

Will China's ETF purchases 'work'?

The moves are aimed at boosting the stock market and supporting the economy amid challenges such as a troubled property sector. **BY BEN CHAROENWONG**

THE recent purchase of exchange-traded funds (ETFs) by China's sovereign wealth fund, Central Huijin, marked the latest attempt by the authorities to stabilise China's financial markets and economy. This year, the Shanghai Composite Index has fallen by over 10 per cent, and global investors are withdrawing from the market. Central Huijin had previously purchased similar ETFs in June 2013 and July 2015, resulting in an increase of over 20 per cent in the stock market within three months. But will the latest ETF purchases stave off an impending recession?

We can gain insights from Japan, which has been implementing similar policies for a considerable time. The Bank of Japan (BOJ) has been purchasing ETFs equivalent to some 3.5 per cent of gross domestic product (GDP) for over a decade as part of its quantitative easing programme to stimulate corporate investment, amounting to around US\$180 billion – over 120 times more than Central Huijin's recent purchase.

My co-authors Randall Morck from the University of Alberta, Yupana Wiwattanakantang from the NUS Business School, and I completed a joint study in 2020 and found that the BOJ purchases raised share prices, similar to Central Huijin's experience in 2013 and 2015. The purchases also increased share issuances and provided companies with more working capital.

However, these purchases did not increase capital investment or growth for most companies. We argued that the limited real economic impact of the BOJ purchases was due to their lack of targeting specific sectors or companies needing capital. Instead, the purchases were based on stock indices that reflected market capitalisation and liquidity. In fact, the government bought more shares of organisations that did not require capital and were less likely to face financial constraints.

Empire-building

Interestingly, the BOJ purchases did stimulate capital investment for some companies – those with weaker corporate governance. This suggests that the purchases did not promote productive investment but facilitated inefficient empire-building by powerful CEOs instead.

The recent experience in China is similar to the BOJ purchases, as they also aimed to boost the stock market and support the economy amid challenges such as the Covid-19 pandemic, troubled property sector, and policy tightening. Further, Huijin's purchases are of blue-chip ETFs. This is similar to Japan's experience of channelling new funds into companies that were likely not capital-constrained in the first place.

However, there are some differences between the two purchases. First, the scale of the China purchase is much smaller, amounting to less than 0.01 per cent of GDP compared to 3.5 per cent for the BOJ purchase. Second, the motivation behind the Chinese purchase may be more defen-



Instead of indiscriminately buying ETFs, China can target fiscal stimulus more directly towards areas with higher potential and social value. PHOTO: LOUISA LIM, ST

sive as it is aimed at countering sell-offs by overseas investors and preventing further market decline rather than stimulating market growth.

Based on these similarities and differences, the China sovereign wealth fund purchase of ETFs may affect stock valuations and corporate responses. Still, the effects may not be as significant or long-lasting as the BOJ purchases.

While the China purchase may temporarily raise share prices, it may not lead to increased capital raising or investment by companies, especially given fundamental issues like a high debt burden, policy uncertainty, or weak demand. The BOJ's experience further shows that even large purchases appear ineffective in stimulating economic growth through broad-based private-sector corporate investment.

For the highest bang for the buck, governments would want to allocate capital to companies that need it the most and delivers the highest return on capital in equilibrium, also known as the highest marginal product of capital. These interventions are not only poised to have the biggest price impact, but they are also likely to have the biggest real economic impact.

Many sectors have some financially constrained businesses that could benefit economically from an injection of capital. But, for the specific purpose of staving off a potential recession, the government may consider channelling purchases into sectors that account for sizable employment, like manufacturing companies that have been hit by real estate-related and demand slowdowns. By providing these companies with capital now as real estate prices fall, they may be empowered to expand new factories and potentially increase participation in the global market, thereby also potentially boosting local employment as well as capital investment.

Beijing may also consider stimulating innovative sectors with financially constrained businesses. As global investors remain apprehensive, innovative small and new companies may be deprived of

crucial capital to survive. They are ripe for stimulus, particularly if their business model has scalability, which can boost employment as well as productivity broadly. To this extent, Beijing may consider looking at ETFs targeting small-cap companies that comprise much of total employment in China.

Non-performing loans

This outcome is particularly important given the backdrop in the Chinese financial system: Souring loans in the property market pose a significant obstacle. In another study on non-performing loans (NPLs) in the Chinese financial system, my colleague Tianyue Ruan and I found that NPLs thought to have been "disposed" of by banks to asset management companies may not have actually been resolved but rather hidden from sight. We estimated that recognising the hidden NPLs would increase the total to two or three times the officially reported amount.

Instead of indiscriminately buying ETFs to boost stock prices and benefit investors, hedge funds, and CEOs, China could target fiscal stimulus more directly towards areas with higher potential and social value without unnecessarily increasing non-productive corporate cash holdings. The country has not shied away from such targeted policies in the past. Hence, such tools can also be used with policies that foster a more competitive and inclusive market environment to improve transparency and appropriately allocate losses and gains to the respective risk-takers. This would help avoid distortionary incentives, which may end up costing taxpayers more.

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