Views on the Chinese economy:

Dynamism Holds the Key in the Private Sector
—China is Using Incomplete Intellectual Property Protection and Insufficient Laws to its own Advantage

Kajitani Kai, Professor, Kobe University

< Key Points >

- The electronics industry in Shenzhen is a perfect example of active technological innovations
- There are cases in which pioneering companies changed the system by disregarding regulations
- Vitality may be lost if the Chinese government strengthens interventions

The Chinese economy can be said to have maintained generally favorable conditions since the second half of 2016, under the positive effects of the expansive macroeconomic policies underpinned by the flexible foreign exchange policies. To cite an example, the Produce Price Index (PPI) moved back into the positive range after staying in the negative range for a long time. Under such good conditions, problems on the supply side, which China should address in the mid- and long-terms, tend to attract interest.

Kajitani Kai, Professor, Kobe University

In this article, I would like to consider the sustainability of the technological innovations on which the future growth of the Chinese economy depends from the viewpoint of systems that support the innovation.

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Are sustainable innovations possible in the Chinese economy? Mainstream economists largely have negative opinions on the matter. The book *Why Nations Fail* by Professor Daron Acemoglu of Massachusetts Institute of Technology and Professor James Robinson of Harvard University in the United States is a typical example of such opinions. Acemoglu and Robinson point out that the sustainable growth of a given economy depends on whether its systems are extractive or inclusive.

In the book, both professors conclude that China's ongoing rapid economic growth is a temporary phenomenon caused by the introduction of a partially inclusive economic system under an extractive political system and that the country's high growth rate will hit a wall if things stay as they are now. Certainly, the institutional characteristics of the Chinese economy, such as weak property rights, the unenforced rule of law and economic interventions made by the unaccountable government, appear to work only as obstacles to the innovations that serve as an engine for sustainable growth.

However, considerably active innovations are found in the current Chinese economy, which contradict their opinion.

The electronics industry in Shenzhen City, Guangdong Province, is a perfect example of such innovations. A special economic zone was first established in Shenzhen based on the open-door policy adopted by China in the 1980s. Labor-intensive industries developed there rapidly, such as importing raw materials and exporting processed goods. Later, many labor-intensive industries pulled out of Shenzhen due to increases in wages and the change in policy of preferential treatment of foreign capital. In the meantime, specialized markets (multitenant buildings where wholesalers and manufacturers have their shops) were rapidly established for supplying electronic components. In this way, Shenzhen acquired its new character as a collection center for the electronics industry.

Among these specialized markets, the Huaqiangbei District began drawing attention as one of the largest markets for electronic products and components in the world. More than 30,000 business operators have shops in this specialized electronics market occupying an area of 1.45 square kilometers.

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The first characteristic of innovations in electronics and other industries in Shenzhen City is that those innovations are occurring under insufficient protection of intellectual property rights. The popularity of *shanzhai* cellular phones (counterfeit cellular phones), which spread across China from this district where they have been manufactured since around 2002, appears to be a classic example of such innovations. We can still find the electronic components for smartphones sold in piles at shops located in multitenant buildings in the Huaqiangbei District. They make us feel the aftereffect of the feverish atmosphere of the days when the district thrived as a mecca for *shanzhai* cellular phones.

Products manufactured in Shenzhen today are not limited to rip-offs and mass-produced items that became obsolete. In addition, this area has given birth to world-class companies, such as Huawei, whose operations range from the manufacturing of telecommunications equipment

to network construction, and Da-Jiang Innovations Science and Technology (DJI), which leapt to fame for manufacturing small unmanned aircraft (drones) for civilian use.

The role of Shenzhen as an ecosystem for individual entrepreneurs with original ideas (makers) is drawing attention at a particularly high level. This role refers to many systems for turning makers' ideas into a reality.

Maker spaces that offer areas for product development, share information and support makers in being matched with financial backers gather in the sphere two hours from Shenzhen, in addition to small and medium enterprises, which mount printed-circuit boards and manufacture trial items in small lots as contractors, and venture capital firms that contribute funds for business startups. Shenzhen is undergoing a transformation into a mecca where makers gather not only from China but also from around the world because such an ecosystem has been formed in the area.

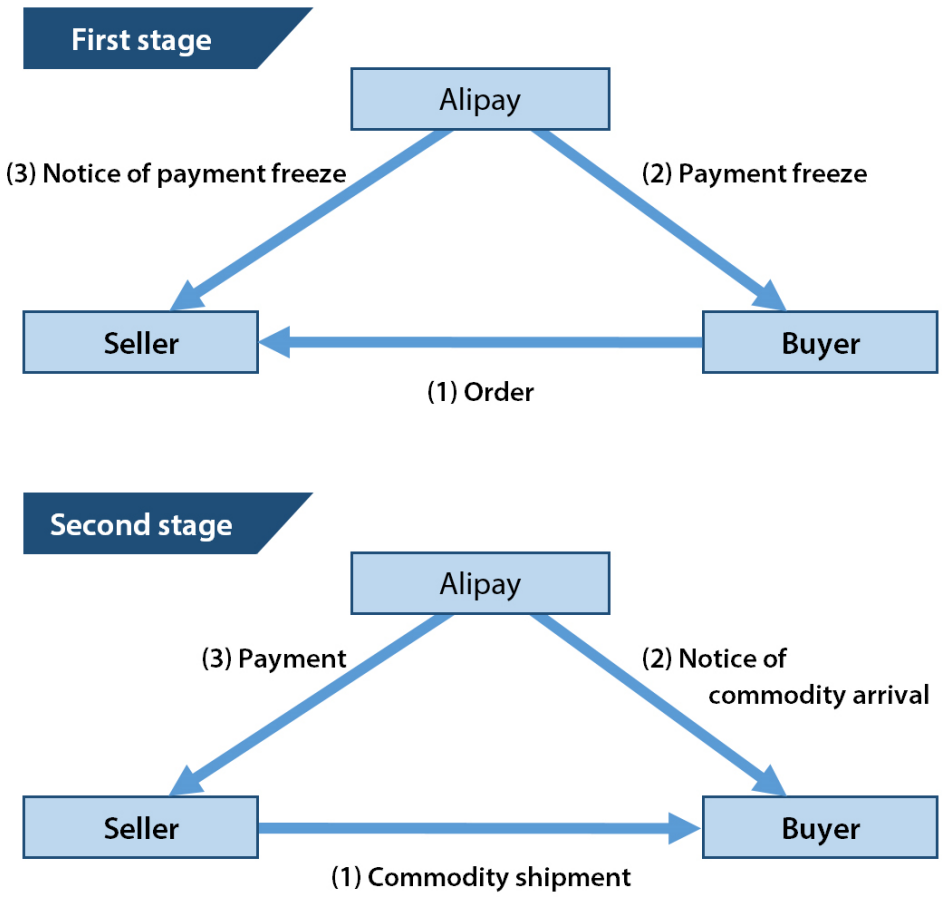
This situation is reminiscent of an argument made by Professor Kal Raustiala of the University of California, Los Angeles and Professor Christopher Sprigman of New York University in the United States in their book, *The Knockoff Economy*. They maintained that the very existence and distribution of rip-offs have an aspect of promoting innovation based on their analysis of many cases in which knockoffs and true innovations coexisted.

The second characteristic of innovations in China is that leading information technology (IT) companies, such as Alibaba Group and Tencent, are offering platforms as information intermediaries and allowing transactions to stably take effect in a highly uncertain market where the rule of law has not been accomplished.

Credit transactions, including credit settlement, remain extremely underdeveloped in China. Legal systems such as a system of nonpayment that supports business-to-business credit have not been established in the country. In addition, China's industrial structure that permits micro enterprises to enter businesses one after another has made it difficult for companies in China to establish long-term business relationships. These conditions are the primary factors that have prevented credit transactions in China.

The historic nature of Alibaba lies in the fact that it overcame the credit transaction hurdle by supplying an original settlement scheme called Alipay, through which cash is not transferred until the execution of a transaction, in a society where credit transactions had been underdeveloped. (Refer to the figure.) Going further, this system of mutual evaluation through the Internet is offering useful information for searching for a party with which transactions were traditionally performed within a market structure where standardized business operators tend to rush in.

Figure: Intermediation mechanism of Taobao, an Internet shopping service offered by Alibaba



Note: Alipay gives the buyer a refund in cases where a commodity shipped by a seller had a problem.

This business model agrees with traditional Chinese business practices that place an emphasis on the intermediary roles of trustworthy third parties. The method of advancing transactions and businesses smoothly through the intermediation of third parties is called "*pao*" in Chinese. The provision of brokerage services through the accumulation of a massive volume of customer information by Alibaba and other IT companies has an aspect of a modern-day reimagining of traditional *pao* business practices. The provision of intermediary functions is playing a big part in the expansion of domestic demand through the spread of Internet shopping in farming villages.

The third characteristic of innovations in China is that pioneering companies are found every so often that change systems little by little, taking actions that disregard government-imposed restrictions.

In November 2016, the Chinese government legalized entry into car dispatch services by ordinary drivers, which had been prohibited by law, after setting certain conditions for their participation. This action only gave ex post facto approval to services which Didi Chuxing and other leading car dispatch service providers had offered practically. The phenomenon of private enterprises and other parties attempting to solve problems by outsmarting systems little by little has created spontaneous order in response to the bewildering market changes and has invigorated the economy as a whole.

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Needless to say, we cannot be completely optimistic about the state of innovations in China. To cite an example, Prime Minister Li Keqiang and other key Chinese government officials have been directing their attention toward the maker movement in recent years. The maker movement may be a development worthy of attention, but the vital force of the movement, which had been supported by a free way of thinking, may become spoiled if and when the Chinese government thoughtlessly strengthens interventions.

Whether China can maintain the dynamism that has given birth to innovations from now on while its government and private sector remain in a tense relationship peculiar to the country is a point in question. The sustainability of the Chinese economy in the future depends on that significantly.

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KAJITANI Kai, Ph.D.

Born in 1970. He earned a Ph.D. in economics from Kobe University. He specializes in the contemporary Chinese economy.
