Accepted Manuscript


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PII: S0261-5606(17)30164-X
DOI: http://dx.doi.org/10.1016/j.jimonfin.2017.08.002
Reference: JIMF 1828

To appear in: *Journal of International Money and Finance*

Received Date: 17 July 2015
Accepted Date: 6 August 2017

Please cite this article as: D. Cubizol, Transition and capital misallocation: the Chinese case, *Journal of International Money and Finance* (2017), doi: http://dx.doi.org/10.1016/j.jimonfin.2017.08.002

# Transition and capital misallocation: the Chinese case

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**Abstract**

This paper demonstrates that the allocation of household savings to State-Owned Enterprises (SOEs) in China, and not to the increasing share of private firms, explains both the patterns of capital flows (the accumulation of foreign assets and FDI entries) and the drop in the consumption share during China's transition. The contribution is to explain these two elements in a dynamic general equilibrium model with TFP growth that differentiates FDI and foreign assets. In addition to other frictions, financial intermediation and SOEs have the crucial role by misdirecting household savings. It modifies firms' labor and capital intensiveness, and creates shifts in savings accumulation and capital flows. Moreover, the increasing share of credit-constrained private firms hinders wage growth, and returns on household savings are low to finance SOEs; these two elements reduce the consumption share. With a calibration adapted to the Chinese economy and deterministic shocks, the model also matches to a large extent the data for a variety of stylized facts during China's transition.

*Keywords:* China's transition, foreign assets, FDI, consumption, global imbalances, factor market distortions.
JEL: E20, F21, F32, O40, P20, P30.

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