"Policy Perspectives from the Bottom Up: What Do Firm-Level Data Tell us China Needs to Do?" by Loren Brandt
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)
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 pursued?
  – 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))
• 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