Weaker economic growth in China can be traced to the way it deployed fiscal stimulus to fight the financial crisis, an approach that enabled local governments to misallocate capital, new research says.

China’s fiscal stimulus in the years following the 2008 collapse of Lehman Brothers was implemented by local governments and mostly financed by the relaxation of financial constraints, according to the paper, “The Long Shadow of a Fiscal Expansion,” to be presented Friday at a Brookings Institution conference.

Local governments were allowed to create off-balance-sheet companies known as local financial vehicles in 2009 and 2010 to fund the stimulus spending. Off-balance-sheet liabilities
can be a source of uncertainty as they potentially obscure debt loads that aren’t included in officially reported numbers.

The study by Chong-En Bai of Tsinghua University, Chang-Tai Hsieh of the University of Chicago and Zheng Michael Song of the Chinese University of Hong Kong says only a quarter of China’s stimulus spending shows up on the government’s balance sheet. Three quarters of the spending was conducted by entities that were off local governments’ balance sheets.

The new local financing vehicles bridged the gap between an increase in the investment rate and the budget deficit, the paper says. That explains a small increase in the Chinese government’s budget deficit despite higher spending on public infrastructure projects.

Despite the stronger investment rate after 2008, aggregate growth rates declined significantly after fiscal stimulus ended in 2010.

“In short, the fiscal stimulus was really partial financial liberalization,” the paper says, since financial constraints were lifted only for local governments, and not for private financial institutions or for state-owned banks.

“This might have had positive effects on welfare and growth if local governments used these resources for high social return projects previously starved of resources,” the authors say. But they contend that in addition to funding infrastructure projects, looser financial constraints made it possible for local governments to channel financial resources toward essentially private firms championed by local governments.

After the stimulus spending ended, local governments continued to use their newfound power to access financial resources and shift them toward favored private firms, the paper says.

That meant the efficiency of capital allocation worsened, hitting China's growth and productivity, the authors say.

“The powerful political forces behind off-balance-sheet lending combined with the fear of the short-run consequences of shutting down this lending may make it very difficult to undo the local financing vehicles in the future, with potentially significant adverse consequences for China’s future growth,” the economists warn.

The paper follows earlier warnings from analysts that more credit- and debt-fueled spending helped China ease its growth slide, though the momentum may prove short-lived and risks exacerbating ills that have dragged on the economy for years.

In recent months, a senior International Monetary Fund official warned that soaring corporate debt is a serious and worsening problem in China that needs to be tackled quickly if Beijing wants to avoid potential systemic risk to itself and the global economy.
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