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Monetary policy, asset prices and consumption in China

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ABSTRACT

This paper studies the wealth channel in China. Although the wealth channel has been found to be functioning in many advanced countries, its existence is yet to be explored in most emerging economies, also in China. In order to illuminate dynamics between monetary policy, asset prices and consumption, we use the structural vector autoregression method. The findings support the view that a loosening of China's monetary policy does indeed lead to higher asset prices. Furthermore, a positive shock to residential prices increases household consumption, while the role of stock prices seems to be small from the households' point of view. Finally, we test the existence of the wealth channel more formally to find out whether those changes in asset prices that are caused by monetary policy are significant enough to increase consumption. In summary, the wealth channel remains weak but there are some signs of it via residential prices. The results are not that different from those attained for the advanced economies, where the size of the wealth channel has been found to be limited.

1. Introduction

One of the monetary policy transmission channels is the so-called wealth channel. It implies that monetary policy can affect the real economy via its impact on asset prices. For example, a loosening of monetary policy is often linked with an increase in asset prices which can then have a positive impact on firms' investment behaviour or household consumption. In the advanced economies, the wealth channel has frequently been introduced to macroeconomic models analysing the impacts of monetary

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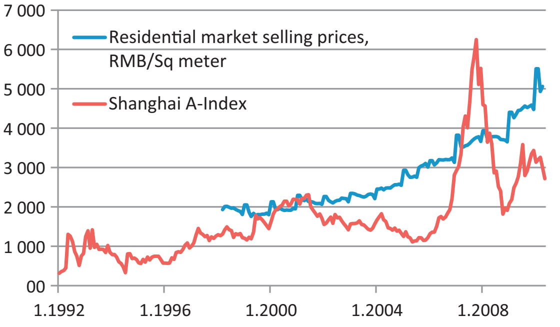

Source: CEIC

Fig. 1. Shanghai A-Index and residential prices.

policy on the real economy. However, the evidence of the wealth channel in emerging markets is still questionable, mainly due to underdeveloped asset markets in these economies.

In this paper, we study whether the wealth channel exists in China. In particular, we explore whether monetary policy can have an impact either on housing or stock prices, and if so, whether these price developments are capable of influencing household consumption. In addition to the fact that the wealth channel in China has not been studied before, this paper is motivated by the growing importance of the stock and residential markets in the Chinese economy. For decision makers it is essential to know whether the asset markets provide another monetary policy transmission channel in the country. Furthermore, taking into account China's rapidly increasing role in the world economy, the knowledge of the dynamics of the Chinese economy is essential for other economies as well.

Interestingly, developments in the two asset markets – stock and residential markets – have been rather uneven in China. In particular, the stock markets have had a bumpy ride, as share prices experienced several booms and busts right after the opening of the Shanghai Stock Exchange in 1992 (see Fig. 1). During the first years of the 2000s, market performance remained weak – especially compared to the strong performance of the economy. The weakness of the stock market was thought to be mainly due to institutional problems such as lack of transparency, low quality of listed companies, weak minority shareholder rights, limited role of institutional investors, and the unclear plan to sell state-owned shares.[1] Efforts were made to revive investors' interest in the stock markets through institutional reforms touching on some of these problems, which in part led to another stock market bubble in 2006–2007, as share prices rose fivefold in less than two years before the market crashed again. The sharpest monthly drop in the Shanghai A-Index amounted to almost 25% in October 2008. Since the beginning of 2009, stock markets have recovered to some extent.

Compared to the high volatility of stock markets, developments in Chinese housing prices have been consistently positive, even though extensive reforms have also targeted this sector (see Fig. 1). Liang and Cao (2007) divide the reforms into three subperiods. The last of the three began in 1998, after which most of the apartments were privatised and the market mechanism was allowed to function. Nowadays 80% of urban residents own their apartment in China.[2] However, the public sector has maintained its role as a moderator in the real estate market, not least because of its monopoly in supplying land. Moreover, minor regulatory changes, e.g., in respect of minimum down payments and land usage, are still common. Housing prices have performed favourably for many years since the start of the data series in 1998. The strong uptrend ended only in 2008 and even then the period of declining prices was short-lived; since the spring of 2009, prices have been on the rise again.

In the past, asset prices had virtually no impact on the Chinese economy. The size of the stock markets compared to the economy was small, and until the second half of the 1990s, apartments were owned by the public sector. Profound economic reforms have gradually increased the importance of

[1] An overview of stock market developments in China can be found for example in Chen and Shih (2002).

[2] Financial Times, 22nd September 2009: http://blogs.ft.com/dragonbeat//2009/09/22/whats-behind-chinas-skyrocketing-residential-property-market-subsidies-subsidies-subsidies/?catid=152&SID=google.