Macroeconomic Environment, Uncertainty Perception and Chinese Corporate OFDI

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Abstract: This paper examines the changes in enterprises' perception of domestic uncertainty when they invest outward in a changing macroeconomic environment, using OFDI (outward foreign direct investment) data of A-share listed enterprises (non-financial and non-real estate industries) from 2007 to 2019 as a sample. The empirical test shows that when the economic growth rate is high, the impact of home country economic policy uncertainty on firms' OFDI will be stronger. This relationship is heterogeneous at the firm level. The findings establish a foundation for understanding how economic policy uncertainty impacts corporate OFDI in the context of changes in the real-world economic environment. They are informative for maintaining stability and continuity in economic policymaking at various stages of economic growth and for targeting policies to different types of enterprises.

Keywords: Uncertainty Perception, Macroeconomic Environment, Outward Foreign Direct Investment, OFDI

1. Introduction

In recent years, there has been a prevalence of hegemony in some countries, leading to increased friction and conflicts between nations. The process of globalization has encountered significant challenges, and the future of the international situation is uncertain. The level of global economic policy uncertainty (EPU) is currently volatile. Global uncertainty remains high due to major events such as the 2018 trade war between China and the United States, the COVID-19 pandemic in 2020, and the 2022 Russian-Ukrainian war. As a result, the world has entered a period of high risk and uncertainty. Meanwhile, China's domestic economic growth has been declining annually due to the aforementioned reasons, including a slowdown in import and export growth and structural changes in the domestic economy amidst the current trend of anti-globalisation. To maintain sustainable economic growth, the Chinese government is implementing a new development pattern and deepening supply-side structural reforms, among other policies. This is leading to changes in China's domestic economic structure and situation, which is increasing the uncertainty of domestic economic policy in the short term.

Due to the uncertainty both domestically and internationally, Chinese investors have undergone a significant shift in their investment mentality. The Statistical Bulletin of China's OFDI shows that China's OFDI flow has been continuously declining since 2017, until it picked up again in 2020. From the micro perspective of the enterprises, Chinese enterprises benefit from many domestic economic policies and operate in a continuously improving business environment. However, when making investment decisions, it is important to consider the potential for biased perceptions of economic policy uncertainty among decision-makers in different environments, which may lead to differing investment decisions.

This paper examines the impact of economic policy uncertainty on China's A-share listed non-financial, non-real estate firms' outward foreign direct investment (OFDI) from 2007-2019. The study includes the macroeconomic environment as a moderating factor and explores how changes in the macroeconomic environment affect the relationship between the home country's economic policy uncertainty and firms' OFDI.

2. Theoretical analysis and research hypothesis

2.1. The effects of EPU in home and host countries on firms' OFDI

Unlike domestic investment, enterprises making OFDI are affected by both home country economic

policy uncertainty and host country economic policy uncertainty. This paper's theoretical model is based on Yang's research^[1] and expands on Darby's results^[2]. While Darby studied the impact of institutional distance on OFDI, this paper examines the impact of economic policy uncertainty and the moderating role of the macroeconomic environment. To simplify the model and explain the impact of the core explanatory variables, this paper assumes that economic policy uncertainty affects both inward and outward investment of firms. At the same time, it is assumed that firms earn stable returns from their investments, so that if the role of economic policy uncertainty is not taken into account, firms earn a certain amount of profit per period for making an investment, denoted by Π_0 , which is the return on that benchmark investment. The expected profit obtained by the enterprise investing in country *i* and investing in country j per period is $EPV_i = EPV_j = \frac{\Pi_0}{1+\delta}$, where δ represents the discount factor.

If an enterprise in country *i* faces economic policy uncertainties (τ_i) and invests outwardly in country *j* whose economic policy uncertainties is τ_j , the relative return on this investment (γ_{ij}) compared to its investment in the domestic country is calculated as $1 + \alpha_i \tau_i - \alpha_j \tau_j$. The coefficients of the relationship between the economic policy uncertainties of the home country and the host country, denoted by $\alpha_i \in (0,1)$ and $\alpha_j \in (0,1)$ respectively, affect the relative return of the enterprise on outward investment. To obtain the partial derivation of τ_i and τ_j in relative investment returns, we need to consider the coefficients of the relationship between uncertainty and firms' relative investment returns are positively related to the home country's economic policy uncertainty and negatively related to the host country's economic policy uncertainty. Additionally, higher uncertainty leads to a lower success rate of the investment project. It is assumed that the probability of success of the investment project in country *j* is $p_j = 1 - \tau_j$. The formula below re-expresses the expected return of the enterprise to make outward investment, based on the assumptions mentioned above:

$$EPV_{ij} = \frac{\gamma_{ij}p_j\Pi_0}{1+\delta(1-p_j)} = \frac{(1+\alpha_i\tau_i-\alpha_j\tau_j)(1-\tau_j)\Pi_0}{1+\delta\tau_j}$$
(1)

The partial derivatives of τ_i and τ_j for EPV_{ij} in Equation (1) can be obtained separately.

$$\frac{\partial EPV_{ij}}{\partial \tau_i} = \frac{\alpha_i (1 - \tau_j) \Pi_0}{1 + \delta \tau_j} > 0$$
⁽²⁾

$$\frac{\partial EPV_{ij}}{\partial \tau_i} = \frac{-(1+\alpha_j + \alpha_i \tau_i - 2\alpha_j \tau_j)(1+\delta \tau_j) - (1+\alpha_i \tau_i - \alpha_j \tau_j)(1-\tau_j)\delta}{(1+\delta \tau_j)^2} \Pi_0 < 0$$
(3)

The results above indicate that the expected return on outward investment is positively correlated with economic policy uncertainty in the home country and negatively correlated with economic policy uncertainty in the host country. When economic policy uncertainty increases in the home country, the expected return on outward investment also increases, leading to an increase in outward investment by enterprises. Conversely, when economic policy uncertainty increases in the host country, the expected return on outward investment in that country decreases, resulting in a reduction of outward investment by enterprises. Therefore, this paper proposes hypothesis 1: OFDI by enterprises is influenced by economic policy uncertainty in both home and host countries. High levels of economic policy uncertainty in the host country can facilitate OFDI, while high levels of economic policy uncertainty in the host country and host country can dampen it.

2.2. The moderating role of the macroeconomic environment

The theoretical model analysis above assumes that firms' expected returns are solely influenced by economic policy uncertainty. However, in reality, enterprises make different investment and financing decisions in various macroeconomic environments, leading to changes in their domestic and foreign relative returns (γ_{ij}). After analysing the macroeconomic changes, the domestic and foreign relative returns of enterprises can be expressed as $\gamma_{ij} = 1 + \alpha_i(g)\tau_i - \alpha_j\tau_j$. The macroeconomic environment in which the enterprise is located is denoted by g. Since the macroeconomic environment perceived by the enterprise in country i mainly comes from country i, its impact on the relative returns of the enterprise is also reflected in the relative coefficient of the home country's economic policy uncertainty. When there is an economic upturn in country i, the expected return on domestic investment increases and γ_{ij} decreases. This means that $\partial \gamma_{ij}/\partial g = \partial \alpha_i(g)/\partial g < 0$.

To examine how changes in the macroeconomic environment affect firms' perceived uncertainty during OFDI, we can partially derive g from equation (2):

$$\frac{\partial \frac{\partial EPV_{ij}}{\partial \tau_i}}{\partial g} = \frac{\frac{\partial \alpha_i(g)}{\partial g}(1-\tau_j)\Pi_0}{1+\delta\tau_i} < 0$$
(4)

Equation (4) shows that the promotion effect of elevated economic policy uncertainty in the home country on the OFDI of enterprises will be weakened when the macroeconomy is upwardly mobile, as $\frac{\partial(\partial EPV_{ij}/\partial \tau_i)}{\partial g} < 0$ Based on this, hypothesis 2 is formulated. Firms' OFDI at times of high economic policy uncertainty in the home country decreases when macroeconomic growth rates are on the upswing.

3. Model construction and data explanation

3.1. Model construction

This paper examines the moderating effect of the macroeconomic environment on the relationship between Chinese firms' uncertainty perceptions and OFDI. A panel data fixed effects model is used, which includes an interaction term between economic policy uncertainty and the macroeconomic environment. The formula for the metrological benchmark model is as follows:

$$OFDI_{i,t,j} = \theta_1 CEpu_{t-1} \times Eg_{t-1} + \alpha_1 CEpu_{t-1} + \beta_1 Eg_{t-1} + \gamma X_{i,t-1,j} + \mu_i + \varepsilon_{i,t}$$
(5)

The subscripts *i* and *t* represent individual firms and time, respectively, while *j* represents the host country of investment. *X* is a control variable, and μ_i is an individual fixed effect. This model does not control for year fixed effects, as controlling for them may generate covariance problems due to the use of annual macro data in some of the variables. Following the practice of previous studies^[3], we mitigate the endogeneity problem caused by omitted variables by adding control variables. Additionally, we reduce the endogeneity problem by including lagged explanatory variables in the model regression. To eliminate the aggregation feature of the sample, we cluster the standard errors in the regression at the firm level.

3.2. Variables

The dependent variable is *OFDI* by Chinese enterprises, expressed as the natural logarithm of the OFDI stock data of Chinese enterprises plus one. This paper considers the investment amount of a Chinese enterprise in its overseas affiliates as the OFDI of the enterprise, based on the practice of existing studies^[4]. When an enterprise has a 'subsidiary', 'associate', or 'joint venture' relationship with an overseas affiliate, and the enterprise's shareholding in the affiliate is 10% or more, the enterprise's investment in the overseas affiliate for the year will be calculated by multiplying the registered capital of the affiliate by the enterprise's shareholding.

The independent variable is the economic policy uncertainty index *CEpu*. *CEpu* is calculated by taking the arithmetic mean of the monthly index of uncertainty provided by Baker.et.al. (2016) ^[5] and summing it up to the year. Meanwhile, the economic environment and uncertainty perception of Chinese firms depend mainly on the domestic level. Therefore, the moderating variable macroeconomic environment (*Eg*) is expressed using the year-on-year growth rate of China's real GDP.

Control variables are selected at three levels: home country, host country, and firm micro level. At the home country level, the paper uses China's price index (CPI) and the macroeconomic sentiment index (PINDEX) released by China's National Bureau of Statistics (NBS) as control variables. At the host country level, the paper uses GDP per capita, trade freedom index (TR), and economic policy uncertainty (*FEpu*) as control variables. At the firm level, referring to Liu's study (2022)^[6], we uses firm size (SIZE), fixed asset ratio (FR), gearing ratio (LEV), return on assets (ROA), and revenue growth rate (SG) as control variables. The control variables mentioned above are measured as presented in Table 1.

3.3. Data sources

The sample of firms are selected based on specific criteria. The sample includes all A-share listed companies in China from 2007 to 2019, excluding ST-type firms and firms in the financial and real estate industries, as well as firms with missing data and investments in tax havens. The final panel data set consists of 990 firms over the period 2007-2019. To mitigate the impact of outliers, this paper applied a 1% before-and-after shrinkage to all continuous variables at the firm level. The data used in this study were primarily sourced from the CSMAR and World Bank databases.

Level	Variable name	Variable measurement	Variable symbol	
Home country	Magnaganamia	China's price index	CPI	
	indicators	The macroeconomic sentiment index from China's NBS	PINDEX	
Host country	Market size GDP per capita		DGDP	
	Trade Freedom Index	Trade Freedom Index from Heritage Foundation	TR	
	Economic policy uncertainty The arithmetic mean of the monthly index of uncertainty provided by Baker.et.al		FEpu	
Enterprise level	Enterprise size	Logarithm of total enterprise assets	SIZE	
	Proportion of fixed assets	Total fixed assets of the enterprise divided by total assets	FR	
	Return on assets Net profit of enterprises as a percentag of total assets		ROA	
	Debt to asset ratio	Total liabilities of the enterprise as a percentage of total assets	LEV	
	Enterprise growth	ise growth Enterprise revenue growth rate		

Table 1: Measurement of control variables

4. Empirical analysis

4.1. Benchmark regression results

Table 2 displays the complete regression results. Column (1) indicates that China's economic policy uncertainty coefficients are all significantly positive at the 1% level. The results suggest that when China's economic policy uncertainty increases, Chinese firms tend to make more outward foreign direct investment (OFDI). This finding is consistent with previous studies. As shown in Column (2), the coefficient of the interaction term between Chinese economic policy uncertainty and macroeconomic environment is significantly negative. When combined with the coefficient analysis of economic policy uncertainty, it can be observed that Chinese economic policy uncertainty has an explanatory power of $(5.812-0.813 \times Eg)$ on Chinese enterprises' OFDI. When the macroeconomic growth rate increases, entrepreneurs become more optimistic about the domestic economic situation, and the perceived uncertainty weakens. As a result, the impact of economic policy uncertainty on enterprise OFDI is also weakened.

Variables	Full sample		Period of high economic growth	Period of slowing economic growth	
	(1)	(2)	(3)	(4)	
L.CEpu	0.449***	5.812***	0.587	0.513***	
	(0.119)	(0.765)	(0.740)	(0.107)	
L.Eg	-0.469***	3.065***			
	(0.064)	(0.470)			
L.CEpu \times Eg		-0.813***			
		(0.111)			
Control Variables	YES	YES	YES	YES	
Constant	-22.113**	-43.859***	-53.899***	-17.682**	
	(9.429)	(9.946)	(20.080)	(7.663)	
Individual Variable	YES	YES	YES	YES	
Observations	10069	10069	2281	7788	

Note: The symbols *, **, and *** indicate statistical significance at the 10%, 5%, and 1% levels, respectively. The data in parentheses represent robust standard errors clustered to the firm level, which remain consistent throughout the paper.

On the other hand, the sample is regressed in subgroup with 2012 as the cut-off point. Columns (3) and (4) in Table 2 show the regression results for the period of high economic growth and the period of

slowing economic growth, respectively. The results show that during a period of high economic growth, economic policy uncertainty does not significantly impact enterprise OFDI. However, during a period of economic growth slowdown, economic policy uncertainty significantly promotes the growth of enterprise OFDI. These results also suggest that the high-speed growth of the economy can alleviate the impact of economic policy uncertainty.

4.2. Robustness test and endogenous test

This section presents robustness tests by modifying the model's form. This means that the previous period's OFDI has an impact on the current period's OFDI. To account for the inertia of firms' decisions to invest abroad, the paper incorporates explanatory variables lagged by one period into the model and employs the GMM regression method. Table 3, column (1), presents the regression results, which indicate that OFDI in the current period is significantly influenced by OFDI in the previous period. The roles of economic policy uncertainty and macroeconomic environment remain unchanged, and the conclusion is robust.

This paper employs several methods to address the endogeneity issue in the model. Firstly, it selects explanatory variables and additional control variables from three levels: China, host countries, and enterprises, to enhance the model's explanatory power for OFDI by enterprises. Secondly, the model uses lagged data of one period for the variables to mitigate endogeneity in the indicators of the same year data. The model shrinks the data of all micro-continuous variables to eliminate the interference of outliers in the regression results. However, endogeneity may still exist in the model. To address endogeneity, this paper employs the instrumental variable method for two-stage least squares regression. The regression results are shown in column (2) of Table 3. The instrumental variable used is the average of the uncertainty indexes of other countries. This is due to the strong correlation between the economic environment and policy implementation of each country in the context of globalization, as well as the correlation between the economic policy uncertainty of other countries and China's economic uncertainty. The weak instrumental variable test and the unidentifiable test were passed, proving the validity of the instrumental variables. The results show that the key explanatory variables remain significant and have the same sign, indicating that the model is robust.

Variables	GMM	Instrument Variable		
variables	(1)	(2)		
LOEDI	0.788***			
L.OFD1	(0.019)			
I CEmu	0.360**	4.151***		
L.CEpu	(0.176)	(0.969)		
I Fa	0.233**	1.737**		
L.Eg	(0.111)	(0.681)		
I CEmux Ea	-0.049**	-0.482***		
$L.C.E.pu \times E.g$	(0.025)	(0.162)		
Control Variables	YES	YES		
Individual Variable	YES	YES		
Observations	10069	9982		

Table 3: Robustness test and endogenous test results

4.3. Direct proof of the impact of uncertainty perception channel

The above empirical analyses examine the different levels of impact that economic policy uncertainty has on firms' OFDI in a changing macroeconomic environment, from the perspective of firms' perception of uncertainty. However, it is still necessary to directly account for whether economic policy uncertainty affects uncertainty perception in firms' OFDI decisions and the difference in that effect in the case of a changing macroeconomic environment. This paper characterises firms' perceived uncertainty (SEN) using the index of firms' perceived policy uncertainty obtained by Nie^[7]. The index is based on the practice of text-mining keywords in annual reports, which has been subjected to numerous tests that demonstrate its reliability. The model below was constructed using the baseline regression formula (1), with the perception of uncertainty as the explanatory variable.

$$SEN_{i,t} = \alpha'_{1}CEpu_{t-1} + \beta'_{1}Eg_{t-1} + \theta'_{1}CEpu_{t-1} \times Eg_{t-1} + \gamma'X_{i,t-1,j} + \mu'_{i} + \varepsilon'_{i,t}$$
(6)

Table 4 shows the regression results using the sample of firms that conduct OFDI in the benchmark

regression. Column (1) indicates that economic policy uncertainty significantly increases firms' uncertainty perceptions, while macroeconomic upturn attenuates them. Column (2) displays the regression results after including the interaction term between the uncertainty indicator and the macroeconomic environment. The results indicate that the macroeconomic environment significantly inhibits economic policy uncertainty, which promotes the uncertainty perception of OFDI firms.

Variables	(1)	(2)	
I CEmu	0.031***	0.020***	
L.CEpu	(0.003)	(0.003)	
I Fa	-0.006***	-0.015****	
L.E.g	(0.001)	(0.002)	
I CEmu X E a		-0.011***	
L.CEPU × Eg		(0.002)	
Control Variables	YES	YES	
Constant	0.140	0.267	
Constant	(0.180)	(0.183)	
Individual Variable	YES	YES	
Observations	9331	9331	

4.4. Heterogeneity analysis

This subsection conducts a heterogeneity analysis based on the different characteristics of firms to provide empirical guidance on the various OFDI decisions made by firms due to differences in uncertainty perceptions resulting from changes in economic growth rates.

4.4.1. Analyses based on differences in risk levels of enterprises.

Due to the subjective consciousness of decision-makers, firms are susceptible to both external and internal risks when making investments. This subsection conducts group regressions on individuals with varying internal financial risk profiles. The internal financial risk of a firm is measured using the standard deviation of the industry-adjusted return on corporate assets over three observation periods. The standard deviation is divided into four equal parts. The samples with high volatility and low volatility are regressed separately in their respective quarters. The regression results are presented in Table 5. The regression results show that economic policy uncertainty has a greater impact on the OFDI decisions of firms with high internal financial risk. High financial risk firms, with high operating cash flow fluctuations and unstable business conditions, tend to avoid risks in OFDI more when uncertainty rises. Additionally, rising economic growth and a stable business environment have a greater mitigating effect on the perceived uncertainty of high financial risk firms in OFDI.

4.4.2. Analyses based on the analysis of enterprise industry differences

Since the reform and opening up, China's industrial structure has undergone continuous transformation alongside the development of the economy and society. The perception of economic policy uncertainty varies among enterprises in different industries, depending on the policy orientation of the period. This subsection presents a regression analysis of samples from different industrial structures, with the results shown in Table 5. The regression results of the secondary and tertiary industries are presented and analysed due to the very small number of samples in the primary industry. The results indicate that economic policy uncertainty plays a more significant role in promoting outward OFDI for firms in the secondary industry than those in the tertiary industry. Additionally, the interaction term between uncertainty and the macroeconomic environment is more significant for firms in the secondary industry. Amidst China's industrial structural transformation, policies such as supply-side structural reform and low-carbon transformation have been introduced. As a result, the secondary industry, which constitutes a significant portion of the manufacturing industry, has been negatively impacted, leading to a continuous decline in its structural share. Enterprises in the secondary industry are particularly sensitive to the uncertainty of China's economic policy. They tend to expand their OFDI when they perceive such uncertainty. An upturn in China's economy would be beneficial in alleviating the perceived uncertainty among secondary industry enterprises. The improvement in China's economy also helps to reduce the uncertainty felt by businesses in the secondary industry.

4.4.3. Analyses based on differences in the regions

Currently, there are variations in the business environment across the eastern, central, and western

regions of China, and economic policy uncertainty affects enterprises differently. To investigate the differences in the perception of economic policy uncertainty among enterprises in different regions, this paper conducts a group regression on enterprises in the aforementioned regions. The regression results are presented in Table 5. The table shows that the coefficients of uncertainty indicators in the eastern and central regions are significantly positive, with the largest coefficient in the central region. However, the effect is not significant in the western region. This suggests that enterprises in the eastern and central regions tend to invest in outward foreign direct investment when domestic uncertainty increases. Although the financial market environment in the western region has improved in recent years, there is still a gap in its business and investment environment compared to the central and eastern regions. Western enterprises face rising uncertainty and higher investment and financing costs, which discourage them from changing the status quo. The coefficient of the interaction term between the eastern and central regions is significant, indicating that the increase in macroeconomic growth rate has the strongest promoting effect on the uncertainty perception of enterprises in the central region.

Variables	Internal Financial Risk		Industrial Structure		Location		
	Low	High	Secondary Industry	Tertiary Industry	Eastern	Central	Western
L.CEpu	2.827	6.938***	6.387***	0.359	6.252***	7.817**	1.617
	(1.870)	(1.371)	(0.820)	(1.707)	(0.799)	(3.134)	(3.052)
L.Eg	1.366	3.825***	3.398***	-0.182	3.326***	4.109**	0.880
	(1.149)	(0.865)	(0.504)	(1.031)	(0.492)	(1.797)	(1.942)
L.CEpu \times Eg	-0.401	-0.984***	-0.893***	-0.001	-0.869***	-1.140**	-0.295
	(0.261)	(0.205)	(0.118)	(0.245)	(0.116)	(0.450)	(0.446)
Control Variables	YES	YES	YES	YES	YES	YES	YES
Constant	-46.962**	-83.034***	-47.317***	-26.070	-36.926	-47.886	-79.632*
	(18.860)	(20.952)	(10.918)	(21.094)	(22.626)	(46.187)	(46.934)
Individual Variable	YES	YES	YES	YES	YES	YES	YES
Observations	2518	2515	8408	1622	8075	902	840

Table 5: Heterogeneity analysis

5. Conclusion and enlightenment

This paper examines the impact of changes in the macroeconomic environment on the perception of economic policy uncertainty by non-financial and non-real estate enterprises listed on the Chinese A-share market, investing in OFDI. This study combines the economic policy uncertainty indicator with the enterprise uncertainty perception indicator, using OFDI data from 2007 to 2019.

It found that home country economic policy uncertainty has a significant positive effect on firms' OFDI. Specifically, when firms perceive an increase in home country economic policy uncertainty, they tend to make more OFDI. Additionally, the study found that a rise in macroeconomic growth rate significantly reduces the impact of home country economic policy uncertainty on firms' OFDI. Furthermore, the study suggests that firms' uncertainty perception serves as a channel through which economic policy uncertainty affects firms' OFDI. When economic policy uncertainty increases, firms' perception of uncertainty also increases. However, the positive effect of macroeconomic growth rate on reducing uncertainty is significantly weakened. Additionally, it is important to note that different types of OFDI firms have varying perceptions of economic policy uncertainty in their home country. In various financial situations, uncertainty has a greater impact on the OFDI of enterprises with high internal financial risk. However, a rising macroeconomic growth rate has a more significant mitigating effect on the uncertainty perception of such enterprises. Economic policy uncertainty has a more significant positive effect on the UCFDI of enterprises in the secondary industry. In different regions, a rising macroeconomic growth rate has a more significant perception of enterprises in the secondary industry. In different regions, a rising macroeconomic growth rate has a more apparent.

Based on the analyses and empirical tests, the following policy insights have been obtained: Firstly, the government should consider the uncertainty caused by policy adjustments when making decisions, particularly during the macro-economy's downturn period. This will provide more stable and optimistic expectations to enterprises through a transparent policy system and a stable policy direction. Enterprises should base their outward investment decisions on an accurate assessment of the current macroeconomic

situation and their own financial status. It is important to pay attention to changes in both domestic and foreign economic policies. Thirdly, the government should assist in developing investment risk indicators for the host country to address the challenges of identifying risks during the outward investment process. This will enable enterprises to identify host country investment risks earlier and reduce associated costs. Fourthly, the perception of uncertainty varies among enterprises, and the Chinese government should implement targeted policies for enterprises with different characteristics when making investment decisions. Based on the policies of supply-side reform and structural transformation of the domestic economy, the focus should remain on the secondary industry. Meanwhile it is important to continue optimizing the investment and financing environment for enterprises in the central and western regions.

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