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China's Investment and Rate of Return on Capital Revisited

Abstract

We revisit China's suspected overinvestment problem by examining the rate of return on capital from two perspectives. First, we find that two existing methods of estimating the rate of return generate conflicting results, and we succeed in reconciling them. Our revised estimates show that the rate of return rose sharply from 1998 to 2014, which helps explain the strong investment drive. Second, we explore what caused the rate of return to rise. We find the explanation lies mainly with the long-term factor of rising total factor productivity but that the short-term cyclical factor of low real interest rates has also contributed.

Keywords: *Overinvestment; Capital Return; Total Factor Productivity; Real Interest Rate; Financial Development*

JEL: *E01, E22, E60*

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