“Policy Perspectives from the Bottom Up: What Do Firm-Level Data Tell us China Needs to Do?” by Loren Brandt

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Discussion by Zheng Liu

Federal Reserve Bank of San Francisco

Summary

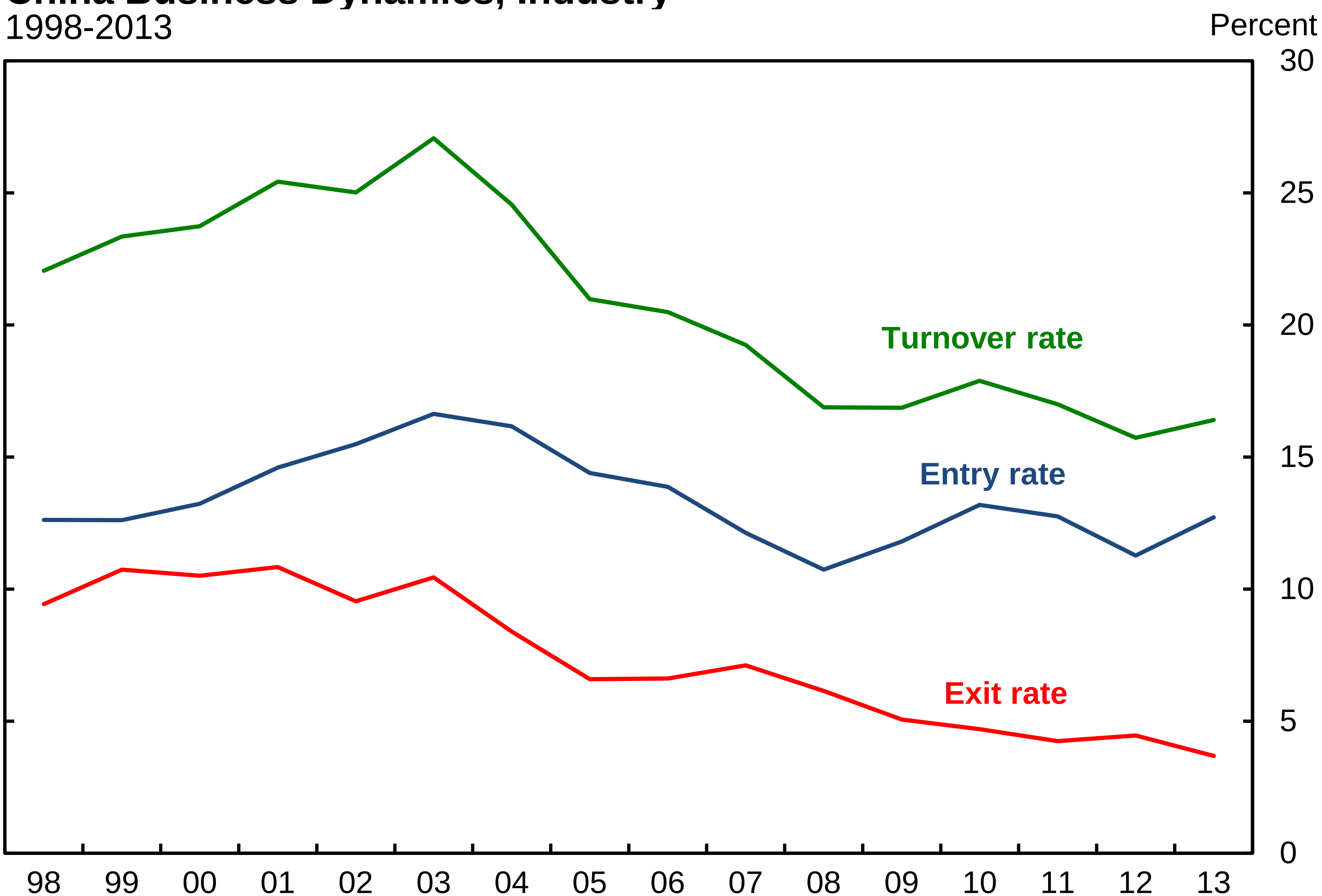
- Chinese economy: “enormous dynamism with huge distortions”
- Firm entry/exit important contributor to TFP
- But industrial policies distorted allocation and hindered dynamism
  - SOE-dominant sectors had lower TFP growth
  - Ownership not entire story: In SOE-dominant sectors, even non-state firms performed poorly

Business dynamism important for TFP

- TFP an important driver for China's rapid economic growth since 1980s (Zhu, 2012)
- Business dynamism improves TFP
  – Entry of young and productive firms
  – Exit of old and less productive firms
  – Business dynamics an important means for reallocation in the US (Decker, et al., 2014)
  – True for China as well [Brandt, et al (2012) attribute 2/3 of TFP growth to entry/exit]

Dynamism declined since early 2000s

China Business Dynamics, Industry
1998-2013

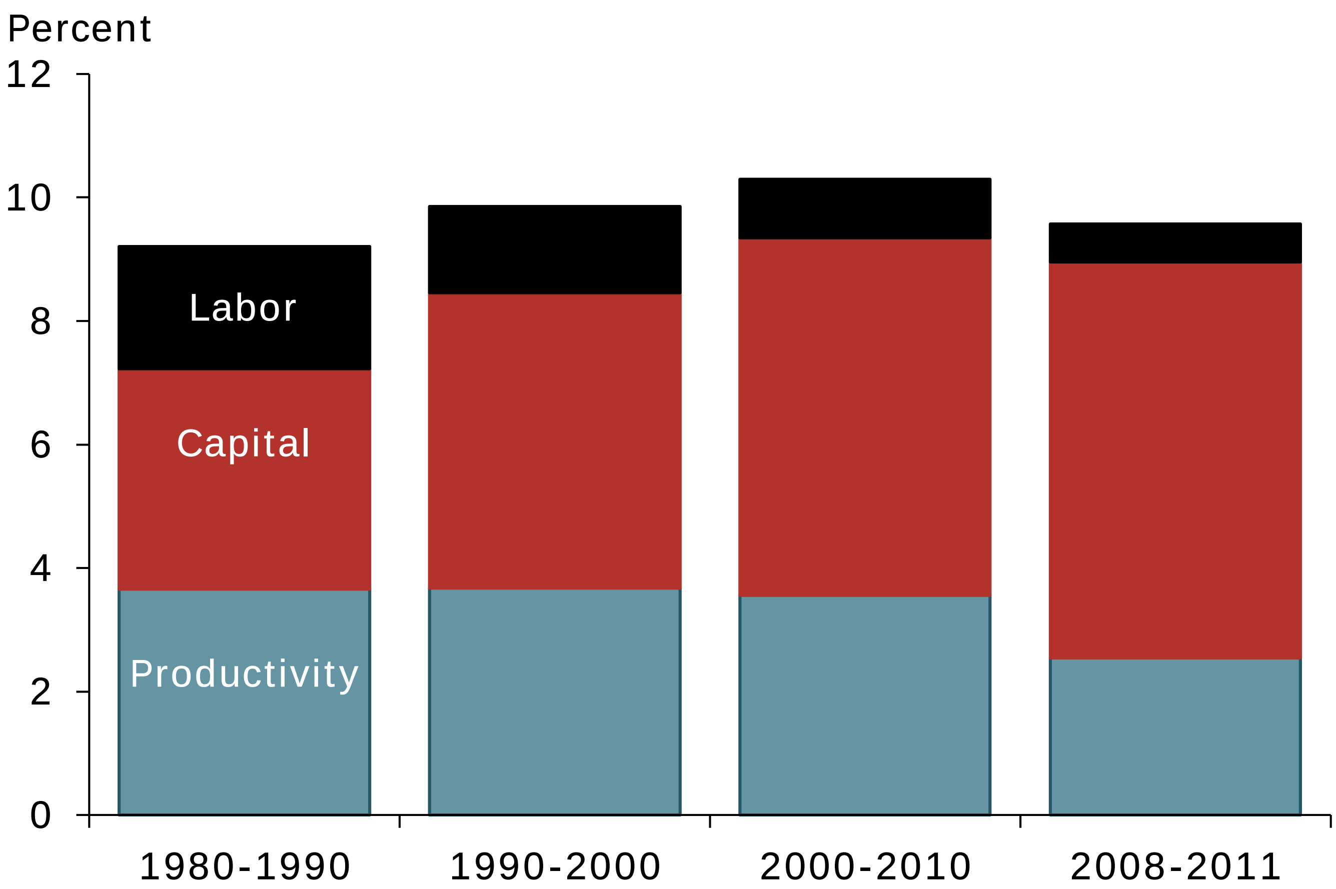


Source: Ministry of Industry and Commerce; Brandt (2016)

Discussion

- Industrial policy contributed to declines in dynamism
  - Entry barriers, monopoly rents, subsidies to favored firms/industries, uneven access to credit, interest controls, capital controls…
  - Distortion mitigated by falling tariffs
- Misallocation depresses TFP
  - SOEs vs private firms (Hsieh-Klenow, 2009)
  - More favored vs less favored sectors (e.g., Chang, et al., 2015)
  - Urban vs rural: Hukou (Tombe and Zhu, 2015)

Recent growth driven more by investment, less by TFP



Source: Penn World Tables and Liu (2015)

Structural reforms needed

- But what reform plans should be pursed?
  - Multiple sources of distortions
  - “Big bang” never been considered an option
  - Partial reforms can have undesirable spillover effects (e.g., Liu, Wang, and Xu (2016) on interest-rate liberalization)
  - Optimal policy: second-best
- Counterfactual policy analysis requires a coherent theoretical framework
  - Theory should incorporate Chinese characteristics

Two-period OG Models of China

- Transition dynamics: Song, Storesletten, and Zilibotti (2011, AER)
  - Easy access to credit enables low-productivity SOEs to survive
  - High productivity POEs save to self-finance investment
  - Transition dynamics consistent with some otherwise puzzling facts in China (e.g., high saving with high growth)
- Trends and cycles: Chang, Chen, Waggoner, and Zha (2015, NBER Macro Annual)
  - Credit policy for promoting heavy industries helps explain observed macro trends (e.g., rising investment rate)
  - Preferential policy more important than ownership status (consistent with Brandt (2016)

DSGE models for policy analysis

- Capital controls and optimal monetary policy: Chang, Liu, and Spiegel (2015, JME)
  - Policy tradeoff between sterilization costs and inflation stability over business cycles
- Reserve requirements (RR) as a stabilization tool: Chang, Liu, Spiegel, and Zhang (2016)
  - Segmented credit access: SOEs can get bank loans with gov’t guarantees, POEs rely on shadow bank financing
  - Laffer curve for RR
    - RR acts as tax on banking and thus on SOE activity, improves TFP by reallocating capital to more productive POEs
    - But increases in RR also raise bankruptcy costs

Conclusion

- Paper makes a convincing case that business dynamism is important for TFP growth
- To sustain dynamism requires structural reforms that reduce entry barriers and liberalize incentives
- **Needed:** A coherent framework to understand implications of counterfactual policy reforms