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Research on the Influence of Host Country's Economic Policy Uncertainty on China's OFDI

Yixuan Wei[1]

[1] Social Sciences and Philosophy, Trinity College Dublin, Dublin, Ireland

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Abstract

The influence of host county economic policy uncertainty (EPU) on China's outward foreign direct investment is examined in this article (OFDI). The impact of host country economic policy uncertainty on China's OFDI is investigated using panel data from Chinese OFDI to 20 important investment countries from 2011 to 2020. A fixed effects model is used, with the host country's economic policy uncertainty as the main explanatory variable and six significant variables chosen as control variables. According to the results of the empirical analysis, the host country's economic policy uncertainty will inhibit investment from the home country to that country.

Keywords

economic policy uncertainty, outward foreign direct investment, host country

1. Introduction

Economic development is aided by foreign direct investment, and China's outward investment has achieved exceptional results due to the Chinese government's aggressive promotion of OFDI. China's outward investment reached US$153.71 billion at the end of 2020, an increase of 12.3% year over year, and for the first time, the flow size placed first globally, accounting for 20.2% of the global share. Economic policy is one of several elements that affect OFDI, but it is a significant one. The more frequently economic policy changes, the greater the uncertainty associated with those changes. The major economies of the globe are utilized to indicate economic and policy uncertainty using the Economic Policy Uncertainty Index. According to (Bakery, Bloom, & Davis, 2016), the EPU indices for all countries save the United States are news indices. The EPU indexes are based on the frequency of key phrases used in each country's main newspapers to represent economic uncertainty, such as "uncertainty, economic, policy, tax, spending, regulation, bank, budget, and deficit" (Bakery, Bloom, & Davis, 2016) Their research demonstrates that the EPU indices have a considerable inverse association with genuine

macroeconomic factors (such as economic growth and employment) and can even explain big changes in equity markets (e.g., S&P500).

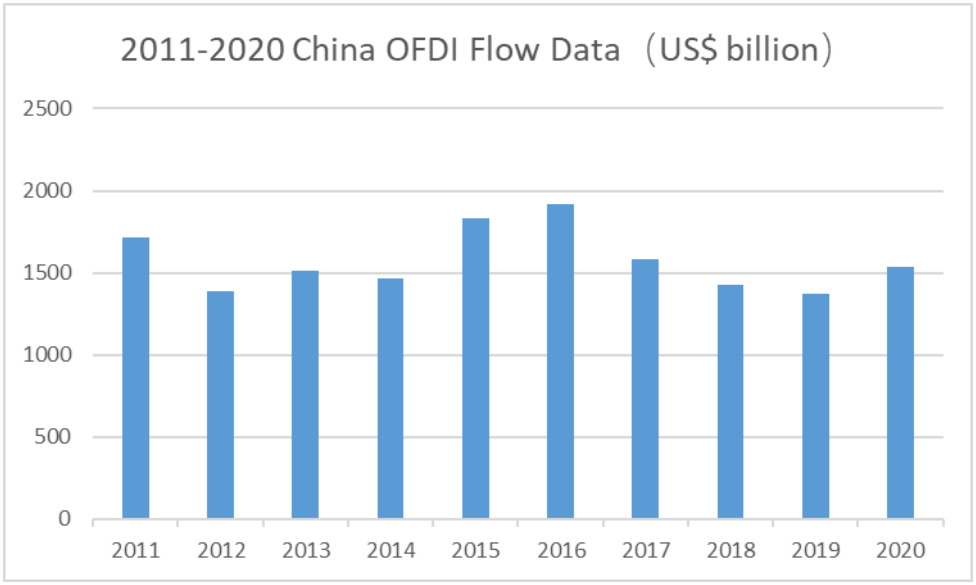

Figure 1. 2011-2020 China OFDI Flow Data (US$ billion)

In this paper, we choose 20 important investment countries based on the most recent EPU index, namely America, Australia, Brazil, the United Kingdom, and Canada. Chile, Colombia, France, Germany, Greece, India, Ireland, Italy, Japan, Korea, Netherlands, Russia, Singapore, Spain, and Sweden were chosen as the 20 most important investment destinations to examine the impact of these host countries' EPU on China's OFDI in these countries. This paper makes an important contribution in that it not only examines the impact of host country EPU on Chinese OFDI, but it also incorporates six factors that influence investment decisions and examines the impact of host country EPU on the second year of OFDI from the investors' perspective. The results indicate that Chinese firms' investment decisions can be seriously deterred by economic policy uncertainty (EPU) in host countries.

Based on this, this paper draws conclusions from a literature review, an economic model and empirical approach, a data description and empirical results from the latest data, and finally, suggests reasonable policy recommendations.

2. Background and Motivation

Economic uncertainty as a factor of global economic recession. On the one hand, in the context of economic globalization, national economies are interconnected and interdependent, and economic uncertainty in one country will inevitably be influenced by economic uncertainty in other countries, prolonging or enhancing the direct impact of its own economic uncertainty on its own economy. On the other hand, the global economy has been in recession since the start of the global financial crisis in 2008,

and a number of frequently implemented government economic stimulus measures have increased the level of uncertainty surrounding economic policy in every country. Rising economic policy uncertainty will inevitably have an impact on domestic economic uncertainty, which could then have an effect on domestic macroeconomic performance. In this context, examining the effect of economic policy uncertainty in host countries on domestic economic development can assist government administrations in implementing targeted responses to uncertainty shocks.

China, as the world's largest trading nation and the world's second-largest economy, ranks among the top in terms of foreign investment inflows and outflows. As a large, open economy and a major participant in the global economy, China's economic uncertainty will inevitably be affected by the economic uncertainty of other major economies as the wave of economic integration continues. While global FDI flows fell by as much as 42% due to the impact of the 2020 global COVID-19 pneumonia epidemic, developing economies, led by China, were less affected, falling by only 12% year on year, and China's outward FDI is a significant global player in terms of both scale and flows. However, China is confronted with a more complex global economic situation and investment environment.

Due to information asymmetry, corporate decision-makers in OFDI activities are unable to predict future policy changes in the country of investment, and their investment activities are exposed to economic policy uncertainty risk. Based on this, this paper will investigate the impact of economic policy uncertainty on China's OFDI from the perspective of the host country's economic policy uncertainty, as well as demonstrate the causal relationship between economic policy uncertainty and China's OFDI, which has both theoretical and practical implications for promoting China's economic growth.

3. Literature Review

3.1 Research on Economic Policy Uncertainty

Economic Policy Uncertainty (EPU) is made up of three parts: economic uncertainty, policy uncertainty, and economic policy uncertainty. Early scholars focused on economic uncertainty because there are too many uncontrollable factors in policy uncertainty. Baker and Bloom (2014) contend that the causal role of policy uncertainty is difficult to assess and that economic policy is vulnerable to unforeseeable factors that these factors stem from the government's policy of currency intervention. Davis (2012) defines economic policy uncertainty as the impediment to economic development caused by policy changes, and they show that an increase in economic policy uncertainty implies a decline in output, employment, and investment.

To investigate in depth how economic policy uncertainty influences economic development, academics have increasingly prioritized quantifying economic policy uncertainty. Manela (2017) proposed news implied volatility (NVIX) as a new indicator to measure uncertainty. However, this indicator covers fewer influencing factors and cannot measure changes in economic policy uncertainty comprehensively. Bhattacharya (2017) measures policy uncertainty by measuring elections in 43 countries and argues that the election of a country's leader is the most influential factor for changes in economic policy. Both of

the aforementioned indicators are restricted to changes in policy uncertainty and do not accurately reflect economic uncertainty; consequently, the results measured using the aforementioned indicators are somewhat biased. This paper employs the news index proposed by Bakery and Bloom (2016) to measure the direction of change in the host country's economic policy uncertainty based on the full range of influencing factors.

3.2 Research on the Factors Affecting Outward Foreign Direct Investment

Outward Foreign Direct Investment, or OFDI for short, refers to the outflow of international direct investment from a country, i.e., investments made by corporate investors who directly create and manage businesses abroad. Since China's reform and opening up, there has been a significant increase in OFDI operations. As China's OFDI operations are impacted by different circumstances in the host country, there is a great deal of uncertainty in OFDI, which has attracted a great deal of inquiry from researchers both domestically and internationally.

Gammeltoft & Peter (2010) examines the significant elements that impact OFDI in India and China. He claims that the primary influencing factors are the host country's GDP, level of technology, and natural resources and that these factors have a positive relationship with OFDI. These influencing elements provide a novel perspective to the research of OFDI. According to Jian, Zhou, and Shu-yu (2010), the main factors influencing Chinese OFDI are the host country's institutions and environment. They suggest that there is a significant positive relationship between the host country's institutional index and Chinese OFDI and that Chinese firms will invest in countries with a better institutional environment. Quer and Claver (2012) analyze how Chinese outward foreign direct investment is affected by host country political risk, cultural distance, and geographic distance between the two countries. They contend that while political risk does not prevent Chinese investment abroad, geographic distance between the two countries dampens Chinese OFDI.

3.3 Impact of Economic Policy Uncertainty on OFDI

Since the beginning of the global financial crisis in 2008, which led to a major increase in the magnitude of economic uncertainty in several nations, but not in China, the amount of outward foreign direct investment (OFDI) by Chinese enterprises has risen steadily. Using a spatial econometric model, (Kuang-Hann, 2011) investigated the influence of the host country EPU on Chinese OFDI in the wake of the global financial crisis. They concluded that the financial crisis had no significant influence on Chinese OFDI, but nations with considerable changes in economic policy had a significant dampening effect on Chinese OFDI. Hsieh and Boarelli (2019) investigate the impact of US economic uncertainty on Chinese OFDI, arguing that under the influence of US economic policy uncertainty, China has clear risk aversion measures in overseas M&A. Based on empirical study, Zhang, Lidan, Colak, and Gonul (2022) show a negative association between host nation EPU and capital outflows from Chinese enterprises and emphasize the risks of Chinese OFDI during the COVID-19 epidemic.

The significance of the influence of economic policy uncertainty on OFDI is evident from our review of the current research. However, the majority of prior research has examined the effect of economic policy

uncertainty in home countries on OFDI, whereas the examination of economic policy uncertainty in host countries is insufficient. Second, the study of the research subjects' heterogeneity has been disregarded. Less research has been conducted on the selection of variables that influence the uncertainty of economic policies in the host country. In order to uncover the elements impacting Chinese OFDI, this research analyzes these issues and proposes more credible factors to evaluate the host country's economic policy uncertainty.

4. Economic Model and Empirical Approach

4.1 Economic Model and Empirical Approach

The study topics in this article are integrated based on economic policy uncertainty and the factors influencing OFDI. This article uses country-level panel data for 20 nations from 2011 to 2020, with economic policy uncertainty serving as the main independent variable and six relevant factors serving as control variables. Typically, investors' business planning for the following year of the enterprise is based on the current year as well as previous data analysis at the end of the year, so this paper studies investors' investment decisions for the second year in the host country based on the last year's data reference, on which the following fixed effects econometric model is developed.

$$lnOFDI_{it+1} = \beta_0 + \beta_1 DEPU_{it} + \beta_2 lnDGP_{it} + \beta_3 Tec_{it} + \beta_4 Re_{it} + \beta_5 \mathrm{lndist}_{it} + \beta_6 Tax_{it} + \beta_7 CPI_{it} + \mu_i + \vartheta_t + \varepsilon_{it} \quad (1)$$

In the model, $lnOFDI_{it+1}$ represents the dependent variable, which is the data of Chinese investment flows to the host country in period t+1. $DEPU_{it}$ denotes the core independent variable in the regression model, which is the index of economic policy uncertainty of the host country in period t. β_1 reflects the degree of influence of economic policy uncertainty of the host country on Chinese OFDI. β_2 is the degree of influence of the host country's economic size ($lnDGP_{it}$) on Chinese OFDI. β_3 is the degree of influence of the host country's technological level (Tec_{it}) on Chinese OFDI. β_4 is the degree of influence of the host country's natural resources (Re_{it}) on China's OFDI. β_5 is the degree of influence of the distance between the host country and China (lndist_{it}) on China's OFDI. β_6 is the influence of the host country's tax level (Tax_{it}) on China's OFDI. β_7 is the influence of the host country's consumer price index (CPI_{it})

on China's OFDI. μ_i represents the fixed effect of unpredictable factors in host country i that do not vary over time, and ϑ_t represents the time fixed effect. ε_{it} is the error term.

To further examine the various investment motivations of Chinese OFDI and analyze the heterogeneity of investment motives, the interaction term DEPU it*G t is introduced to model (1), yielding the following econometric model.

$$lnOFDI_{it+1} = \beta_0 + \beta_1 DEPU_{it} + \beta_2 DEPU_{it} * G_t + \beta_3 lnDGP_{it} + \beta_4 Tec_{it} + \beta_5 Re_{it} + \beta_6 \text{lndist}_{it} + \beta_7 Tax_{it} + \beta_8 lnCPI_{it} + \mu_i + \vartheta_t + \varepsilon_{it} \quad (2)$$

Where G stands for $lnDGP_{it}$, lndist_{it}, $lnCPI_{it}$.

4.2 Variable Description

(1) dependent variable

The dependent variable is Chinese outward foreign direct investment (OFDI) flow data. Flow data represents the cumulative change over a period of time and is a more accurate measure of the extent of change impacted by indicators of economic policy uncertainty than OFDI stock data.

(2) Primary independent variable

The primary independent variable is the Economic Policy Uncertainty Indicator (EPU) of the host country. Since this indicator is measured on a monthly basis, a yearly average is employed as a measurement in this paper.

(3) Control variables

In addition to the EPU, other factors can have an impact on OFDI. To account for the impact of other variables on OFDI, the model includes the control variables lnGDP, Tec, Re, lndist, Tax, and CPI.

① Size of the economy (GDP)

The size of a country's economy is a good indicator of its level of economic progress. A country with a strong economy can entice more international businesses. The size of a country's economy (GDP) is also a significant element affecting OFDI since it might affect an investor's degree of profitability.

② Technology level (Tec)

With the expansion of the global economy, innovative and emerging technologies are now a crucial component of a nation's economic growth. The country's innovation in new technologies is better the higher the degree of technology. More investors will be drawn as a consequence.

③ Natural endowment (Re)

The quantity of natural resources that a nation has is measured as its natural endowment. The country's natural resources are more abundant the bigger the natural endowment. If companies orient their investments more towards the country's natural resources, they will save a lot of raw material cost issues.

④ Level of taxation (Tax)

The economy determines taxation, and taxation reflects the development of the country and assures the level of fiscal income. As a result, the tax level of the host country will have an indirect impact on China's OFDI.

⑤ The distance between the host country and China (lndist)

Geographical distance is a measure of the cost of distance for OFDI, namely transportation, information, and labor expenses. These cost considerations also have an impact on OFDI in China.

⑥ Consumer Price Index (CPI)

The consumer price index is a macroeconomic statistic that measures changes in the prices of goods and services purchased by households. The consumer price index can be used by investors to assess the economic market conditions in a host country.

Table 1. Variable Description

Variable Type	Variable	Variable Description
Dependent Variable	lnOFDI	Natural logarithm of Chinese OFDI flows
Independent Variable	DEPU	Natural logarithm of the EPU index for the host country
	lnGDP	Natural logarithm of the host country's GDP
	Tec	Host country technical level proxy indicator
	Re	Proxy indicators for host country resource endowment
Control Variables	lndist	Natural logarithm of the geographical distance between China and the host country
	Tax	Host country taxation levels
	CPI	Consumer Price Index

5. Data Sources

Based on data collection and processing, the following nations were chosen as samples for this paper: America, Australia, Brazil, Britain, Canada, Chile, Colombia, France, Germany, Greece, India, Ireland, Italy, Japan, Korea, the Netherlands, Russia, Singapore, Spain, and Sweden.

Data on Chinese OFDI flows are derived from the *China OFDI Statistical Bulletin*, the host country economic policy uncertainty index (EPU) is derived from the website: http://www.policyuncertainty.com, data on other control variables such as host country GDP, Tec are derived from the World Bank database, and the distance between the two capitals is derived from the CEPII database.

After compiling the appropriate data, this research uses STATA17 to get panel data for 20 countries from 2011 to 2022, with a total of 200 observations. The following are the descriptive statistics for the indicators used in this article.

Table 2. Descriptive Statistics

	(1)	(2)	(3)	(4)	(5)
VARIABLES	N	mean	sd	min	max
ln_OFDI	191	10.56	1.952	3.761	14.35
DEPU	200	5.013	0.433	4.044	6.297
ln_GDP	200	14.08	1.120	12.15	16.88
Tec	200	18.24	10.46	4.679	55.45
Re	200	23.11	20.71	1.037	75.42
ln_dist	200	8.880	0.676	6.862	9.856
Tax	182	17.74	5.724	9.183	28.12
CPI	200	115.2	17.59	99.68	186.8
Uem	200	8.100	5.211	2.4	27.47
Fl	200	5.060	10.616	-37.67	81.30

Table 2 shows that the dependent variable (lnOFDI) has a minimum value of 3.761 and a maximum value of 14.35, with a big gap between the maximum and minimum values showing a wide fluctuation in China's pair investment in the host country. The primary independent variable (DEPU) has a mean value of 5.013, a minimum value of 4.044, and a maximum value of 6.279, showing that the nations analyzed in this article saw less fluctuation in economic policy uncertainty during this era. Because both the independent and dependent variables were in flux during this time period, this study will be significant.

6. Empirical Results

6.1 Baseline Regression Results

The study starts with a correlation test between the variables using a baseline regression. Table 3 shows that the correlation coefficients between the variables are all less than 0.5, indicating that the variables are not multicollinear.

Table 3. Correlation Coefficient Matrix

Variables	F.ln_OFDI	DEPU	ln_GDP	Tec	Re	ln_dist	Tax	ln_Uem	CPI
F.ln_OFDI	1								
DEPU	0.0523	1							
ln_GDP	0.2652*	0.2242*	1						
Tec	0.0854	0.2327*	-0.0806	1					
Re	0.0005	-0.1027	-0.342*	-0.366*	1				
ln_dist	-0.118	0.1023	-0.172*	-0.410*	0.3632*	1			
Tax	0.0995	-0.163*	-0.318*	-0.0277	-0.1337	0.0924	1		

Uem	-0.0357	-0.1188	-0.341*	-0.387*	0.072	0.334*	0.3375*	1	
CPI	0.1350	0.1382	0.0516	-0.209*	0.2976*	0.0793	-0.406*	-0.0663	1
Fl	-0.0907	-0.0176	-0.342*	0.4043*	-0.0944	0.0509	-0.0236	0.0064	-0.11

* indicates at 5% level of significance

Based on the STATA17 analysis of the two-way fixed effects model, we obtain the results of Table 4-Modle 1. The econometric results show that the host country's economic policy uncertainty (DEPU) is negatively correlated with Chinese OFDI at $p<0.05$, indicating that it passes the test at the 5% level of significance. It can be concluded that the host country's economic policy uncertainty inhibits Chinese OFDI, with each unit increase in EPU magnitude decreasing OFDI by 0.85 units.

Furthermore, table4-model1 also shows that the GDP, technology level (Tec), resource endowment (Re), and consumer price index (CPI) of the host country are positively related to China's OFDI, suggesting that the GDP, technology level (Tec), resource endowment (Re) and consumer price index (CPI) of the host country all contribute to the increase of China's OFDI and pass the test at the 1% significance level. Geographical distance (lndist) has a coefficient of -0.75 but does not pass the significance level test, suggesting that under the influence of economic policy uncertainty in the host country, greater distance discourages Chinese OFDI.

6.2 An Empirical Analysis Based on the Heterogeneity of Investment Motives

On the basis of the diversity of investment motives, model (2) interaction terms were introduced to investigate whether there is variation between host country EPU and Chinese OFDI depending on investment motives. Table 4 displays the results of the interaction term regression.

Table 4. Baseline Regression and Regression Results for Different Investment Motives

	(1)	(2)	(3)	(4)
	model1	model2	model3	model4
VARIABLES	F.ln_OFDI	F.ln_OFDI	F.ln_OFDI	F.ln_OFDI
DEPU	-0.85**	0.75	-31.08***	12.95**
	(0.40)	(5.63)	(10.36)	(5.66)
DEPU_lnGDP		-0.11		
		(0.40)		
DEPU_lnCPI			6.31***	
			(2.16)	
DEPU_lndist				-1.54**
				(0.63)
ln_GDP	1.06***	1.63	1.08***	1.04***

	(0.17)	(2.02)	(0.16)	(0.16)
Tec	0.07***	0.07***	0.07***	0.07***
	(0.02)	(0.02)	(0.02)	(0.02)
Re	0.05***	0.05***	0.04***	0.04***
	(0.01)	(0.01)	(0.01)	(0.01)
ln_dist	-0.75	-0.78	-0.79*	6.94**
	(0.49)	(0.50)	(0.48)	(3.18)
Tax	0.19***	0.19***	0.19***	0.19***
	(0.04)	(0.04)	(0.04)	(0.04)
CPI	0.04***	0.04***	-0.20**	0.04***
	(0.01)	(0.01)	(0.08)	(0.01)
Constant	-3.48	-11.37	26.24**	-72.74**
	(4.79)	(28.18)	(11.20)	(28.72)
Observations	163	163	163	163
R-squared	0.33	0.33	0.37	0.36

Standard errors in parentheses

*** p<0.01, ** p<0.05, * p<0.1

According to Table4-Model 2, the coefficient of the interaction term DEPU*lnGDP is negative, but the correlation coefficient fails the significance test, indicating that if firms' investment is motivated by the level of economic size (GDP) of the host country, a rise in the index of economic policy uncertainty in the host country has a dampening effect on firms that value the size of the host country's economy to undertake OPDI, but the effect is not significant. Table 4-model 3 shows that the coefficient of the interaction term DEPU*lnCPI is positive and p<0.01, passing the test at the 1% level of significance. This implies that if companies' investment is motivated by the host nation's consumer price index (CPI), an increase in the index of economic policy uncertainty in the host country will promote outbound FDI by Chinese firms. This might be an investment decision made by investors that appreciate the host country's strong demand market. Table 4-model 4 shows that the coefficient of the interaction term DEPU*lndist is negative and p<0.05, passing the 5% significance test. This implies that if enterprises' investment is motivated by the distance between the two countries, an increase in the host country's index of economic policy uncertainty will hinder outbound FDI by Chinese firms.

6.3 Robustness Tests

(1) Add new control variables

The control variables used for this article in the econometric model (1) are lnGDP, Tec, Re, lndist, Tax, and CPI. To verify the model's robustness, two more control variables are added: the degree of

unemployment (Uem) and the host country's openness (FI) (the ratio of foreign capital inflows into the host country to the GDP of the host country). The model is robust, with the inclusion of the two variables Ume and FI, DEPU is still negatively associated with OFDI at the 1% significance level, and the signs of the coefficients of the other control variables are the same as the empirical results of table4-model 1.

(2) Endogeneity test

In order to avoid endogeneity, the DEPU data in the econometric model (1) is replaced by data with a one-period lag before doing the empirical analysis. The results from Table 5 -model 2 show that there is no significant difference in their findings, EPU still suppresses OFDI and therefore it can be shown that the above empirical results are robust.

Table 5. Robustness Tests

	(1)	(2)
	model1	model2
VARIABLES	F.ln_OFDI	F.ln_OFDI
DEPU	-0.7529*	
	(0.3878)	
L.DEPU		-2.3189***
		(0.3560)
ln_GDP	1.2937***	1.0807***
	(0.1839)	(0.2149)
Tec	0.0761***	0.0494***
	(0.0219)	(0.0183)
Re	0.04689***	0.0426***
	(0.0132)	(0.0116)
ln_dist	-0.7753	-0.3060
	(0.4925)	(0.4488)
Tax	0.1852***	0.1648***
	(0.0436)	(0.0393)
Uem	0.1025***	0.0895**
	(0.0385)	(0.0377)
CPI	0.0329**	-0.0058
	(0.0129)	(0.0133)
Fl	0.02142	0.0178
	(0.01493)	(0.0136)
Constant	-7.5744	4.6419

	(4.9064)	(4.9557)
Observations	163	153
R-squared	0.3726	0.4954

Standard errors in parentheses

*** p<0.01, ** p<0.05, * p<0.1

7. Conclusion

This research investigates the influence of host country economic policy uncertainty on Chinese outward foreign direct investment (OFDI). According to the literature review is organized into three sections: the study of economic policy uncertainty, the study of factors influencing outward foreign direct investment, and the impact of economic policy uncertainty on outward foreign direct investment, and the research methodology appropriate for this paper is summarized. A panel data regression was performed on data from 20 investing countries from 2011 to 2020, with EPU as the core independent variable and economic size (GDP), technology level (Tec), natural endowment (Re), tax level (Tax), geographical distance between the host country and China (lndist), and Consumer Price Index (CPI as representative control variables. The influence of host country economic policy uncertainty on China's OFDI is experimentally investigated using a panel data regression model. Based on this, the following conclusions are drawn.

Economic policy uncertainty in the host country is significantly and negatively connected with Chinese OFDI, implying that the greater the increase in the host country's economic policy uncertainty, the greater the disincentive effect on Chinese OFDI. The host country's GDP, technology level (Tec), resource endowment (Re), and consumer price index (CPI) are all positively correlated with Chinese OFDI, implying that the host country's GDP, technology level (Tec), resource endowment (Re), and consumer price index (CPI) all contribute to the increase in Chinese OFDI. Geographical distance (lndist) is negatively connected with OFDI, the farther away a place is, the less likely it is that China will invest there.

Based on different investment objectives, shocks resulting from economic policy uncertainty in the host nation vary. The most significant results are based on the consumer price index (CPI) of the host country as a motivation for investment. The least significant result is based on the size of the host economy (GDP).

Based on the above research findings and China's economic development in recent years, this paper puts forward the following policy recommendations: First, optimize the industrial structure of outbound investment, progressively enhance China's foreign direct investment legislation, and assist businesses in conducting outbound investment effectively. Second, cultivate favorable connections with host nations, promote tight commercial cooperation and form solid bilateral relations. Thirdly, reduce the negative impact of uncertainty about the host country's economic policies on OFDI, and conduct OFDI in a targeted and rational manner.

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