

**New model of China's macroeconomic policy
with slowing down of potential growth:
deflation, high debt, coordination of
monetary and fiscal policy**

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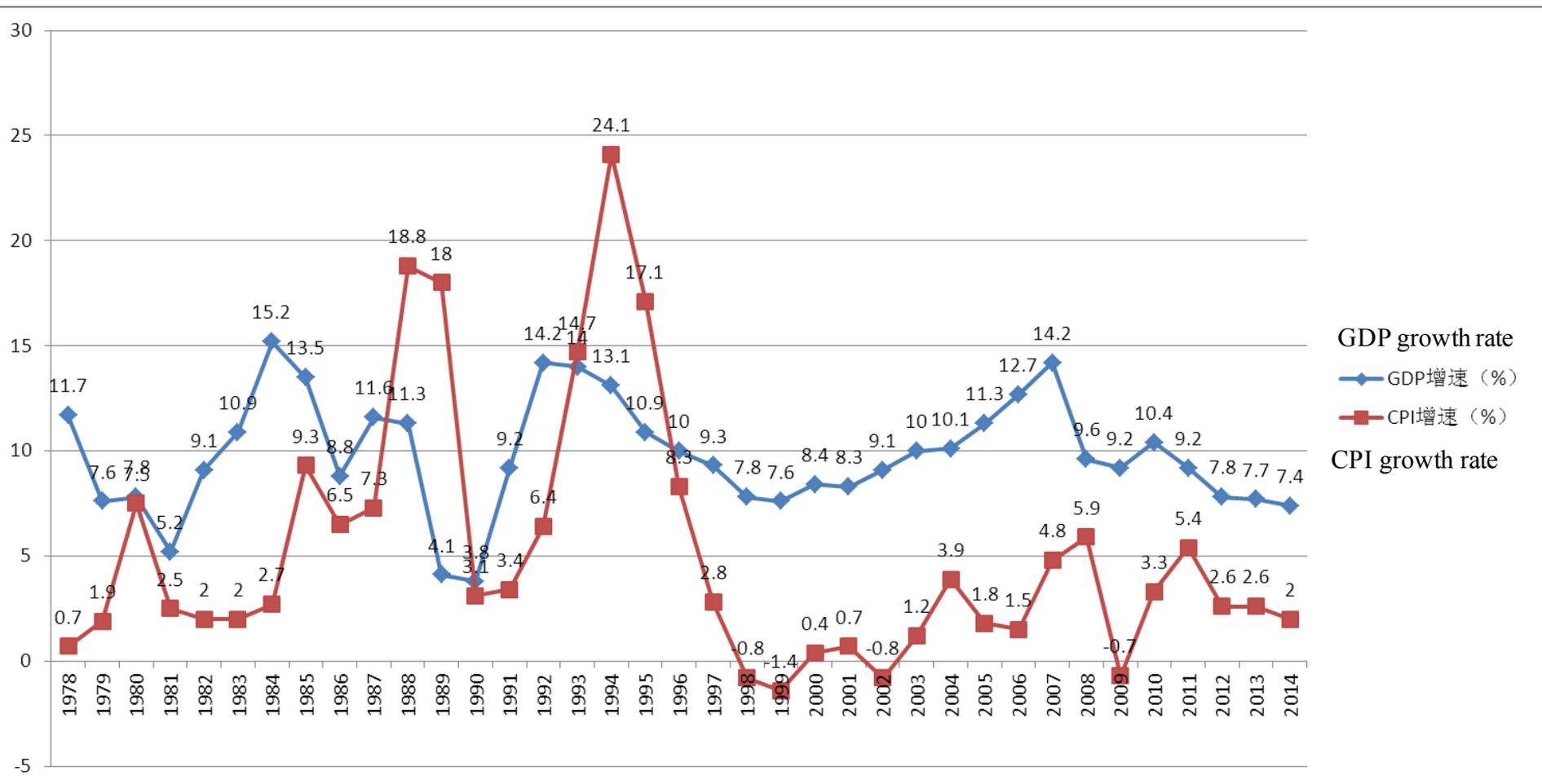
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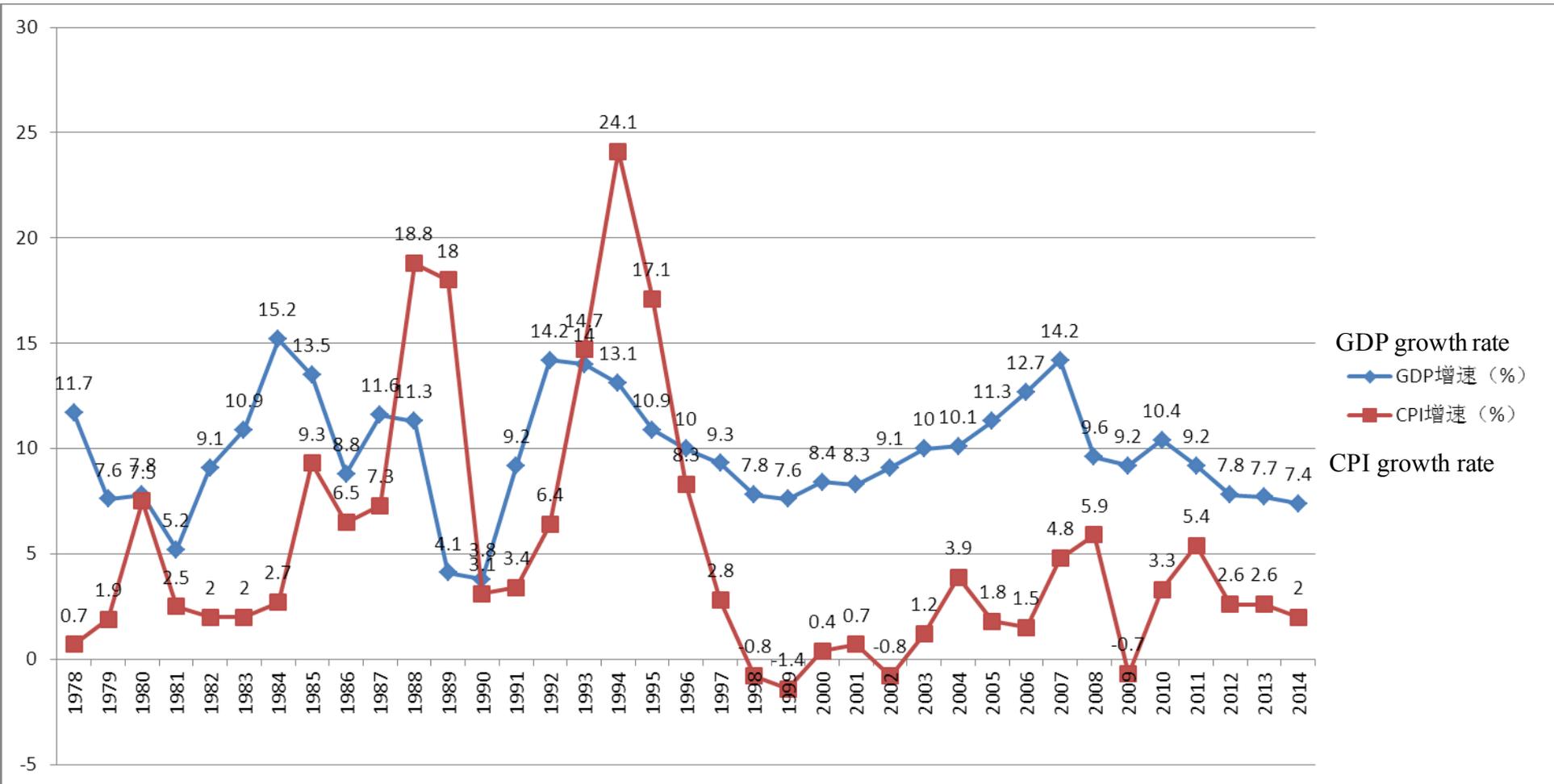
Main Findings

- Keynesianism has been widely understood as a form of the Old Keynesianism in China, which indicated that proactive fiscal policy could be even more effective than monetary policy during a recession. And the view has been highlighted due to more frequently emphasized fiscal policy after the 2008 crisis.
- It is a wide consensus that the independence of Central Bank of China is poor, far from that of the Federal Reserve. Thus the public is paying more attention to fiscal policy, rather than monetary policy, to control the economic recession.
- However, this paper argues that, aggressive monetary policy would play an more important role under the current pressure of deflation and high debt level, than that in the traditional views.

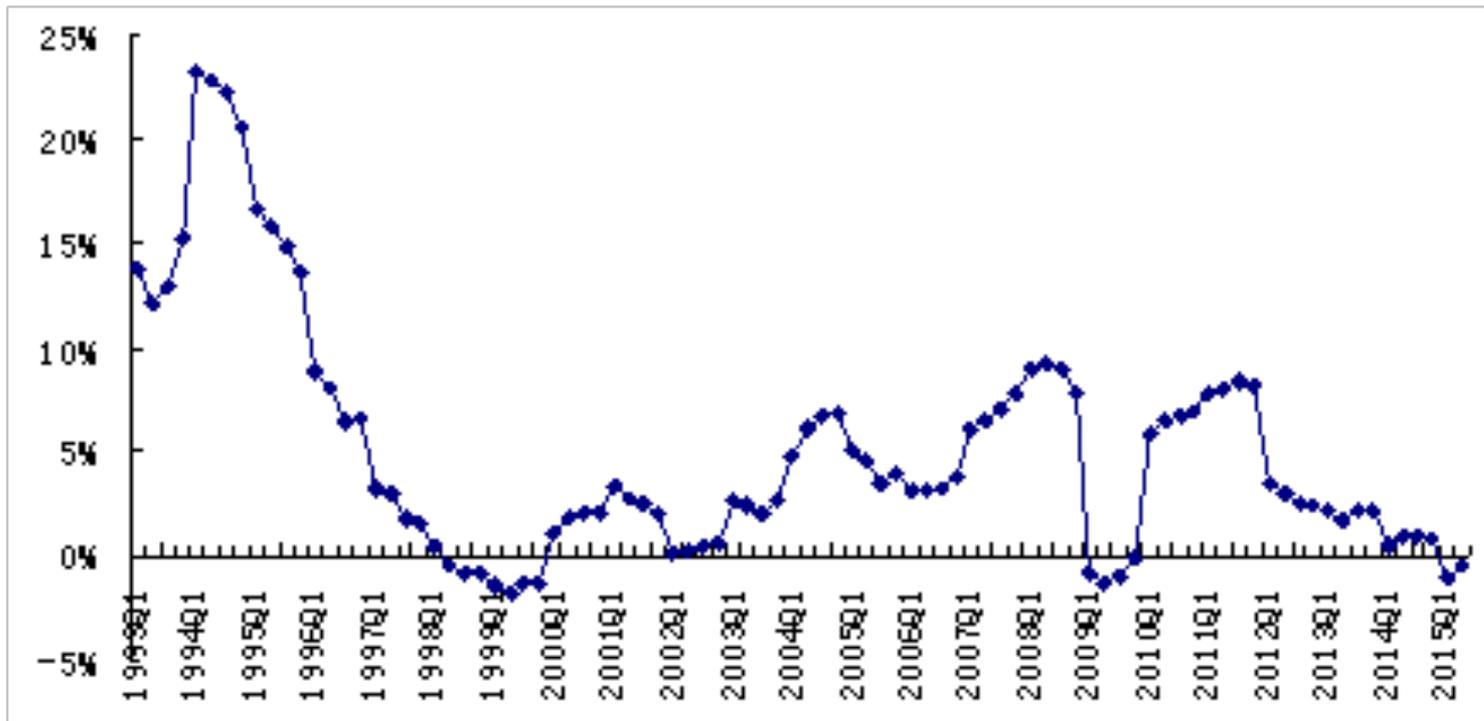
1. Macroeconomic policy pursuing steady growth didn't work well since the "new normal"



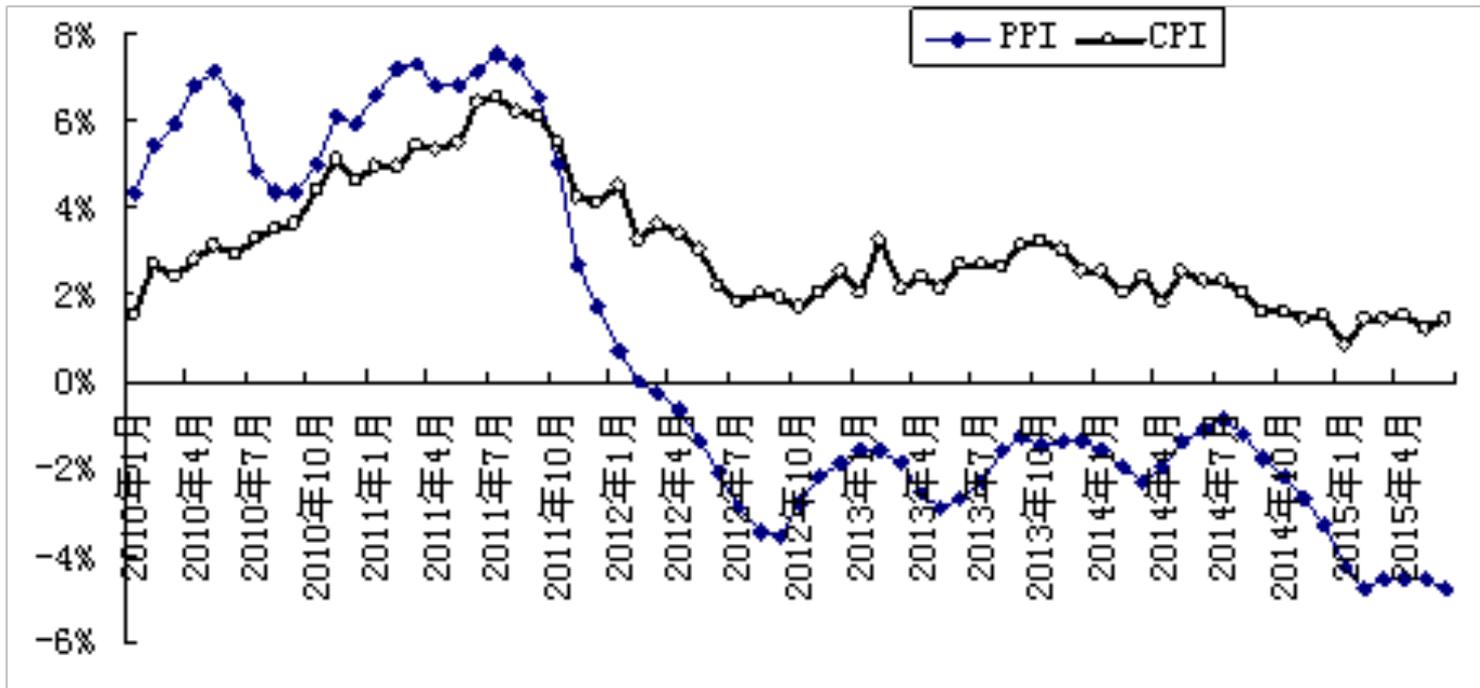
Economic Growth and Inflation since the Reform and Opening Policy in 1970s



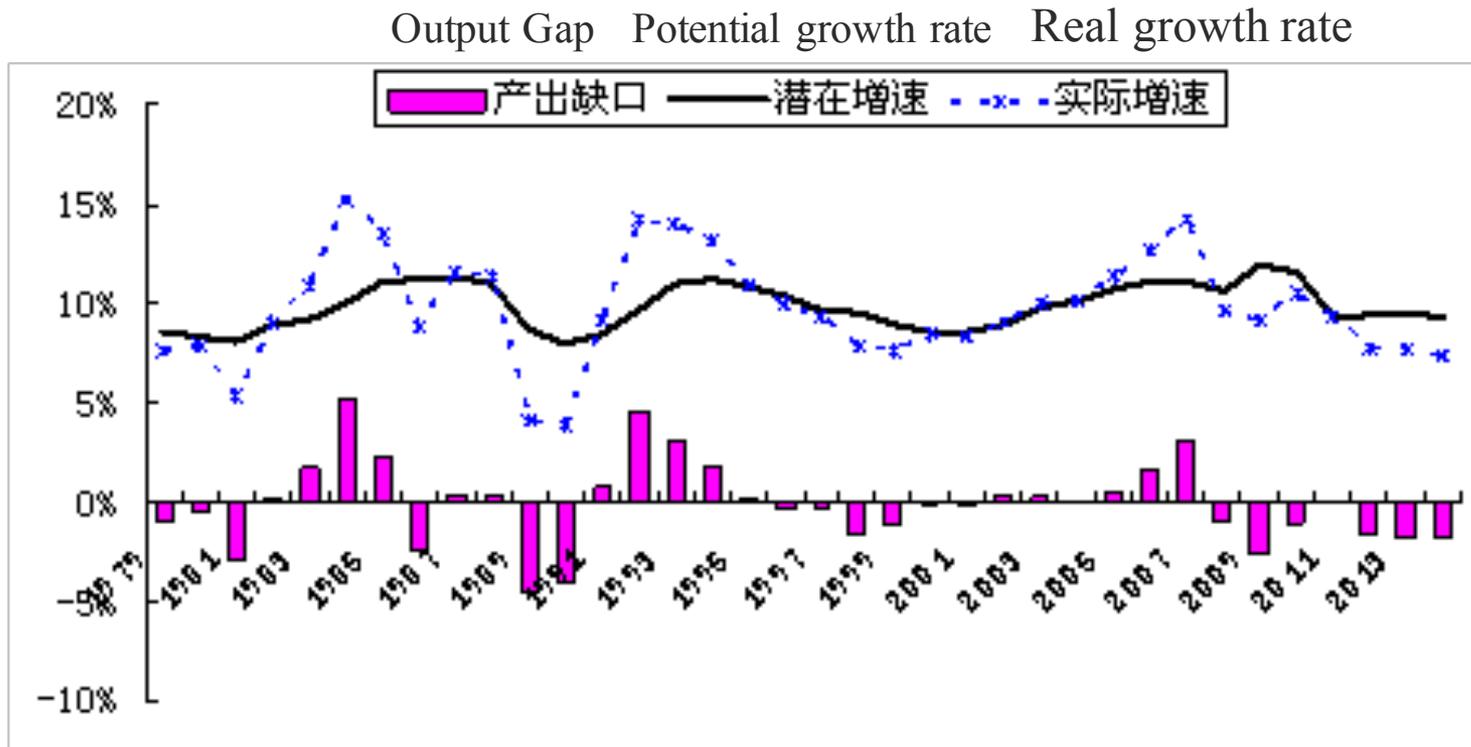
The current state of the economy is "depression"



GDP Deflator. The GDP Deflator was -0.5% the in first and second quarter of 2015



CPI was 1.6% in July. Pork prices rose by 16.7%, which contributed to 0.48 percentage points increase of CPI.



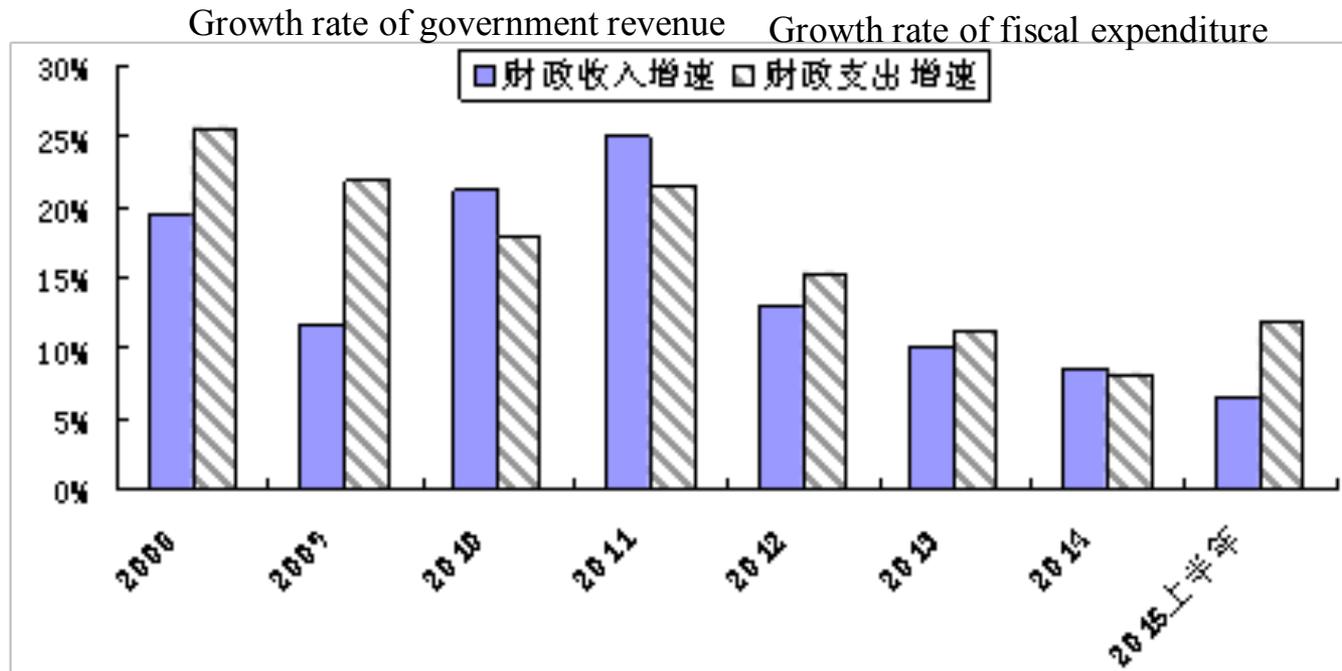
China's potential growth rate were 9.38%, 9.49% and 9.24% from 2012 to 2014 respectively, while the real economic growth rate were 7.7%, 7.7% and 7.4, implying -1.72%, -1.81% and -1.84% Output Gap during 2012 ~2014.

2. Why macroeconomic policy pursuing steady growth didn't work well ? Execution of fiscal and monetary policy is not proactive enough.

(1) Execution of fiscal policy is far from proactive

Table 1 : the Target and Execution of Fiscal Policy since 2009

| Year | Definition of policy | Deficits target (hundred million RMB) | Real deficits (hundred million RMB) | Ratio of targeted deficits | Ratio of real deficits | Whether the target has been achieved |
|------|----------------------|---------------------------------------|-------------------------------------|----------------------------|------------------------|--------------------------------------|
| 2009 | Active | 9500 | 7782 | 3% | 2.25% | No |
| 2010 | Active | 10500 | 6773 | 2.8% | 1.66% | No |
| 2011 | Active | 9000 | 5373 | 2% | 1.11% | No |
| 2012 | Active | 8000 | 8699 | 1.5% | 1.63% | Yes |
| 2013 | Active | 12000 | 11002 | 2% | 1.87% | No |
| 2014 | Active | 13500 | 11312 | 2.1% | 1.78% | No |
| 2015 | Active | 16200 | ? | 2.3% | ? | ? |



The growth rate of fiscal expenditure has sharply reduced from 21.6% in 2011 to 8.2% in 2014, with a decrease of 13.4%. It is 10% lower than the average growth rate from 1993 to 2014. While the government is constantly improving the deficit ratio, the growth rate of fiscal expenditure, however, has plunged a lot, which also indicates that the fiscal policy is not proactive enough.

Why fiscal policy is not proactive enough?

- In terms of fiscal revenue, the growth rate had dropped from 25% in 2011 to 8.6% in 2014, which was the first time that the growth rate of fiscal revenue is lower than double-digit since 1992. In the first half of 2015, the growth rate of the total government revenue fell to 6.6%. Liaoning, Xinjiang, Shanxi and Qinghai provinces have seen even a negative growth rate in government revenue .

Why fiscal policy is not proactive enough?

- In terms of fiscal expenditure, the government not only has to fund investment projects to stabilize growth, but also needs to undertake the expenditure for people's livelihood in education, health care, etc. Besides, it also has to pay off the debts of local governments, the central government and some state-owned enterprises, including both capital and interest. The latter two kinds of expenditure will constantly crowd out the space of positive fiscal policies and make the fiscal policy less effective in stabilizing growth. According to data from State Statistics Bureau, the growth rate of state's fixed-asset investment deriving from the national budget has greatly decreased from 29.7% in 2012 to 17% in 2013 and 14.1% in 2014. Local project investment, which constitutes the biggest part of fixed-asset investment, has seen its growth rate dropped from 27.2% in 2011 to 15.9% in 2014. In 2015, that figure dropped again to 11.9%.

Why fiscal policy is not proactive enough?

- What's more, the increasing local government debt and last year's No.43 document have strengthened the management on local government debt. By June, 2013, the amount of local government debt reached 17.89 billion, which was 70% higher than that of 2010. The total of central and local government debt amounts to 30.27 billion, accounting for 58% of the GDP.

(2) Execution of monetary policy is not proactive enough?

Table 2 : Target and Real Growth Rate of M2 since 2003

| Year | Definition of policy | Target of GDP Growth rate | M2 Growth rate | | | |
|------------------------|----------------------|---------------------------|----------------|-------|-------------------|------------------|
| | | | Target | Real | Target minus Real | Whether achieved |
| 2003 | prudent | 7% | 16% | 19.6% | 3.6% | Yes |
| 2004 | prudent | 7% | 17% | 14.7% | -2.3% | No |
| 2005 | prudent | 8% | 15% | 17.6% | 2.6% | Yes |
| 2006 | prudent | 8% | 16% | 17.0% | 1% | Yes |
| 2007 | prudent | 8% | 16% | 16.7% | 0.7% | Yes |
| 2008 | tight | 8% | 16% | 17.8% | 1.8% | Yes |
| 2009 | modest loose | 8% | 17% | 27.7% | 10.7% | Yes |
| 2010 | modest loose | 8% | 17% | 19.7% | 2.7% | Yes |
| 2011 | prudent | 8% | 16% | 13.6% | -2.4% | No |
| 2012 | prudent | 7.5% | 14% | 13.8% | -0.2% | No |
| 2013 | prudent | 7.5% | 13% | 13.6% | 0.6% | Yes |
| 2014 | prudent | 7.5% | 13% | 12.2% | -0.8% | No |
| The first half of 2015 | prudent | 7% | 12% | 11.8% | -0.2% | No |

3. The policy coordination of "active fiscal + modest loose monetary" can better promote steady growth under the pressure of deflation and high debt, thus monetary policy should be more expansionary.

- (1) According to the traditional IS-LM model, the combination of "proactive fiscal policy+ loose monetary policy" can lower the real interest rate, helping to expand enterprises' investment demands.
- (2) When deflation and high debt both exist, loose monetary policy can not only encourage enterprises to increase investment, but also leave more room for fiscal policy to stabilize growth. Therefore, the combination of "proactive fiscal policy + loose monetary policy" can better promote steady growth.

- **First, besides deflation, the enterprises and government sectors are also facing high debt issue.**

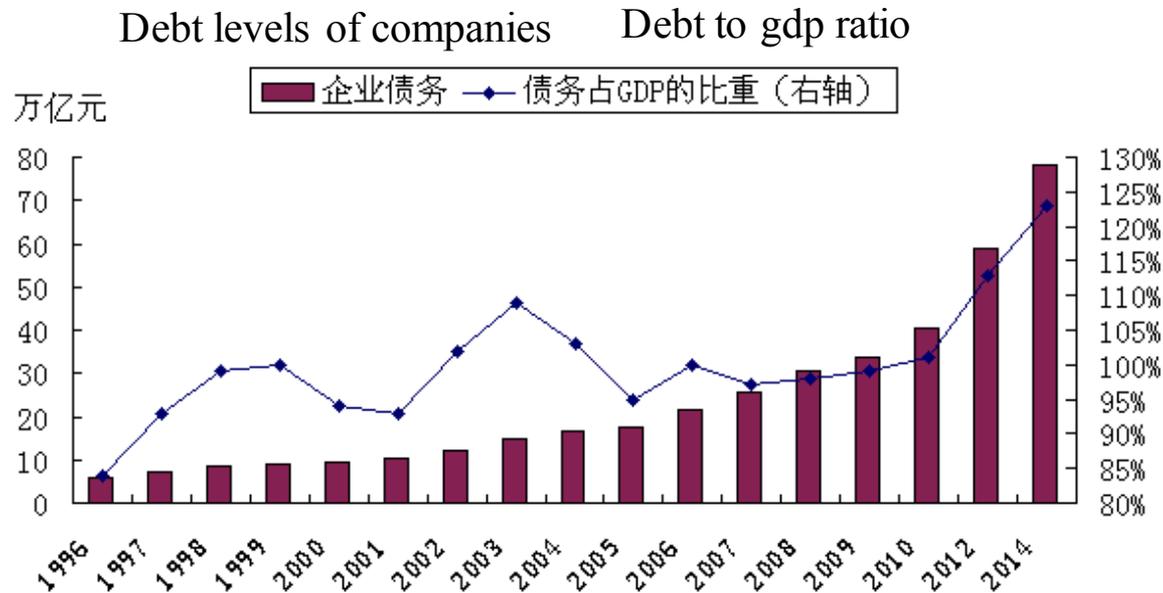


Table 3 : Levels of Government debt (Unit / Trillion Yuan)

| year | Level of government | Debt should paying | Debt for secured responsibility | Debt for assistance | Total debt | Debt to GDP ratio |
|------------------------|---------------------|--------------------|---------------------------------|---------------------|------------|-------------------|
| 2010 | Central | 6.71 | 2.34 | 1.67 | 10.72 | 26.21% |
| 2012 | Central | 9.44 | 0.28 | 2.16 | 11.88 | 22.88% |
| | local | 9.63 | 2.49 | 3.77 | 15.89 | 30.58% |
| By the end of 06, 2013 | Central | 9.81 | 0.26 | 2.31 | 12.38 | 21.06% |
| | Local | 10.89 | 2.67 | 4.34 | 17.89 | 30.43% |

- **Second, we can learn by looking back at the Great Depression that, when deflation and high debt both exist, the central bank has to carry out loose monetary policy to raise up commodity price to ease debt burden and stimulate investment demands.**
- **Third, for China, strengthening loose monetary policy can not only reduce enterprises' debt burden, but also make room for government's fiscal policies to stabilize growth.**

**Table 4 : Estimate of the Benefits of Loose Monetary Policy to the Enterprise
(Unit / Trillion Yuan)**

| Basic information | | Simulation 1: RRR cuts | | Simulation 2: RRR cuts + interest rate cuts | |
|-------------------|------|------------------------------|----------------------|---|------------------------------|
| Debt | 73.8 | Debt burdens whittled down | $73.8 * 2\% = 1.48$ | Debt burdens whittled down | $73.8 * 2\% = 1.48$ |
| | | | | Debt interest whittled down | $73.8 * 80\% * 0.5\% = 0.30$ |
| Financing | 16.0 | Financing cost whittled down | $16 * 2\% = 0.32$ | Financing cost whittled down | $16 * 2.5\% = 0.40$ |
| Debt-paying ratio | 20% | Total benefits | $1.48 + 0.32 = 1.80$ | Total benefits | $1.48 + 0.30 + 0.40 = 2.17$ |

**Table 5 : Estimate of the Benefits of Loose Monetary Policy to Government
(Unit / Trillion Yuan)**

| Basic information | | Simulation 1: RRR cuts | | Simulation 2: RRR cuts + interest rate cuts | |
|-------------------|-------|------------------------------|----------------------|---|-------------------------------|
| Debt | 30.27 | Debt burdens whittled down | $30.27 * 2\% = 0.61$ | Debt burdens whittled down | $30.27 * 2\% = 0.61$ |
| | | | | Debt interest whittled down | $30.27 * 80\% * 0.5\% = 0.12$ |
| Financing | 5.67 | Financing cost whittled down | $5.67 * 2\% = 0.11$ | Financing cost whittled down | $5.67 * 2.5\% = 0.14$ |
| Debt-paying ratio | 20% | Total benefits | $0.61 + 0.11 = 0.72$ | Total benefits | $0.61 + 0.12 + 0.14 = 0.87$ |

Conclusion

- Now China's combination of "proactive fiscal policy + prudent monetary policy" is drawn from the IS-LM model, which neglects deflation and high debt issue.
- For one thing, faced with the deflation pressure, the combination of "proactive fiscal policy + moderately loose monetary policy" can prevent real interest rate from rising and stimulate the whole society's investment demands.
- For another thing, faced with high debt issue, the combination of "proactive fiscal policy + moderately loose monetary policy" can encourage enterprises to invest and make more room for fiscal policies to stabilize growth, which further makes it necessary for China to strengthen its loose monetary policy.

Conclusion

- By calculation we can find that, if the inflation rate is increased by 2% through loose monetary policy, the debt and financing cost of enterprises will decrease 1.8-2.17 trillion Yuan. The growth rate of society's fixed-asset investment will thus increase by 3.5-4.2%. More importantly, loose monetary policy will offer ¥720-870 billions' fiscal space for government and increase 2015's growth rate of fiscal expenditure by 4.7-5.7%. This shows that strengthening loose monetary policy and changing the combination of “proactive fiscal policy + prudent monetary policy” to “proactive fiscal policy + moderately loose monetary policy” can effectively push forward steady growth.

Thank you !