the electrical industry can acquire advanced technology, manufacturing experience, and management methods through mergers and acquisitions or equity participation in enterprises in developed countries, then improve the progress of their domestic production technology through reverse technology spillover, and finally promote the optimization of industrial structure. Additionally, enterprises as well as industrial clusters can use advanced technology to build regional value chains by OFDI in host countries, the profits from the production and operation activities in the overseas market flow back to the domestic parent companies, which can be further invested in R&D, improve the technology level and consolidate its position in the regional value chains. Through OFDI, the enterprise and the industrial cluster can build and dominate the innovative technology-based value chains and develop towards high-end, intelligent, informatization and branding.

## 6. Conclusion

In the context of global value chains restructuring, private enterprises can seize the investment opportunities brought by the Belt and Road Initiative and RCEP, and build regional value chains by combining their own characteristics with the location factors of the host countries and occupy high value-added sectors in the regional value chains. Natural resource-

intensive enterprises can build natural resource-intensive value chains through resource-seeking OFDI. Labor intensive enterprises can build labor efficiency-seeking value chains through efficiency-seeking OFDI. Enterprises with advanced technology and relative competitive advantage can build innovation technology-based value chains through OFDI, and enterprises seeking market and bypassing trade barriers can build market resource utilization-based value chains through market-seeking OFDI. The countries along the Belt and Road and RCEP member countries have different resource endowments and market characteristics, so private enterprises can choose suitable host countries for OFDI, build regional value chains in the process of OFDI, and finally improve their position in the value chains.

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