Headline: Hidden perils of China's stimulus boost
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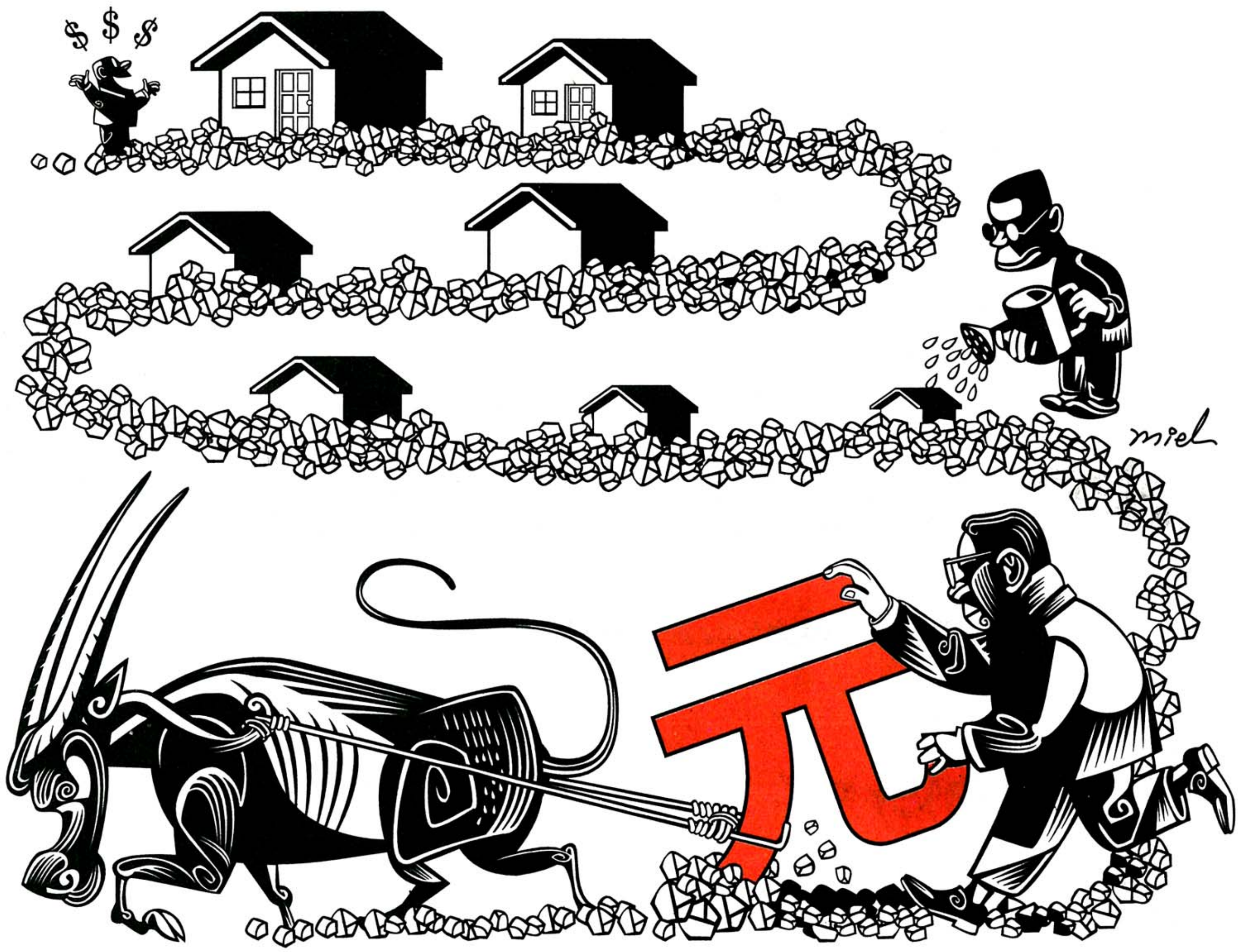

By Yongheng Deng & Bernard Yeung
FOR THE STRAITS TIMES

THE recent financial crisis saw many governments and central banks use monetary and fiscal interventions to propel their economies out of the recession.

Such packages have met with mixed success. The United States package resulted in limited stimulation while the Chinese package appears to have achieved a swift and significant response.

In end 2008, the Chinese government adopted a two-pronged approach in its stimulus package – loosening its monetary policies and injecting government spending. The resulting growth in money supply volume, total loan balance, and government spending saw a steady increase in annualised gross domestic product (GDP) growth rates, from 6.2 per cent in the first quarter of last year to 11.9 per cent a year later.

Some attribute this success to the size of the stimulus. But China's is not significantly larger than other countries'. The US package is larger than China's both in absolute terms – US$841.2 billion (S$1.1 trillion) versus US$204.3 billion – and as a ratio of GDP – 4.8 per cent versus 4.4 per cent, by International Monetary Fund estimates. In terms of loosening up money supply, China's lowest benchmark interest rate of 2.25 per cent is not lower than most other countries'.

We think China's quick result is due to its command and control economy where state-owned enterprises (SOEs) dominate China's industrial sectors. While many have been privatised, SOEs remain in control of key industries and are dominant players controlling big segments of the Chinese economy. Even when banks and former state corporations are publicly listed and have their own boards, the web of cross-firm ownership allows SOEs to control these corporations.

These banks and corporations are monitored by the China Bank Regulation Commission and the state-owned Asset Supervision and Administration Commissions, respectively.

These two organisations, along with the Communist Party's Organisation Department, appoint and reward or punish their executives according to their corporate performance, as well as their support of the state's policy agendas.

In such a system, the state has the tools to shore up aggregate demand. Both state-owned banks and non-financial state enterprises responded expeditiously and significantly to the government's economic stimulus package.

For instance, immediately after the Chinese government announced its shift in monetary policy, the four state-owned commercial banks increased their loan balance to 4.1 trillion yuan (S$800 billion) in the first quarter of last year, an increase of 2.31 trillion yuan, greater than the total amount of loans in 2008 of 1.8 trillion yuan.

But the majority of these loans go to, ironically, cash-rich SOEs – 59.58 per cent to central SOEs and 24.49 per cent to local SOEs.

What did the recipients do with these loans and investments? Recall that asset growth and profitability are key performance yardsticks for SOE executives. As such, SOEs did not invest in their core business because the ongoing recession gave limited opportunities for growth. Instead, they invested in real estate because of its staggering return on equity, and few barriers of entry.

By last year, there were 94 centrally controlled SOEs that owned or controlled real estate developers, exceeding the Chinese government guideline of 16. This reflected the way SOEs gave immediate and en masse support to the government's economic agenda, and that boosted their own profitability figures.

Our research shows that such SOE involvement in real estate accounted for the rise in property prices. We obtained, from public sources, the bids in various cities' land auctions. After accounting for quality variations and focusing on centrally controlled SOEs, several observations were made.

In Beijing, the centrally controlled SOEs consistently overbid other bidders for land in Beijing. In Shanghai, their influence was more limited. Our econometric analyses further confirmed that centrally controlled SOEs' overbidding behaviour exacerbated price increases.

In our opinion, the Chinese government literally forced a rise in aggregate demand. Banks were ordered to lend, SOEs were induced to borrow and invest. The money ended up in real estate land development, leading to a surge in house prices in cities where SOEs' investments dominated.

Assuming the possibility of a sharp decline in property prices, would this trigger a housing crisis such as the one that occurred in the US? We believe this is unlikely. On a corporate level, SOEs remain cash-rich. On a household level, the massive down payment of 30 per cent to 40 per cent minimises the likelihood of a large-scale mortgage default.

Of greater concern though is the impact of falling prices on consumer wealth. The lack of alternative attractive investment options has resulted in real estate becoming a disproportionately large store of wealth. Any fall in prices will have a large negative wealth effect.

With its state ownership and supervision of China's banks and large corporations, China remains a de facto command and control economy. The government has effectively used its banks and SOEs to influence macroeconomic outcomes. No doubt the stimulus package has worked, but the speedy result masks underlying problems that can lead to significant distortions that are costly to unwind.

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