Credit Allocation under Economic Stimulus: Evidence from China

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Abstract

We study the allocation of bank credit across firms and its short and medium run consequences, against the backdrop of China’s stimulus package of 2008-2009. In response to the global economic downturn and financial crisis, the Chinese government introduced a 4 trillion RMB stimulus plan (12.6% of China GDP in 2008), which triggered an unprecedented credit flow to the real economy through the banking system. Using private firm-level data we show that, under this policy-driven credit expansion, new credit was allocated disproportionately more towards State-Owned, low-productivity firms than to privately-owned, high-productivity firms. We use a dynamic model of bank lending, firm production, and individual consumption and investment to illustrate that financial frictions lead to misallocation of capital and labor that is aggravated by economic downturn and credit expansion. Financial frictions, therefore, not only restrict the gradual reallocation of capital and labor from low to high productivity firms, but potentially lead to a reversal of the reallocation process, especially under credit expansion during recessions. We show early signs of such reversal after the onset of global recession and China’s economic stimulus package, which are consistent with the model.