HKUST IEMS
INSTITUTE FOR EMERGING MARKET STUDIES

NEWSLETTER

SPRING 2014

DIRECTOR'S WELCOME

Albert Park
Director of HKUST IEMS

The HKUST Institute for Emerging Market Studies (IEMS) was launched on May 27, 2013 with generous financial support from EY and the mission to provide thought leadership by leading experts on key issues facing businesses and governments in emerging market countries. HKUST IEMS has organized a series of events examining issues ranging from governance to education, inequality, innovation, and urbanization, and has supported new research by faculty from diverse academic disciplines. HKUST, as a globally elite university whose location makes it a gateway to China and other Asian economies, is well-positioned to become a thought leader on issues facing emerging markets. HKUST IEMS has about 40 Faculty Associates with research interests in emerging markets, mainly from the six Business School departments and the Division of Social Science.

To realize its mission, HKUST IEMS has three main goals. The first is to generate new knowledge by promoting high-quality research on issues of practical importance to businesses and policy makers in emerging markets. The Institute provides financial support for faculty research and develops collaborations with research partners worldwide. The second is to communicate relevant research findings to the business and public policy communities through reports, newsletters, and events, to have maximum impact on the public discourse on emerging markets. Finally, the Institute aims to provide a platform through its events and online for increasing knowledge, awareness, and exchange of ideas among academics, the business community, government, non-governmental organizations, and the public. This is a conversation that is vital for successfully meeting the many challenges confronting the world's most dynamic countries. I hope you will join us in this endeavor.

A MESSAGE FROM OUR PARTNERS AT EY

Jay Nibbe
EY Global Executive
and Accounts Leader

Emerging markets are the future growth markets. Every growth-oriented company, regardless of where they are headquartered knows and understands that a significant part of their future success will be in these markets. At EY we recognize that our future success will depend on understanding and building our presence in these markets.

Even with the current volatility in the global economy, the GDP growth in these markets will be 2.5 times faster than the developed markets. In the short term emerging markets will contribute two-thirds of all GDP growth. Capital flows into and trade flows between these markets will represent more than sixty percent of global economic activity. These markets represent the future employment opportunities.

In order to succeed it will be necessary to have the appropriate insights and understanding of these markets. This is why we at EY are very pleased to support and work with HKUST to establish the HKUST Institute for Emerging Market Studies. The Institute will provide an opportunity to collaborate with a global leading institution on research and knowledge development to provide thought leadership and insights. This knowledge and insight can benefit policy makers, including government institutions, business and professional leaders, emerging market domestic enterprises, global companies and other organizations operating in emerging markets. The HKUST IEMS will be a forum for our partners, clients and key stakeholders to address the critical issues in these markets.

We look forward to this collaboration in building these future markets.

LAUNCH EVENT OF HKUST IEMS
(2013.5.27)

The launch event of the HKUST Institute for Emerging Market Studies (IEMS) was officiated by Prof. Tony F Chan, President of HKUST. In addition to remarks by Mr. Jay Nibbe of EY, HKUST IEMS Director Albert Park moderated a panel discussion on "Prospects for Emerging Markets in the Global Economy" featuring world-renowned academic scholars. Prof. Jan Svejnar, Director of the Center for Global Economic Governance at Columbia University, discussed the effects of the current global economic situation on emerging market economies, explaining how globalization and foreign competition have affected domestic firms in emerging markets. Prof. Yang Yao, Dean of the National School of Development at Peking University, commented on China's economic growth prospects, and suggested that although China is likely to maintain relatively high rates of growth, technology lock-in, environmental problems and energy shortage constitute real challenges that China must overcome to achieve sustained economic growth. Prof. Deepak Nayyar, Emeritus Prof. of Economics at Jawaharlal Nehru University and former Chief Economic Adviser to the Government of India, analyzed the technological capabilities of China, India and Brazil, and emphasized the opportunities for late-comer countries to learn from these countries to promote their own technological development. He also pointed out that each economy has its own specificities and may be allies on many issues but also competitors in some arenas.

Prof. Christopher Pissarides

SIR CHRISTOPHER PISSARIDES DISCUSSES EUROPE AND CHINA (2013.12.3)

In December 2013, Nobel Prize Laureate Sir Christopher Pissarides delivered a luncheon speech at the Island Shangri-La Hong Kong, on "Europe in Crisis: Lessons for China". The event was co-organized by HKUST Jockey Club Institute for Advanced Study, HUKST Institute for Emerging Market Studies (IEMS), School of Business and Management, and Leadership and Public Policy Executive Education Programs Office.

In the speech Prof. Pissarides pointed out that Germany and other northern European countries are growing again, whereas Southern Europe is in prolonged recession, creating fundamental tensions among Eurozone members about where Europe will go next. Because of the unified currency, Southern countries are unable to allow their currencies to depreciate which could help boost exports and support recovery. At the same time, richer European countries lack the political will to provide large transfers to bail out poorer members and stimulate recovery. This combination reveals inherent internal inconsistency of the current arrangement and leads to debt crises as investors realize that rich countries are not willing to back the debts of the poorer countries. Prof. Pissarides pointed out similarities to the situation in China, where fiscal decentralization has led local authorities to borrow excessively, leading to mounting debts and non-performing loans. China must decide whether to rescue local banks to support growth keeping in mind how this affects the incentives of local governments to act responsibly.

Another issue that Prof. Pissarides discussed is population aging and pensions. European nations are aging societies with early retirement ages but high life expectancy and generous pension benefits. He pointed out that this could be a time bomb threatening the public pension system, government finances, and the ability to sustain economic growth. In view of the European situation, China should re-set its retirement age by tying it to life expectancy, re-think its one-child policy, and reform the pension system so as to achieve sustainable development during the course of population aging.

HKUST IEMS RESEARCH GRANTS AWARDED IN 2013

Income Distribution and Sovereign Credibility in Emerging Market Countries	Hye Jee Cho, Assistant Prof. of Social Science
Understanding Demand for Counterfeit Products in Developing Nations	Amy Dalton, Assistant Prof. of Marketing
A Study of User Behavior in using Search Engine for Locating Infringing Digital Media in Emerging Markets	Kai Lung Hui and James S.H. Kwok, Associate Prof. and Adjunct Associate Prof. of Information Systems, Business Statistics, and Operations Management
Relatedness Between Industries and Industrial Relocation: Evidence from Chinese Firms	Amber Li, Assistant Prof. of Economics
Corporate Risk Management in Emerging Markets: Challenges and Opportunities	Peter MacKay, Associate Prof. of Finance
Private Sector Financial Contract Design to Overcome Public Sector Inefficiencies in Emerging Markets	Abhiroop Mukherjee, Assistant Prof. of Finance
Preemption and Defense: Strategy of International Patenting in Emerging Economies	Naubahar Sharif, Associate Prof. of Social Science
Workshop on Pathways to Sustainable Urbanization in Emerging Economies	Jimin Zhao, Associate Prof. of Social Science
Reverse Migration and Technology Transfer in Emerging Market Societies	David Zweig, Chair Prof. of Social Science

RESEARCH HIGHLIGHT: "INNOVATE OR DIE: THE FATE & FUTURE OF HONG KONG-OWNED PEARL RIVER DELTA (PRD) FACTORIES"

Naubahar Sharif and Can Huang, "Innovation Strategy, Firm Survival and Relocation: The Case of Hong Kong-Owned Manufacturing in Guangdong Province, China." Research Policy 41, no.1 (2012): 69–78.

"Nothing is permanent except change" a popular quote by Heraclitus succinctly hints towards firms investing in techniques and strategies to survive in a dynamic world. Schumpeter had argued that innovation is critical in a firm's survival plan helping them to competitively tide over the threat of new technologies and improving existing capacities. HKUST IEMS Faculty Associate Naubahar Sharif's recent study coauthored with Can Huang, analyzed firm survey data collected by the Hong Kong firms that engaged in R&D or innovative collaborations in China showed a greater tendency of survival in Guangdong. Since most emerging economies operate in dynamic environments and face similar problems of firm survival, the paper highlights the importance of forging links between industry and knowledge warehouses such as universities and research institutions to enable a healthy flow of learning and knowledge.

In 2011, Guangdong province accounted for 23.6% of the total FDI directed to China with Hong Kong being the largest contributor. In recent years, Hong Kong's investment in Guangdong has been diversified from manufacturing to the service sector. Several factors contributed to Guangdong becoming Hong Kong's favorite destination for investment such as favorable and flexible tax policies. Although Guangdong enjoys geographical proximity to Hong Kong, it is the ethnic ties (cultural and linguistic) that link the two societies more closely together than with other provinces. Guangdong and Hong Kong have enjoyed a symbiotic relationship: while Hong Kong capitalizes on the availability of cheap and abundant labor and land in Guangdong; Guangdong takes advantage of Hong Kong's information on trade and knowledge about the global market demand.

However changing business environments in Guangdong such as rising prices of raw materials, strict environment controls, cancellation and reduction of tax refunds are forcing many Hong Kong manufacturers, especially those in labor-intensive and environmentally unfriendly industries such as leather tanning, shoe making, textile and garment production to shut down or relocate. In this context firms are compelled to develop a firm survival strategy.

Prof. Sharif's study finds that innovative strategies such as R&D investment, higher technology use, patents etc. improve firm's survival chances. Analysis of the data from an innovation survey of Hong Kong manufacturers in Guangdong reveals that "low cost" and "being close to the market and customer" were primary motivations for firms to engage in R&D or innovative collaborations. Large exporting firms were more likely to engage in R&D and innovative collaborations since the internal financial and organizational capability of such firms allowed them to undertake the heavy initial fixed investment required for an innovation plan. Other studies in emerging markets also consider the growth potential of the market to be a significant predictor of innovation. Innovative firms preferred to collaborate with knowledge warehouses such as universities and consultants who were based in Hong Kong and hence enjoyed the advantage of geographical proximity. Surprisingly, public financial support from the concerned governments had no impact on the tendency of these firms to innovate. Hence the paper points towards focusing on building a regional integrated innovative system wherein the strengths and capacities of the industry and research organizations yield positive externalities.

IEMS LUNCHEON SEMINAR SERIES 2013

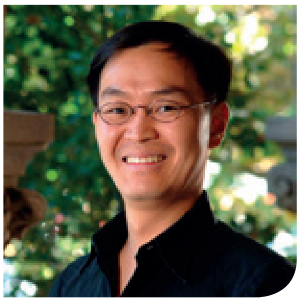
11.11
INNOVATION OR DIE: THE FATE AND FUTURE OF HONG KONG-OWNED PEARL RIVER DELTA (PRD) FACTORIES

Prof. Naubahar Sharif
Division of Social Science, HKUST

12.2
TALENT RECRUITMENT, REVERSE MIGRATION AND TRANSNATIONAL BRIDGES IN SOUTH KOREA AND CHINA

Prof. David Zweig
Division of Social Science, HKUST

Prof. Joon Nak Choi
Department of Management, HKUST



CONFERENCE ON WEALTH ACCUMULATION AND INEQUALITY OF OPPORTUNITY *(2013.10.18-19)*

Rising inequality has recently become a hot topic globally. Pope Francis has highlighted the issue, and Thomas Piketty's recent book Capital in the 21st Century has provided new evidence on rising wealth inequality in the US and Europe that has led to heated discussions about the reliability of the evidence and appropriate policy responses. Inequality also is rising rapidly in many emerging markets, especially China, with new markets for housing and capital playing an important role. To explore these issues in depth, HKUST IEMS co-sponsored a conference on Wealth Accumulation and Inequality of Opportunity in October 2013 with HKUST's School of Humanities and Social Science (HKUST), the French Centre for Research on Contemporary China (CEFC), and GATE Lyon Saint-Etienne, bringing together leading economists, sociologists, and historians from France, Hong Kong and China.

The two keynote speakers were well-known French economists Thomas Piketty and Francois Bourguignon (formerly Chief Economist of the World Bank). In his opening speech, Prof. Piketty explained why global inequality levels are on the rise and may reach 19th century levels. Citing remarkable newly constructed data for the US, UK, and France spanning decades, he argued that the main drivers of rising inequality are a higher after-tax return to capital exceeding the rate of economic growth, fueled by the power of global capital markets, which leads to inherited wealth growing faster than earned wealth and a higher concentration of wealth over time. This trend is reinforced by rising income inequality particularly in America where there has been an exorbitant rise in top labor incomes and a decline in top tax rates. To counter these trends he proposed imposing a progressive tax on inherited wealth.

Prof. Bourguinon, a leading expert on inequality in developing countries, reviewed different aspects of the relationship between inequality and growth, and concluded that the two dimensions of development could each influence the other positively or negatively but the key focus should be on "institutions" as the fundamental determinant of growth and development. For this reason, he advocated shifting the focus of research from measuring and explaining income inequalities to examining how inequalities arise from differential opportunities. He noted that top Chinese leaders asked him how much inequality is too much inequality, and that he answered that inequality becomes a problem when wealth inequality in the current generation creates unequal opportunities for the next generation. For this reason, governments should take an active role in creating new opportunities in a progressive way (e.g. through education, microfinance, etc.).

One of the highlights of the conference was the presentation for the first time ever of preliminary estimates of recent wealth inequality in China based on three different nationally representative household surveys. Prof. Jijun Tan of Southwestern University of Finance and Economics reported that according to the China Household Finance Survey, which surveyed over 28,000 households in 29 provinces, China's wealth gini coefficient was 0.78 in 2011. Their survey had previously reported an income gini coefficient of 0.61 for 2011, which attracted great media attention and public discussion because it was much higher than those reported by China's National Bureau of Statistics (0.47) or other national surveys (0.52-0.54). Prof. Shi Li of Beijing Normal University, a well-known expert on inequality in China, presented an estimate of China's wealth gini coefficient of 0.76 in 2010 using survey data from the nationally representative China Family Panel Study conducted by Peking University of over 14,000 households. Finally, Prof. Albert Park of HKUST and Prof. Yan Shen of Peking University presented an estimate of the wealth gini coefficient of 0.68 in 2010-11 based on surveys of over 10,000 households (with at least one member age 45 or older) of the China Health and Retirement Longitudinal Study run by Peking University. All of these estimates are much higher than available estimates for the 1990s and early 2000s. For example, according to Prof. Li survey-based estimates from the China Household Income Project found the wealth gini to be 0.40 in 1995 and 0.55 in 2002. Thus, the conference produced the first credible estimates of very rapidly rising wealth inequality in China during the first decade of the 21st century. Prof. Piketty commented that if these numbers were accurate, it suggests that China's wealth inequality moved from being like Sweden to being like the US in less than a decade!

All three authors found that the main contributor to high and rising wealth inequality in China has been differences in housing wealth, which all of the surveys found accounted for most of households' total wealth. Many urban homeowners in China experienced windfall gains from housing reforms in the late 1990s and early 2000s.Household had opportunities to purchase apartments from their work units at very low prices, and all homeowners gained from market windfalls associated with booming housing prices in the 2000s as the real estate market developed rapidly, especially in China's largest cities. Prof. Park and Shen estimated that three fourths of current housing values are from windfall gains. Because younger adults in China are more likely to rent housing and not benefit from similar gains as their parents, between-cohort inequality and the role of inherited wealth may become important issues in China. This highlights the relevance of Prof. Bourguignon's advice that governments focus on making sure that family wealth differences do not lead to differences in education and other opportunities.

Several other presentations examined in more depth how institutions influence inequality in China. Analyzing wage data from China's 1% population mini-census in 2005, Prof. Xiaogang Wu of HKUST found that in Chinese cities rural migrant workers earned significantly less than their urban counterparts, especially in government/state institutions and state-owned enterprises, reflecting longstanding differential treatment of rural and urban citizens dating back to China's socialist planning period. Decomposition analysis reveals that the earning inequality is largely attributable to rural migrants working in lower-paying occupations than local urban workers rather than unequal pay within the same occupation.

Prof. Xin Meng of Australia National University analyzed several micro data sets to investigate the impact of differences in parent's education caused by school interruptions due to a political event, the Cultural Revolution, on their children's educational attainment. The natural experiment provides an opportunity to isolate the "nurture effect" on children's education, since exposure to the shocks was not related to parent's ability. She finds that a one year decrease in the parent's schooling due to schooling interruptions leads to 0.32-0.38 years less schooling for the child, and that a child becomes 35-53% less likely to obtain a university degree if the parent did not graduate from college. This suggests that the intergenerational transmission of education is important in China.

Analyzing the China Household Income Project (2002), Prof. Sylvie Demurger of GATE Lyon Saint-Etienne measured the inequality of opportunity as the difference between the observed earnings inequality and the inequality that would have prevailed if circumstances such as parental characteristics, location of birth, gender, and migration status are held constant. She found that the most important circumstantial factor was one's birth location (rural or urban and coastal or inland), and that consistent with Prof. Meng's study parent's education and parent's political background mattered amongst the cohort born after the Cultural Revolution. However, when migrants are included in the sample inequality of opportunity only explains 8% of observed inequality.

Extremely high levels of wealth inequality in contemporary China represent large departures not only from more equitable distribution of wealth during China's early reform period and socialist period, but also with wealth outcomes during imperial China. Prof. James Lee of HKUST presented fascinating historical evidence from different regions of China that equitable land distribution, especially the absence of landless peasants, characterized local regions during the late imperial period in China. He argued that this reflects the norm that equitable property distribution was the responsibility of the state, which continued with the Communist Party leadership, who used land reform to further reduce the number of "have-nots". However, this equity norm did not mean that inequality was not transmitted across generations. Prof. Cameron Campbell of HKUST presented evidence from analysis of large multigenerational demographic data that high status founders of descent lines could influence the descent line size and reproductive behavior of descendants for over 150 years. This phenomenon shapes the intergenerational transmission of knowledge, attitude, social or economic or cultural capital and attributes that are conducive to success.

Other interesting presentations on contemporary and historical inequality in France were made by Jérôme Bourdieu (Paris School of Economics), Louis-André Vallet (OSC SciencesPo), and Nicolas Pistolesi (Toulouse School of Economics).

Prof. Thomas Piketty

Prof. Francois Bourguignon

INTERNATIONAL CONFERENCE ON HUMAN RESOURCES AND ECONOMIC DEVELOPMENT (2013.6.24-26)

HKUST IEMS cohosted the International Conference on Human Resources and Economic Development in June 2013, which included many of the world's leading development economists studying the challenges facing educational systems in developing countries. The conference also was supported by the Institute for Advanced Study, the Department of Economics, the Division of Social Science, and the School of Humanities and Social Science.


Prof. Paul Glewwe

A highlight of the conference was a panel discussion on how research can impact educational outcomes in developing countries, which featured comments by Paul Atherton of the United Kingdom's Department for International Development (DFID), Jishnu Das of the World Bank, Michael Kremer of Harvard University (an advisor to USAID) and Eric Hanushek of Stanford University. Paul Glewwe of the University of Minnesota, who co-organized the conference with HKUST IEMS Director Albert Park, moderated the discussion, which elicited lively discussion among participants.

In the past decade, an explosion of evaluation studies of specific educational interventions in developing countries using randomized control trials (RCTs) have provided new insights into what works and what does not. Michael Kremer pointed out that much research confirms that cost and distance strongly influence access to education, and that RCTs have shown that deworming, conditional cash transfer programs, efforts to reduce mismatches between curriculum and student ability levels, and use of local contract teachers can be effective across different settings, while popular programs to reduce class size or provide laptop computers are rarely successful. He explained how the convincing research findings that deworming in Kenya could have large impacts on school attendance at a very low cost eventually convinced the government to adopt deworming programs on a large scale, and that a number of Indian states are now following suit.

Eric Hanushek and other conference participants expressed concern about advocating specific interventions globally based on a limited number of studies, because differences in local capabilities and demands might make it hard to generalize about which policies are most appropriate for a given locale. He emphasized that research has taught us that just giving things to schools (e.g., laptops, textbooks, equipment, money) is rarely effective, but that incentives matter. He advocated a policy approach in which local school systems are given a menu of options along with strong incentives to achieve improvements and to learn from their experience. However, given the limited capacity of schools in some developing countries, some participants felt more prescriptive approaches might be appropriate, thus local capacity must be balanced against the desire to empower local communities.

Paul Atherton commented that although much research has studied specific educational interventions, little research has informed practical issues of project implementation often confronted by aid agencies such as DFID. DFID must work with partners such as governments, NGOs, and the private sector and would like to know how to interact with these partners in a way that will maximize educational outcomes. He also pointed out the need for more research on educational systems as a whole that considers how public and private sector players interact dynamically.

Jishnu Das also strongly endorsed the need for examining educational systems, explaining that much recent research, especially in India, finds that private schools clearly outperform public schools, that they react to reforms in public schools, and that their performance often deteriorates once they receive government subsidies. He raised the question of how we should evaluate whether an educational system is working or not, and suggested that rather than just focusing on test scores, it might make sense to focus on the valuation of parents, who have their children's interest at heart and may care about school attributes other than test scores (e.g., infrastructure, location, values, etc.). This implies that a desirable feature of educational systems is that they provide a wide range of choices for parents and be more directly accountable to them. In discussing how to evaluate the welfare impacts of different policies, participants also pointed out the need to avoid focusing on just learning outcomes, but to also consider broader social impacts as well as how scaled up interventions might influence the system as a whole, such as through market prices, government capacity, private sector responses, etc.

Finally, several participants suggested that international organizations and governments can support evidence-based policy-making by supporting evaluation studies and sharing and disseminating research findings, collecting and sharing detailed administrative data on students and teachers, and systematically measuring learning outcomes in their countries in a way that facilitates international comparisons.

A videotape of the session can be found at:
http://iems.ust.hk/cgi-bin/iems/eng/events_detail.php?id=4.

CHINA'S URBANIZATION STRATEGY: CHALLENGES AND PROSPECTS (2013.11.18)

Urbanization is playing a key role in economic development in China and other emerging markets. Premier Li Keqiang has made promoting healthy urbanization a key part of the new leadership's reform agenda, with a number of supporting reforms announced following the Chinese Communist Party's Third Plenum meetings in November. To better understand the challenges and prospects facing urbanization in China, HKUST's Institute for Emerging Market Studies (IEMS), in collaboration with the HKUST Leadership and Public Policy Executive Education Office (LAPP), co-organized a forum on *China's Urbanization Strategy: Challenges and Prospects*. Three prominent authorities weighed in with different perspectives, sharing insights on different aspects of urbanization in China.

The forum was kicked off by Dr. Chorching Goh, the World Bank's Lead Economist for China and Mongolia, who spoke on "*China's Next Transformation: Efficient, Inclusive and Sustainable Urbanization*". Dr. Goh headed the Bank's team working with the Development Research Center (DRC) under the State Council to write a major report on China's urbanization strategy. She pointed out three challenges China faces in its urbanization process: the falling population density in cities, high social inequality, and severe environmental degradation. Tackling these problems requires a comprehensive policy package, but a crucial requirement is that the Chinese government redefines its role by strengthening capabilities in the public sector and relaxing controls in areas where markets work more efficiently. Reforms of factor markets (land, labor and capital) should receive top priority.

HKUST IEMS Director Albert Park, an expert on China's labor market, discussed how urbanization can be made more inclusive by providing greater opportunities to rural migrant workers. China's labor markets have become more integrated over time, benefitting workers in interior regions, and in recent years the real wages of rural migrants have grown rapidly (by 17% annually from 2007-2012) which has contributing to a decline in income inequality. Nonetheless, institutional factors related to China's residential registration system continue to create barriers to labor mobility and provide less social insurance and protections to migrants. For example, rural households do not own the land they cultivate and have limited ability to sell land use rights or collateralize such rights, complicating decisions to migrate. Also, it remains difficult for migrants' children to gain equal access to schooling in urban areas and for their parents to use health insurance in distant cities. Benefits of social insurance programs are uncertain and frequently not portable, discouraging participation by young migrant workers. Promoting greater labor mobility furthers both growth and equity objectives. The government should promote rural land ownership and stronger property rights over land, equalize public services and social insurance programs across regions, and abolish the hukou system in favor of a residence-based benefit system.

Financing is a concern for many countries undergoing urbanization. In China, the issue is even more acute due to its decentralized fiscal structure. Professor Christine Wong, Director of the Centre for Contemporary Chinese Studies at the University of Melbourne and a leading expert on China's public finance, analyzed how China's city leaders meet their financing needs despite the lack of authority to impose local taxes. It turns out that they rely heavily on off-budget financial vehicles, especially land sales and other revenues from real estate development. The funds raised through these channels enables city leaders to make infrastructure investments and promote local economic development. But the disadvantage of this approach is that it leads to overdevelopment of land, soft budget constraints for local governments, and increased financial risk for banks and city governments. To address these serious issues, a fundamental restructuring of the central-local fiscal relations should be put on the government's reform agenda.

After the three presentations, a panel discussion featuring the three speakers and audience questions led to further discussion of the appropriate roles of government and the market. Most agreed that an efficient, inclusive and sustainable urbanization can only be achieved if the market plays a decisive role and the government acts as a facilitator.


Dr. Chorching Goh


Prof. Albert Park


Prof. Christina Wong

SYMPOSIUM ON ECONOMIC GOVERNANCE IN CHINA AND THE DEVELOPING WORLD (2013.5.31-6.1)

China has achieved remarkable economic growth over the past three decades despite relatively weak institutions as measured by international rankings of corruption and property rights protection. Many view this as evidence that China's growth model is unsustainable while others argue that these measures fail to capture the key institutional foundations of China's economic success. To better understand these issues, HKUST's IEMS hosted a two-day symposium on Economic Governance in China and the Developing World in 2013, cosponsored by HKUST's Institute for Advanced Study, Department of Economics, Division of Social Science, and School of Humanities and Social Science. The event brought together the world's foremost experts on the Chinese economic and political systems to discuss how China's governance system has contributed to its rapid economic growth, and whether China's experience provides lessons, if any, for other developing countries.

In an opening keynote presentation, Prof. Pranab Bardhan (UC Berkeley) contrasted China's politically centralized and economically decentralized system with India's politically decentralized, economically centralized one, noting that both systems had advantages and disadvantages. He argued that the deep involvement of China's government in its economic activities, which leads to misallocation of capital, build-up of excessive capacity, and entrenched vested interests of political elites, will handicap its future development; suggesting that China needs to lift market barriers, free information flow and encourage innovation to achieve sustainable growth. For India, challenges arise from the short-term strategies of local politicians seeking to deliver rents to their constituents, and the failure of the system to invest adequately in infrastructure and human capital.

Prof. Chenggang Xu (HKU) described the Chinese system as a regionally decentralized authoritarianism regime (or RDA). He argued that despite the success of RDA in incentivizing local leaders to pursue economic growth, the growth-at-all-costs orientation has also been the cause of many socio-economic problems such as absence of rule of law, worsening corruption and inequality, low domestic demand, etc. To restore appropriate balance, China should reform its institutions to better establish constitutionalism, perhaps starting by granting greater economic freedoms (such as buying and selling land rights) and developing local judicial independence and allowing for a free press.

Prof. Yong Wang (HKUST) presented a paper on China's state capitalism, investigating the role of China's state-owned enterprises (SOEs) during the industrialization process. He argued that SOEs now monopolize key industries in upstream sectors of the economy (e.g., energy, telecommunications, steel and cement, etc.) while private firms compete openly in downstream industries such as manufacturing where lower-productivity SOEs are less competitive. This structure delivers economic rents to SOEs (and thus political elites), which benefit from the success of downstream private firms because they demand inputs and services from upstream industries. He concluded that it is the incompleteness of market-oriented reforms rather than the greater efficiency of SOEs that has led to SOEs' prosperity in the past decade. By reducing competition in upstream sectors and protecting relatively inefficient SOEs, the system actually imposes significant costs on the economy.

In a session on leadership, Prof. Barry Naughton (University of California at San Diego) assessed China's new national leadership team. He asked whether the interaction between leaders and bureaucratic institutions in China were likely to prevent or facilitate the process of market-oriented reforms, concluding that China's economic bureaucracy is deeply troubled and faces severe challenges. However, if the new leaders are determined reformists, they still have the power to reform the bureaucratic system to more effectively pursue their agenda.

Prof. Hongbin Li (Tsinghua University), meanwhile, focused on China's young political agents. He presented an empirical study of the selective process of entry-level bureaucrats among recent college graduates. Their surveys of graduating college students found that although many college graduates prefer jobs in the government or state sector, such jobs are less attractive to elite students and parental political connections and economic advantage don't increase the willingness of graduates to join the public service but do improve the probability of getting hired. The study raises concerns that the quality of Chinese leaders may deteriorate over time.

One aspect of China's governance system that has received a great deal of attention by China scholars but is rarely studied in other countries is the important role played by local leaders in promoting growth. A question arises about whether the success of China's government is due to the system's ability to recruit and select talented individuals, or its ability to incentivize leaders to exert greater effort to promote growth, either due to their desire to be promoted to a

higher position via the Communist Party's internal promotion system, or to seek private rents in a decentralized system. A number of studies presented at the symposium empirically investigate the incentives of local leaders and their consequential behaviors.

Prof. Yuen Yuen Ang (University of Michigan) used qualitative and quantitative data on street-level bureaucrats to analyze the paradoxical behavior of Chinese local officials, who aggressively pursue economic growth but at the same time impose heavy burdens on local firms. She argued that lower level officials in China face a dual incentive scheme in which they are encouraged to seek local development for promotion on the one hand, but also to extract petty rents as "supplementary public compensation" on the other.

Prof. James Kung (HKUST) presented evidence that county leaders who raise more land revenues are more likely to be promoted, suggesting that discretionary opportunities to mobilize resources through land sales do not necessarily undermine promotion incentives but rather local leaders use such revenue to maximize their chances of being promoted, for instance by investing in highly visible infrastructure projects. These findings reinforce the fact that China's promotion system provides strong incentives for local leaders.

Prof. Shuo Chen (Fudan University) linked the career incentive of city officials to the pace of urbanization in China in his presentation on "The political economy of Chinese urbanization." Analyzing data on personnel changes at the city level, he showed that the career incentives of officials are an important driving force for urbanization, leading to the physical expansion of cities but without significant increases in the urban population or urban residents' income.

Competition for promotion also incentivizes local officials to extract fiscal resources. Prof. Pierre Landry (University of Pittsburgh) argued that inter-jurisdictional competition in authoritarian regimes incentivizes greater fiscal extraction as promotion-seeking local politicians desire to signal loyalty and competence. Excessive taxation is constrained by the risks of political instability. Consistent with theory, in most provinces there is an inverse U-shaped relationship between the number of county-level jurisdictions within a prefecture/municipality and the amount of fiscal extraction.

Prof. Monica Martinez-Bravos (Center for Monetary and Financial Studies, Spain) also investigated the incentives of local Chinese officials, focusing on a different institutional practice — village leader elections in rural Chinese villages. Analyzing panel data on rural households and detailed village election histories, she showed that elections significantly increase public goods expenditures and redistribution of income within villages.

Prof. Li-an Zhou (Peking University) studied the relationship between the selection of leaders and economic performance from another perspective, investigating how political turnover could impact the local economy. He presented evidence that at prefectural level, leadership turnover negatively affects economic growth, FDI, investment and housing construction projects, reminding us of the economic costs of too frequent leadership changes.

Prof. Daniel Treisman (University of California, Los Angeles) tackled the issue of corruption in a presentation on "Embezzlement versus Bribery". He distinguished two types of corruption: embezzlement and bribery, and argued that China's political leaders deliberately tolerate small-scale embezzlement to avoid bribery extraction, because bribery is more economically distortionary and costly for development.

A panel discussion featuring comments by Prof. Bardhan, Prof. Park, Prof. Treisman and audience members concluded the symposium. People shared their thoughts on the lessons that could be drawn from the Symposium. Prof. Treisman suggested that aside from institutional factors, other fundamental advantages might better explain China's incredible growth, for example the massive transfer of labor and resources from agriculture to industry during the marketization and globalization process, which provided great opportunities for China to become the "world factory". Prof. Bardhan expressed concerns about corruption, local political capture, and state capacity in solving conflicts. In his opinion, researchers should pay attention to the social costs, not just the economic costs, of corruption/bribery, and its influence on social stability. He also stressed the importance of environmental challenges, which require coordinated actions among different stakeholders. Prof. Park suggested that researchers studying China should be forward-looking in asking research questions and bringing forth solutions, because the institutional challenges facing China today are quite different from the past.

Prof. Pranab Bardhan

RESEARCH HIGHLIGHT: SUSTAINING EXTERNAL FINANCE IN A POOR LEGAL SYSTEM

Radhakrishnan Gopalan, Abhiroop Mukherjee, and Manpreet Singh: Do Debt Contract Enforcement Costs Affect Financing and Asset Structure? (2014)

The Ease of Doing Business Index constructed by the World Bank ranks the institutional quality of countries based on 10 indicators, one of which is "enforcing contracts". Enforcement costs can include, for example, the efficiency with which parties to a contract can be made to adhere to its terms by a country's judicial system. In the context of emerging economies, weak enforcement frameworks could undermine the willingness of banks to lend to firms. The paper by Professor Mukherjee (with co-authors Gopalan and Singh) uses empirical methods to show that such situations can be partly remedied if firms borrow short term debt from multiple lenders.

Douglas Diamond, in his presidential address to the American Finance Association in 2004, suggests that short-term debt by itself may not be sufficient. If there is only one lender involved, then it may be possible for the borrower to force the lender to renegotiate and take a 'haircut'. But, if there are multiple lenders, then each of the lenders has an added worry discouraging them to take a haircut – are the benefits of the haircut actually accruing to a competing co-lender who does not renegotiate? Companies know lenders are unlikely to renegotiate, and try their best not to enter a default scenario.

Although this is an important idea, it hasn't been previously tested in a convincing fashion. Professor Mukherjee uses the phased establishment of Debt Recovery Tribunals (DRT) in India – which reduced the time taken to settle debt recovery cases, reducing enforcement costs – and studies its impact on firms' debt and asset maturity structure. Analyzing panel data on publicly listed and unlisted firms, Professor Mukherjee's study finds that this judicial reform led to a reduction in the proportion of short term debt, allowing firms to invest in assets with longer maturities. They also find that the firms reduced the number of banks they borrowed from in the post-reform period, as predicted by Diamond.

The paper highlights an important link between the enforcement costs and the nature of assets the firms can invest in. Although firms can compensate for poor legal environments by borrowing short term debt from multiple lenders, high enforcement costs reduce the availability of long term finance for firms, preventing them from investing in long term assets. Thus improvements in the legal system in emerging markets are not only important for reducing firms' exposure to rollover risk and consequent financial fragility, but also to encourage long-term investments.

CHINA ECONOMICS SUMMER INSTITUTE 2013 (2013.8.22-24)

HKUST Institute for Emerging Market Studies (IEMS) hosted the 6th annual meeting of the China Economics Summer Institute (CESI) in August 2013 at the Hong Kong University of Science and Technology. Co-sponsored by the Institute for Advanced Study, Department of Economics, and Division of Social Science of HKUST, it is CESI's first meeting in Hong Kong.

China Economics Summer Institute has the objective to create a network and community of leading scholars working on China's economic development. It is organized by a consortium of organizations from universities including HKUST, University of Chicago, University of California at Berkeley, Catholic University of Leuven, Peking University, and Tsinghua University. This year's CESI Hong Kong meeting brought together more than 40 researchers for two and a half days of research presentations, engaging the participants in active discussions on issues related to public finance, international trade, labor and family, and political economy in China.

The conference commenced with a session on Economic Geography, in which John Marrow from the London School of Economics and Political Science (LSE) presented his work Productivity as if Space Mattered: An Application to Factor Markets across China, and Kerem Cosar from the University of Chicago Booth School of Business spoke on Internal Geography, International Trade and Regional Outcomes. The next session on Trade had three papers presented, including Trade Liberalization, Quality and Export Prices by Amber Li from HKUST, China's Pure Exporter Subsidies by Alejandro Riano from University of Nottingham, and Trade Reforms and Current Account Imbalances by Kang Shi from The Chinese University of Hong Kong.

In the session on Public Finance and Education, Xiaobo Lu from Texas A&M University presented his study Interjurisdiction Political Competition and Fiscal Extraction in China, and Binzhen Wu from Tsinghua University explored China's higher education in the presentation Matching Mechanism, Matching Quality and Strategic Behavior: Evidence from China. Chang-tai Hsieh from Booth School of University of Chicago chaired the session on Labor, the Family and Macroeconomics, in which Lena Edlund from Columbia University presented Foreign Brides and the Domestic Front – The Case of Taiwan, Jacqueline Oliveira from Yale University presented The Value of Children: International Transfers, Fertility and Human Capital, and Keyu Jin from LSE presented the One-Child Policy and Household Savings in China.

The closing session had three speakers discussing Political Economy in China. Ruixue Jia from University of California San Diego presented her study Pollution for Promotion, Bei Qin from Hong Kong University (HKU) examined The Determinants of Media Bias in China, and Chenggang Xu from HKU delivered his research results on the Political Economy of Private Firms in China.

The presentations and following discussions stimulated intellectual exchanges between the speakers and the audience. Ample opportunities for interaction were created for Ph.D students and young researchers seeking new research ideas and collaboration possibilities.

RESEARCH HIGHLIGHT: A MODEL OF CHINA'S STATE CAPITALISM

Xi Li  Xuewen Liu  Yong Wang 

The weaknesses of many capitalist market economies revealed by the recent global economic crisis combined with the economic success of the BRIC countries, especially China, has given rise to an alternative growth model–state capitalism. As practiced in China, state capitalism is an economic system in which the national government provides support to "national champions" but also lists the champions on the stock market and subjects them to global competition. Many intellectuals are voicing opinions on this debate, with the demand for state capitalism as opposed to liberal capitalism gathering momentum.

During the second phase of the reform of state-owned enterprises (SOEs), China endorsed the "socialist market economy" as a goal, and "nurturing the large and letting go of the small" as a policy to deal with inefficient state owned enterprises (SOE). Gradually, the inefficient SOEs that were unable to compete with private, foreign, and other firms were weeded out of the economy, leaving mainly large SOEs that consolidated their monopoly positions through mergers and acquisitions. Today's SOEs are mainly in upstream, non-tradable sectors, so they are cushioned against the intense competition that resulted from agreements China made when it joined the WTO in 2001. This has led to a vertical structure in which SOEs dominate the upstream and nontradable sectors such as petroleum and natural gas, electricity and power, banks, transport, storage and information transmission, while private and other firms dominate downstream and tradable sectors, including most manufacturing. While SOEs maintain market power in protected upstream sectors, the downstream sectors are highly competitive.

Interestingly, SOEs outperformed non-SOEs in terms of profitability during the past decade even though the opposite was true during the 1990s. Another important trend has been the declining share of labor income in GDP over the past two decades.

Recent research by HKUST Business School faculty Xi Li, Xuewen Liu, and Yong Wang attempt to explain these puzzling developments by analyzing the emergence of the state capitalist economy and the impact of trade liberalization on the opportunistic behavior of SOEs. They argue that the extraordinary profitability of China's SOE arose due to a combination of factors. After China's entry into the WTO, the demand for downstream tradable goods increased, and the resulting increase in demand for intermediate goods monopolized by the SOE's in upstream sectors explains the rise in SOE profitability.

This mechanism hinges on three key phenomena: openness (international trade and export-promoting policies facilitate industrialization which in turn boosts growth through induced demand); labor abundance (persistence of low wages even as exports increase increases monopoly rents and leads to a declining share of labor income in GDP) ; and strong government and political favoritism (preferential subsidies and tax treatments for SOEs, easier access to finance, etc., which enables them to maintain their monopoly position). Such a strategy presumes that political elites prefer high profitability in the state sector, either for ideological reasons or to extract rents.

An important question is whether this form of state capitalism can remain viable and successful as the economy continues to mature. The authors note the following developments that are now occurring in China. First, China is experiencing a rise in wages caused by demographic changes that are reducing labor supply, increasing labor productivity, and robust labor demand. This is expected to lead to a higher labor income share in GDP and reduce the profitability of SOEs. Second, under this system, weak external demand (like we have witnessed in the years following the global financial crisis) disproportionally impacts the upstream SOEs' profits through less induced demand from exporters in downstream sectors. Third, greater competition for export markets from countries such as Bangladesh and Vietnam also reduces monopoly rents of SOEs if they are unable to improve their productivity. At the same time, maintaining monopoly power of SOEs in upstream sectors increases input prices for downstream sectors, reducing their competitiveness and China's overall growth potential.

These findings have important policy implications for emerging market countries. It serves as a warning to countries like Vietnam that are on the verge of following China's economic reform path. It also raises a word of caution for India, which although it is a labor-abundant economy does not enjoy the magnitude of FDI and exports that China has benefited from and so relies more on domestic demand. If Indian upstream industries could be less politically regulated and more efficient, it would help facilitate its downstream export. Russia also practices state capitalism where the important industries like oil and natural gas are controlled by powerful oligarchs with close relationships to the state. However, downstream sectors don't enjoy the comparative advantage of cheap labor as in China.

The authors believe that since the SOE's extracted disproportionate profits during the trade liberalization phase due to unique conditions operating in China, it is unlikely that SOEs will continue to thrive given the dynamic changes that occurring. For this reason, it is unlikely that this type of development model of state capitalism (upstream state monopoly plus downstream capitalism)will be sustainable in China or appropriate for other emerging markets.

HKUST IEMS Faculty Associates

Associates	Department/Division	Interests/Areas of Expertise
Erik Baark	Social Science	National Innovation Systems in Asia and Europe; China's Science & Technology Policy; Hong Kong Innovation System and Policy; Innovation in Service Industries
Hye Jee Cho	Social Science	International Political Economy; International Relations; Comparative Politics
Joon Nak Choi	Management	Social Network Analysis; Organizational Theory; Corporate Strategy; Globalization and Global Cities; Industry Clusters; Korean Studies
David Cook	Economics	International Macroeconomics; Monetary Policy
Amy Dalton	Marketing	Consumer Psychology
Sam Garg	Management	Entrepreneurship; Innovation Management
Vidhan K. Goyal	Finance	Capital Structure; Corporate Governance; Bankruptcy; Debt Contracts; Emerging Markets
Liang Guo	Marketing	Economics of Psychology; Marketing Strategy; Industrial Organization; Applied Economics
Li Han	Social Science	Political Economy; China
Kai Lung Hui	Information Systems, Business Statistics and Operations Management	Information Privacy and Security; Information Technology Policies; Electronic Commerce
Mingyi Hung	Accounting	International Capital Markets; Financial Accounting; International Financial Reporting Standards
James K S Kung	Social Science	Economic History; Institutions and Institutional Change; Political Economy; Applied Economics
James Kwok	Information Systems, Business Statistics and Operations Management	Digital Rights Management; Computer Security for Business; Hacking Techniques; Digital Watermarking
Edwin Lai	Economics	International Trade; Industrial Organization; Technological Change; Growth and Development; East Asia and China Economies
Siu Fai Leung	Economics	Health Economics; Household Behavior and Family Economics; Labor and Demographic Economics; Law and Economics; Cross Sectional Data
Yao Amber Li	Economics	International Trade; Chinese Economy; Development; International Macroeconomics; Applied Econometrics; International Business and Strategy
JT Li	Management	Strategic Management; Multinational Corporate Strategy; Global Management; Managing Alliances; Joint Ventures and Partnerships in China; Doing Business in China
Xi Li	Accounting	Global Macro Investments; International Corporate Governance; Chinese Economy; Sell-side Analyst; Product Market Competition; Earnings Management; Corporate Financing Events
Yimin Lin	Social Science	Political Economy; Organizations and Institutions; China
Peter Mackay	Finance	Corporate Finance; Risk Management; Capital Structure; Corporate Investment; Corporate Governance
Abhiroop Mukherjee	Finance	Behavioral Finance; Role of Information in Equity Markets; Corporate Governance
Javad Nasiry	Information Systems, Business Statistics and Operations Management	Behavioral Operations Management; Revenue Management; Supply Chain Management; Healthcare Operations
Albert Park	Social Science, Economics	Development Economics; Labor Economics; Human Capital; Economics of Aging; Applied Microeconomics; Chinese Economy
Christopher Pissarides	HKUST Jockey Club Institute for Advanced Study	Macroeconomics of Labor Markets; Structural Change; Economic Growth
Barry Sautman	Social Science	China/Africa Links; Ethnic Politics in China; Nationalism in Comparative Perspective
Naubahar Sharif	Social Science	Sociology of the Innovation Systems Conceptual Approach; The Role of Innovation/ Technology in Hong Kong; University-industry Linkages; Economic Linkages between Hong Kong and Guangdong
Satoru Shimokawa	Social Science	Agricultural Economics; Development Economics; Health Economics
Bilian Sullivan	Management	Organizational Theory; Organizational Learning; Social Networks; Corporate Governance; Policy and Firm innovation
Kellee Sing Tsai	Social Science	Chinese Politics; Political Economy of Development; Informal Finance; Private Sector Development; Sub-national Models of Political Economy; China-India Comparison; Remittances
Sujata Visaria	Economics	Development Economics; Applied Microeconomics; Institutional Economics; Financial Economics; Welfare and Poverty
Jin Wang	Social Science	Development Economics; Public Economics; Chinese Economy
Pengfei Wang	Economics	Macroeconomic; Monetary Economics; International Macroeconomics
Wenbo Wang	Marketing	Advertising; Pricing; Pro-social Behavior; Sustainability, especially in the Context of Emerging Market
Yong Wang	Economics	Macroeconomics; Growth and Development; Political Economy; Chinese and Indian Economies; International Trade
Xiaogang Wu	Social Science	Education; Inequality and Mobility; Migration and Urbanization; Survey Research and Quantitative Methods
Jenny Juanyi Xu	Economics	International Macroeconomics; Monetary Economics; Macroeconomics; Chinese Economy
Jane Zhang	Social Science	Experimental economics; Development Economics; Applied Econometrics
Jimin Zhao	Social Science	Environmental Policy and Governance; Climate Change and Global Environmental Governance; Sustainable Transportation and Automotive Technology; Energy Policy and Technology Development; Chinese Environmental and Energy Policy
David Zweig	Social Science	Movement of High Quality Talent; China's Energy Policy; China's International Political Economy; Chinese Politics