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Solving Chinese outward foreign direct investment puzzle: The effects of geopolitical risks on Chinese outward foreign direct investment into Eastern European countries

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Abstract

We investigate the effects of geopolitical risks on China's outward foreign direct investment (OFDI) into the Central and Eastern European countries (CEECs). We employ the Poisson Pseudo Maximum Likelihood with the High-Dimensional Fixed Effects and use country level panel data from 2003 to 2022. Chinese OFDI stocks are differentiated by geopolitical risk and economic factor motives. We find both geopolitical risk and economic factor determine Chinese OFDI. In terms of specific countries, Chinese OFDI into Hungary and Serbia as well as three Baltic countries has a stronger geopolitical-seeking motive; while Chinese FDI into the rest of CEECs has a weaker geopolitical-seeking motive.

Neighboring with Ukraine or Russia deters Chinese OFDI to their direct neighbors. However, this effect decreases for a broader European market potential. We recommend that China can invest different resources and implement an OFDI screening process to balance geopolitical influences.

Keywords: Geopolitical risk, economic factor, foreign direct investment, gravity model, economic potential, market access

JEL Classification: F21, F51, P33

1. Introduction

Why are the Central and Eastern European countries (CEECs) important for China? Geographically, the CEECs are located between Western Europe and Asia. Therefore, their strategic location has attracted Chinese investors. Ongoing economic integration between Asia and Europe makes the CEECs more and more important. A good example is the recent “Belt and Road Initiative”. On the one hand, the CEECs can be regarded as an important gateway for China’s economic activities to the Single European Market. On the other hand, the CEECs have emerged as important cargo centers for European products exported to China.

Despite their strategic importance, Chinese outward foreign direct investment (FDI) in the CEECs is still relatively low and Chinese investors remain reluctant. For example, in 2022, Chinese FDI outflows to the CEECs amounted to 532.16 million USD, and total Chinese FDI outflows to Europe to 10,335.98 million USD. This means that FDI outflows to the CEECs accounted for only 5.15% of the total outflow to Europe. In terms of FDI stocks, Chinese FDI stock in the CEECs amounted to 3,361.93 million USD, and total Chinese FDI stock in Europe was equal to 141,072.93 million USD according to Statistical Bulletin of China’s Outward Foreign Direct Investment published by Ministry of Commerce of China. This means that the CEECs accounted only for 2.38% of the China’s total OFDI stock in Europe.

With the recent developments related to reshaping global value chains (GVCs) and current and potential military conflicts, China’s trade and investment activities in the CEECs suffer from complex and challenging environment which creates a real puzzle for China. This puzzle combines geographic, political and economic factors that can be jointly labeled as geoeconomics (Clayton *et al.*, 2023). Therefore, in this paper we attempt to address the importance of geoeconomic factors in determining Chinese outward FDI (OFDI) in the CEECs. According to the Statistical Bulletin of China’s Outward Foreign Direct Investment, China’s OFDI flows to Europe mainly go to Western European countries while the involvement in the CEECs is still quite limited. This is surprising given the strategic importance

and the geographic location of the CEECs. Therefore, in this paper we attempt to address the following research questions. Why does China's OFDI in CEECs not correspond to their geoeconomic position? How can this geoeconomic puzzle for Chinese OFDI be explained?

The determinants of FDI have become an increasingly popular research topic that has already attracted substantial attention in international business, economics, and political science literature. With the development of theoretical and empirical studies on FDI, we can better understand the determinants of China's general pattern of OFDI. On the one hand, Asiedu and Lien (2011) find that the abundance of natural resources and large markets combined with political stability can promote FDI. On the other hand, traditional FDI theories can explain economic motives for Chinese OFDI to CEECs as seeking access to the EU markets (Richet, 2019). At the same time, however, CEECs may suffer from geopolitical risks that have been recently intensified by the conflict between Russia and Ukraine. Hence, in the CEECs economic motives and geopolitical risks might jointly affect Chinese firms' investment decisions. Therefore, this special geopolitical environment in the CEECs may pose some new challenges to traditional FDI determinants, especially when the big political powers are competing for influence in the region.

Therefore, in this paper we extend the study of FDI determinants by focusing on the role of geopolitical factors. In particular, in contrast to the traditional international politics literature, which remains mainly descriptive, our paper employs a formal quantitative approach, that draws on international economics literature. In particular, by estimating an empirical model we identify geoeconomic motivations for Chinese FDI outflows to the CEECs. This approach allows us to combine both international economics and international politics literatures. Therefore, we can use the empirical model to investigate quantitatively the effects of both geopolitical and economic characteristics of CEECs on Chinese OFDI. In particular, in this paper, we study the effects of geopolitical risks on Chinese FDI into CEECs, having controlled for traditional economic FDI determinants.

The prior literature shows that geopolitical risks – from war, conflict, or tensions – create uncertainty that lowers investment (Caldara and Iacoviello, 2022; Tuathail *et al.*, 2003; Wang *et al.*, 2023). In our paper, geopolitical risk effect is to explain the FDI activity of an international investor whose primary aim is to create a structure of power to influence a host country and/or neighboring countries that are located geographically nearby. Similarly, economic factor is to explain the FDI activity of an international investor whose primary aim is to gain economic benefit.

Therefore, it is crucial to identify and distinguish between foreign direct investments motivated by geopolitical risks and those motivated by economic factors. Therefore, in this paper we explain whether China can potentially use OFDI as a tool to impact the whole CEE region and extend the study of geoeconomics.

As for our empirical methodology, we employ both gravity and economic potential models that are well established analytical frameworks in the international economics literature. Our sample is based on the China-CEEC cooperation framework, also known as “17 + 1” (later “14 + 1”). The reason to follow “17 + 1 / 14 + 1” to set up our sample is that this cooperation framework has been the most important cooperation platform for China to develop bilateral relationships since 2012. The motivation is to establish a mutually beneficial platform for both sides. Trade and investment are the most important fields covered under this framework.

The remainder of this paper is organized as follows. In the next section we provide the review of the relevant literature. Then, we describe our research methodology and discuss the properties of the dataset. Subsequently, we report and interpret our estimation results. The final section summarizes and concludes with policy recommendations and directions for further studies.

1. Literature Review

With the new background of emerging geopolitical risks and GVCs reshaping, traditional models of multinational enterprise stressing market seeking or access to production resources as investment motives might not be fully sufficient to explain FDI locational choices. The existing empirical studies effectively explain the economic determinants of FDI from developed countries, but investigations of FDI motives from emerging economies remain relatively limited.

Economic motivations for FDI are well-established in the literature for both developed and emerging economies. Market size and similarity encourage horizontal FDI (Nguyen and Cieřlik, 2021), and mainstream theories explain emerging economy outflows through factors like market size, skilled labor, and costs (Biswas, 2002; Blonigen, 2014; Cieřlik and Tran, 2019, 2023). For China, OFDI is driven by trade, market size, growth, openness, and resources (Zhang and Daly, 2011), with state-owned enterprises (SOEs) focused on exchange rates and resources (Amighini *et al.*, 2013; Duanmu, 2012), and private firms on markets and strategic assets (Amighini *et al.*, 2013; Wang and Tao, 2023). Host country’s economic size and market potential are also key determinants (Chang, 2014), with energy investments targeting developing countries (Li *et al.*, 2020).

At the same time outward FDI from emerging economies seems to be affected by institutional distance, favoring hosts with better institutions and showing a stronger preference for proximity (Aleksynska and Havrylchyk, 2013). Institutions are also critical for Chinese investors. Home country institutions and government support stimulate Chinese OFDI (Buckley *et al.*, 2018; Gaur *et al.*, 2018; Qu *et al.*, 2022; Wang *et al.*, 2012). Host country institutions also attract FDI by reducing uncertainty (Bevan *et al.*, 2004; Grosse and Trevino, 2005), influencing investment modes (Alon *et al.*, 2020), with cooperation frameworks like the Belt and Road Initiative acting as positive signals (Yu *et al.*, 2023). China's OFDI in institutionally diverse Europe is a key case study.

Governance quality indicates institutional strength. Social relations (Bandelj, 2002), risk-sharing (Albuquerque, 2003), democracy (Jensen, 2003; Asiedu and Lien, 2011), and political stability (Janicki and Wunnava, 2004; Kang and Jiang, 2012) attract FDI, though Chinese SOEs may prefer lower governance quality (Fon and Alon, 2022). Public perception can deter investment (Zeng and Li, 2019), while manager experience affects risk tolerance (Buckley *et al.*, 2018). FDI can also improve stability (Okara, 2023). The prior literature concludes that better host country's institutions can attract FDI due to predictable and reliable business activities. Institution and governance quality can be closely related to geopolitical risk, but existing literature on institution and governance quality pay little attention on positive or negative effect of geopolitical risk on FDI in Europe and or CEE region specifically.

Geopolitical risk creates uncertainty that suppresses investment (Caldara and Iacoviello, 2022; Wang *et al.*, 2023). Its effects are significant and negative for BRICKS and MENA countries (Moosa, 2009; Cetin and Yamen, 2023) and context-dependent (Kluge, 2017; Campos *et al.*, 2023). For China, findings are mixed: some studies find no effect from host political risk (Quer *et al.*, 2012), while others show negative effect of geopolitical risk on OFDI, especially in energy and green sectors (Lu and Liu, 2022; Du *et al.*, 2023). Geopolitical alignment also affects flows (Aiyar *et al.*, 2024), and OFDI can be a tool of geopolitical influence (Richet, 2019). We can observe the effect of geopolitical risk on FDI in general pattern and in specific regions, but not in CEECs. Hence, it is still difficult to find evidence about positive or negative effects of geopolitical risk on FDI for China and Europe or CEE region.

The previous studies have well documented the determinants of Chinese OFDI, including political risks. However, prior studies on Chinese FDI in the CEECs still remain limited to the investigation of general determinants of Chinese OFDI and did not pay much attention on the positive or negative effect of geopolitical risk on OFDI. In contrast to the existing literature, our study concentrates on the effects of geopolitical risks faced by the CEECs instead of the importance of institutions from the host country's domestic perspective. In particu-

lar, our paper investigates the entire CEE region which has strong geopolitical environment as well as strong market access to the EU in the form of full memberships or association agreements.

2. Model Specifications and Data Description

As argued by Faeth (2009) in the extensive survey of theoretical and empirical studies FDI should not be explained by a single theoretical model, but rather a combination of various analytical approaches that can complement each other. Therefore, on the one hand, our study is based on the traditional FDI literature that emphasizes the market seeking motive according to which the market size plays the most important role in attracting FDI. We employ the modified approach originally proposed by Cieřlik and Ryan (2004) who demonstrate that economic potential framework model can outperform the standard gravity model when explaining Japanese OFDI to the CEECs. In particular, they differentiate between the external market potential and the self-potential of a particular host country in the region. We modify their economic potential framework and employ it in our empirical model to account for the role of geopolitical risks.

On the other hand, in order to account in our empirical study for geopolitical risks, we refer to the recent theoretical study by Clayton *et al.* (2023) who develop a formal theoretical model to analyze economic networks with the influence of a hegemon. In particular, Clayton *et al.* (2023) argue that the production network is the subject for a hegemon to insert political influence and affect economic activities in host countries. With the expansion of FDI networks between China and the CEECs, production network structures can be established. These networks are the collections of firms and sectors between China and the CEE region. When production networks are augmented with geopolitical risks as additional externalities, they can transfer these externalities to their networks through specific firms or sectors. In this way, the production networks can be affected. One possible approach is to deter trading activities through production networks. The other possible approach is to increase trade costs through production networks.

The aforementioned framework allows us investigating the effects of geopolitical risks on Chinese FDI outflows to the CEECs. “Economic seeking” and “geopolitical seeking” can be regarded as two important motive drivers for Chinese OFDI to the CEE region. Based on our conceptual framework, our empirical model can be expanded to include market motivations combined with the recent geopolitical framework.

3.1 Estimating equation

In this paper, following the geopolitical framework used in the study by Clayton *et al.* (2023) and the modified economic potential model employed by Cieřlik and Ryan (2004), we construct the following economic potential model:

$$FDI_{it} = \alpha_0 + \alpha_1 GeoP_{it} + \alpha_2 EMP_{it} + \alpha_3 GDP_{it} + \alpha_4 InDist_{it} + \alpha_5 EU_{it} + \alpha_6 NATO_{it} + \alpha_7 CEE_{it} + \alpha_8 Ukraine_{it} + \alpha_9 Russia_{it} + \varepsilon \quad (1)$$

where $i = 1, \dots, 16$ is a specific CEE country; $t = 2003, \dots, 2022$ represents a particular year. In sum, there are 16 CEECs¹ along with other European countries, and covering 20 years. FDI_{it} is the foreign direct investment stock in millions US dollars from China to CEE country i in year t ; $GeoP_{it}$ is the geopolitical risk index for specific CEE country i in year t ; EMP_{it} is the external market potential; GDP_{it} is the measure of the market size in current US dollars in country i in year t ; $InDist_{it}$ is the internal distance of country i in year t ; $NATO_{it}$ is the dummy variable to show whether CEE country i in year t is a member of NATO. It takes value 1 if the CEE country is a member of the NATO in year t ; otherwise, it takes value 0. EU_{it} is the dummy to show whether the CEE country is a member of the European Union. It takes value 1 if the CEE country is a member of the European Union in year t ; otherwise, it takes value 0; CEE_{it} is the dummy to show whether the CEE country is within the frame of Cooperation between China and Central and Eastern European Countries; $Ukraine_{it}$ is the dummy to show whether CEE country i shares a border with Ukraine; $Russia_{it}$ is the dummy to show whether the CEE country i shares a border with Russia; ε is a white noise disturbance term that satisfies the standard properties.

In our empirical approach, we start with estimating the base gravity model which is equivalent to the empirical equation (1) with no EMP . Then we estimate the full economic potential model as shown in equation (1). We select most of the regressors based on Cieřlik and Ryan (2004). However, they do not have geopolitical variables. Hence, we follow Clayton *et al.* (2023) approach and add geopolitical risks as the core variables. The dummies for $NATO$, $Ukraine$, $Russia$ are also included, following Clayton *et al.* (2023), due to their relevance for geoeconomic power analysis.

In the estimated specifications all the non-dummy explanatory variables are expressed in logs while the FDI stock is expressed in levels (*i.e.* without log) to be able to employ

1 In terms of Serbia and Montenegro, before 2006, we treat them as one single country. Starting from 2006, we treat them as two separate countries. All the variables follow this principle.

the Poisson Pseudo Maximum Likelihood with the High-Dimensional Fixed Effects (PPM-LHDFE) estimation technique. For our estimations we use a panel dataset that includes 16 CEECs over the period from 2003 to 2022. The sample choice is determined by data availability. The sample starts in 2003 as it is the earliest possible year for Chinese OFDI to be available. The sample ends in 2022 as this is the most recent year for which data is available.

Since the empirical model estimated in our paper is a gravity-type model, we use PPM-LHDFE as our benchmark estimation strategy. PPMLHDFE is currently the most widely used empirical approach for estimating gravity-type models, especially when the dependent variable has many zeros and the model includes many dummies. This is exactly our case, as in some years, it is common for China to invest zero in some specific CEECs. Besides, we also include some dummies to show special geopolitical relationships in the CEE region. Therefore, we choose PPMLHDFE as our benchmark estimation approach. However, to study the robustness of our estimates we also employ alternative estimation techniques.

3.2 Data sources

FDI stock data come from the Statistical Bulletin of China's Outward Foreign Direct Investment. Geopolitical risk indices are sourced from the International Country Risk Guide (ICRG). Three proxies are used for geopolitical risk in our paper. Firstly, Political Risk Index is a composite index (0–100, where a higher rating indicates lower risk) based on 12 components: Government Stability, Socioeconomic Conditions, Investment Profile, Internal Conflict, External Conflict, Corruption, Military in Politics, Religious Tensions, Law and Order, Ethnic Tensions, Democratic Accountability, and Bureaucracy Quality. Secondly, Composite Risk Rating is a pre-calculated ICRG index combining the political risk (50%), financial risk (25%), and economic risk (25%) ratings. A higher rating indicates lower risk. Thirdly, External Conflict is a specific component from the political risk rating, scored from 0–12 (a lower score indicates higher risk). It is based on wars, cross-border conflicts, and foreign pressures, making it a direct proxy for geopolitical risk.

External market potential (EMP) is measured as the sum of other European countries' GDPs, discounted by their distance from the host country. This captures market accessibility and multilateral resistance (Cieřlik and Ryan, 2004), justifying its inclusion in our model. The EMP for the i -th host country is calculated according to the following formula:

$$EMP_i = \sum_{j \neq i} \frac{GDP_j}{D_{ij}} \quad (2)$$

where j represents another European country. D_{ij} is the geographic distance from the capital city of country i to the capital city of country j .

The data source for GDP is the World Development Indicators (WDI), while the data source for distance is CEPII. To calculate the external market potential, we consider not only the GDPs of the CEECs but also all other European economies, especially those from Western Europe that could potentially be the buyers of Chinese products manufactured in the CEECs and then exported further to the West (*i.e.*, in this case the CEECs could attract Chinese export-platform FDI). we calculate the external market potential using GDP and distance data with all European countries (*i.e.*, both EU and non-EU members). Therefore, we use both host country's GDP and external market potential variables as measures of access to host country and third country markets.

According to Cieřlik and Ryan (2004), the internal distance is rather important as the measure of the host country's self-potential to explain FDI location determinants, especially in the CEE region. We use internal distance obtained from CEPII GeoDist. According to CEPII, the internal distance is calculated using the following equation:

$$InDist_{it} = 0.67 \sqrt{\frac{area_i}{\pi}} \quad (3)$$

Since there no internal distance data for Serbia and Montenegro individually available in CEPII GeoDist, we use the same equation to calculate internal distance for these two countries to fill the data after 2006. The land area for both countries is obtained from United Nations.

In addition, we also include several dummy variables control for other national characteristics. The EU dummy indicates membership in the European Union, signaling unrestricted access to the EU single market, which could attract Chinese OFDI. NATO dummy indicates membership in the North Atlantic Treaty Organization, which may increase geopolitical risk due to a potential armed conflict, suggesting a negative parameter estimate. Membership data is from NATO's official website. CEE Cooperation dummy indicates participation in the China-CEE cooperation platform, which can lower political uncertainty for Chinese OFDI. Ukraine dummy indicates a shared land border with Ukraine, a source of external geopolitical pressure due to the ongoing conflict that began in 2014 and escalated in 2022. The Russia dummy indicates a shared land border with Russia, which may deter Chinese FDI due to the associated geopolitical tensions.

4. Results and Discussion

In this section we report and discuss several empirical estimation results for geopolitical risks and market related motivations. In the first set of baseline estimation, we investigate relationship between geopolitical risks and Chinese OFDI to CEECs using the traditional gravity-type model. In the second set of baseline estimation results we investigate the effects of geopolitical risks on Chinese FDI to CEECs using the economic potential model.

4.1 Baseline Gravity Model Estimation Results and Discussion

Table 1 shows the estimation results obtained for different measures of geopolitical risks. Column (1) of Table 1 reports the estimation results with external conflicts used as a geopolitical risk index. The R^2 values in Table 1 range from 0.3961 to 0.4411, indicating a reasonably good model fit. The external conflicts variable is statistically significant at the 1 % level and shows the expected negative sign. It means the higher the external conflict score, the lower Chinese OFDI to the CEE country. The definition of high score of external conflict means lower of risk. Therefore, the negative sign of the estimated parameter on the external conflict variable on Chinese FDI to the CEECs can be interpreted as the higher score of external conflict which equates lower risk, the lower of Chinese FDI to a CEE country. To simplify the interpretation, lower external conflict risk is associated with less Chinese FDI to a CEEC. Alternatively, the higher of external conflict risk, the more of Chinese FDI to CEE country.

The first reason is that Chinese FDI is more competition averse in the CEE region. Higher geopolitical risk can deter other OFDI and decrease competition. The second reason is that China may use OFDI as an economic tool to gain political influence, where the externality affects regional production networks. The higher risk implies more uncertainty, the higher FDI means China seeks political influence to decrease uncertainty. This approach could be quite common among economically and politically big and powerful economies. Through OFDI, China can attempt to exert political influence to achieve its geoeconomic goals or better serve economic motives. This strategy can work well, especially in the case of some small economies with high uncertainty in the CEE region. We can observe that the case for CEECs is different from BRICKS and MENA. Cetin and Yamen (2023) and Moosa (2009) argue that geopolitical risks decrease FDI inflows to BRICKS and MENA countries. Our result is also different from Quer *et al.* (2012) who claim that country risk has no effect on FDI decision. However, Richet (2019) shares a similar result for Chinese OFDI in Southeastern Europe only with our finding.

The estimated parameter on the GDP variable in column (1) of Table 1 is statistically significant already at the 1 % level and shows an expected positive sign. It means the higher the GDP of the CEE country, the more of Chinese OFDI flows into this country. GDP can be interpreted as a measure of the market size. It implies that the bigger the economic size of the CEE country, the more Chinese OFDI goes to that country. Therefore, this result support the view that Chinese OFDI in the CEE region has strong economic motivation and is a typical economic factor. Existing literature also aligns with our findings in terms of economic motives. For example, Zhang and Daly (2011) & Chang (2014) find that Chinese OFDI is determined by market size.

The estimated parameter on the internal distance in column (1) of Table 1 is statistically significant at the 1% level and shows a negative sign. It means that the larger internal distance of the CEE country, the less Chinese OFDI flows into that country. We posit that infrastructure in the CEEC region remains underdeveloped, though this is gradually changing due to inflows of EU structural funds, particularly in EU member states. This can explain why the estimated effect of the internal distance on the Chinese OFDI is less attractive. The EU membership in column (1) of Table 1 is statistically significant at the 1 % level and shows a negative sign. We argue that the EU membership can be interpreted as the market institution index, so the negative sign of EU dummy implies Chinese OFDI to CEE has to follow high investment standards and complex institutions of EU. For the non-EU members, the CEECs' geographic locations are close to the EU market and they can benefit from its proximity. Hence, we can argue that Chinese OFDI to CEE is affected by economic factor.

The estimated parameter on the NATO membership variable in column (1) of Table 1 is also statistically significant already at the 5 % level and displays a negative sign. It means if the CEE country is a member of the NATO, Chinese OFDI is relatively smaller than for a non-NATO CEE country.

The China-CEE variable in column (1) of Table 1 is statistically significant already at the 1% level and shows a negative sign. It means that the participation of the cooperation framework between China and CEECs plays an important role in determining Chinese FDI outflows to the CEECs. However, comparing to some other non-CEECs, China has strong motivation to invest in those European countries. The cooperation framework between China and 16 CEECs was established in Warsaw in 2012. However, Lithuania withdrew from the cooperation framework in 2021 and Latvia and Estonia followed suit in 2022.

The dummy variable for sharing a border with Ukraine in column (1) of Table 1 is statistically significant but only at the 5% level and shows a negative sign. It means that Chinese OFDI in the CEECs is negatively related to neighboring with Ukraine. At the same time,

the dummy variable for sharing a border with Russia in column (1) of Table 1 is statistically significant already at the 1% level and shows a negative sign. It means that neighboring with Russia may actually deter Chinese OFDI to the CEECs. Four countries around Baltic Sea in the CEE region share the land border with Russia. Three of them already withdrew from the cooperation framework between China and the CEECs in 2021 and 2022, while Poland, the remaining country, shares a border with the Russian exclave of Kaliningrad only and not with the mainland Russia.

In Column (2) of Table 1 we show the estimation results with the political risk rating instead of the external conflict variable. However, it turns out that the estimated parameter on the political risk rating is not statistically significant. It means political risk in the CEE region is not related to Chinese OFDI into the region. The political risk rating includes only factors related to internal governance quality. Hence, this result clearly shows that internal affairs do not matter for Chinese OFDI decisions to establish production networks into the CEECs. Moreover, it also implies that external conflicts are more important than internal factors for Chinese OFDI in the CEE region.

Column (3) of Table 1 shows results with using the composite risk rating as an alternative risk measure. However, the estimated parameter on the composite risk rating is also not statistically significant. It means that composite risk does not matter for Chinese OFDI into the CEECs. The composite risk rating includes political, financial and economic risks. The insignificant coefficient implies that CEE country's internal financial and economic risks are not related to Chinese OFDI decisions.

Summing up, the significant coefficients on external conflicts and CEEC GDP, combined with the EU membership, lead us to conclude that Chinese OFDI in the CEECs can be affected by both geopolitical risk and economic factor. Moreover, in addition to the market access motivation for Chinese OFDI, higher external geopolitical risks can motivate Chinese investors to invest even more.

Table 1: The effect of geopolitical risk on Chinese FDI to CEE using gravity model

	(1)	(2)	(3)
	PPMLHDFE	PPMLHDFE	PPMLHDFE
	FDI	FDI	FDI
GeoP/External Conflict	−4.3688*** (0.5573)		
GeoP/Political Risk		−1.3389 (0.9850)	
GeoP/Composite Risk			0.6897 (0.8944)
GDP	1.0982*** (0.0847)	0.9704*** (0.0868)	0.8764*** (0.0858)
InDIS	−1.1924*** (0.1789)	−0.8415*** (0.2266)	−0.6386*** (0.2103)
EU	−0.5919*** (0.1743)	−0.6836*** (0.1914)	−0.6781*** (0.1864)
NATO	−0.5749** (0.2933)	−0.0964 (0.2687)	−0.0427 (0.2516)
CEE/China-CEE	−0.6558*** (0.2051)	−0.8009*** (0.2277)	−0.6724*** (0.2081)
Ukraine	−0.5911** (0.2296)	−1.0782*** (0.2308)	−0.9518*** (0.2011)
Russia	−1.5581*** (0.2218)	−1.2707*** (0.2226)	−1.2985*** (0.2177)
Constant	−5.3900*** (2.0064)	−8.0074** (4.0370)	−15.3560*** (3.4048)
Observations	721	721	721
R²	0.4411	0.3982	0.3961

Notes: Robust standard errors in parentheses. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

Source: Author's own calculations

To enrich our analysis we categorize particular CEECs according to their different attitudes to China's "Belt and Road Initiative" and "17 + 1 / 14 + 1" cooperation framework and interact them with our geopolitical risk measures. In particular, we can assign CEECs into three groups: supportive, non-supportive or neutral groups depending on their involvement into the China-CEE cooperation scheme. The first group is coded with 1 for Hungary and Serbia, indicating the most supportive countries. The second group is coded with 2 for Lithuania, Estonia, and Latvia, indicating the non-supportive countries. The third group is coded with 3 for the rest CEECs, indicating neutral countries. Then, we create three dummy variables separately for each group. If the FDI host country from China is in supportive group, it takes value 1, otherwise it is 0. Similarly, If the FDI host country is in non-supportive group, it takes value 1, otherwise it is 0. If the FDI host country is in neutrality group, it takes value 1, otherwise it is 0. Then we interact these dummy variables with our measures of geopolitical risks.

The results of these interactions are reported in columns (4)–(6), respectively. Column (4)–(6) show the interactive estimations between external conflict, political risk, composite risk and diverse groups. The R^2 of interactive term models ranges from 0.3969 to 0.4470. Hence, the evaluation of the model fit is good. The interactive terms between three geopolitical risks and supportive group are all statistically significant and display positive signs for all three geopolitical risks measures. It means that supportive CEECs can enhance the FDI stocks from China through external conflict, political risk and composite risk. The interactive terms of external conflict as well as composite risk and non-supportive group are all statistically significant and show positive signs for the two geopolitical risks measures. It means non-supportive CEECs cannot enhance the FDI stocks from China through political risk.

The interactive terms between three geopolitical risks and the neutral group are all statistically significant and display negative signs. It means that neutral CEECs can weaken the FDI stocks from China through external conflict, political risk and composite risk. The neutral policy of CEECs provides uncertainty for FDI investors from China. The uncertainty expectations make Chinese investors less motivated to invest in neutral CEECs, especially with the roles of external conflict, political risk and composite risk.

Table 1b: The effects of interactions with geopolitical risks on Chinese FDI to CEE using gravity model

	(4)	(5)	(6)
	PPMLHDFE	PPMLHDFE	PPMLHDFE
	FDI	FDI	FDI
c. External Conflict #c.support	18.0619*** (3.2152)		
c. External Conflict #c.nonsupport	9.5767*** (3.0518)		
c. External Conflict #c.neutral	-15.3774*** (2.4511)		
c. Political Risk #c.support		11.5815*** (2.4054)	
c. Political Risk #c.nonsupport		1.9968 (4.4676)	
c. Political Risk #c.neutral		-10.4883*** (2.2803)	
c. Composite Risk #c.support			11.6554*** (2.6474)
c. Composite Risk #c.nonsupport			9.2891** (4.3573)
c. Composite Risk #c.neutral			-9.7156*** (2.4347)
Observations	721	721	721
R² for supportive group	0.4470	0.4018	0.3977
R² for non-supportive group	0.4412	0.3989	0.3969
R² for neutral group	0.4467	0.4014	0.3975

Notes: Robust standard errors in parentheses ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively. All the control variables are included while estimating the model. Completed estimation results with all variable can be provided on request.

Source: Author's own calculations

4.2 Economic Potential Model Results and Discussion

Table 2 reports the estimation results with different geopolitical risks obtained from the economic potential model. The columns in Table 2 correspond directly to those in Table 1. The R^2 ranges from 0.4632 to 0.4495. Hence, the evaluation of the model fit is good. The external conflict in column (1) of Table 2 remains statistically significant at the 1% level and displays a negative sign. Hence, the result is very similar to the result obtained earlier in the base gravity model reported in column (1) of Table 1. It also supports the geopolitical risk effect interpretation suggesting that the higher of the risk of external conflicts, the larger Chinese OFDI in the CEE country. The external market potential variable in column (1) of Table 2 is statistically significant and shows a positive sign in the specification with external conflicts. In this case, it means the external market potential has positive effect on Chinese FDI to the CEECs.

In Column (2) of Table 2 we show the estimation results obtained for the political risk rating, as an alternative risk measure, having controlled for the external market potential. However, it turns out that the estimated parameter on the political risk rating remains not statistically significant. The same applies to composite risk rating variable. Interestingly, the estimated parameters on the external market potential are still statistically significant already at the 1 % level, and display the same positive sign.

We check for multicollinearity and find no multicollinearity between the geopolitical risks and the external market potential variables. The external market potential can be interpreted as a market access proxy for Chinese producers in the CEECs. In principle, Chinese OFDI into the CEECs could establish the production in the CEE region with input or value chains from China with other European countries. Hence, the external market potential can produce a complementary effect for Chinese OFDI in the CEECs. This could potentially explain why the sign of the estimated parameter on the external market potential variable is positive. The investment can increase trading activities through production networks. Therefore, in the case of the specification that includes political risk rating the external market potential might be boosting Chinese OFDI into the CEECs. Some existing literature supports our findings. For example, Chang (2014) finds that developing country's market potential is important for Chinese OFDI. Similar result can be found in Cieřlik and Ryan (2004) that host country's domestic size and surrounding markets both important for attracting FDI. Therefore, we believe that economic potential model can better serve the explanations of geopolitical risk effects than the base gravity model.

Moreover, it can be noted that the signs and statistical significance of the estimated parameters on other explanatory variables reported in columns (1)-(3) in Table 2 are generally consistent with the estimates reported earlier in Table 1. The only major difference is that all the specifications reported in Table 2, that include the external market potential, the internal distance variable in columns (2) and (3) in Table 2 are statistically insignificant, which is different from the results in Table 1. With external market potential, the physical internal distance becomes a minor issue for investments from China.

To enrich our analysis, we follow a similar strategy as Table 1b. The difference here in Table 2b from Table 1b is that we now control for external market potential in this model. Table 2b reports the interactive estimations between geopolitical risks and CEE country groups.

The results of interactive terms are the same as that in Table 1b except the case of composite risk and neutral group, having controlled for the external market potential. It means that the economic potential model does not change the interactive effect channels through geopolitical risks much while the FDI host countries fall into different groups. However, composite risk channel becomes insignificant for the neutral group.

Table 2: The effect of geopolitical risk on Chinese FDI to CEE using economic potential model

	(1)	(2)	(3)
	PPMLHDFE	PPMLHDFE	PPMLHDFE
	FDI_Potential	FDI_Potential	FDI_Potential
<i>GeoP/External Conflict</i>	−4.0812*** (0.5624)		
<i>GeoP/Political Risk</i>		−0.8117 (0.9669)	
<i>GeoP/Composite Risk</i>			1.3800 (0.8657)
<i>EMP/External Market Potential</i>	1.8362*** (0.2325)	1.9857*** (0.2559)	2.1283*** (0.2626)
<i>GDP</i>	0.7767*** (0.0927)	0.6589*** (0.0957)	0.5633*** (0.0980)
<i>InDIS</i>	−0.3880* (0.2016)	0.0626 (0.2534)	0.3178 (0.2256)
<i>EU</i>	−0.5283*** (0.1707)	−0.6038*** (0.1709)	−0.5947*** (0.1690)
<i>NATO</i>	−0.6338*** (0.2433)	−0.2078 (0.2200)	−0.1286 (0.2080)
<i>CEE/China-CEE</i>	−1.1034*** (0.2239)	−1.2498*** (0.2457)	−1.1911*** (0.2431)
<i>Ukraine</i>	−0.4880** (0.1990)	−0.8564*** (0.2183)	−0.7895*** (0.2202)
<i>Russia</i>	−1.3761*** (0.2260)	−1.2132*** (0.2634)	−1.1496*** (0.2688)
Constant	−44.8506*** (5.5060)	−53.4236*** (8.1885)	−65.1118*** (7.6704)
Observations	721	721	721
R²	0.4995	0.4632	0.4646

Note: Robust standard errors in parentheses. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

Source: Author's own calculations

Table 2b: The interactions with geopolitical risks on Chinese OFDI to CEE using economic potential model

	(4)	(5)	(6)
	PPMLHDFE	PPMLHDFE	PPMLHDFE
	FDI_Potential	FDI_Potential	FDI_Potential
c. External Conflict #c.support	13.4317*** (2.6122)		
c. External Conflict #c.nonsupport	11.5240*** (3.4126)		
c. External Conflict #c.neutral	-11.3839*** (2.1665)		
c. Political Risk #c.support		7.7356*** (2.4747)	
c. Political Risk #c.nonsupport		4.1221 (4.8351)	
c. Political Risk #c.neutral		-6.8681*** (2.4839)	
c. Composite Risk #c.support			7.3902*** (2.8303)
c. Composite Risk #c.nonsupport			12.5711** (4.9657)
c. Composite Risk #c.neutral			-6.0262 (0.0000)
Observations	721	721	721
R² for supportive group	0.5043	0.4649	0.4653
R² for non-supportive group	0.5001	0.4648	0.4665
R² for neutral group	0.5044	0.4651	0.4654

Note: Robust standard errors in parentheses. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively. All the control variables are included while estimating the model.

Source: Author's own calculations

4.3 Robustness Test and Discussion

In the baseline estimations, we used the PPMLHDFE approach and found that Chinese OFDI into the CEECs is affected by both economic factor and geopolitical risk effect. We further validate the robustness of the results obtained from the PPMLHDFE approach. Following the recent study by Nguyen *et al.* (2020), we use Tobit model to study the robustness of the estimates of our baseline empirical model. Thus, the primary aim of this subsection is to validate whether the baseline approach is robust or not.

Table 3 reports the estimation results obtained using Tobit. In this case, we take the log value for the dependent variable FDI stock. The R^2 for Tobit model is only 0.1560. The estimated parameter on the external conflict variable remains statistically significant at the 1 % level and shows the expected negative sign.

The similar results also apply to GDP and external market potential. In general, the estimation results reported in Table 3 and obtained using alternative estimations technique are similar to our baseline estimation results reported in Tables 1 and 2, except China-CEE and Ukraine. Hence, the main results that Chinese OFDI into the CEE region is affected by both economic factor and geopolitical risk remain robust.

Table 3: The economic potential model with a different econometric approach

	(1)
	Tobit
	ln <i>FDI</i>
<i>GeoP/External Conflict</i>	−6.5030*** (0.7291)
<i>EMP/External Market Potential</i>	1.4666*** (0.2304)
<i>GDP</i>	1.3784*** (0.0780)
<i>lnDIS</i>	−0.6785*** (0.1411)
<i>EU</i>	−0.3291 (0.2234)
<i>NATO</i>	−0.8559*** (0.2063)
<i>CEE/China-CEE</i>	1.2194*** (0.2319)
<i>Ukraine</i>	−0.0581 (0.2622)
<i>Russia</i>	−0.7572*** (0.2758)
<i>/ var(e. ln <i>FDI</i>)</i>	4.1022*** (0.2161)
Constant	−47.3510*** (4.9412)
Observations	721
<i>R</i>²	0.1560

Note: Robust standard errors in parentheses. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

Source: Author's own calculations

5. Conclusions

We investigated the effects of geopolitical risks on Chinese FDI outflows to the CEECs. We used different econometric approaches to estimate our empirical model and demonstrated that geopolitical and economic motivations both determine Chinese FDI decisions to the CEECs. For specific CEEC groupings, the role of geopolitical risk effect is stronger if China invests in Hungary and Serbia, as well as three Baltic economies that have recently withdrawn from the cooperation between China and the CEECs. We also find economic potential model can better serve the explanations of geopolitical risk effects than the base gravity model.

Moreover, comparing to non-neighboring countries, neighboring with Ukraine and Russia attracts less Chinese FDI outflows to those Ukraine and Russia's direct neighbors. However, this effect decreases once we consider the broader European market potential. Kostruba (2025) finds armed conflict in Ukraine disrupts supply chains and foreign business, which can potentially deter FDI. Soussane *et al.* (2023) find geopolitical factors have negative effect on FDI in the secondary and tertiary sectors with Ukraine crisis.

Different from existing literature, our findings provide robust evidence to explain China's OFDI in CEECs from both geopolitical and economic motives. We also differentiate the geopolitical risk effects among different CEECs groups as well as neighboring countries for Ukraine and Russia and identify the specific countries' response for geopolitical risks.

Our study can provide several policy implications to develop and better enhance China and the CEECs relationships in terms of OFDI. Specifically, China could pursue differentiated geoeconomic policies across the CEECs. In the case of seeking geopolitical influence, China could allocate resources to ensure the geopolitical risk can serve the investment target in different CEECs. Moreover, in countries where both geopolitical and economic factors are significant, China may implement an OFDI screening process to balance geopolitical influences to better serve economic motivations.

A limitation of our study is the omission of the influence of other major powers (e.g., the USA, the UK). Incorporating multiple hegemonies could yield a more diverse range of geopolitical risk effects. The geopolitical risk effect might be more diverse with the influence from other hegemonies. Therefore, in the future, it will be interesting to extend the model with multiple hegemonies.

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