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Cultural Risk Of The Host Country And Foreign Direct Investment - Evidence From China's Investment In BRI Countries

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Abstract:
Under the Belt and Road Initiative, China's direct investment in partner countries has continued to grow, yet the risks posed by cultural differences have become increasingly prominent. Existing research predominantly relies on linear assumptions, overlooking the nonlinear effects of cultural differences and paying insufficient attention to emerging economies. This study integrates the Optimal Distinctiveness Theory with institutional theory, constructing a multidimensional cultural distance index. Employing a progressive empirical approach—including linear testing, the Heckman two-stage model, and inverted U-shaped testing—it analyzes the complex impact of cultural risk on China's direct investment. The findings reveal an inverted U-shaped relationship between cultural differences and investment performance: moderate differences can facilitate knowledge complementarity, whereas excessive differences increase coordination costs. Accordingly, enterprises are advised to prioritize host countries with moderate cultural differences and enhance cross-cultural management capabilities.

Keywords: *BRI; foreign direct investment; gravity model; cultural differences*

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I. Introduction

Theoretical frameworks like Hofstede's cultural dimensions highlight how national culture shapes business practices, making cultural risk a critical factor in FDI decisions. Misaligned values, communication barriers, or leadership styles can derail cross-border ventures, leading to conflicts, inefficiencies, or failed market entry. Practically, cultural missteps may trigger regulatory non-compliance, labor disputes, or consumer rejection—directly impacting profitability. Conversely, firms that invest in cultural due diligence, localized management, and cross-cultural training gain competitive advantages in stakeholder trust and operational adaptability. Thus, bridging the gap between theoretical models and real-world strategies ensures FDI resilience, proving that cultural risk management is indispensable for sustainable global expansion.

Traditional research posits a linear relationship between cultural differences and investment risk (Kogut & Singh, 1988). However, recent studies suggest a nonlinear effect: moderate differences can foster innovation, while excessive differences increase costs (Berry et al., 2010). The Optimal Distinctiveness Theory (Brewer, 1991) emphasizes balancing cultural convergence and divergence, yet its application in Belt and Road

research remains limited, particularly regarding emerging economies and multidimensional cultural factors (e.g., religion, language) (Beugelsdijk et al., 2018).

The existing literature mostly dwells on the investment between the developed countries, where the cultural risk is uncomparable to those between the developing countries. Recently, China's Belt and Road Initiative has become a significant platform for global economic and trade cooperation, with direct investments exceeding $200 billion by 2023. However, notable differences in culture, religion, and legal systems between China and partner countries may lead to communication barriers, management conflicts, and other cultural risks (Shenkar, 2001). Hence, this paper will study the effects of cultural difference on foreign direct investment with the sample of the investment from China to the BRI countries.

This study combines institutional theory with the Optimal Distinctiveness Theory to explore the inverted U-shaped impact of cultural risk on direct investment, innovatively employing a multidimensional cultural distance index. In practice, either over-avoidance or neglect of cultural differences may lead to investment failures, such as management conflicts in Central Asia or environmental disputes in Africa (Buckley et al., 2020). The findings provide theoretical support for optimizing Chinese enterprises' overseas investment strategies.

II. Literature Review

The existing research on the impact of cultural differences on foreign direct investment (FDI) has not reached a consensus, with some studies highlighting positive effects while others emphasize negative consequences.

1. Positive Effects of Cultural Differences

Some literature has concluded that the following effects can lead to the positive impacts of cultural risk on foreign direct investment. Firstly, cultural risk may induce complementarity effect. Traditional views suggest that cultural differences increase management costs (Kogut & Singh, 1988). However, recent studies find that moderate differences (15%–25%) can facilitate knowledge transfer and innovation (Morosini et al., 1998). The Optimal Distinctiveness Theory (Brewer, 1991) posits that moderate cultural differences allow firms to maintain uniqueness while adapting to local environments. For example, Chinese investments in ASEAN benefit from balanced power distance differences (Hofstede index gap of 20–30), enabling efficient execution while accommodating localized management (Liu et al., 2021). Secondly, cultural risk may produce competitive advantage from differentiation. Cultural differences can create unique competitive advantages. Zaheer's (1995) "outsider advantage" theory suggests that differentiated products or business models can offset foreign disadvantages, as seen in the success of French luxury brands in Asia (Verbeke, 2013). Emerging market firms, such as those from China and Turkey, leverage cultural differences to establish advantages in Africa and Central Asia (Buckley et al., 2020; Cuervo-Cazurra & Genc, 2008). Thirdly, cultural risk may play a mediating role of dynamic capabilities. Firms can transform cultural differences into advantages through organizational learning. The Uppsala model (Johanson & Vahlne, 2009) emphasizes gradual adaptation, while digital tools (e.g., cross-cultural collaboration platforms) expand the "optimal range" of cultural differences (Chen & Tan, 2023).

2. Negative Effects of Cultural Differences

On the contrary, some literature concluded that cultural risk can produce negative impacts on foreign direct investment. Firstly, cultural risk may increase transaction costs in foreign direct investment. Cultural differences exacerbate information asymmetry and contract enforcement costs (Williamson, 1985). Kogut and Singh (1988) found that a one-standard-deviation increase in cultural distance raises the probability of joint

ventures (vs. wholly-owned subsidiaries) by 35%. Language differences are particularly impactful, increasing merger integration costs by 8.5% per 10% gap (Dow & Karunaratna, 2006). Secondly, cultural risk may well result in management conflicts and efficiency losses. Hofstede's (2010) cultural dimensions theory indicates that differences in power distance and uncertainty avoidance often trigger conflicts. For example, Chinese firms faced employee resistance in Malaysia due to centralized management (Li et al., 2020). In cross-border mergers, cultural differences are the second-leading cause of failure (Very et al., 1997). Thirdly, cultural risk can also bring about challenges to institutional legitimacy. Cultural differences reduce policy support and social acceptance in host countries. Kostova and Zaheer (1999) found that a one-standard-deviation increase in cultural distance decreases the likelihood of policy support by 22%. Religious differences are especially sensitive—Chinese projects in Islamic countries have faced delays due to cultural misunderstandings (Peng et al., 2023).

Some Chinese literature has also investigated the impacts of cultural risk of the host countries on the Chinese investment in the BRI countries. However, no consensus has been reached (Zhang Jianhong & Zhou Mao, 2020; Li Xiangyang, 2021; Ma Shuzhong & Fang Chao, 2022; Huang Weiping & Han Jian, 2023).

Most studies assume a linear relationship, overlooking nonlinear effects, particularly in emerging economies. This paper will integrate Optimal Distinctiveness Theory and multidimensional cultural indicators (e.g., religion, language) to explore dynamic mechanisms.

III. Methodology

The incorporation of cultural risk into foreign direct investment analysis is grounded in three key theoretical perspectives. Institutional theory (Kostova and Zaheer, 1999) conceptualizes cultural distance as a critical dimension of institutional difference that affects organizational legitimacy and adaptation. Transaction cost theory (Williamson, 1985) explains how cultural differences create information asymmetries and increase coordination costs in cross-border operations. Optimal Distinctiveness Theory (Brewer, 1991) provides the nonlinear framework that accounts for the empirical finding that moderate cultural differences can enhance knowledge transfer while extreme differences hinder investment performance. These theoretical foundations collectively justify the treatment of cultural risk as a multidimensional construct influencing investment decisions.

This paper will employ gravity model to study the impacts of cultural risk on foreign direction investment. Since Tinbergen (1962) first applied Newton's law of universal gravitation to the field of international economics, the gravity model has been widely used in international economics. Since the 1990s, an increasing number of empirical studies on cross-border direct investment have adopted this model (Anderson, 2010). Building on this foundation, this paper constructs a gravity model for cross-border direct investment that incorporates cultural risks and host-country selection factors. This model systematically examines the complex mechanisms through which cultural differences influence cross-border direct investment.

1. Log-linear Model

Based on the framework of the classical gravity model, this study uses the Euclidean distance synthesized from Hofstede's cultural dimension indices as the core explanatory variable. It controls for traditional influencing factors such as economic scale and geographic distance, while incorporating industry and year fixed effects to improve estimation accuracy. In addition, Baiers and Bergstrand has also incorporated a multilateral resistance term in the traditional gravity model to capture the possible third coutry effect.

The traditional linear regression model with multilateral resistance term is constructed as follows:

$$fdi_{ij} = a_0 + a_1 \cdot y_i + a_2 \cdot y_j + a_3 \cdot \log(D_{ij}) + a_4 \cdot MR_{ij} + a_5 \cdot CR_{ij} + \epsilon_{ij} \quad (1)$$

Here, lowercase letters denote the logarithmic form of the relevant indicators. D_{ij} represents the geographic distance between the home country and the host country, MR_{ij} denotes the multilateral resistance term between the home country and the host country, and CR_{ij} denotes the cultural risk of the host country along the Belt and Road, measured by the cultural differences between China and the host country. This model validates the direct impact of cultural distance and serves as a benchmark for subsequent analyses (Kogut & Singh, 1988).

2. Poisson Model

A challenge in estimating the gravity model is the presence of zero values in cross-border direct investment between many country pairs. If these zero observations do not follow a normal distribution, ordinary least squares (OLS) estimation may yield biased results. Following the method of Silva and Tenreyro (2006), this paper employs the Poisson Pseudo Maximum Likelihood (PPML) estimator to fit the model parameters:

$$FDI_{ij} = b_0 + b_1 \cdot y_i + b_2 \cdot y_j + b_3 \cdot \log(D_{ij}) + b_4 \cdot MR_{ij} + b_5 \cdot CR_{ij} + \epsilon_{ij} \quad (2)$$

Unlike the log-linearized model, the dependent variable in the PPML model is the actual value of FDI, rather than its logarithmic form.

3. Quantile Regression Model

Building on the linear model, this paper further employs the quantile regression method (Koenker & Bassett, 1978) to analyze the heterogeneous effects of cultural distance on cross-border investments of different scales. The quantile regression model can be expressed as:

$$Q_{FDI}(\tau|RS) = RS'\beta(\tau) \quad (3)$$

Here, $Q_{FDI}(\tau|RS)$ represents the τ-th quantile (where $0 < \tau < 1$) of the dependent variable (cross-border direct investment, FDI) given the independent variable (country risk, RS). $\beta(\tau)$ is the coefficient vector associated with τ, describing how the independent variable (RS) influences the τ-th quantile of FDI. RS' denotes the transpose of the country risk variable.

The quantile regression model estimates$\beta(\tau)$ by minimizing the weighted absolute error, with the objective function specified as:

$$\min_{\beta(\tau)} \sum_{i=1}^{n} \rho(\tau)(FDI_i - RS_i'\beta(\tau)) \quad (4)$$

Here, $\rho_\tau(u) = u(\tau - I(u < 0))$ is the check function, used to compute the weighted absolute error. $I(u < 0)$ is an indicator function that equals 1 if $u < 0$ and 0 otherwise. By adjusting the value of τ, quantile regression reveals the relationship between the dependent and independent variables across the entire distribution of FDI, including tail behavior.

4. Nonlinear Model

To examine the potential nonlinear effects of cultural risk on FDI, this paper augments the log-linear model with a quadratic term for cultural risk (Blundell & Bond, 1998; Green, 2008):

$$fdi_{ij} = h_0 + h_1 \cdot y_i + h_2 \cdot y_j + h_3 \cdot \log(D_{ij}) + h_4 \cdot MR_{ij} + h_5 \cdot CR_{ij} + h_6 \cdot CR_{ij}^2 + \epsilon_{ij} \quad (5)$$

Here, h_5 captures the linear effect of country risk, while h_6 reflects the nonlinear effect (i.e., the squared term of country risk). If h_6 is significantly negative and h_5 has the opposite sign (or even if not, but $(h_5 \cdot CR_{ij} + h_6 \cdot CR_{ij}^2)$ is positive in some range of CR before turning negative), this indicates an inverted

U-shaped relationship (Acemoglu & Robinson, 2012). The inflection point is calculated as $-\frac{h_5}{h_6}$.

This paper employs the U-test method proposed by Lind and Mehlum (2010) to verify the presence of an inverted U-shaped relationship between cultural risk and China's investment in BRI countries.

IV. Empirical Analysis

1. Data Description

This paper employs Hofstede's six-dimensional indices to construct the host country's cultural risk index. Hofstede's cultural dimensions include power distance, uncertainty avoidance, individualism-collectivism, masculinity-femininity, short-term vs. long-term orientation, and restraint-indulgence. The Euclidean distance of these cultural dimension indices is calculated for 152 partner countries along the Belt and Road to reflect the cultural risk between China and these countries. A larger cultural distance indicates greater cultural risk between the two nations.

The other indicators employed in this study include China's foreign direct investment (FDI) in Belt and Road partner countries, the GDP of both the host country and China, the geographical distance between China and the host country, the gap in financial infrastructure, trade volume, and whether a bilateral investment agreement has been signed. Among these, bilateral FDI data are sourced from the IMF's CDIS database, GDP data come from the World Bank database, geographical distance is obtained from the CEPII database, trade volume is derived from the United Nation's COMTRADE database, financial infrastructure data are sourced from the World Bank database, and bilateral investment agreement information is taken from the UNCTAD's bilateral investment agreement database. All data cover the period from 2009 to 2022.

2. Empirical results

Based on the preceding analysis, this paper conducts empirical tests. Table 1 presents the results of the descriptive statistical analysis.

Table 1 Descriptive Statistics

	Observations	Mean	Median	Max	Min	Standard Deviation
lfdi	848	5.1472	5.1761	11.2325	0.0000	2.6130
lgdp_h	2046	24.1399	24.1428	30.5193	18.7015	1.9728
lgdp_s	2114	30.0087	30.0422	30.5193	29.2606	0.3641
ldist	2072	8.9839	9.0231	9.8677	6.8624	0.5254
mr_term	2114	8.9908	8.9438	9.6176	8.6278	0.2454
CRdist	2114	45.3150	50.0000	57.0454	10.7316	9.1068
INFT	2114	44.7703	45.1223	50.0034	36.4488	3.7075
BIT_dum	2114	0.3685	0.0000	1.0000	0.0000	0.4825
ltrade	1595	21.2219	21.2658	26.4610	10.4058	2.1469

Notes: lfdi: Logarithm of foreign direct investment. lgdp_h: Logarithm of the host country's GDP. lgdp_s: Logarithm of China's GDP. ldist: Logarithm of the geographical distance between China and the partner country. mr_term: Third-country effect. CRdist: Cultural distance. INFT: Difference in financial infrastructure. BIT_dum: Dummy variable for bilateral investment agreements. ltrade: Logarithm of bilateral trade volume.

Table 1 displays the descriptive statistics of the main variables. The standard deviation of foreign direct

investment (lfdi) is relatively large, indicating significant differences in FDI scale between China and various host countries. The mean geographical distance (ldist) is 8.9839, with a small standard deviation, suggesting that the distance distribution between sample countries and China is relatively concentrated. The mean cultural distance (CRdist) is 45.3150, with a considerable gap between the maximum and minimum values, reflecting notable cultural differences among Belt and Road partner countries.

Table 2 Impact of Cultural Risk on FDI

	LL	IV	PPML
lgdp_h	0.0224	-0.0121	-0.6291***
	(0.1367)	(0.1515)	(0.1242)
lgdp_s	2.1679***	2.2087***	2.1332***
	(0.5152)	(0.7367)	(0.4886)
ldist	-0.5881***	-0.5570***	0.0998
	(0.1537)	(0.1681)	(0.1033)
mr_term	2.7248***	2.5682***	0.6561***
	(0.3058)	(0.3283)	(0.2011)
CRdist	-0.0018	0.0006	0.0037
	(0.0073)	(0.0078)	(0.0071)
INFT	0.1141**	0.0854	0.2022***
	(0.0556)	(0.0868)	(0.0377)
BIT_dum	0.1934	0.2198	0.2550
	(0.1681)	(0.2026)	(0.1760)
ltrade	0.6350***	0.6891***	1.0446***
	(0.1342)	(0.1515)	(0.1438)
constant	-98.6822***	-97.9505***	-80.4946***
	(17.8670)	(25.7164)	(16.4679)
R^2	0.430	0.426	0.519
N	742	630	804

Notes: ***, **, * denote significance at the 1%, 5%, and 10% levels, respectively. Robust standard errors are in parentheses. LL: Log-linear model. IV: Instrumental variable model. PPML: Poisson Pseudo Maximum Likelihood model (accounts for zero FDI observations).

Table 2 employs three models (LL, IV, PPML) to examine the impact of cultural distance (CRdist) on FDI. The results show that the coefficient of CRdist is insignificant across all models, suggesting that cultural differences alone do not exert a significant linear effect on FDI. This further indicates that the influence of cultural differences may be nonlinear.

Table 3 Impact of Cultural Risk on FDI: Quantile Regression Analysis

	q=0.2	q=0.4	q=0.6	q=0.8
lgdp_h	-0.0792	-0.0496	0.0437	-0.1478
	(0.1642)	(0.2091)	(0.1422)	(0.2019)
lgdp_s	1.5419***	2.1038***	1.8683***	2.0015***
	(0.5597)	(0.7128)	(0.4849)	(0.6883)

ldist	-0.1443	-0.8206***	-0.9999***	-0.3471
	(0.1885)	(0.2400)	(0.1633)	(0.2318)
mr_term	2.8682***	2.5131***	1.9329***	3.5281***
	(0.4365)	(0.5558)	(0.3781)	(0.5367)
CRdist	-0.0004	0.0113	0.0181**	0.0047
	(0.0086)	(0.0110)	(0.0075)	(0.0106)
INFT	0.0039	0.0850	0.1198**	0.1420*
	(0.0616)	(0.0785)	(0.0534)	(0.0758)
BIT_dum	0.2475	0.2204	-0.0553	0.1245
	(0.2045)	(0.2605)	(0.1772)	(0.2515)
ltrade	0.8963***	0.7666***	0.6679***	0.6238***
	(0.1558)	(0.1984)	(0.1350)	(0.1916)
constant	-85.2946***	-93.6071***	-80.7219***	-98.2566***
	(19.8071)	(25.2240)	(17.1606)	(24.3587)
R^2	0.307	0.287	0.294	0.238
N	742	742	742	742

Notes: ***, **, * denote significance at the 1%, 5%, and 10% levels, respectively. Robust standard errors are in parentheses. q: Quantile, reflecting samples at the 0.2, 0.4, 0.6, and 0.8 quantiles.

Based on Equation (4), Table 3 employs quantile regression to analyze the heterogeneous effects of cultural distance (CRdist) on FDI across different quantiles. At the low quantile (q=0.2), the coefficient of CRdist is insignificant, but it becomes significantly positive at the mid-high quantile (q=0.6). This suggests that cultural differences have a weaker impact on small-scale investments but may promote large-scale investments. The third-country effect (mr_term) is significantly positive across all quantiles, though its coefficient first decreases and then increases, indicating that market potential affects investments of varying scales differently. The inhibitory effect of geographical distance (ldist) is most pronounced at mid quantiles (q=0.4, q=0.6), likely reflecting the heightened sensitivity of medium-scale investments to distance.

Table 4 has reported the estimation results of the nonlinear relationship based on Equation (5).

Table 4 Nonlinear Test

	LL	IV	PPML
lgdp_h	-0.0025	-0.0366	-0.6305***
	(0.1380)	(0.1523)	(0.1227)
lgdp_s	2.2808***	2.3773***	2.1431***
	(0.5129)	(0.7247)	(0.4827)
ldist	-0.5869***	-0.5552***	0.1100
	(0.1567)	(0.1713)	(0.1053)
mr_term	2.9055***	2.7529***	0.7716***
	(0.3020)	(0.3264)	(0.2124)
CRdist	0.1060***	0.1076***	0.0547*
	(0.0373)	(0.0395)	(0.0332)
CRdist2	-0.0015***	-0.0015***	-0.0007*

	(0.0005)	(0.0006)	(0.0004)
INFT	0.1239**	0.1038	0.2021***
	(0.0552)	(0.0846)	(0.0373)
BIT_dum	0.2216	0.2440	0.2522
	(0.1676)	(0.2024)	(0.1751)
ltrade	0.6217***	0.6732***	1.0280***
	(0.1337)	(0.1503)	(0.1378)
constant	-104.8449***	-106.1524***	-82.3447***
	(17.7639)	(25.2012)	(16.3085)
R^2	0.435	0.430	0.521
U-test value	2.767^{***}	2.606^{***}	1.407^{*}
N	742	630	804

Notes: ***, **, * denote significance at the 1%, 5%, and 10% levels, respectively. Robust standard errors are in parentheses. LL: Log-linear model. IV: Instrumental variable model. PPML: Poisson Pseudo Maximum Likelihood model (accounts for zero FDI observations).

Table 4 introduces the quadratic term of cultural distance (CRdist2) to test the nonlinear impact of cultural differences on China's FDI in partner countries. The results from the three models (LL, IV, PPML) are highly consistent: the coefficient of CRdist is significantly positive, while that of CRdist2 is significantly negative. This strongly supports an inverted U-shaped relationship between cultural differences and FDI, indicating an optimal range of cultural differences that maximizes investment performance.

First, on the left side of the inverted U-shaped curve, when cultural distance is small, the cultural similarity between the host and home countries may lead to a lack of competitive advantage for firms. According to the "learning advantage hypothesis" (Brouthers, 2013), moderate cultural differences can provide novel market knowledge, management practices, and innovation opportunities, thereby enhancing investment performance. Second, near the inflection point of the inverted U-shaped relationship, cultural differences offer sufficient diversity to create value without exceeding firms' adaptive capacity. This aligns with Hutzschenreuter et al. (2016)'s "golden difference zone", where cultural differences generate organizational flexibility (e.g., hybrid management models) that maximizes investment performance. Finally, on the right side of the inflection point, Shenkar (2012)'s "cultural friction threshold" theory suggests that when cultural differences exceed firms' absorptive capacity, management costs grow faster than benefits, and cultural differences begin to exert a negative influence (Li et al., 2018).

The empirical findings of this study demonstrate that cultural differences exert a complex, inverted U-shaped influence on China's FDI in Belt and Road partner countries.

V. Conclusion

The cultural risks arising from cultural differences between host and home countries are a significant factor affecting cross-border direct investment and an issue that requires attention in China's investment process in countries along the "Belt and Road" initiative. However, existing literature lacks sufficient analysis of the complex mechanisms through which cultural differences influence cross-border direct investment, and there is even less research on how cultural risks impact China's investments in Belt and Road countries. This paper integrates institutional theory, adopts Hofstede's multidimensional cultural distance indicators, and employs empirical methods to examine the impact of cultural risks on China's direct investment in Belt and Road

countries. The study finds that the relationship between cultural differences and FDI follows an inverted U-shaped curve.

Based on the findings of this study, to overcome cultural differences in Belt and Road countries and promote China's investment in these regions, the following measures must be taken. First, the government should strengthen the construction of a cultural risk early-warning system, providing enterprises with cultural difference databases and risk assessment tools for investments in Belt and Road countries, particularly focusing on host countries within the inflection point interval. Second, cultural friction can be reduced through bilateral agreements and training programs, such as establishing a special fund for cross-cultural exchanges to support enterprises in localizing their practices. Finally, enterprises should prioritize host countries with moderate cultural differences, avoiding overreliance on markets that are either too culturally similar or excessively divergent.

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