COMMENTARY

Policy Perspectives from the Bottom Up: What Do Firm-Level Data Tell Us China Needs to Do?

David Dollar

It is a real pleasure to discuss Loren Brandt's paper. I do not have any major disagreement with his empirical work, which is carefully done. The richness here is in providing us with microfoundations for understanding what is happening in China's very complicated economy. First, I would like to briefly highlight what I think are four key empirical results in this paper. Second, I want to talk about how those four results can give us a good understanding of why China has done so well over the past three decades. Third, I want to talk about the current slowdown. Some of that may be cyclical, but there is also a structural slowdown going on. These results actually can help us understand that slowdown. Fourth, I will talk about policy issues. What are some of the things China can do to mitigate the slowdown and to prevent the buildup of risks?

First, let me pay tribute to the paper by highlighting what I see as four key results. The presentation was very clear. First, though we think of China as an investment-heavy growth model, and certainly in the aggregate it has had a high investment rate, Brandt shows that there has really been very fast total factor productivity growth in Chinese industry. This is similar to the earlier so-called East Asian miracle experiences. That has been established by other work as well, but it is nice to see it confirmed here. The thing that is most new here for me is this key role of entry, which is definitely different than what we have seen in other economies. According to Brandt's estimates, upwards of two-thirds of the productivity growth in sectors can be attributed to the entry of firms coming in at a higher level of productivity. Some of that entry of course would be foreign firms. Most of the entries are going to be domestic firms. Then the third thing—and I think this is not that surprising—is that there is tremendous variation across sectors. But it is interesting to relate that to the presence of state enterprises and the degree of openness of these different sectors. You have a very dualistic economy with some sectors open and competitive. Other sectors are relatively closed and dominated by state enterprises. The paper shows that the more open sectors, with more private-sector participation, have faster productivity growth—an intuitive result, but nice to actually see in the data. The fourth result I want to mention: everything I have highlighted is about manufacturing. But then the paper brings in services in the last part. This is going to be a very important issue in China's future. The paper has nice estimates of the real productivity of capital in different sectors. There is a clear hierarchy of (1) private industry, (2) private services, and (3) state enterprises in both services and manufacturing at a very low level of productivity. Also, if you look carefully, between 2008 and 2013, there is a distinct drop in the productivity of capital in private industry, though it remains the most productive kind of investment. These results can help us understand a number of things about China's economy.

First, look at China's tremendous growth record over three decades: when China joined the World Trade Organization (WTO) in 2001, it agreed to open up its economy. But if you look at the WTO agreement, it is very partial. China agreed to open up most of manufacturing to foreign investment, including wholly owned subsidiaries of foreign companies. But some key manufacturing sectors were not included. Automobiles, for example, remain relatively protected, with restrictions on foreign investment. Foreign investors have to operate in these awkward 50-50 joint ventures. But mostly manufacturing has opened up.

But there's almost nothing in the WTO agreement about opening up the modern service sectors; I will come back to that. Joining the WTO started a dynamic process in which manufacturing expanded its share of the economy, while at the same time the private sector expanded its share of manufacturing. That contributed to the overall growth.

Some of that entry is coming from multinational firms. They play an important catalytic role initially. But most of the entry is coming from the domestic private sector. For a long time the majority of China's exports (that is, in terms of gross value) have come from foreign-invested firms. Tang, Wang, and Wang (2014) show that in terms of value-added, most of China's exports come from the domestic private sector. So the entry of private firms in manufacturing is a key part of their success. Brandt's paper emphasizes that exports have always been a minority of output, but still they play an important catalytic role. But there are a lot of other things going on as well. When it joined the WTO, China opened up a lot of these sectors that become very competitive domestically. Most of the manufacturing output is not being sold as exports. Most of it is actually contributing to investment in China. So it is important to bring in the macroeconomic story, that this is an economy with high savings rate and high investment. Aside from joining the WTO, Zhu Rongji opened up the housing market in China, so there was a big private housing boom. A lot of investment started going into housing starting around 1995 and accelerating into the 2000s. The demand coming from exports peaked around the time of the global financial crisis. And then China's exports dropped very sharply. China chose to replace that with a stimulus program that was almost completely investment. So they took their investment rate, which was already pretty high, up to about 50 percent of GDP. To relate this back to the micro story, all the way up through that stimulus, there was a period in which manufacturing was increasing its share of the economy and the private sector was increasing its share of manufacturing. These productivity results help us understand why China's overall growth has been so good.

My third point is that the model that I have just described inevitably runs out of steam. China started out as a small player and became a very successful exporter. It was so successful that it became the biggest exporter in the world. So now it is difficult for China's exports to grow at the kind of rates we have seen in the past. This year, China feels that its exports are not growing well. But actually China's exports are growing in line with world trade: about 2 percent real. And it is just not realistic for exports to grow much faster than that. Add in that the investment-heavy model at the macro level has generated excess capacity throughout the economy. So now real estate is overbuilt. A lot of apartments are empty. A lot of manufacturing is now operating at low capacity.

In his remarks yesterday, Stan Fischer mentioned that it is natural at this stage for China's service sectors to start becoming a more important source of growth. And we actually see that in the data. While investment and industry have slowed down, there is a nice dynamic in which the labor market so far has remained tight; wages and household income are going up, consumption is rising, and consumption is mostly services. So China is growing pretty well. But then bring in Brandt's results. A lot of the service sectors that are expanding are the relatively closed, unproductive sectors in China. The OECD calculates an index of foreign direct investment restrictiveness by sector (Kalinova, Palerm, and Thomsen 2010). China is almost completely closed to foreign investment in financial services, telecom, logistics, media, and health care. Essentially the core of modern services is restricted in terms of foreign investment. And in many cases, there are restrictions on domestic investment as well. So naturally there will be some slowdown in China's growth rate as the manufacturing sector peaks and starts to decline as a share of GDP. But I think in China, this natural slowdown will be exacerbated, because now resources are shifting into sectors that are uncompetitive and where there is not a very important private-sector role.

The fourth and last issue is policy. China could help itself by opening up more. The obvious thing to do would be to open up these service sectors, both domestically and internationally. We have a relatively new leader in China, Xi Jinping. The Third Plenum two years ago rolled out a comprehensive reform program. That program includes a lot of these plans. The problem is that so far implementation has been slow. To be fair, they have made some progress. They have made it easier to register firms, for example. So the kind of start-ups that spur entry actually should be facilitated in a lot of sectors that are already open. But they have not really opened up new sectors. They certainly have not opened up new sectors to foreign investment. China is negotiating a bilateral investment treaty with the United States. The fact that they are trying to do that on the basis of a negative list indicates willingness to consider opening up. But the negotiation is going slowly. China has also not chosen to be part of the initial Trans-Pacific Partnership negotiations. This is the kind of agreement that could help China a lot if it opened up service sectors. It is not going to get the same kind of productivity growth as in manufacturing, but it certainly would get a better performance than we are seeing now.

The last reform issue I will just mention briefly. Eswar Prasad covered the issues of financial liberalization very nicely. There is a lot of progress in financial liberalization. You would hope the financial sector could play a role, bringing about exit of less productive firms and shifting resources to more productive firms. As Brandt said, we have not seen much of that so far. They certainly have done some things like liberalizing interest rates. But there are still a lot of problems in the financial sector. Private firms cannot easily go to the capital markets. It is a bureaucratic process that requires approval. Firms cannot just meet standards and issue stocks or issue bonds. A lot of the private investment is self-financed because the financial system is not financing it. But as Eswar Prasad emphasized, they are making progress with liberalizing the capital account. I want to end on a worrying note: By moving ahead with financial liberalization, and especially opening the capital account, but not moving on the real-sector reforms, China is creating certain types of risks. As investment slows down, as manufacturing slows down, if there are not a lot of good opportunities in the service sectors, then of course more capital is going to go overseas. Some of that can be healthy, but a very large, continual outflow from China could be quite disruptive.

In conclusion, it is useful to take a detailed look at firm dynamics and industry dynamics, as in Brandt's paper. China is very complicated. And this paper gives us a good sense of some of the things that are going on at the grassroots level, which in turn help us understand the macro level.

REFERENCES

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