A Model of China’s State Capitalism

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Growing like China (Song et al. 2011 AER)

- Puzzling facts about Chinese economy
  - High rate of investment and high return to capital
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  - High capital return and current account surplus

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  - High capital return and current account surplus
- An explanation based on financial imperfection
  - Two types of firms: entrepreneurs and SOEs
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  - High rate of investment and high return to capital
  - High capital return and current account surplus
- An explanation based on financial imperfection
  - Two types of firms: entrepreneurs and SOEs
  - The entrepreneurs are more productive but financially constrained.
  - SOEs are less efficient but have better access to credit markets.
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  - Banks make most loans to SOEs.
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  - Household savings can only be deposited to banks.
  - Banks make most loans to SOEs.
  - SOEs shrink $\rightarrow$ excess domestic savings
Growing like China (Song et al. 2011 AER)

- The model is also consistent with several other features of Chinese economy
  - CA surplus increases in the share of entrepreneurs.
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- What are missing in Song et al. (2011)
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  - CA surplus increases in the share of entrepreneurs.
  - Entrepreneurs specialize in labor intensive products.
- What are missing in Song et al. (2011)
  - SOEs outperform private companies in China after 2001.
  - SOEs’ profits comove with China’s export and CA surplus after 2001 while their shares in exports decline significantly.

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Profit Margin of Chinese State-owned Enterprises Up Sharply in Last Decade

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Vertical structure in Chinese economy (after 2001)

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Trade liberalization (Accession to the WTO) ➞ rapid expansion of downstream firms

Profits of upstream SOEs increase, as a result.
Why is it an important issue?

- Complement Song et al. (2011) in understanding China’s economic growth
- Different prescription for China’s long-run economic growth
  - Eliminating financial frictions in Song et al. (2011)
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- Different prescription for China’s long-run economic growth
  - Eliminating financial frictions in Song et al. (2011)
  - Not enough in Li et al. (2012)
    - Remove entry barriers in upstream industries to sustain long-run economic growth.
Some assumptions need to be verified more carefully

- Upstream vs downstream industries
  - Clarify upstream and downstream industries: input-output table?

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  - Coincide with other classifications such as capital intensive vs. labor intensive?
  - Are profits of upstream/downstream industries in other countries high/low?
  - Other reasons for rising profits in upstream industries, such as the run-up of energy prices?
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- Reasons for the monopoly status of SOEs
  - Entry barriers by assumption
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- A result of financial frictions in Song et al. (2011)?
  - Financial frictions $\rightarrow$ SOEs specialize in capital intensive industries
  - Capital intensive industries coincide with upstream/high-profit industries

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- Reasons for the monopoly status of SOEs
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  - A result of financial frictions in Song et al. (2011)?
    - Financial frictions $\rightarrow$ SOEs specialize in capital intensive industries
    - Capital intensive industries coincide with upstream/high-profit industries
  - In either case, financial market liberalization is good for China’s long-run economic growth
    - Banking is one of the upstream industries that are dominated by SOEs.
    - Dallas Fed President Richard Fisher’s RMB speech
Disconnections among data, model, and arguments

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- Model: total profit of SOEs increased (profit margin is constant)
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- Argument and model: China’s economic growth after 2001 is mainly driven by trade liberalization
  - Data: Reallocation of resources may continue after 2001 (Figure 4)
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- Data and argument: the increase in profit margin is from the composition effect
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- Argument and model: China’s economic growth after 2001 is mainly driven by trade liberalization
  - Data: Reallocation of resources may continue after 2001 (Figure 4)
  - How much trade liberalization contribute to China’s economic growth?
This paper proposes a different story to explain Chinese economy after 2001

- SOEs outperformed private companies
- SOEs’ profitability comoved with trade though their shares in trade declined.

Vertical structure between SOEs and private firms

- SOEs monopolize upstream industries.
Conclusion

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▶ A sensible story on a very important issue
▶ More cross-checks of this story with the data are desirable.

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