Comments on

# "The Long Shadow of a Fiscal Expansion"

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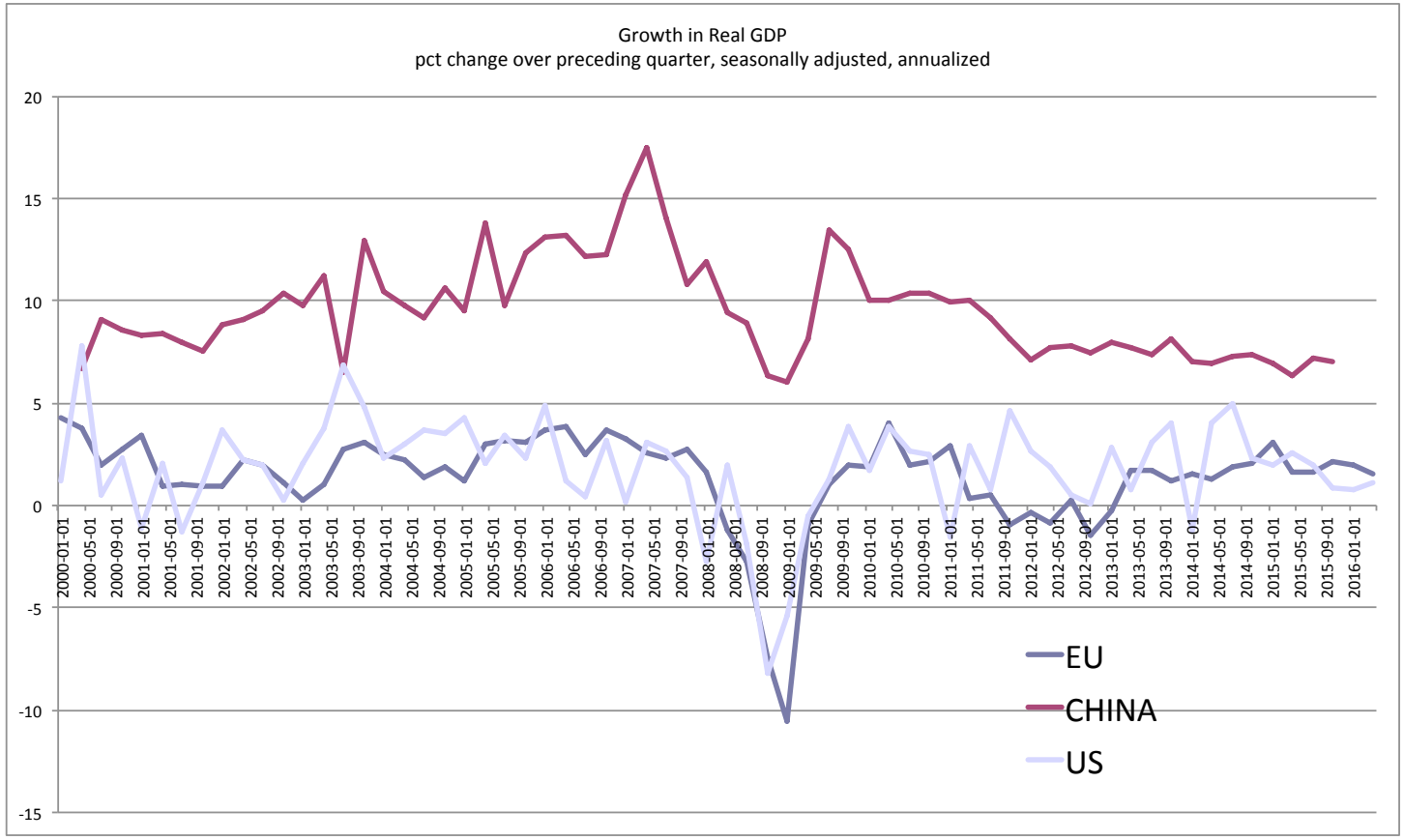
The argument made in this paper (BHS):

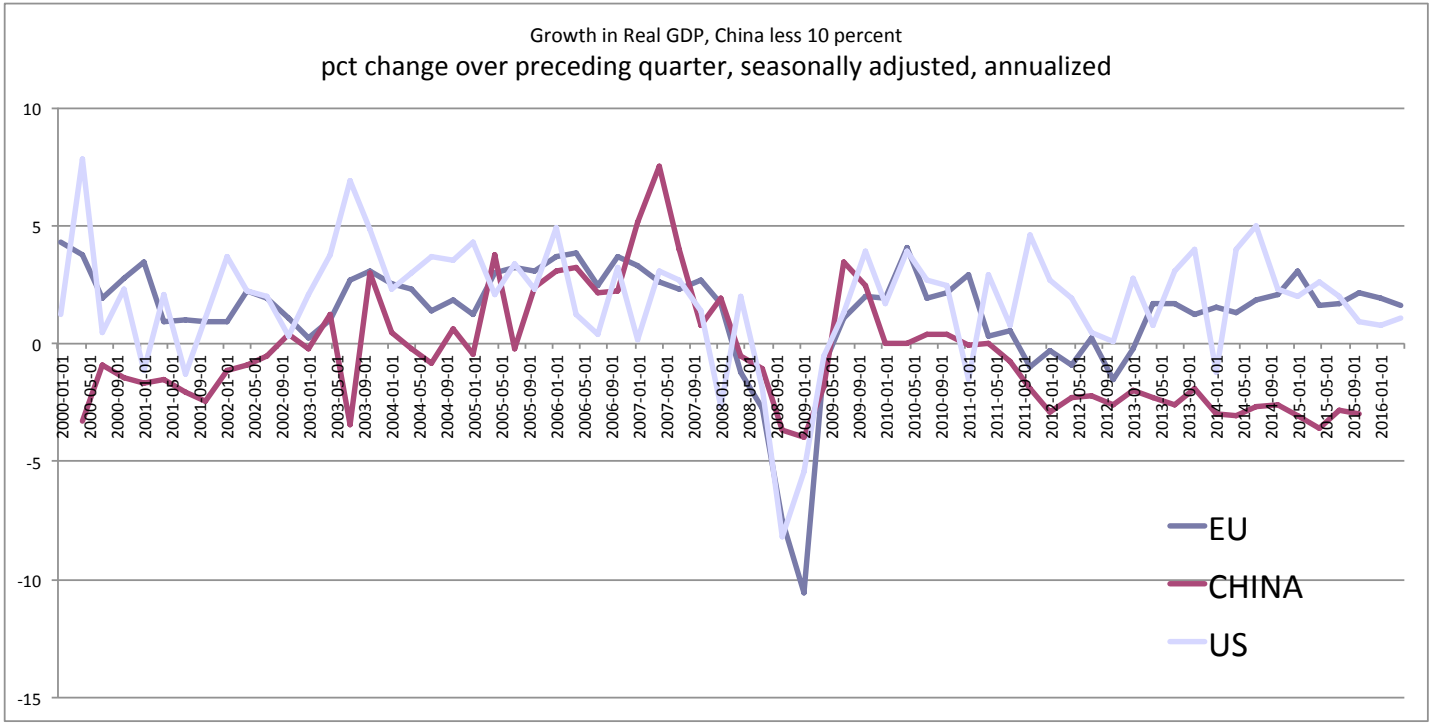
1. During 2009-2010, the Chinese government undertook a fiscal expansion of roughly 11 percent of annual GDP.
2. The fiscal stimulus was financed by a relaxation of the balanced budget constraint on local governments.
3. Governments set up local financing vehicles (LFVs) that borrowed and spent on behalf of the government.
4. The funds were used to invest in infrastructure, boosting aggregate investment.
5. Governments continued to use the LFVs to provide financial resources to "favored" firms. About two-thirds of the off balance sheet spending was allocated to private commercial projects.
6. Because the firms undertaking these projects are inefficient, the outcome was a misallocation of capital and a permanent decline in TFP and GDP.

# Putting China's experience into perspective:




- China has a high real growth rate, catching up to the ROW and accumulating capital
- China experienced the 2008 crisis along with the ROW

“Normalize” China’s growth rate - subtracting out the “catch-up” component (China’s growth – 10 percent)




One way to interpret this paper

A - China’s recession was less deep – possibly due to the large stimulus package

B - But the form of the stimulus resulted in lower growth rates in the long run

Doing A cost them B.

Many institutions believed stimulus to be the right policy prescription:

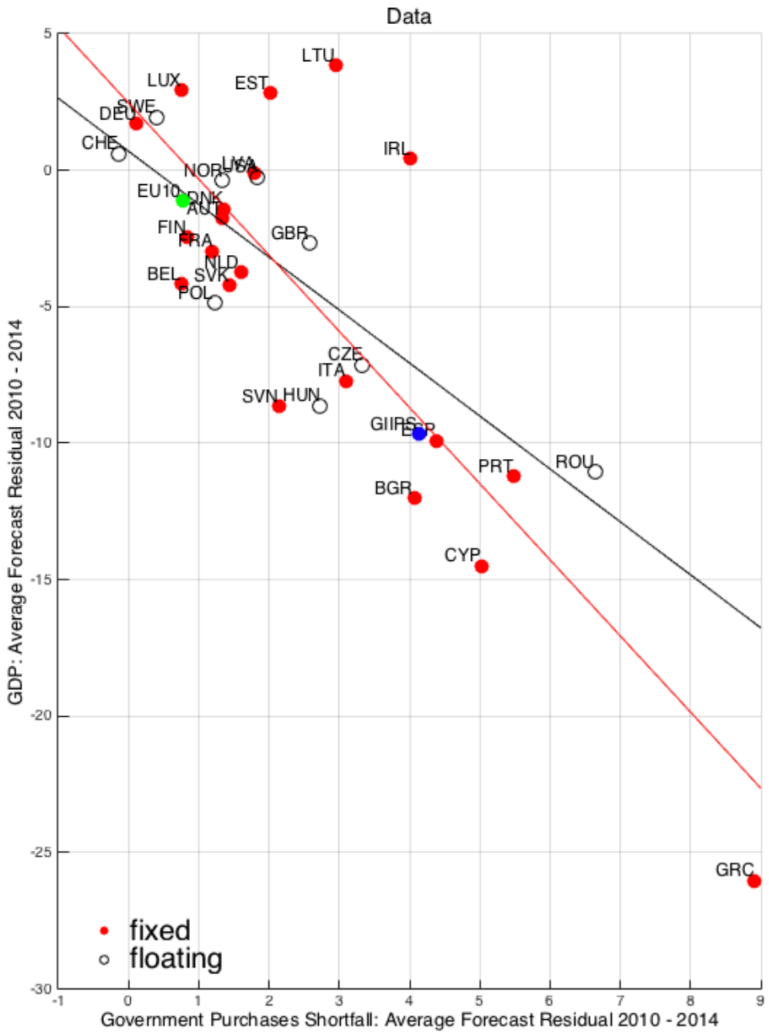
OECD directive on stimulus.

Focus on infrastructure projects which are “shovel ready”, projects that can be implemented quickly and effectively. …

Target expenses to idle resources, notably vulnerable groups such as low skilled youth, women and older workers, who are at greater risk of falling into unemployment trap ….

Use existing programmes and agencies to distribute the spending but make sure that they are equipped for the task. Regional agencies can be used as a vehicle to reach actors that cannot be reached by national agencies and programmes.

But does stimulus work? E.g. how big is the multiplier?




Cross-section of European countries in the aftermath of the crisis:

House, Proebsting and Tesar (2016) "Austerity in the Aftermath of the Great Recession"

After controlling for taxes, productivity and debt/GDP, countries with greater shortfalls in government spending had significantly lower output

Multiplier ~ 2.0

Larger than that found by Blanchard, Erceg and Linde (2016)

Factors that can affect the size of the multiplier

- Timing of the spending –
    - *China: stimulus continued well after the recession*

- How the funds are spent
    - *China: spending on infrastructure but not the best projects*

- How the spending is financed –
    - *China: added to debt and weakened bank balance sheets*

- Does the spending crowd out other, more productive projects?
    - *"loans to firms, as a share of total assets of the banking system, have increased and the investment that is crowded out by LFV spending are the Central Bank's purchases of US Treasury bills."*

BHS main critique:

- *Which firms do the spending?*

Their conjecture:

- the fiscal stimulus was a partial financial liberalization
- local governments used the additional funds to make loans to inefficient, "connected" firms.
- The connected firms borrow to their limit,
- For some reason, the marginal lending cost facing good, unconnected firms goes up (why? It's mechanical in the "model" but the economics are unclear)
- This causes $MPK_U > MPK_C$, generating wider dispersion in returns

Strength of the paper: Telling the narrative

- BHS document the changes in the institutional environment in China.
- Track the off-balance sheet funding through the local financial vehicles; compare official data on the stimulus to the financial statements of the financial sector including the shadow banks.

Weakness of paper: Connecting the dots

- Providing convincing proof of a misallocation of capital
- Proof that the misallocation, if it did occur, can be linked to a long-run decline in *growth*
    - Misallocation is a second-order phenomenon. How can it produce a first-order decline in the rate of economic growth?

What do they show?

- Aggregate investment increased but GDP growth did not
- Some evidence that listed firms took on more debt relative to other firms (listed ~ connected)
- Dispersion in the Y/K ratio of industrial firms

Alternative explanations for what the authors find:

- China looks like other countries after the global recession. i.e. nothing special going on

- Govt front-loaded investment; suppose some number of good ideas arrive every year. In 2009-2010, China invested in the backlog of underfunded good ideas and even dipped into some less good ideas. This would cause investment to boom, a dispersion in MPK, produce a spurt in growth in the short run but a slow down in the medium run until more good ideas come along.

- investment in bad ideas might still be better than no investment at all. Even if one accepts that the bad, connected firms got more financing, there is no evidence that it was a reallocation from good firms to bad firms. Would still be welfare improving if all the new money went to bad firms and the good firms maintained status quo (i.e. what is the counterfactual here?)

More convincing evidence:

- better identification of connected firms. Government officials on the board of directors? Firms in industries that require permits from the government?

- Show that such firms in fact received the funding, they were previously credit constrained and they are less productive than other firms.

- Show that the dispersion in the Y/K ratio is an increase in the dispersion between connected and unconnected firms (and not just an increase in overall dispersion)

- Use cross-provincial variation in China (a la Nakamura and Steinsson AER 2014) to show that in areas where firms are more influenced by government, spending increased, and the multiplier was lower.