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State-owned Enterprises' Outward Investment and the Structural Reform in China

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Abstract

Since China's accession to the WTO in 2001, China has been on a steep learning curve in terms of engaging in outward direct investment, and state-owned enterprises (SOEs) have played a predominant role in this drive. We argue that investment overseas by SOEs is a double-edged sword as far as its impact on domestic reform is concerned. Investing overseas offers opportunities to deepen structural reform in China, but such investment could also strengthen the monopoly position of some SOEs, which is inconsistent with the objective of domestic reform. Therefore, it is important for China to deepen domestic reform with respect to competition, ownership and regulations, to maximize the benefits from investing overseas. The present paper also discusses how building market-compatible institutions will result in increased innovation. This provides opportunities for Chinese firms to effectively catch up with the advanced technologies to remain competitive in overseas markets.

Key words: multinational company, outward direct investment, state-owned enterprise, structural reform

JEL codes: D23, F23, L22

I. Introduction

China's outward direct investment (ODI) has increased rapidly with the expansion of its income and, in particular, since its entry into the WTO in 2001. This in itself is not unusual: most industrialized countries undergo a similar ODI expansion at a comparable point in

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their industrialization and development. However, unlike in other countries, in China, state-owned enterprises (SOEs) are the major investors on a value basis.

The expansion of SOEs' ODI has occurred against a backdrop of domestic reform, which has resulted in the falling share of the state sector in the total economy through the implementation of privatization programs (Garnaut *et al*., 2006). In the 1990s, the private sector began to play a key role in competitive sectors, such as labor-intensive manufacturing industries, with SOEs concentrating in heavy industries, such as steel and machinery; the resources sectors, such as petroleum and minerals; and utilities and infrastructure, such as transport, electricity, water and telecommunications.

Most of the large SOEs are administered by the central government, which allows these firms to continue to enjoy certain privileges, especially in terms of government-supported finance, subsidies, procurements and regulations. Furthermore, SOEs are generally becoming more profitable, as a result of monopoly positions rather than efficiency gains.

The SOEs have both political and economic incentives in making overseas investment decisions. Economically, SOEs are motivated to invest overseas for similar reasons as private enterprises, such as the prospect of increasing their market share, efficiency, technology and know-how, resource supply and strategic assets. Politically, managers of SOEs can use overseas investment to demonstrate their ability to manage international business, and claim credit for themselves and the organization for undertaking activities that serve the national interests.

By the end of 2009, China's 108 central government-owned SOEs had invested in 5901 foreign firms (SOASAC, 2010). The total overseas assets belonging to central government-owned SOEs exceeded RMB4000bn (equivalent to US$597bn using the current exchange rate). In 2009, the profits received from overseas operations accounted for 37.7 percent of the total profits of central government-owned SOEs.[1] According to the Ministry of Commerce, ODI from China's SOEs accounted for 69.2 percent of total ODI stock by the end of 2009, whereas that from private firms only accounted for 1 percent of total ODI stock (MOF, 2009). All the top 30 firms ranked by the sizes of overseas assets and firm size are SOEs.

The Chinese Government has played a crucial role in shaping the structure of China's outward investment. Among the famous overseas merger and acquisition (M&A) cases, Chinese overseas acquisitions have been more commonly carried out by SOEs, and are more likely to have been in primary sectors, notably minerals and energy, with the aim to

[1] See the report published in *21 Shiji Jingji Baodao* (*21st Century Business Herald* newspaper) on 8 December 2010. Available from: http://epaper.21cbh.com/html/2010-12/08/content_136316.htm.

secure access to critical raw materials (Deng, 2004). Since the turn of the 21st century, the Chinese Government has recognized outward investment as necessary for the growth for Chinese firms and as a precondition for competing in global markets. The Chinese Government has therefore become more strategic in thinking about ODI as part of its integration with the global economy and a way of securing supplies of resources for its long-term development. This thinking forms the basis for China to develop its own "going out" strategy under which the government encourages and lends support for key firms to globalize within the rationales of their own needs and policies. Firms' ODI has also been facilitated by the dramatic increase in foreign exchange reserves (Child and Rodrigues, 2005).

The major role of SOEs in China's ODI at this stage of reform and development raises a number of questions regarding the link between ODI and domestic structural reform. For example, how is SOE ODI linked to the domestic structural reform in China? What lessons can be learned from China's "going out" strategy in terms of improving its SOE policy position, its competition policy and its regulatory system? Do SOEs enhance their ability to innovate and make technological improvements through investing overseas? Why is it important for China's private sector to be engaged more in investing overseas?

The link between ODI and domestic structural reform has not been explicitly addressed in the published literature, which focuses mainly on the motivation and rationale for Chinese ODI. Wei and Chen (2009) use the panel data of China's ODI in 73 countries to determine the motivations behind China's overseas investment. They conclude that political risk in host countries has no obvious influence on the inflow of China's ODI. They argue that ODI from China is led by SOEs, and that the main motivation for ODI is to gain foreign resources and to secure the long-term supply of energy. Some studies show that ODI from China has its own special institutional and cultural characteristics (Deng, 2007), but fall short of linking China's ODI with domestic institutional reform.

With regard to the analytical approaches in examining firms' behaviors in investing overseas, Dunning and Lundan (2008) provide an eclectic paradigm to analyze ODI. There are certain elements, such as firms' ownership advantages, which can be applied in discussing China's ODI, especially by large firms. However, such a paradigm does not equip us with a framework for looking at firms' ODI and how they interact with domestic institutional factors, which are rather unique for a country in the process of economic transition. Therefore, Morck *et al.* (2008) conclude that ODI from China cannot be explained in terms of the mainstream theory derived largely from multinational corporations (MNCs) from developed nations.

In the present paper, we discuss these issues by focusing attention on competition,

ownership reform, regulatory changes and firm development in response to the new challenges brought about by ODI. We conclude by drawing implications for reforming the SOEs and the domestic institutions in carrying out China's going out strategy.

The present paper is organized as follows. Section II discusses the link between China's ODI and domestic structural reform. Section III explores more explicitly the relationships between ODI and market competition and ownership reform. Section IV discusses how ODI is affected by domestic regulatory system reform, and vice versa. Section V connects ODI with firms' capacity for innovation and technological progress. Section VI concludes.

II. China's Outward Direct Investment and Domestic Structural Reform: A Double-edged Sword

The reform of SOEs is an unfinished task. Although most of the small- and medium-sized SOEs have already been privatized, the state still controls a number of the large SOEs, most of which are in monopoly positions. These large SOEs operate, using predominantly state capital, in areas that have either no or little competition. Hence, opportunities are lost to gain profits from non-productive, rent-seeking activities. Incentives exist for firms to lobby, bargain or even bribe government officials to protect their own sectoral interests. These activities have removed the focus of the SOE firms on actively engaging in more productive work, such as innovation, cost reduction and improvement of services. Furthermore, SOEs have incentives to influence policy-makers to formulate regulations that favor them, such as the limitation of market entry into the sectors that generate monopolistic profits (Wang, 2010).

Opening up the sectors occupied by the SOEs to domestic private enterprise is an important way to enhance competition, which is crucial for reforming the state-owned sector. Introducing inward FDI, as China has done over the past three decades, has also played an important role in inducing China to adjust its domestic policies and regulations, so that they are compatible with the desired development of the market. However, both market entry for the private sector and inflow of FDI have been ineffective in pushing further reform in the state sector, especially those state-controlled industries. This is because SOEs are operating essentially in a domestic policy setting and within a regulatory framework in which SOEs enjoy certain privileges. China's entry to the WTO accelerated the pace of this change, but further work is needed for these institutional and policy frameworks to be in-step with international standards.

The participation of SOEs in overseas markets can be linked with domestic structural

reform and firm development as they are forced to navigate a new business and political or institutional environment in which privileges enjoyed in China are no longer available. This changed operating environment of overseas markets forces change in the basic characteristics of SOEs' activities, including the way they operate to be more in line with international practice. The heightened competition aboard forces SOEs to increase their competitiveness through efficiency-enhancing measures. Therefore, for them, changes must occur in three fundamental areas of reform: competition, ownership and regulation. The changes in these areas are crucial for the success of SOEs' investment abroad and will have some impact on China's reform agenda for the state sector in the future.

Conversely, investing overseas by large SOEs, especially those who occupy monopoly positions, could also work against the implementation of domestic reform. This is because global rationalization through M&A can promote monopoly, oligopoly or oligopsony in domestic markets (Trebilocock and Howse, 1995). This is particularly true in high-technology sectors as firms in these sectors tend to form strategic alliances to streamline their R&D expenditure (or to reduce R&D costs) and, thereby, to achieve a dominant position. These strategic alliances could produce some efficiency enhancing effects as key resources (such as R&D) could be more effectively utilized. However, a dominant position occupied by these firms in the industrial sectors could result in a segmented market as these firms prevent competitive foreign entry and distort competitive conditions in upstream and downstream competitive markets. As a result, the firms with a predominant position in the market could earn supracompetitive profits, which could be used by these firms to engage in "strategic" (predatory) dumping in export markets (Trebilocock and Howse, 1995).

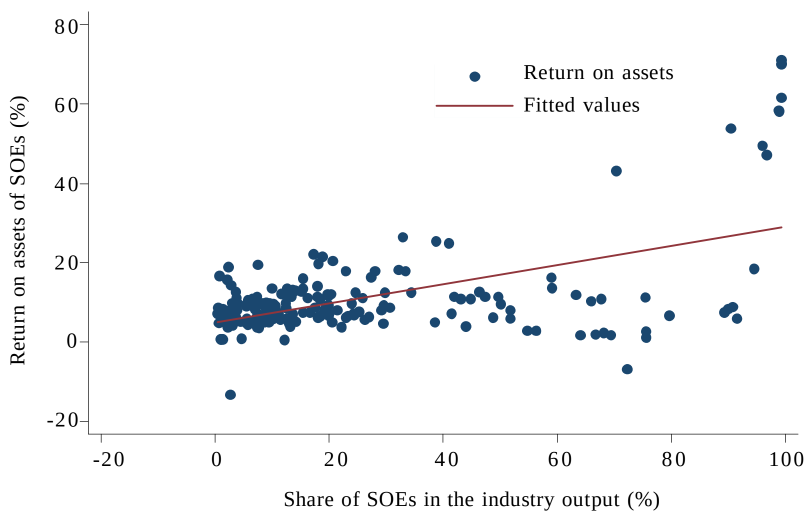
The behaviors of some MNCs might be determined not by the most efficient or lowest cost arrangement, but by the high profit share resulting from lack of competition. MNCs might increase profits through the restriction of competition in final product markets, and this might offset the generally superior allocation of resources associated with MNC activity (Cantwell, 1991). This could also lead to welfare losses, where MNCs maximize monopoly profits by restricting the output of goods, such as high-technology goods and services, where vertical integration is used as a barrier to entry (Buckley, 1985).

The likelihood of these negative aspects dominating is high if China does not actively deal with these issues arising from monopoly industries. To illustrate this, it is helpful to look at why China's SOEs are highly profitable. In 2009, the profit of central government-owned SOEs was RMB815.12bn (US$121bn), an increase of 17.1 percent from the previous year (SOASAC, 2010). In fact, central government-owned SOEs have higher levels of profit

than those received by private companies.[2] In 2009, the net profits of the top 500 private companies was RMB217.95bn (US$32.5bn), which is less than the total profits of the two largest SOEs, China Mobile and China Petroleum, at RMB249.2bn (US$37bn) (SOASAC, 2010). The question is, why are SOE profits so high when compared with even the most dynamic private sector enterprises?

Using industrial firm-level data from 2005 to 2009, we run a simple regression analysis to look at the correlation between the return on assets of SOEs and the share of SOEs' value in all industries (to measure the monopoly power of SOEs). We assume that SOEs have higher monopoly power if SOEs occupy larger shares in their industries. The results show that higher SOE shares positively contribute to higher asset returns (see Figure 1). This result suggests that SOEs' high profits are not correlated to a higher level of efficiency or competitiveness, but are closely correlated to their monopoly power and to government support. Because the most dynamic private sectors have been barred from entering those

Figure 1. Correlations between the Profits of State-owned Enterprises (SOEs) and Their Monopoly Power



Source: Authors' own estimations.

[2] SOEs' corporate governance has been significantly improved since China's accession to the WTO in 2001. According to the new report from SOASAC (2010), the number of central government-owned enterprises declined from 196 in 2003 to 125 in 2010. This shows that SOEs have made significant progress in relation to restructuring. At the same time, the proportion of state-owned corporations (stock company) is increasing rapidly over time.

industries occupied by SOEs, the opportunity cost of the high levels of SOE profits resulting from the monopoly power is high.

The financial positions of SOEs have been further strengthened by the dividend policy of SOEs granted by the central government. Before 1993, SOEs were required to turn over dividends to the state. However, the tax reform in 1994 removed this dividend payment requirement and SOEs were only required to pay taxes to the state. After further reforms in 2007, SOEs were required to pay 10 percent of their dividends to the central government, with this rate increasing over time: by 2010, some sectors were handing over 15 percent of dividends to the government. In contrast, in some European countries, such as France, Germany and the UK, SOEs are required to turn over 50 percent of their profits to the treasury.

With high profits directly affecting employees through the distribution of dividends, the SOEs are driven to maximize their own interests and investing overseas can be an important channel for them to expand these opportunities. However, responding to the call by the government to “go out” is also an important consideration as it is also in their interest to be closely in line with the governments’ strategies. Furthermore, SOE managers might be driven by non-profit motivations. For instance, high ranking officials are often appointed as the top managers of SOEs, while high profile managers of SOEs are often appointed as government officials. For the top managers of SOEs, a mix of economic and political considerations is applied to maximize their personal interests.

Second, SOEs have privileged access to various resources, such as policy supports and financial resources, including loans from China’s state-owned banks. For the state-owned banks, both financial and political risks are reduced when lending to SOEs. At present, an outstanding constraint on the development of the private firms in China is lack of access to financial resources. This affects the private sector’s ability to make investments overseas. In most M&A cases, ODI cannot succeed without bank backing.

Third, at the moment, one important motivation for China’s ODI is to secure natural resource supplies to meet the needs of China’s booming industrialization process. The resource sectors in China are dominated by large SOEs, with most private firms in these sectors facing restrictions, including limited access to bank loans. If the scenario changes and companies are presented with equal opportunity to invest overseas, it is likely that the predominant overseas investors from China would be more dynamic and efficient private companies. From an efficiency point of view, the predominant role played by SOEs in investing overseas reflects the lack of reform in the state sector, which could see much of the ODI incur high opportunity costs. In other words, if the same amount of ODI were invested by the private sector, the economic benefits from investing overseas could be

larger or the financial losses could be smaller as the investment decisions made by private firms are essentially based on economic rather than political considerations.

The predominance of SOEs in China's ODI is a reflection of their monopoly power and privileged positions at home, which highlights the need for China to intensify its domestic structural reform with respect to competition, ownership and regulation in order to maximize the opportunities available from investing overseas. Without deepening the reform in the areas where the state holds monopolies and resolving the associated structural problems, SOEs will strengthen their monopoly positions as they form alliances with other MNCs through equity investment or M&A. As a result, China's ODI could be moving towards a position that is inconsistent with its goal of domestic reform, which is to develop a more competitive market economy.

III. Outward Direct Investment, Competition and Ownership Reform

In principle, private investors are allowed to enter all sectors of the Chinese economy, except for a few special industries, such as the military. However, in reality, private investors are confronted with various intangible barriers to market entry, often referred to as "glass doors" or "glass ceilings." Most lucrative resource and service sectors are dominated by SOEs, including mining, financing, banking, rail, aviation, telecommunication, media and education. The state's monopoly in these areas causes a number of problems.

First, it is not possible to achieve fair competition as long as there are many SOEs still operating in those competitive industries. Without competition, firms are becoming less innovative and efficient. Furthermore, the "market power" of the monopolies leads to distortions in market structure, which leads to the misallocation of resources. To correct these distortions, it is important to deepen the reform of SOEs by allowing more private firms to enter the markets to increase competition. Second, the entry barriers in lucrative sectors prevent private companies from developing into large-scale operations, which, in turn, hampers efforts of the private sector to undertake ODI, especially for those projects that require large amounts of capital investment. Third, monopolists often lack the motivation to minimize the costs of production.

Despite productivity levels being lower than the world average, some of the monopoly industries, such as electricity, telecommunications, water, oil and gas, tobacco and the financial sector, provide their employees with salaries that are three times higher than the average levels of other sectors (Wang, 2010). This distortionary effect associated with income distribution in the monopoly industries prevents many SOEs from operating their

business on a purely commercial basis. However, when these firms invest overseas, it is crucial that they should operate efficiently.

The market-oriented domestic structural reform plays a vital role in determining the performance of SOEs' operations overseas. As reforms are rolled out, the state sector has fewer privileges available to their domestic operations. As SOEs increase investment overseas, and competition intensifies, SOEs will be pushed to reduce the cost of production, to be more innovative and to improve their management.

However, implementing domestic reform might not be easy because the monopolies enjoy some tremendous advantages from being in privileged positions. Groups protect their own interests and act against the structural reforms. Because of the relationship between those interest groups and the government, their stance toward the direction of reform can be powerful and influential. To overcome this obstacle to reform, breaking up the state sector monopolies is key. An effective way of achieving this is to deepen ownership reform. China should increase support for private investors in sectors in which SOEs are still playing dominant roles. The increased competition will allow the private sector to play a greater role in implementing China's going-out strategy.

Supporting the private sector to play a more active role in China's ODI also helps to ease the pressure placed on China by other countries with respect to the SOEs' domination of their ODI. Since 2005, several high profile M&A cases initiated by SOEs have been rejected by host countries on the basis that the Chinese enterprises are state-owned. Chinalco's bid by Rio Tinto to extend its ownership to 18 percent of the company in 2009 is a case in point (Drysdale and Findlay, 2009). These incidents have made Chinese companies aware of the differences in the basic institutional settings under which they do business. These companies have to think about how these differences can be abated to facilitate business transactions overseas.

To achieve this objective, it will be necessary to deepen ownership reform to increase private investment. Furthermore, the pressure on SOEs to adapt themselves to the more competitive overseas markets could also lead to internal changes, in particular reducing costs of production through reform of the corporate governance system and technological progress. As China's ODI expands, it is expected that conflicts between China and the foreign host countries will increase, and these interactions will play an important role in reshaping China's institutions to be more compatible with market development (North, 1990).

However, SOEs' investment overseas, especially in cooperation with MNCs, might not be working in accordance with the direction of domestic structural reform. Much of China's ODI is undertaken through M&A with MNCs. On the one hand, connecting with these firms helps China's SOEs learn how true MNCs operate in global markets. On the

other hand, once MNCs are engaged with profitable monopolistic SOEs, the role they play in influencing China's reform can be mixed. Because the general objective of MNCs is to maximize profit, they might have the opportunity to acquire a privileged position through M&A with SOEs. MNCs might encourage SOEs to maintain their privileged positions. As a result, a lack of competition and a high degree of industrial concentration will prevail. Quite often among MNCs, an active firm increases the extent of its market power and then colludes with others to raise barriers to entry or new competition (Cantwell, 1991). Dealing with this type of issue involves making changes to China's regulatory system.

IV. Outward Direct Investment and Changes in Regulations

As SOEs' ODI gains momentum, China will feel increased pressure to reform its regulatory system, to be more consistent with the practices of other countries. As Ostry (1997) argues, a globalizing world has low tolerance for system divergence. It is important to note the following:

- Harmonized domestic laws and policies are likely to reduce the administrative (compliance) costs of firms operating across a wide range of jurisdictions.
- Differential or distinctive regulatory requirements can constitute a barrier to entry to a foreign market, where a foreign producer is required to adapt its products to distinctive requirements of the importing jurisdiction.
- Common regulatory standards across a range of jurisdictions might enable economies of scale in production and distribution to be realized (Trebilcock and Howse, 1995).

This suggests that for Chinese companies to invest overseas more smoothly, China has incentives to adapt its regulatory framework to harmonize with other countries and regions.

China has made important steps in reforming its regulatory system since its accession to the WTO in 2001, but the system is yet to be uniformly applied to all economic entities, including private firms. According to (Steinfeld, 2007, p. 300):

> … legal institutionalization has moved forward differentially across ownership sectors. Domestic state-owned industry and foreign-invested firms have enjoyed the earliest and most extensive provisioning of legal and regulatory infrastructure — thus permitting these firms to formalize their activities in China — whereas domestic private firms have generally been discriminated against or otherwise shut out of the legal system. To enjoy the preferen-

tial access granted to foreign firms to public regulatory and legal goods, domestic firms essentially "put on a foreign cap" by selling themselves to an overseas investor.

Despite the progress that has been made in deepening the market-oriented reform, those in the private sector in China have faced difficulty in obtaining access to finance from the commercial banks, in listing on the stock markets and in gaining market entry to certain sectors of the economy, such as services. This is one of the key reasons for the phenomenon of "round tripping," referring to the phenomenon where Chinese capital comes back to China under the name of foreign investment seeking preferential treatment. Obviously, the contribution made by the private sector to China's rapid growth and development would expand if the sector were better supported. China has made progress in terms of unifying the treatment of foreign and domestic firms: for example, the new corporate income tax rate for both domestic and foreign firms was set at 25 percent from 1 January 2008 (Chen, 2011). However, China needs to do more to develop a regulatory system that essentially treats all types of ownership firms equally.

China enacted its first Anti-Monopoly Law in 2008, and it has played an important role in regulating the monopoly industries. However, implementing and enforcing the law requires a strong legal system, which is still lacking in China. It remains a considerable task for China to resolve the problems of market entry to encourage competition in monopolistic sectors. Vested interests are entrenched in the existing institutional arrangements. Resolving this problem will require extensive reform of the state sector and the government system, as well as changes to the manner in which governments are involved in managing the SOEs.

As newcomers to ODI, Chinese companies have had relatively low market shares in the areas of their investments. For example, although it has increased rapidly over the past 5 years, China's total ODI flow accounted for only 5 percent of the global total in 2009 (Wang and Wang, 2011). This disadvantaged position might lead to investors being tempted to do whatever is needed to increase their market shares in overseas markets. However, this could result in violation of the rules and regulations in place in overseas markets, including those relating to competition policy and M&A in general. Chinese companies need to be aware of the differences in the legal and regulatory system from different countries. Importantly, Chinese companies need to avoid engaging with foreign counterparts in activities that might be accepted in the domestic environment, such as collusion or other anti-competition behavior.

Further development of its own regulatory system will place China in a better position to harmonize its own system with those of other countries, as well as that being formulated

under the auspices of the WTO.[3] China can make contributions to improving the international regulatory system by deepening its own reform. Enhanced domestic competition is a prerequisite for economic progress, and competition in the international arena extends the benefits from domestically market-oriented policies (Pennington, 2011). Chinese overseas investors will benefit from such reform, as transaction costs of investing overseas will fall. Regulatory system reform and harmonization are crucial for China to establish and develop its own MNCs, including its private MNCs.

V. Outward Direct Investment, Innovation and Technological Progress

Currently, Chinese companies are far from reaching the global technological frontier. Introducing FDI to China has helped it in the process of "catching up" with developed countries. Many advanced technologies have been made available directly and through technological spillovers associated with the inflow of FDI. Investing overseas provides SOEs with good opportunities to further upgrade their technological capabilities, which will be a crucial factor for the survival of Chinese investors in international markets. Chinese investors can take advantage of these learning opportunities. China needs to do more to reform its domestic market systems, such as the labor market and the institutional arrangements for managing human resources and innovative activities.

Developing a system to support these goals will provide Chinese companies with the required flexibility to adjust to participate in world markets. Currently, because of the lack of reform in these areas, Chinese companies, especially SOEs, are facing enormous challenges in managing their transactions and in acquiring new technologies across different institutional and geographical boundaries. As argued by Steinfeld (2007, p. 296):

> … to be involved in global production networks today, even at the relatively low end, and even just to produce the sort of commodity products that can be "thrown over the wall," new entrants must climb exceedingly steep managerial and technological learning curves, and they must do so with unprecedented rapidity.

At this stage of development, Chinese companies have demonstrated the following characteristics with respect to their operation and performance as compared with their

[3] Especially with respect to the WTO Agreement on Trade-Related Aspects of Investment Measures (see the details at http://www.wto.org/english/docs_e/legal_e/ursum_e.htm#eAgreement).

global counterparts, as summarized in Noland (2001) and Steinfeld (2007). First, Chinese firms tend to be both newer and smaller in production scale and asset bases than their global counterparts. Second, Chinese firms tend to be extremely localized in terms of their actual operations. Third, the localized nature of Chinese commercial networks leads to the relative shallowness with which Chinese firms integrate into global supply chains. Finally, Chinese firms lack innovative capacity. Chinese companies now face great pressure to upgrade their technological capabilities in the face of increasing competition both domestically and internationally.

The experiences of the USA and Japan in developing their home-based institutions highlight the importance for China to intensify its market-oriented reform and to build market-compatible institutions, including firm-level institutions, such as corporate governance. The USA has a more liberal market institutional environment, which enables US firms to have considerable flexibility to extend their organizational and human resource systems across geographical boundaries, thereby enhancing firms' transnational learning. Japan implements a much more tightly integrated organizational and business system, which tends to limit the transnational learning by Japanese MNCs (Lam, 2007).

The outcomes resulting from these two different domestic institutional backgrounds in terms of their impact on firms' learning process are illustrated further by Lam (2007, p. 162):

> The inward-learning pattern has led Japanese firms to treat overseas R&D unites primarily as "technology listening posts" or highly specialized unites within the corporation. The implication of this tight home-centered structure is that Japanese overseas R&D facilities may be limited in the scope of their innovation activities and their ability to integrate themselves within local innovation networks. US MNCs, by contrast, are less likely to be inhibited by their dominant system of management co-ordination and home-based innovations system from moving towards the integrated R&D network structure. US MNCs in general are more decentralized and their subsidiaries are loosely co-ordinated via financial performance measures. This allows the subsidiaries a greater degree of autonomy in managerial decision-making and local adaptation.

Because of the nature of SOEs and the fundamental ways in which they manage their activities, the behaviors of Chinese companies are more likely to concur with the Japanese model than with the US model. SOEs' highly centralized and closed style of running business will not be conducive to their business operations overseas, especially with respect to innovation and acquisition of new technology and know-how. Moving towards a system of more decentralized decision-making and managing business activities through

coordination will require further changes to the ways in which SOEs undertake their business. Such changes can be achieved through corporate reform, including development of share-holding companies. The existing domestic institutional arrangements will also need to be modified, including the system of economic organization to encourage firms to follow the best practices in the corporate world. The latter is important as firms' behavior is heavily influenced by the home-based institutions.

China is fairly new to overseas investment. As Cantwell and Tolentino (1990) argue, the ODI of countries itself tends to follow a development course over time. Beginning from resource-based activity with fairly limited technological requirements, MNC involvement gradually shifts towards more sophisticated types of manufacturing. The initial pattern of ODI demonstrated by the Chinese firms seems to follow this pattern of development. For China to successfully develop its own MNCs, it is crucially important for its firms to become innovative, especially in high growth sectors. This is largely because the most innovative firms in an industry are likely to position themselves at the frontier of technological development, thereby increasing their international production more rapidly, and boosting their world market shares. In contrast, the least innovative firms will lose market share, and are likely to be driven out of both domestic and international markets (Cantwell, 1991). Deepening domestic labor market reform and institutional reform, such as corporate governance system reform, will support Chinese companies in achieving ODI objectives. The government can also play an important role in building and enhancing a system of innovation that is conducive to firms' development and technology advancement.

VI. Conclusions

China has been on a steep learning curve in terms of engaging in international investment since its accession to the WTO in 2001, and SOEs have played a key role in this drive. The present paper explores the implications of China's SOEs' ODI for domestic structural reform. We argue that investment overseas by SOEs is a double-edged sword as far as its impact on domestic reform is concerned. Investing overseas offers opportunities to deepen the structural reform in China; however, such investment can also strengthen the monopoly position of some SOEs, which is inconsistent with the objective of domestic reform. Therefore, it is important for China to deepen domestic reform with respect to competition, ownership and regulations to maximize the benefits from investing overseas.

The present paper also discusses how building market-compatible institutions will result in increased innovation. This provides opportunities for Chinese firms to more effectively catch up with the advanced technologies to remain competitive in overseas

markets. Linking investing overseas with domestic market and institutional reform sheds light on the interplay between domestic SOEs and foreign firms, and between domestic and international institutions in shaping the structural reform in China. These are the areas in which China needs to pay attention to integrate the Chinese economy more closely with the global economy through ODI.

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