1. Introduction

The international business networks that tie the European Union with China have grown from the first pioneering steps taken in the EU-China trade relationship in the early 1950s. Until the Open Door Policy of the People's Republic of China, introduced in December 1978, the only international business relationship that could be countenanced was one based on international trade. Trading companies were an important part of this picture, and the role of locations such as Hong Kong were key to facilitating the growth of international trade. With regard to foreign direct investment (FDI) the Open Door Policy was the turning point that heralded in the modern era of international business between China and the EU based to a substantial extent on FDI.

In this chapter we look at EU-China Investment Relationship in both directions. First we consider EU to China investments as they are larger and longer established. Second we consider Chinese to EU investments, using the available data, mainly from 2004 onwards.

Since the 1950s international economists have wrestled with understanding the theoretical causes of foreign direct investment. The sort of FDI and that came under scrutiny in the post-war period was primarily investment between developed economies. A leading early example is John Dunning's seminal study of United States' manufacturing FDI into the United Kingdom (Dunning, 1958). During this post-war period the importance of FDI between developed and developing economies was, to some extent, overlooked. Developed-to-developing FDI had been dominant before the Second World War and, to a large extent, this leading position had receded with decolonisation by the imperial powers of the world, principally those located within Europe. A body of theory arose, *pari passu*, which explained manufacturing FDI between developed countries (Hymer, 1960; 1976). This FDI was a natural outgrowth of trade liberalisation under successive rounds of multilateral trade negotiations under the General Agreement on Tariffs and Trade (GATT) and this type of FDI came to characterise multinational enterprises and the bulk of FDI in the post-war period.

It was only with domestic economic liberalisations, mostly occurring during the 1980s, when developing countries embraced foreign direct investment as a source of economic growth, largely prompted by the long-standing exemplars of the free-trade-oriented open economy, such as Hong Kong, Taiwan, and Singapore. In this respect China was ahead of the pack with its major liberalisation dating from 1978. At this time many developing economies still regarded FDI with great suspicion and hostility, particularly those whose economic model was based in some way upon Marxism, often as a response to a history of imperial colonisation. The subsequent economic *volte-face* by these economies has been nowhere as comprehensive and successful as that in China.

1.1. European investments in China and the big questions

Foreign direct investment is, of course, just one form of international business, and of market servicing strategy. The market to be serviced may well be within the host country, or may be the home country, or indeed a third country. These, respectively, align with the various motives for foreign investment: market seeking, efficiency seeking, resource seeking, and strategic asset seeking (Dunning and Lundan, 2008). The motives for FDI in China are likely to shift, particularly for FDI in the developed East, towards market seeking FDI and away from efficiency seeking greenfield projects. The mode of entry may also shift towards acquisition where this is permissible.

The first stage of a direct foreign market entry strategy is the choice of foreign direct investment over other forms of market servicing. Once FDI has been selected, the parent firm must choose the type and extent of ownership of the new foreign affiliate. Acquisition necessarily means the taking over of an existing business, which may be locally owned, or may indeed be in by a different foreign parent. However, acquisition is generally to preserve of inward investment into developed economies where attractive acquisition targets are likely to exist. In emerging markets, it is far less likely that a foreign firm will wish to take over an existing business. This explains why greenfield entry is preferred in China, plus the added reason that acquisition may not be legally possible in certain industries. Regarding the extent of ownership, joint-venture ownership has been widespread, but often the result of an obligation to find a local partner (Buckley, Clegg and Tan, 2003).

One of the perennial controversies regarding FDI into, and by, China is the degree to which market distortions are responsible for both the pattern and level of FDI[1]. With regard to FDI into China, Havrylchyk and Poncet (2007) conclude that private enterprises in China are forced to look for a foreign investor in order to escape the constraints imposed by the Chinese state-owned banking sector, while foreign investors are channelled toward business partnerships with Chinese state-owned enterprises (SOEs) as a result of frequent intervention by state bureaucrats. The forced joint venture is emblematic of the legacy of distortions endemic within Chinese industry whereby, before 1986 foreign firms had to enter into joint ventures with a Chinese partner - typically a bureaucratically imposed state-owned enterprise, or a shortlist of enterprises that the foreign investor would not have selected given a free choice. Such joint-venture, or ownership, restrictions are now largely removed from manufacturing (but with some notable exceptions such as automobile manufacturing) and, to a lesser extent, the services sector. It is further argued that business cooperation between the local Chinese enterprise sector and SOEs is a rarity, and this leads to an incapacity of China's state dominated industry to behave in an entrepreneurial manner. These findings accord with the conventional wisdom of many researchers studying inward FDI into China.

As China develops as a host environment, and as its domestic institutions at grade, there may paradoxically, be a lessening of the pressure to engage in FDI in China. This is because the imperative to internalise non-core operations (owing to poor quality or missing suppliers) is lessened as the host matures, and as domestic institutions become more predictable and supportive of contractual relations. We can expect greater outsourcing the local suppliers, with direct production by foreign and affiliates increasingly confined to only essential operations. Dynamically, of course, this may encourage greater competition from domestic firms, as they seek to move up the value chain and compete head-to-head with Western firms. The eclectic paradigm,

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[1] Inward foreign direct investment has responded to a number of major policy initiatives to liberalise the Chinese market. Before the Open Door Policy of 1978, FDI was banned in all Chinese industry. The Open Door Policy provided for a programme of industry-specific liberalisation, rolling inland from the Special Economic Zones (SEZs) on the eastern coastal provinces of China. To date just under 90 per cent of inward FDI flows go to these eastern provinces. Policy is now far more liberal, however, restrictions on activity or ownership remain in some key sectors for European investors, within services and particularly motor manufacturing.

which employs a classification of ownership, locational, and internalisation (OLI) factors to explain the ownership, location and type of coordination (intrafirm or external market) applies not only at the national level, but also at the subnational level. Within China is this is a very meaningful classification, as each province is often considerably larger than most EU member states. The regional investment strategy of EU firms within China is an important dimension to understanding the overall attractiveness of China to the EU as an investment location. Recent work has shown that the attractiveness of the different locations within China is developing away from the heavily invested locations of the Eastern seaboard (UK Trade & Investment. 2008). However, it has to be noted that the Central and Western Regions of China, are dominated by State-Owned Enterprises, and for foreign investors this environment is less attractive.

Foreign direct investment into China has been at the centre of Chinese economic growth policy. But we are now entering a phase where Chinese outward FDI may become just as central to China's future economic growth. The following sections examine both these dimensions from the perspective of the EU-China business relationship.

Such empirical work as there has been on the business relationship between China and the rest of the world has concluded that countries that are geographically, politically, ethnically and economically close to China have a higher FDI intensity with China (Zhang, 2005). The scale of investment is found to increase with high productivity and with the degree of advancement in the economic structure of the home country.

Chinese GDP would have been three percentage points lower if it would have not been for inward FDI from all countries (Whally & Xin, 2010). This means that Chinese growth to this day has been dependent on inward FDI. The significance of this is greater than might at first be thought. Given that China's population is still growing, for material living standards to rise it is necessary that the growth of GDP exceeds the growth in population. In simple terms, China has to run in order to stand still. Therefore only very high rates of growth are sufficient to guarantee the continued growth of living standards for the average citizen.

American FDI to China has been less concentrated in manufacturing than the average for all investors for China while Japan's FDI has focused on manufacturing. As a result Japanese affiliates in China are far more export orientated than their American counterparts (Greaney and Li, 2009). The impact of European investments on China are less clear, precisely because the internal diversity of the EU. Some, in services, are primarily domestic market oriented, but in manufacturing, it can be highly export-oriented as FDI. Many small and medium sized investors, as well as larger investors, have dramatically cut their production costs by locating labour-intensive production in the export-oriented production locations of China, in what is classic efficiency-seeking FDI.

To gain a grasp on the overall EU outward investment relationship, and working with Eurostat figures EU15 FDI flows to China and Hong Kong, from Table 1 we can see that, for certain, since 1992 the annual FDI flow has risen in absolute terms to both economies. More important for gauging the comparative strategy of EU investors is the proportion (of EU FDI to the world). This has clearly risen since 1992 –to both China and Hong Kong– but it has not continued to rise monotonically. Clearly investment outflows from the European Union to other parts of the world continue to keep pace with those to China.

In stock terms the picture is little different from that of flows. Table 2 shows that EU15 FDI in China is under 2 per cent of the world total, and is exceeded by EU15 FDI into Hong Kong, at around 2.4per cent. The considerable links between EU15 and Hong Kong, notably with the UK, are undoubtedly a factor, but it cannot