‘Round Tripping’ or ‘Capital Augmenting’ OFDI?

Chinese Outward Investment and the Caribbean Tax Havens

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Paper prepared for Leverhulme Centre for Research on

Globalisation and Economic Policy (GEP), University of Nottingham

14th and 15th January, 2009

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Introduction

In recent years China's outward foreign direct investment (hereafter OFDI) has grown at a faster rate than at any time in its preceding history. Although there is active debate about these trends in the International Business (IB) literature, particularly concerning *natural resource seeking* and *strategic-asset-seeking* OFDI, relatively little has been made of the rapid expansion of outward investment from China to the world's tax havens. This is surprising as by 2006 around 44 percent of China's officially recognised OFDI flows and one fifth of all OFDI stock was directed at just one tax haven alone, the Cayman Islands.[1] A considerable share of China's inward investment, moreover, originated from another haven, the British Virgin Islands. In general, these flows have been considered merely as a statistical discrepancy created by the 'round-tripping' of capital. This process involves firms sending capital abroad only in order to bring it back under the semblance of 'foreign' investment to enjoy special government benefits and lower taxes. Even a cursory review of the evidence, however, raises questions about whether round tripping alone can fully explain these trends. If, for example, so much OFDI from China is undertaken solely for the purposes of round-tripping, why does so much of it go to only one of the several dozen possible tax havens? And why is Hong Kong, which has historically been the favoured host country for China's round tripping OFDI, now receiving less than the Cayman Islands? Why, furthermore, is there so much inward investment to China from *one* other tax haven – the British Virgin Islands? And finally, why did estimates of the net FDI flows from the Cayman Islands and British Virgin Islands (henceforth abbreviated CBVI) to China stand at a surplus of around $16.5 billion in the 2004 to 2006 period? If round tripping alone was the answer they should roughly balance themselves out. On the face of it these observations suggest a more complex picture than round-tripping explanation alone describes.

This paper elaborates on why so much FDI is flowing between CBVI and China and, more generally, the issues raised above. It also relates our study to current theory and debate regarding the internationalisation of Chinese business. It is organised as follows. We first review relevant Chinese OFDI statistics and literature related to the internationalisation of Chinese business. In light of this we further refine our research questions and explain our methods and data. This is followed by our

[1] The OECD used four criteria to decide if a certain jurisdiction was a tax haven: no, or only nominal, taxes; lack of effective exchange of information; laws or administration which keep individuals or organisations free from tax scrutiny; lack of transparency in the operation of regulations, laws and administration in the jurisdiction; the lack of a condition that activity must be substantial (OECD 1998: 23). According to this definition there are 38 identified tax havens. Recently, the fourth criterion has been discarded.

results. We argue that Chinese OFDI to the tax havens should not be viewed simply as the round-tripping of capital. Instead, the flow of FDI to CBVI and back again is a process that, among other things, involves capital augmentation. Few current theories of the internationalization of Chinese business, which for the most part dwell on strategic-asset and resource seeking investments, explain this phenomenon very well. The idea of 'institutional arbitrage', however, based around the relative transactions costs of doing business in China and abroad, does provide some insights into thinking about this process (Boisot and Meyer, 2008). This theory sees the internationalization process of Chinese business as one involving 'strategic exit' rather than 'strategic entry' to international markets.

Background and Literature Review

Chinese OFDI has increased gradually from the late 1970s. At the end of 2002, however, after the Sixteenth Congress of the Chinese Communist Party adopted the 'Go Global' strategy, OFDI rose quickly. It was promoted by, among other things, creating greater incentives, streamlining administrative procedures, easing capital controls and providing information and guidance to reduce investment risks (Zhang 2005: 7-10). Since 2003, it is argued, the Chinese government has 'engaged in various initiatives to promote outward investments' (Pamlin and Baijin 2007: 19). As a result of this liberalisation and promotion China's OFDI grew quickly. In the first 11 months of 2003, For example, Chinese companies invested 92% more in offshore acquisitions and mergers than in the same period in 2002 (Pamlin and Baijin 2007: 19). Over the longer period of 2002 and 2006 Chinese OFDI expanded from only several billion dollars to over 15 billion. While this OFDI growth is noted in numerous studies concerned with the internationalization of Chinese business, the expansion in OFDI to the Cayman Islands, which has also been striking, is often overlooked or ignored. By 2003, however, the Cayman Islands accounted for 28.3% of total Chinese OFDI flows. By 2006 it had increased to 44% (7.83 billion US dollars) (MOFCOM 2006: 62). The stock of OFDI into the Caymans Islands alone, moreover, had reached around 19% of China's total at the end of 2006 (14.2 billion US dollars) (MOFCOM 2006: 56).[2] The Cayman Islands overtook Hong Kong as the largest recipient of Chinese OFDI, according to official statistics.

[2] Unfortunately, statistics for Chinese OFDI in full are unavailable before 2003. However, UNCTAD's 2004 World Investment Report, using data from the China Ministry of Commerce, provides a table entitled 'China's approved FDI outflows, top 30 destinations, 1979-2002' (UNCTAD 2004: 298). China could not have invested more than a cumulative total of 36.6 million

Like the Cayman Islands, since the expansion of OFDI in 2002 the British Virgin Islands (BVI) has also received a considerable amount of Chinese OFDI. Although not nearly as impressive as the Cayman Islands, in 2005 the BVI accounted for a full 10% of Chinese OFDI flows. By 2006 the BVI held 6.33% of Chinese OFDI stock (at 4.75 billion US dollars) (MOFCOM 2006: 57) (MOFCOM 2006: 62). As well as being a recipient of OFDI, even more importantly, it had also become one of the most important inward investors to China. The BVI invested 9.02 billion US dollars in 2005 and 11.2 billion US dollars in 2006, making up 14.9% and 17.8% respectively of all inward Chinese FDI (National Bureau of Statistics of China 2007). By contrast, the Cayman Islands invested only 1.95 billion US dollars back into China in 2005 and 2.1 billion US dollars in 2006, accounting for only 3.2% and 3.4% of total foreign direct utilized investment, respectively (National Bureau of Statistics of China 2007).

By 2006, the Cayman and British Virgin Islands accounted for 47.5% of Chinese OFDI flows and 25.3% of Chinese OFDI stock. By comparison to the Cayman Islands, however, the BVI had received far less outward Chinese OFDI but instead made up a considerable part of the direct investments back into China. How can we explain these trends which have been largely overlooked in the literature on the internationalization of Chinese business?

Traditional theories of FDI, insights from research on Chinese OFDI and round tripping

How well do existing theories explain China's OFDI to the CBVI? Mainstream theory suggests that a firm will undertake foreign direct investment for a number of purposes, commonly discussed under the following categories: natural resource seeking; market seeking; efficiency seeking; and strategic-asset-seeking OFDI (Dunning and Lundan (2008)). Natural resource seekers aim to secure resources at a lower cost than they could otherwise obtain in their home economy, thus making the firm more profitable. Considering that the CBVI are small, offshore islands with no natural resource supplies, physical resource seeking FDI into the tax havens can be ruled out. A second type of resource seeking FDI is described as 'seeking plentiful supplies of cheap and well-motivated unskilled or semiskilled labour' (Dunning and Lundan 2008: 68). China has an abundance of cheap, highly productive un- or semiskilled labour. The Cayman Islands and BVI, by contrast, have very small populations (United Nations 2007, 39). Again, we can rule this out. What about market seeking FDI? This occurs when a firm undertakes FDI in order to supply goods and services to the market it has

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US dollars between 1979 and 2002; otherwise a place in UNCTAD's top 30 destinations of Chinese approved OFDI would be warranted.

invested in. The ‘Internalization theory’ of FDI suggests that firms invest abroad in order to minimize agent, information and transactions costs involved with supplying a foreign market from abroad (either by licensing or exporting). Thus firms will ‘internalise’ imperfect markets up until the point that the ‘costs of further internalisation outweigh the benefits’ (Buckley et al. 2007, 500). Market seeking FDI hangs on the premise that the market the MNE is supplying to is lucrative enough to justify production abroad; that the firm exports enough and has enough customers/suppliers (and rivals in that market) to produce abroad. Tax havens, however, are not big markets, so again this argument does not hold. Are firms investing in CBVI for efficiency seeking FDI? This is carried out in order to gain advantages from economies of scale and scope and to spread risks: the ‘motivation of efficiency-seeking FDI is to rationalise the structure of established resource-based or market-seeking investment in such a way that the investing company can gain from the common governance of geographically dispersed activities’ (Dunning and Lundan 2008: 72). A MNE will spread production in order to take advantage of differing resource prices, regulations and demand in multiple countries. As addressed above, resource and market seeking FDI into the tax havens is unlikely; therefore efficiency seeking FDI into the tax havens is unlikely as well (because MNEs have no motivation for moving at least part of their production to the tax havens anyway).

Two more recent explanations for Chinese OFDI, specific to the Chinese context, have also been proposed. One currently much discussed motivation is for Chinese firms to undertake OFDI to gain strategic assets (Child and Rodrigues 2005; Rui and Yip 2008). These are usually assets owned by a foreign company, bought by an MNE in order to help the firm become more globally competitive, or to become more competitive in that particular market. Strategic-assets could be global brand names that Chinese firms historically have lacked, or technology and local distribution networks (Buckley et al. 2007: 505).Yet again, however, this assumption does not appear to hold for investment into the tax havens, as their strategic assets (usually also associated with manufacturing firms) are obviously limited. Another, more promising explanation for our purposes of explaining OFDI to CBVI, conceives Chinese OFDI as a means of ‘institutional arbitrage’ (Boisot and Meyer, 2008). In this scenario Chinese firms look to avail themselves of more efficient institutions outside of China, and thus engage in a form of arbitrage whereby they exploit the superior institutions of foreign markets. In this explanation part of the motivation for OFDI is not so much ‘strategic entry’, but rather ‘strategic exit’ from China. More specifically, when transactions costs are high (which is it argued they are in China) and the costs of crossing domestic borders exceed those of international borders, it is suggested firms internationalize at a relatively earlier stage of development. We return later to this view of the internationalisation of Chinese firms, which contrasts starkly with the aforementioned standard views of internationalization, to explain our findings.

Are there any other mechanisms whereby round-tripping could actually add value to Chinese capital rather than simply circumventing domestic Chinese restrictions? A number of studies note also the importance of raising capital of foreign capital markets. A 2004 paper by Xiao, for example, accepts that some round-tripping is purely to escape regulations 'such as barriers to trade, high taxes, lack of property rights protection' (Xiao 2004: 12), creating no value added. Xiao, however, also adds a further point: that there may be another type of value-adding round-tripping which '*creates value added much like the financial sector's role for the real economy*' (Xiao 2004: 12). Xiao's argument is not further developed, though the intuition and implications are clear: registering as a company in the CBVI could add extra value to existing Chinese capital that it could access as domestic capital. In such a way it may create for itself greater value than it may obtain in listing on domestic stock exchanges, if such an option was even available in the first place. Of course, these Chinese firms may also benefit from foreign banking and financial experts, who can help add value to the Chinese capital (Zhan, 1995). It is well known that Chinese firms set up companies in such tax havens for the purpose of raising capital, and a number of high profile firms have received considerable media attention. To date, however, the true extent and implications of this process have not been well documented.

To summarize, most standard theories of why a firm would want to invest abroad then are not especially relevant for understanding why so much Chinese OFDI flows into and out of CBVI. As a result most, if not all of the IB literature, rather glosses over OFDI to the CBVI. Indeed, OFDI to the CBVI is generally thought to be exclusively 'round-tripping' – assets recycled through the tax havens to accomplish preferential treatment of foreign capital (Luo and Tung, 2007; Lunding, 2006).[3]

[3] This usually entails registering a firm in the Cayman Islands to become a parent or contractor to a Chinese firm, restructuring capital and equity so that investment appears to be foreign and then obtaining preferential treatment by the Chinese government as a foreign invested firm (Lunding 2006: 3; Luo and Tung 2007: 482).

Research Questions

Following from the above several important questions emerge:

i. Do Chinese companies engage in capital augmenting OFDI in the CBVI as opposed to simply round-tripping? If so, to what extent? Considerable emphasis has been placed on the latter to date, though far less is known about the former.

ii. If capital augmenting activities are being undertaken, are these activities consistent with the aggregate macroeconomic trends detected in official statistics noted earlier? For example, can firm level activities in raising capital also explain the trends in FDI to the Cayman Islands from China and back again from the BVI? This is an important question, as it allows us to corroborate our findings from our firm-level insights.

iii. Finally, how is such OFDI, if at all, related to the internationalisation of Chinese business? Can the ideas of capital augmentation or 'institutional arbitrage' help understand this phenomenon? If so, should the current focus of research on Chinese strategic asset and natural resource seeking OFDI be somewhat redirected?

We now turn to explain the particular approaches we use to further address these questions and understand Chinese investment to the tax havens.

Method and approach

Following from point (i) above, our first objective is to investigate whether capital adding activities are common place. As we shall show, addressing (i) allows us to address questions (ii) and (iii).

Owing to the inherent secrecy of these tax havens it is difficult to uncover which Chinese firms have investment interests in the CBVI. This said, Chinese companies that wish to become publicly listed on American stock markets must submit many formal documents to the U.S. Securities and Exchange Commission (SEC). Annual financial statements, for example, are required by the SEC and these are also reported by the country in which a company has its main operations. Indeed, as of 4th September 2008, on this basis there were 602 filings made by Chinese firms on US markets, the majority being notices of sales of securities and statements of beneficial ownership of securities. However, 72 firms provide a 20-F form, which is a more detailed annual report of securities of foreign private investors. These 20-F reports are often quite candid in nature, providing lists of subsidiaries and graphs depicting the organizational structure of the firm. These reports provide one of the few windows through which to examine firm-level strategies related to the internationalisation of Chinese businesses in these tax havens. Our first approach, therefore, is to use these reports to ascertain in greater detail firm-level strategies. Our sample of public companies is shown in Table 1.[4] We list the name of the firm and outline the different tiers of firms involved and their particular geographical registrations as well as the stock markets in which they are listed in the US, their main lines of business.

TABLE 1: sample of US listed firms with main activities on Chinese mainland

[4] Unfortunately, six of the 72 firms do not provide enough information to determine their organizational structure. However, we do know that of these six, four were registered in the Cayman Islands, one was registered in Hong Kong, and the other was registered in South Korea.

Table 1

Firm	**Industry**	**Markets**	**Incorporated**	**1st Tier**	**2nd Tier**	**3rd tier**
Blue Earth	Primary smelting & refining of nonferrous metals	American	BVI	Uganda / Canada		
Seaspan CORP	Deep sea foreign transportation of freight	NYSE	Marshall Islands	3 Marshall Islands		
China Eastern	Air Transportation	SSE/SEHK/NYSE	PRC	9 PRC, 1 HK		
Actions Semiconductor	Semiconductors & related devices	NASDAQ/FRA	Cayman Islands	3 HK, 2 BVI, 1 PRC, 1 MR		
ChinaEdu Corp	Educational services	NASDAQ/FRA	Cayman Islands	5 PRC		
China Finance Online	Business services	NASDAQ	Hong Kong	1 HK, 8 PRC	1 HK, 3 PRC	
China Medical Technologies	Surgical and medical instruments	NASDAQ	Cayman Islands	1 BVI, 1 PRC	2 BVI, 1 US, 1 HK	
China Nepstar	Drug stores and properietary stores	NYSE	Cayman Islands	4 PRC	11 PRC	2 PRC
China Pharmaceuticals International	Business services	OTC	BVI	None (agents in PRC)		
China Techfaith	Business services	NASDAQ	Cayman Islands	1 BVI, 1 PRC	7 BVI, 2 PRC, 1 HK	6 PRC, 1 US
China Technology Global	Converted paper & paperboard prods	OTC	BVI			
eLong, Inc.	Transportation services	NASDAQ	Cayman Islands	1 BVI, 2 PRC	Various affiliates	
eFuture Information Technology	Computer programming services	NASDAQ	Cayman Islands	2 PRC		
Grand Toys International	Wholesale - Misc durable goods	NASDAQ	Hong Kong	China, US, Canada		
Hurray! Holding	Communication services	NASDAQ	Cayman Islands	1 HK, 11 PRC	1 PRC	4 PRC
KongZhong Corp	Business services	NASDAQ/FRA	Cayman Islands	1 CI, 3 PRC	1 PRC / Contracts	
LDK Solar	Semiconductors & related devices	NYSE/FRA	Cayman Islands	3 PRC, 1 HK, 1 US	1 PRC	
Longtop Financial Technologies	Computer programming services	NYSE	Cayman Islands	5 PRC, 1 HK, 1 BVI		
New Oriental Education & Technology	Educational services	NYSE	Cayman Islands	3 PRC, 1 Canada		
Noah Education Holdings	Prepackaged software	NYSE	Cayman Islands	3 PRC, 1 BVI	2 PRC	
Qiao Xing Mobile Communication	Telephone and telegraph apparatus	NYSE	BVI	1 PRC	3 PRC	

ReneSola	Semiconductors & related devices	NYSE/LON	BVI	3 PRC, 1 US, 1 SING		
Semiconductor Manufacturing International	Semiconductors & related devices	NYSE/SEHK	Cayman Islands	5 CI, 2 Samoa, 5 HK, 2 BVI, 7 PRC		
Sinovac Biotech LTD	Pharmaceutical preparations	AMEX	Antigua and Barbuda	2 PRC		
Trina Solar LTD	Semiconductors & related devices	NYSE/FRA	Cayman Islands	2 PRC, 1 HK (1 ex BVI)		
VanceInfo Technologies	Computer programming services	NYSE	Cayman Islands	1 BVI, 1 PRC, 1 US, 1 JP	4 PRC, 1 HK	1 PRC
VisionChina Media	Advertising agencies	NASDAQ	Cayman Islands	1 PRC	1 PRC	19 PRC
Yingli Green Energy Holding	Semiconductors & related devices	NYSE/FRA	Cayman Islands	1 PRC, 1 BVI	5 PRC, 2 GER	2 PRC
3SBio	Pharmaceutical preparations	NASDAQ	Cayman Islands	1 BVI	1 PRC / Contracts	
51 job	Employment agencies	NASDAQ/FRA	Cayman Islands	1 BVI, 2 CI		
Acorn International	Miscellaneous retail	NYSE	Cayman Islands	1 BVI	9 PRC, 2 HK	3 PRC
AirMedia Group	Advertising agencies	NASDAQ/FRA	Cayman Islands	1 BVI	Various	
ATA Inc	Educational services	NASDAQ	Cayman Islands	1 BVI	2 PRC	1 PRC
Baidu.com	Computer programming services	NASDAQ/FRA	Cayman Islands	1 BVI	3 China, 1 JP, 1 HK	
China Netcom Group	Radio telephone communications	NYSE/SEHK	Hong Kong	1 PRC, 1 BVI, 1 BER	3 PRC, 1 JP, 1 US, 1 UK, 1 HK	
China Sunergy	Semiconductors & related devices	NASDAQ	Cayman Islands	1 BVI	1 PRC, 1 HK, 1 GER	1 PRC
E-House (China) Holdings	Real estate agents & managers	NYSE	Cayman Islands	5 BVI	2 PRC, 1 BVI, 1 HK	16 PRC
Focus Media Holding	Advertising agencies	NASDAQ/FRA	Cayman Islands	2 BVI, 1 CI, 1 HK	Various	
Fuwei Films	Unsupported plastics film & sheet	NASDAQ	Cayman Islands	1 BVI	1 PRC	
Giant Interactice Group	Business services	NYSE	Cayman Islands	1 BVI	1 PRC	Various
China GrenTech	Radio telephone communications	NASDAQ	Cayman Islands	1 BVI	2 PRC	3 PRC
Home Inns & Hotels Management	Hotels & motels	NASDAQ	Cayman Islands	1 HK	4 PRC, 1 HK	77 PRC / JV
JA Solar Holding	Semiconductors & related devices	NASDAQ/FRA	Cayman Islands	1 BVI, 1 HK	4 PRC, 1 US	
Linktone	Computer processing & data preparation	NASDAQ/FRA	Cayman Islands	2 BVI, 2 HK	6 PRC	
Mindray Medical International	Surgical and medical instruments	NYSE/FRA	Cayman Islands	2 BVI, 2 HK, 1 UK	Various	
NetEase.com Inc	Business services	NASDAQ/FRA	Cayman Islands	1 BVI, 1 HK	4 PRC, 1 HK	Various
Ninetowns Internet Technology Group	Prepackaged software	NASDAQ	Cayman Islands	1 BVI	2 HK, 1 BVI	
Origin Agritech	Agricultural Production	NASDAQ	BVI	1 BVI		

Perfect World Co.	Business services	NASDAQ/BER	Cayman Islands	1 HK	1 US, 1 PRC	
Qiao Xing Universal Telephone	Telephone and telegraph apparatus	NASDAQ	BVI	2 BVI, 1 HK	3 PRC	
Simcere Pharmaceutical Group	Pharmaceutical preparations	NYSE	Cayman Islands	1 BVI	2 PRC, 1 HK	8 PRC
Suntech Power Holdings	Semiconductors & related devices	NYSE/FRA	Cayman Islands	2 BVI, 1 JP	4 PRC and various	
Tongjitang Chinese Medicines	Pharmaceutical preparations	NYSE	Cayman Islands	1 BVI	1 PRC	6 PRC
WSP Holdings	Oil & gas filed machinery & equipment	NYSE	Cayman Islands	1 BVI	2 PRC, 1 US, 1 Canada	2 PRC
WuXi PharmaTech	Pharmaceutical preparations	NYSE	Cayman Islands	1 BVI, 1 US	5 PRC, 1 US	
Xinhua Finance Media	Communication services	NASDAQ	Cayman Islands	6 BVI, 3 HK	Many PRC	
Xinyuan Real Estate Co.	Building contractors	NYSE	Cayman Islands	1 CI	3 PRC, 3 HK	8 PRC
China UNICOM LTD	Radio telephone communications	SEHK/SSE/NYSE	HK	1 China, 1 HK, 1 Macau		
Agria Corporation	Agricultural Production	NYSE	Cayman Islands	1 BVI	1 HK	1 PRC
China Digital TV Holding	Prepackaged software	NYSE/FRA	Cayman Islands	1 BVI	2 HK	1 PRC
Cninsure Inc	Insurance agents brokers	NASDAQ/FRA	Cayman Islands	1 BVI	1 BVI	2 PRC, 1 HK
Gushan Environmental	Industrial Organic Chemicals	NYSE	Cayman Islands	1 BVI	3 BVI, 1 HK	7 PRC
Solarfun Power Holdings	Semiconductors & related devices	NASDAQ	Cayman Islands	1 BVI, 1 US	1 HK	1 PRC, 1 GER
The9 Limited	Business services	NASDAQ/FRA	Cayman Islands	1 HK	2 HK	4 PRC
TOM Online	Computer programming services	SEHK	Cayman Islands	1 CI	8 BVI, 2 HK, 1 CI	Various
ChinaGrowth North Acquisition Corp	Blank checks	OTC	Cayman Islands			
ChinaGrowth South Acquisition Corp	Blank checks	OTC	Cayman Islands			
China Mobile LTD	Telephone Communications	NYSE/SEHK	HK	34 BVI, 1 CI		
Hutchison Telecommunications International	Telephone Communications	NYSE/SEHK	Cayman Islands			
Shinhan Financial Group	National Commercial Banks	NYSE/SEO	South Korea			
Vimicro International Corp	Semiconductors & related devices	NASDAQ/FRA	Cayman Islands	5 PRC, 1 HK, 1 US		
China Petroleum & Chemical Corp	Petroleum refining	NYSE/SEHK/SSE	PRC	1 BER, 1 HK		

Source: SEC; various 20-f annual reports

This approach is not without its problems. There is, of course, a selection bias in so far that all of the firms we analyse, by definition, trade their stocks on American markets. They are therefore aiming to attract foreign capital. This of course may limit conclusions that we can make about capital augmentation, as we cannot compare our findings to the structures of firms that have invested in the CBVI to trade on other non-American markets, or have invested in the CBVI but do not wish to raise equity in this way (preferring, for example, to raise money through the banking system or venture capitalists). This may be a problem. It is well known, for example, that many firms listing on the Hong Kong growth market also use a Cayman Islands domiciled parent company to structure their investments. By looking only at US listed firms we miss these firms. This said, even detecting a large number of firms undertaking public listings via a Cayman Islands company could be in and of itself an interesting finding, one not yet well documented.

It should also be noted that there are also limits on what these reports can tell us about the structure of such companies and their purpose. Information about ultimate shareholders of the company, for example, is still normally quite limited on the 20-F forms. We cannot therefore develop a good picture of what is going on behind the scenes regarding ownership. For example, an interesting further question involves investigating the types of investors that have become involved in these Cayman Island registered firms.

A final but important point to consider is that the information we have gathered is from the latest submitted SEC filings from 2007 or 2008 (not the 2003 to 2006 period for which we have the aggregate foreign direct investment trends) and use the firm-level investigation from this period to explain the earlier macroeconomic FDI trends. This is not ideal. We argue, however, that it is still useful to look at these firm structures as they offer a rare and interesting look into Chinese OFDI into the CBVI and can provide an explanation, not wholly dependent upon the round tripping story. No studies to date have used such company filings and our study is also one of the few works to look at firm-level evidence of investments in the CBVI, as opposed to aggregate OFDI data.

In order to investigate question (ii) we compare China's official aggregate outward and inward FDI data with the firm-level picture generated from the firm sample. Do, for example, the aggregate trends of large outward FDI flows to the Cayman Island and large inward flows from the BVI to China fit the firm-level description generated from our sample?

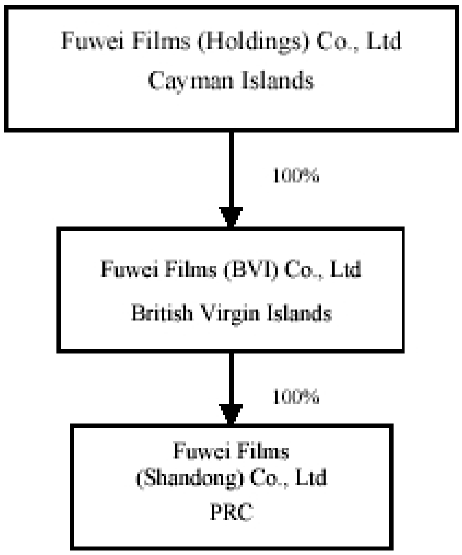
Results from the firm-level sample

Our results show the striking prevalence of Cayman Islands' registered firms among our sample of US listed firms operating in China. Table 1 shows 55 of the 72 firms were registered in the Cayman Islands. Seven more were registered in the BVI, five were registered in Hong Kong, two in mainland China and one each in Antigua and Barbuda, the Marshall Islands and South Korea. The majority of the firms we have looked at therefore incorporate in the Cayman Islands, a handful in the BVI and one or two in other tax havens. Aggregate statistics on Chinese OFDI noted earlier showed the Cayman Islands received the majority of Chinese outward FDI, the BVI a fairly distant second, with a very small amount going to other tax havens. In this regard the two sets of information seem remarkably consistent.

Interestingly, only two of the 72 firms which provide structural information were incorporated in China. This includes China Eastern Airlines, which was incorporated in China along with all of its subsidiaries, except for one in Hong Kong. China Petroleum & Chemical Corporation (Sinopec) was also incorporated in China and has one Hong Kong subsidiary and one Bermudan subsidiary. Possibly these tax haven subsidiaries are used to undertake 'unbundling' activities. A MNE will use a variety of techniques in order to reduce costs, including transfer pricing, dividend remittances, royalty payments and fronting loans; to shift income to the subsidiaries in lower tax jurisdictions, in order to minimize tax liability (Hill 2007: 680). Or, perhaps these firms want to keep capital abroad in the face of political or economic risk. Both of these companies are listed on the New York Stock Exchange (NYSE), the Hong Kong Stock Exchange (SEHK) and the Shanghai Stock Exchange (SSE). This begs the question as to why the majority of these 'Chinese' firms who wish to trade stocks on American stock exchanges restructure and register outside China. One explanation is that mainland firms when seeking to raise capital are severely limited when undertaking an initial public offering (IPO) (Ellis and Styles 2007: 37). Common law countries by contrast, such as the CBVI, allow firm structures which are a lot more familiar to US investors. For instance, only one class of stock is allowed for foreign invested firms in China. In the tax havens there can be differentiation between common and preferred stock (Ellis and Styles 2007: 37). This also allows 'valuation adjustment mechanisms' (VAMs).This is where preferred stock is allowed to be converted into a greater amount of common stock if the firm in question does not reach certain financial goals (Ellis and Styles 2007:37). Obviously this is not possible with only one type of stock in China. In the CBVI, moreover, shareholder agreements and corporate governance are far more familiar to international investors (Chao and Xu 2008). This in part explains why a firm may incorporate in the CBVI.

The BVI, as discussed, receives a lot less Chinese OFDI than the Cayman Islands, yet invests a lot more into China. How can we explain the outward investment from the BVI back to China? Again, analysis of the typical organizational structures adopted by these Cayman Island registered firms seems to be consistent with this finding if indirect investment through the BVI is expressed as FDI from the BVI by Chinese FDI statistics. Indeed, 41 of the 72 firms in question had direct control over a BVI subsidiary and most of these had structures which used the BVI subsidiary as an intermediary before (indirect) control over further Chinese subsidiaries (Table 1). A structure, therefore, featuring Cayman Islands incorporation with at least one BVI intermediary is the most common structure we find. In total 28 of the 72 firms are organized in this manner, approaching nearly 40% of the total. A straightforward example of one the 28 firms which use a BVI firm as an intermediary between the Cayman parent and the indirectly owned Chinese subsidiary is Fuwei Films (Figure 1).

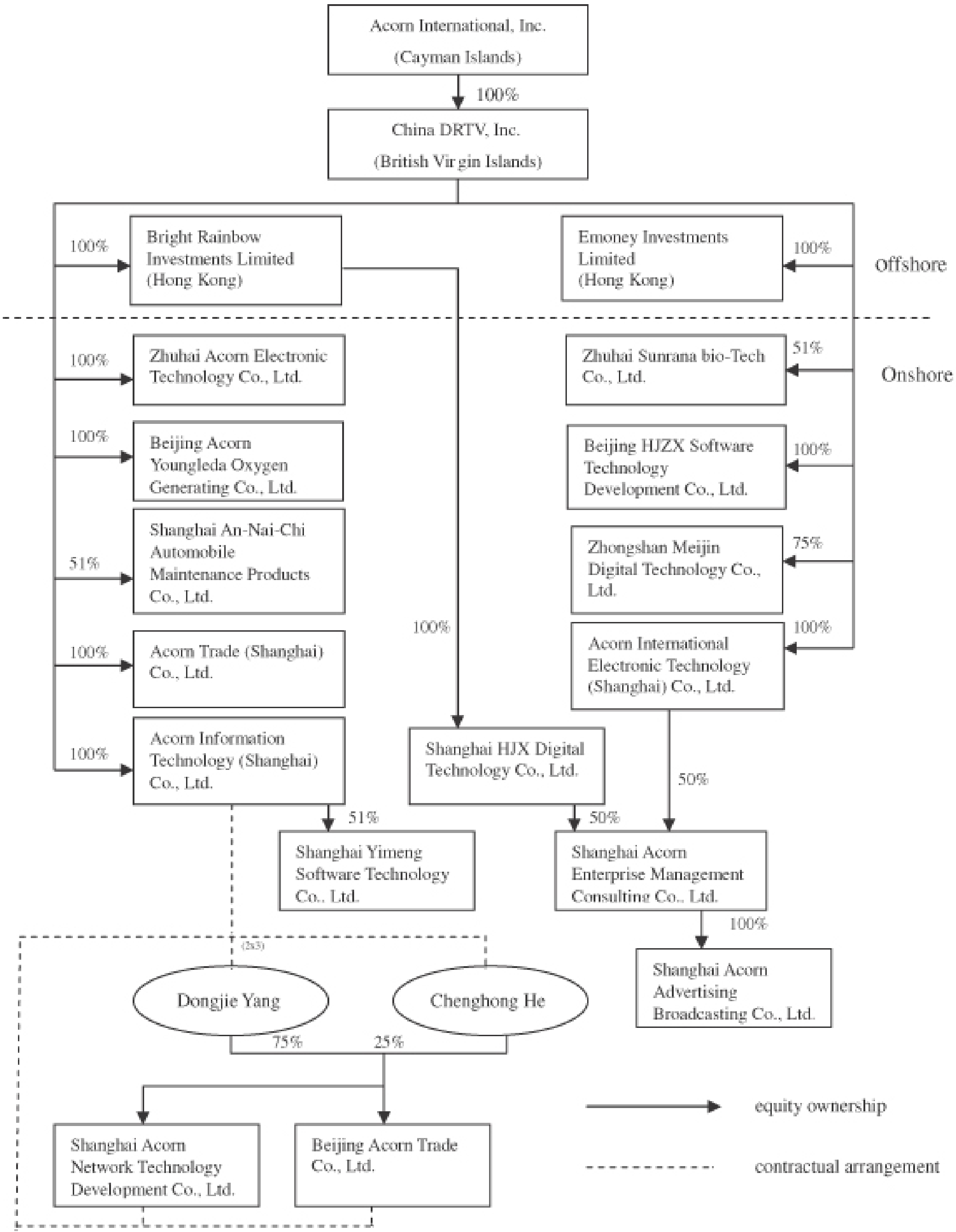
FIGURE 1



(Source: Fuwei Films (Holdings) 2008: 30)

Of course, numerous structures exist and typically they are more complicated than Fuwei. A more complex example of a structure that uses BVI intermediaries is that of Acorn International. Acorn itself has numerous Chinese subsidiaries controlled ultimately by the Cayman Island registered company (Figure 2).

FIGURE 2



(source: Acorn International 2008: 61)

There are also other structures that use two levels of BVI intermediaries, for instance CNinsure (source: CNinsure 2008: 45).

Briefly looking through each firm's 20-F form, therefore, does shed some light on our questions. It appears that many of the firms are originally incorporated in China. A CBVI firm is then incorporated as a holding company to facilitate future international fundraising. This eventually becomes the parent company of the Chinese subsidiaries. Typically a Cayman Islands firm is incorporated and becomes a holding company for the BVI firm. Shares held by the BVI firms' shareholders are then swapped for shares in the Cayman firm. These shareholders then own shares in the Cayman Islands firm, which in turn holds all of the shares of the BVI subsidiary. The Cayman Islands firm is then used as a listing vehicle for any remaining shares, in order to raise foreign capital. An example is Acorn International, whose organizational structure was shown above. An extract from their annual 20-F form is presented below:

> *Prior to January 1, 2005, our business was operated through Beijing Acorn, Shanghai Acorn and Shanghai Trade, including their subsidiaries. To enable us to raise equity capital from investors outside of China, we established a holding company structure by incorporating China DRTV Inc., or China DRTV, in the British Virgin Islands on March 4, 2004. Commencing on January 1, 2005, our business was conducted through China DRTV and its subsidiaries and affiliated entities. In connection with our initial public offering, we incorporated Acorn International in the Cayman Islands on December 20, 2005 as our listing vehicle. Acorn International became our ultimate holding company when it issued shares to the existing shareholders of China DRTV on March 31, 2006 in exchange for all of the shares that these shareholders held in China DRTV*

(Source: Acorn International 2008: 35).

This appears to be a fairly typical example of many of the firms in our sample (Table 1). In other examples, the Cayman Islands listing firm is incorporated first, the BVI firm after. Solarfun Power Holdings is an example, as is The9 limited. Below is an extract from Solarfun Power Holding's latest 20-F filing:

> *In anticipation of our initial public offering, we incorporated Solarfun Power Holdings Co., ..., in the Cayman Islands on May 12, 2006 as our listing vehicle. To enable us to raise equity capital from investors outside of China, we established a holding company structure by incorporating Linyang Solar Power Investment Holding Ltd., or Linyang BVI, in the British Virgin Islands on May 17, 2006. Linyang BVI is wholly-owned by Solarfun. Linyang BVI purchased all of the equity interests in Linyang China on June 2, 2006.*

(Source: Solarfun Power Holdings 2008: 28).

The above raises a further important question - why do the Cayman Islands' holding firm always act as a listing vehicle? An important part of the explanation, consistent with the idea of value adding as opposed to round tripping OFDI, appears to be that Cayman Island (unlike their BVI counterparts) firms can also undertake IPOs on the Hong Kong stock exchange. Greguras et al. outline the differences between registering in the CBVI (as well as Bermuda, Delaware and Hong Kong) (Greguras et al. 2008: 7). Although Bermudan registered firms are allowed to undertake an IPO on American stock exchanges as well as the Hong Kong stock exchange, the cost of incorporation is a lot higher than in the BVI or the Cayman Islands. The time taken to incorporate is also a lot longer (2 to 5 weeks as opposed to 1 to 3 days in the Cayman Islands and 1 to 2 days in the BVI). This may explain why the Cayman Islands are preferred to Bermuda for incorporation. The major difference between incorporating in the Cayman Islands and the BVI, by contrast, is that only Cayman firms can undertake an IPO on *both* Hong Kong and US stock exchanges. This is the only major difference, although Greguras et al. note that government authorities are more likely to be easier to deal with in the Cayman Islands than the BVI (Greguras 2008: 7). It appears then that one important reason why firms are more likely to incorporate in the Cayman Islands is that there is greater flexibility in listing, with options of American and Hong Kong stock exchanges. The firm, therefore, can undertake an IPO in the market that gives the highest valuation, so maximising its value. This has arguably become more relevant to these firms after the stricter listing requirements of the Sarbanes Oxley act were passed.

Is there any evidence that firms listed in Hong Kong use similar structures? Unfortunately, the Hong Kong Stock Exchange does not have a search function allowing us to limit listed firms by country. It is unlikely that a firm registered in the Cayman Islands will allow trading of stocks on both the Hong Kong and American stock exchanges (out of our 72, for example, only 2 trade on both the NYSE and SEHK: Hutchison Telecommunications International and Semiconductor Manufacturing International). Perhaps a list of Cayman Islands registered firms trading shares solely on the SEHK would be roughly equal in size or even greater than our list of Cayman Islands firms which (generally) trade exclusively on American markets. Of course, stock market conditions may be such that one market gives higher valuations over another consistently over a certain period, yet one would expect this to even out over time. As Greguras et al. conclude, however, 'today a CI [Cayman Island] company is the clear choice for a China related business' (Greguras et al. 2008: 1).

One major unanswered question that is left after the analysis is why the most common organisational structure includes a BVI intermediary used to redirect investments back into China. The only benefit over the Cayman Islands, according to the list supplied by Greguras et al., is that it could potentially take one day less to incorporate in the BVI (1 to 2 days, as opposed to 1 to 3 days in the Cayman Islands) (Greguras et al. 2007: 7). Yet this doesn't seem a good enough reason for the pattern we are seeing. Unfortunately, the 20-F forms do little to help answer this question. Most filings, in almost identical wording, imply that the BVI firm serves to 'enable [the firm] to raise equity capital from investors outside of China', which is provides no adequate answer to this question (Acorn International 2008: 35). One possible explanation is that such a structure, to some extent, helps conceal the 'round-tripping' element of these operations. Another, more plausible explanation, is that it creates greater anonymity and secrecy for the controlling shareholders using this type of control chain.

Results: consistency with aggregate data

Now addressing question (ii), is the firm-level picture we present here consistent with the official Chinese FDI statistics outlined earlier, even using this small sample of firms? In other words, do the micro-level trends witnessed among our sample accurately mirror macroeconomic data and, by extension, might this explain what we actually observe?

TABLE 2: Flows to and from CBVI, Hong Kong and China (billion US dollars)

	2004	2005	2006	Total
FDI to China from:				
Cayman Islands	2.04	1.95	2.10	6.09
BVI	6.73	9.02	11.25	27.00
Hong Kong	19.00	17.95	20.23	57.18
OFDI from China to:				
Cayman Islands	1.29	5.16	7.83	14.28
BVI	0.39	1.23	0.54	2.15
Hong Kong	2.63	3.42	6.93	12.98

Source: SSB (2007, 2005).

If capital augmentation is taking place in CBVI we would expect the flows from CBVI to China to be greater than those from China to CBVI. Is this the case? Between 2004 and 2006, according to official statistics, there was approximately $33 billion of inflows from CBVI but just $16.4 billion in outflows from China to CBVI, leaving net investment from CBV I of around $16.5 billion (SSB 2007; SSB 2005). This again, is suggestive of a process involving more than just round tripping. It is, however, by no means definitive proof. Official statistics, of course, may only capture part of the story. More importantly, it is of course also possible that other international investors from outside of China (i.e. the US, Europe) looking to establish operations in China may also do so through the formation of a company in a tax haven such as CBVI. It is also possible that FDI may flow out first to a third intermediary country (such as Hong Kong) then on to the CBVI and back again into China.

Hong Kong, which received a total of around $13 billion in this period under consideration, could well be filling such a role. Thus it is impossible to say just how much capital is actually added during this process using such aggregate data alone.

One way of checking these aggregate figures is by again using company filings and financial reporting to estimate the total amount of capital raised by our sample firms in the corresponding period. From our 72 firm sample we found relevant information for 44 firms. According to estimates based on these reports these firms raised approximately $12 billion in total between them, a figure not so far away from the $16.5 billion net inflows shown in the official aggregate figures noted earlier. These estimates, it should also be remembered, exclude Chinese firms registered in CBVI but trading on other stock markets outside the US. These estimates, therefore, almost certainly underestimate the true amount raised on foreign capital markets.

Discussion and conclusion

Our analysis has focused on questions (i) and (ii) relating to the idea that round-tripping OFDI to CBVI may in fact have a significant value-adding function, in so far as it augments the existing capital of Chinese firms. All of the firms we have looked at of course, by definition, have moved capital abroad in order to raise funds from international investors, in this example by registering on an American stock exchange. Using this sample we have shown how assets are transferred from the Chinese operating companies to the Cayman or BVI parent before listing, thus contributing to official Chinese OFDI data. We have provided a sketch of firm-level behaviour consistent with Chinese OFDI data – one in which the majority of OFDI that goes to the tax havens is invested in the Cayman Islands, with the BVI second and various others with much smaller pockets of investment.

One important point emerging from this analysis is, we believe, is that this value-adding round-tripping is likely to be the major reason for Chinese OFDI to CBVI. One important reason that so much Chinese OFDI flows specifically to the Cayman Islands, we contend, is that it alone provides flexibility in listing on international capital markets. In particular, it provides the flexibility of either listing on American or Hong Kong stock exchanges. If Chinese OFDI into the tax havens were primarily for non-value-adding round-tripping we argue there would be a far more even spread of investment in the tax havens - rather than 90% of Chinese OFDI flowing to the Cayman Islands. Related to this, why would a Chinese firm go to the trouble of arranging a shell company in the CBVI, when round-tripping can more easily be carried out via Hong Kong? The CBVI have a completely different culture, legal structure and language to China; Hong Kong, by contrast, shares a lot of similarities with Chinese culture. This line of thinking suggests that there is some real or potential benefit to investing capital into the Cayman Islands (or BVI), rather than sending it straight back into the Chinese economy as foreign investment. Our findings, therefore, contrasts somewhat with the general consensus of the literature, that either ignores round-tripping or argues it adds no value and is carried out purely for lowering taxes and for gaining preferential treatment for foreign investors (non-value-adding round-tripping). Of course, there is nothing to say that firms may not also enjoy these benefits at the same time.

Moving to question (iii), looking at the bigger picture, what does all of this mean for our understanding and conceptualization of the internationalisation of Chinese business? On the face of it our findings suggest much of this type of Chinese OFDI has not been for the purposes of internationalisation as it is commonly understood: for market, resource, efficiency and strategic asset seeking. Do the alternative theories of Chinese OFDI mentioned earlier provide any help in thinking about this process? If previous evidence on the capital augmenting function of this process is accepted, it could be argued that a major reason for the investments to CBVI is the result of the deficient domestic institutions, leading to 'strategic exit'. Particularly, the high transactions costs for private firms on Chinese capital markets are among the most significant factors in driving this behaviour. In this sense the idea of 'institutional arbitrage', as noted earlier, can help explain the observed capital augmenting OFDI we observe (Meyer and Boisot 2008). It is only, however, in the very areas where transactions costs are particularly high that these firms look to find international substitutes –in capital markets and possibly also intellectual property protection. Thus by moving outside of China these firms only internationalise *specific* parts of their firms operations. Indeed, the capital raised outside of China, as far as we aware, is primarily to fund domestic expansion. In this sense, we would argue, the internationalisation of Chinese firms to CBVI is quite specific and related institutional constraints in capital markets. Boisot and Meyer (2008), in making their argument, refer primarily to product markets (i.e. logistic costs). Thus their ideas need a degree of refinement to be consistent with our findings but nonetheless are helpful.

Boisot and Meyer (2008) suggest, in the Chinese case, firms will tend to internationalise earlier (i.e. at a smaller size) than in other cases. Is this the case? If we look at greater detail at the type of firms registering in our Cayman Islands sample it is clear they are not, for the most part, the large state owned enterprises we would expect to be dominating China's OFDI. Instead they are relatively smaller private businesses in fast growing dynamic industries with potential – attractive to private investors looking for growth but also the very firms keen to escape domestic institutional constraints. Of the 72 examples we find, for example, eleven belong to the ‘semiconductors and related devices’ industry. Eight belong to ‘business services,’ five belong to ‘computer programming services’ and ‘pharmaceutical preparations.’ Three are ‘advertising agencies,’ ‘educational services’ and ‘radio telephone communications.’ Without exception the firms tend to be smaller than their larger SOE counterparts but also in more dynamic industries.

While at face value then it appears OFDI to CBVI has little to do with the internationalisation of Chinese business (as these investments are made to finance expansion back in the Chinese market) this observation needs qualification. While the capital raised in CBVI may well flow back to China, the corporate structures developed in CBVI are more familiar to international investors and may provide opportunities for these companies also to move, in the longer term, more aggressively into other international markets. There are already examples of CBVI registered Chinese firms undertaking takeovers of firms on other international stock exchanges (on the Toronto stock exchange). The greater transparency and the more familiar corporate structures these firms have developed may therefore place them in very advantageous positions for the further genuine internationalisation of their business operations.

This paper then challenges the current widespread exclusion of Chinese OFDI into the CBVI by the existing literature. By using a qualitative microeconomic approach based around company filings, we conclude that firm-level behaviour is consistent with aggregate macroeconomic statistics. This behaviour sees the majority of investment into the Cayman Islands, with smaller amounts in the British Virgin Islands and negligible amounts into the various other OECD identified tax havens. We regard this as value-adding round-tripping, because extra capital value is gleaned from listing on foreign stock exchanges. We disagree with the literature, which argues that Chinese investment into these tax havens is for purely non-value-adding activities (such as enjoying lower taxes offered to foreign firms). This conclusion could have important policy implications, as recently we have seen a government effort to clamp down on these so-called ‘round-tripping’ investments, investments which could actually be bringing beneficial foreign investment into the country. In September 2006, for example, new provisions on mergers and acquisitions of domestic enterprises by foreign investors came into force, meaning that any sort of round-trip investment would need to be approved beforehand. Thus recently: ‘There have been virtually no approvals for restructurings of Chinese companies into offshore holding companies’ (Chao and Xu 2008: 2). Even after these provisions, however, it was still possible to restructure offshore, create a wholly-owned foreign subsidiary in China, which in turn would control Chinese subsidiaries with contractual arrangements (Chao and Xu 2008: 2). We have certainly seen contractual arrangements used (as in the case of CNinsure, a sample firm). However, a second major law, SAFE issued Circular no. 106, has made this practice almost impossible. Circular 106 demands that only domestic companies with a three year operating history may become involved in round-tripping (Chao and Xu 2008: 2). Circular 106 also stipulated that any Chinese resident who registers an offshore firm in order to acquire existing assets in a Chinese company must undertake a 'Circular 75 registration,' which is increasingly costly for firms (Chao and Xu 2008: 4). Some are pessimistic over the future use of offshore firms: 'China has a tremendous amount of domestic liquidity seeking investments [*sic*] opportunities, preferably close to home. By offering more investment opportunities to Chinese domestic investors, the Chinese government can soak up domestic liquidity, and at the same time avoid too much foreign currency entering China, which is undesirable because it adds pressure to appreciate the RMB' (Chao and Xu 2008: 5). It seems then that after a few more years of heavy Chinese OFDI to the CBVI, the phenomenon may end as abruptly as it started.

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