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Monetary policy, government control and capital investment: Evidence from China

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ABSTRACT

This study examines how the relationships between local governments and local enterprises moderate the effect of targeted monetary policies through different action-propagating mechanisms. First, we investigate the impact of monetary policies on enterprise investment in areas with different institutional environments. Second, we investigate the impact of monetary policies on state-owned enterprises (SOEs) with different property rights structures. Third, we examine how political connections can influence the action-propagating mechanism of monetary policies. We conclude that in China monetary policies have different effects on SOEs and on private enterprises with or without political connections. Specifically, local government interventions can significantly weaken and distort the effects of monetary policies, such that the intended reduction in investment is noticeably alleviated for SOEs and private enterprises with close links to local governments.

1. Introduction

Over the past 30 years, China's reform and opening-up policy has led to continuous high-speed economic growth, which has attracted global attention. During this period of economic transition, the government's aim has been to establish a market mechanism to allocate resources. In recent years, the Chinese government has gradually established and continuously improved its monetary policy, which is actively used to regulate the

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economy. Monetary policy not only affects the development of the macro-economy, but also has important effects on the micro-economic environments in which enterprises make decisions.

China's monetary policy is still undergoing a transformation into a fully market-based model, and its effectiveness has been the focus of academic discussion. Research has revealed that there is a time lag in the monetary policy transmission process that reduces the efficiency of the monetary policy (Zhou and Jiang, 2002; Dickinson and Liu, 2007; Fu and Liu, 2015). When the central bank loosens or tightens its monetary policy, the funds do not always flow to or from the industry or enterprise that the central bank intended to control. As local governments focus on promoting economic growth that optimizes local and regional development and investment, the central bank's monetary policy can encounter local failures in its transmission mechanism (Sun, 2004; Song and Zhong, 2006).

Research on the impact of macro policy on firms' decision making at the micro level (Jiang and Rao, 2011) is still scarce. Although some studies (Hao et al., 2014) have explained macro-level economic growth problems from the micro perspective of enterprise investment, there are no studies examining how the monetary policy transmission mechanism affects micro enterprise investment behavior and capital structure in different institutional environments and under different property rights. In this study, we use an integrative perspective to investigate the interplay between macro-level monetary policy and micro-level investment and financing actions by enterprises. We aim to attain a better understanding of the mechanisms through which monetary policy influences the economic actions of enterprises.

In-depth examinations of the interactions between macro- and micro-economic environments have shown that the impact of monetary policy on a firm's investment and financing activities depends on the firm's ownership arrangement and governance structure. China is the largest country in the world with a transitional economy. Since 1978, its market-oriented reform has been focused on decentralization. Economic decentralization motivates all levels of local governments to develop their local economies. As the growth of the local GDP is the benchmark for China's performance evaluation systems, decentralization also directly drives and strengthens local governments' interventions in local business investment activities (Blanchard and Shleifer, 2001; Leuz et al., 2003; Li and Zhou, 2005; Wang et al., 2007). To achieve rapid GDP growth, local governments resist strict financial regulations that might slow the development of the local economy. They directly intervene in local financial institutions through deregulation or alternative policies to provide guarantees for enterprises' financing and investment activities. The impact of local government on local enterprises' investment behaviors depends on the enterprises' ownership structures and governance modes (Huimin and Mak, 2002; Lee, 2003; Michael et al., 2012). These processes affect the mechanism through which the central bank's monetary policy influences micro-level investment decisions.

The continuous improvement in marketization caused by the expanding reform and opening-up policy has greatly reduced the government's direct control over the economy. Although the government initiated the market-oriented reform, it still directly dominates the reform process and the standardization of the market mechanism. As both a "referee" and a "player" in the reform process, the government has a strong influence on all enterprises, and a non-market economic system still exists. As it is intensively controlled by the government, the market cannot play a dominant role in resource allocation. In capital-scarce areas, capital investment has a significant effect on the promotion of economic development through SOEs, whose concentrated property rights are controlled by the government. Therefore, the government has a strong ability to intervene in local economies (Chen and Wong, 2013). These interventions, often conducted through property rights control and business investment intervention, achieve short-term economic goals, but have a negative effect on the government's monetary policy goals (Dewatripont and Maskin, 1995; Hansona and Steina, 2015). The unique property rights arrangement of China's SOEs is an important corporate governance characteristic related to this special investment phenomenon. The frequent changes in government policy and regulations and the fluctuating levels of government control of the economy increase the uncertainty of the economic environment. Private enterprises with political connections can more easily access long-term bank loans than other enterprises. The ability to obtain credit loans and other financial resources strongly depends on political relationships (Bartels and Brady, 2003; Faccio, 2006; Gulen and Ion, 2016). As SOEs are by definition connected to the government, research on the role of political connections has mainly focused on private enterprises. These studies have shown that political connections have a significant positive correlation

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