POLITICS IN COMMAND: POLITICAL ECONOMY AND CHINA'S INNOVATION PROSPECTS

Douglas B. Fuller with Joe Wong
CDO Annual Network Meeting
April 30, 2015

Outline

- Overview of China's past development and some of the problems it has created for future development
- Prospects for reform
- Weak institutions for funding innovation in China today
  - Underperformance of domestic firms' innovation
- Incorporating political economy into the analysis of firm and industry performance in China

China's Successful Path to Middle-Income Status

- Moved from under-employment on the farm to employment in the factory (and elsewhere)
- Gradualism
- Financial repression via state banking system did lead to sustained, high levels of industrial and infrastructure investment
  - Big push industrialization
  - Aided the movement from farm to factory
- Local government incentives to pursue development
  - Aided industrial investment given the incentives structures in place—hard economic targets
- Human Capital Development
- Increased Investment in R&D
  - In 2012 almost two percent of GDP and tripled as a share of GDP since 1995
- Competitive Markets—many sectors have seen tremendous amount of entry, especially of MNCs

Problem 1: Financial Repression leads to Financial Misallocation

- Financial repression leads to massive capital misallocation
  - Rising if still mainly official unrecognized non-performing loans (NPLs)
  - Levels of sustained investment that skews GDP heavily against consumption
    - Consumption a little over half the global average; 34-35 percent versus 65-70 percent for developing countries and 65% as the global average
    - China's own consumption rate was 50-52% in the early 1980s
  - The pace of credit expansion 2006-2013 in China has been double that of 2002-2007 US or 1985-1990 Japan
  - Flirting with debt limit
- Bright spot: deflation is at least turning real interest rates for the state-favored positive
- Massive subsidization of state-owned firms—safe bet is to lend to these firms—leads to their lack of competitiveness
    - 4-9% of GDP per year transferred via low real interests from households to the corporate sector (primarily SOEs) (Pettis 2013, IMF 2012)
    - Unirule Institute (2011): 2001-2010 interest rate subsidy accounted for 400-500% of SOE profits and direct subsidies and monopoly pricing accounted for another 150%
    - 90% of SOEs unprofitable without these subsidies

Problem 2: When Good Incentives Go Bad—Encouraging Bad Behavior among Local Officials

- Hard Targets Remain in place so local officials interested in investment for career advancement
  - 2007 and 2013 announcements were made to move away from hard targets but they haven't stuck—Premier Li Keqiang early this year was emphasizing growth objectives again
- Creation of local revenues through land confiscation and conversion as a motivation
    - Take from farmers for US$17,850 in average compensation and sell the land to developers for an average of US$740,000
    - Local land sales have gone from one-sixth to one-third of total local revenue from 2006 to 2013
- China's industrial land accounts for 50% of new land development (worldwide average is 10-15%)
- Ignore the hard work of upgrading—zones are all about attracting new investment rather than upgrading capabilities of local/domestic firms

Problem 3: China's Problematic Industrial Policy and the Difficulty of State-led Upgrading

- Fragmented authoritarianism
- Sheer geographic and population size
  - Large information asymmetries
- Exports not as large as share of GDP as previous developers
  - Much industrial policy driven by state procurement
- Very inefficiently skewed capital allocation
- Political incentives that have driven opening up
- Example: R&D mismanagement—Minister Wan Gang estimates in 2013 that MOST can only account for how 40% of research funding was spent

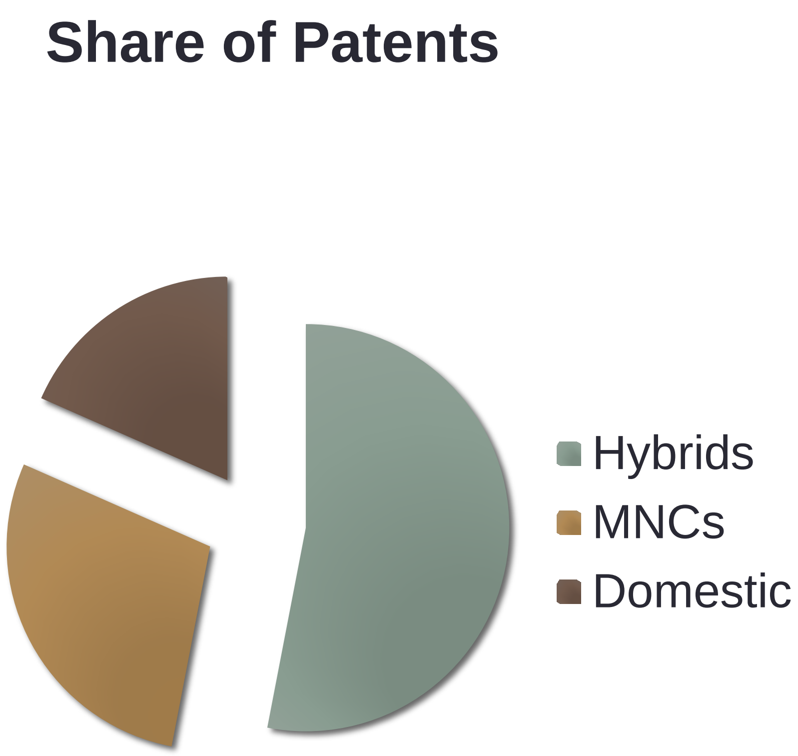
Prospects for China’s Reform?

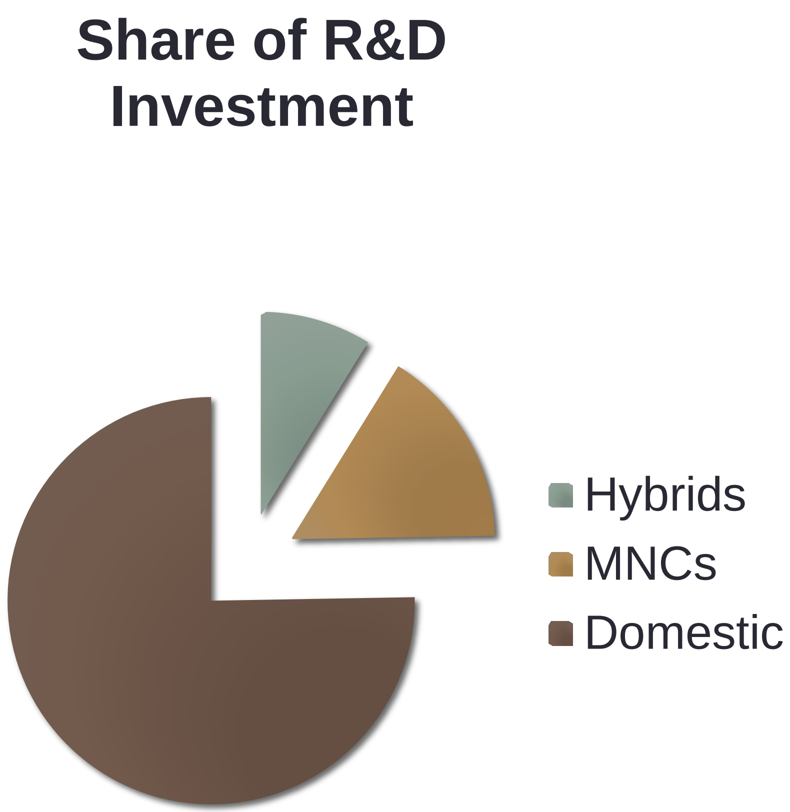
- Reasons to Forecast Reform Success
  - Xi Jinping’s anti-corruption campaign could be the first step to taking on the vested interests which want to maintain the current system e.g. SOE managers
  - Positive real interest rates
- Reasons for Concern
  - CCP is still a Leninist party—Reform means letting go whether to markets (liberal capitalism) or other organizations (coordinated/organized capitalism) but CCP wants to maintain control
    - Message of the Fourth Plenum
  - Vested interests in the current system are deeply entrenched

Weak Institutions for Funding Innovation

- Domestic Venture Capital
  - Sufficient changes in legal structures by 2007 BUT
  - State vehicles loom large in domestic VC and are generally not interested in investing in early stages or ineffective at doing so i.e. act like other state financial vehicles
  - Recent state efforts to subsidize venture funds, such as the Venture Guiding Fund, have actually led to less emphasis on seed and early stage investment and more investment in mature industries as opposed to high-tech (Wang *et al*. 2013).
  - Giant industry-specific investments like the Megaprojects likely will exacerbate the inefficiencies of such investments
  - Domestic equity markets still not an attractive exit option yet
- Foreign venture firms funding the “domestic” firms that actually innovate
  - Provide an escape from China’s institutional disadvantages for these hybrid firms
  - Invested in large majority of firms in Rein’s The End of Copycat China
- Alternatives
  - Business groups—the state financial system has served to undermine rather than bolster the capabilities of nascent ones in the state sector; unlikely that Korean chaebol will emerge
  - Industrial clusters—the local incentives for officials are not in place to replicate Taiwan’s Hsinchu

Innovation Performance across Hybrids, Domestic and Multinational Firms, 2003-2011





Steps to Bring Politics into the Analysis of Performance of Chinese Firms and Industries

- Properly specify the relationship of firms to the state
  - Identify which firms are actually state-owned by rejecting the formal categories and searching for the ultimate owners
    - Work of Jiang Lei and Pierre-Olivier L. Tremblay
  - Question whether corporate governance as defined by imitation of foreign corporate board structures is where the power lies
    - Investigate the role of the party committees in SOEs
- Better specification of how state intervention has shaped specific markets
  - Procurement shaping market performance outcomes
  - Tilting the playing field through access to finance
- Re-examining state-given incentives for patenting behavior
  - Increases in local and foreign patenting of domestic firms may have little to do with innovation and much more to do with incentives to encourage as much patenting as possible