A Review of China's Macroeconomic Development and Policies in the 1990s

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Over the past two decades, China succeeded in obtaining an average annual growth rate of about 10 percent, while the average annual inflation rate was being kept under 3 percent. During and after the Asian financial crisis, China maintained its growth momentum, and consolidated its financial stability. No matter what will happen in the near future, no one can deny that China's success over the past two decades amounts to a true economic miracle. One of the most important contributing factors has been the Chinese government's success in macroeconomic management. This paper examines the main experience in the Chinese government's macroeconomic management during the 1990s, to show how, in China, macroeconomic policies were implemented to achieve non-inflationary growth.

I. A Brief Review of China's Macroeconomic Development since the Early 1990s

Since 1978 when reforms began, China's economic growth has been spectacular. Over the past twenty odd years, China registered an average annual growth rate in GDP of about 10 percent. From 1991 to 2000, China's average annual growth rate of GDP was 10.1 percent.

Figure 1. China's Economic Growth in the 1990s

However, China's economic growth has not been smooth. The economy has
experienced several cycles. The latest cycle began in the early 1990s when economic growth picked up from 4.1 percent in 1990 (the lowest growth rate China has ever registered since 1978) to 9.5 percent in 1991. In response to Deng Xiaoping's call for speeding up reform and widening the opening up, in his famous tour to southern China in the Spring of 1992, China's growth rate shot up to 14.2 percent, and the economy began to over-heat very quickly. In 1993, while the economy continued to grow strongly with the growth rate reaching 13.5 percent, inflation accelerated suddenly to 14.7 percent. (In contrast, in 1990, 1991 and 1992, inflation rates had been 3.1 percent, 3.4 percent and 6.4 percent, respectively.)

In the middle of 1993 the government began to tighten its macroeconomic policy to clamp down on inflation. However, inflation continued to worsen. In 1994, the rate of inflation was 24.1 percent, the worst on record since reform. It was attributable to three factors. The first was the lagged effect of previous years' excess demand which had resulted from excessive growth of the money supply. The second was price liberalisation, implemented by the government in the middle of 1994. The third was related to the sterilisation policy used by the central bank, the People's Bank of China (PBC).

In 1995, as a result of the government's restrictive macroeconomic policy, the rate of inflation fell to 14.8 percent. On the other hand, China succeeded in maintaining its growth momentum. In that year, its growth rate was still as high as 10.8 percent. China's macroeconomic situation continued to improve in 1996. While the growth rate was 9.6 percent, inflation further fell to 6.1 percent. All indicators seemed to point to a successful soft landing initiated in the second half of 1993. A further improvement was expected for 1997.

In 1997 the Chinese economy slowed down significantly. With the benefit of hindsight, the signs of over-production had become quite common in 1996. However, at the time, the government was not sure whether it was a result of industrial restructuring or lack of effective demand resulting from the over-kill of previous macroeconomic tightening. Being uncertain about the nature of the slowdown, for the most part of 1997, the government insisted on treating inflation as enemy number one, and refused to take actions such as cutting interest rates to deal with the slowdown head on. *

In October of 1997, the retail price levels began to fall. Signs of lack of effective demand became prevalent. Many surveys showed that there were excess supplies of goods in almost all markets, and capacity utilization rates were low for almost all industries. In November of that year, prompted by the rapid deterioration of the domestic economy and the gloomy prospect of the global economy, the government cut the interest rate on one year deposits by 1.8 percent (see Table 2), signaling a change of policy direction.
For China, 1998 was one of the most difficult years in the 1990s. In that year, the Asian crisis, with some lag, eventually impacted negatively on China's macroeconomic situation. Due to worsening of the world economy, China's export growth had dropped since late 1997 and deteriorated further in 1998. The persistent decline of the price levels and the significant slowdown of the economy showed that China encountered a situation never before experienced—deflation. Owing to concerns that the GDP growth rate in 1998 might fall below 8 percent, and to the fact that monetary policy was becoming increasingly impotent, the government turned to expansionary fiscal policy ("proactive fiscal policy") in the middle of 1998.

The marked slowdown of the economy, deflation, the worsening of non-performing loans (NPLs) and the mounting devaluation pressure on China's currency, the renminbi (RMB) prompted some foreign "China experts" to bet on an imminent financial crisis in China. Their predictions proved to be incorrect. In 1999, China's growth rate was 7.1 percent, the lowest since the early 1990s. The most worrisome development was the continuous decline in the growth rate of investment. In the four quarters of 1999, China's fixed assets investment growth rates were 23.8 percent, 16.2 percent, 8.5 percent and 6 percent, respectively. The rate of investment growth in non-state-owned enterprises was even lower.

However, some important positive signs began to emerge in 1999. From the second half of 1999, the deflation rate was bottoming out. In 1999, China's imports increased very significantly, (although, to a large extent, the increase was attributable to the anti-smuggling campaign and the resultant improved customs statistics.) These changes signaled the beginning of the recovery of the economy. In early 1999, China's export performance had been rather dismal. However in the latter half of 1999, due to the recovery of the world economy including Asian economies, and the Chinese government's export promotion policy, China's exports increased dramatically. As a result, China managed to obtain a respectable trade surplus of US$ 29.2 billion in 1999, (though this was US$ 14.4 billion or 33 percent less than in 1998.)

Owing mainly to improvements in tax administration, the government was hugely successful in raising tax revenue. In 1999, tax revenue increased by 1031.2 billion yuan, a year-on-year increase of 13.4 percent. More importantly, the restructuring which had been implemented over the past years seemed to begin to pay off. Through mergers, bankruptcy, reorganization, debt-to-equity swaps, improved management and other measures, the profitability of enterprises improved dramatically and the number of large and medium-sized state-owed enterprises (SOEs) that were loss-making decreased significantly in 1999. According to Zhu Rong-ji, profits from industrial enterprises totaled 220.2 billion yuan in 1999, an increase of 52 percent over the previous year. Total profits from SOEs and the enterprises whose controlling shares were held by the state reached 96.7 billion yuan, a rise of 77.7 percent over the previous year, and a record for the past five years. The improvement in China's economic fundamentals, combined with expansionary macroeconomic policies, paved
the way for the recovery of the economy. Despite the fact that investment demand was still weak, the decline in overall economic growth rate began to bottom out in the third quarter of 1999.

The GDP growth rates in the four quarters of 2000 were 8.1 percent, 8.2 percent, 8.2 percent, and 8 percent, respectively. The increase in housing investment that was stimulated by the expansion of mortgages played an important role in an improving economic outlook in the year 2000. Owing to the progress made in establishing a social safety net and the increase in income (urban 6.9 percent, rural 1 percent, in real terms in the first quarter of 2000), and the improved global economic outlook, consumer demand also increased steadily. The growth rate of exports in the first quarter of 2000 was a staggering 39 percent. China's price levels as measured by CPI have stopped falling since the first quarter of 2000. The unemployment problem in China seems to have become less noticeable. The steady growth in 2000 and the end of deflation may have signaled that China's macroeconomic situation has reached the turning point in the current cycle.

The major weakness in China's economy is the unstable growth of investment. The increase in government expenditure in public works since the second half of 1998 succeeded in arresting the rapid decline in investment demand. However, the expansionary fiscal policy failed to bring about a self-sustained growth of the economy. How to build a solid foundation for the Chinese economy to grow steadily without heavy involvement of the government is still a great challenge China has to face.

II. China's Monetary Policy

Since reform and opening up, macroeconomic policy mix has gradually become the Chinese government's most important instrument to ensure non-inflationary, stable economic growth. During the 1980s and up to the first half of the 1990s, the role of the government budget in macroeconomic management was very limited, because of the dramatic fall in the proportion of GDP which comprised government budget, and because of other institutional constraints. For example, implementation of the enterprise contract responsibility system in the 1980s virtually deprived the government of any flexibility to use expenditure and taxes to influence macroeconomic activities. Consequently, monetary policy assumed a dominant role in macroeconomic management in China during this period. However, since the middle of 1998, due to the impotence of monetary policy, fiscal policy has replaced monetary policy as a more active instrument in China's macroeconomic management, aimed at getting rid of deflation.

1. Monetary policy
China's monetary policy in the 1990s can be divided into two stages. From the latter half of 1993, faced with the upsurge of inflation, the Chinese government adopted a tight monetary policy to cool down the overheated economy. Since late 1997 up to the present time, an expansionary monetary policy has been in place to fight against deflation.

From the middle of 1993, the important policy measures taken to suppress inflation were as follows:

—Clearing up and withdrawing unauthorised loans. Within four months of the launch of monetary tightening, under the order of then vice premier Zhu Rong-ji, 81 billion yuan in unauthorised loans extended by specialised banks to enterprises and nonbank financial institutions were called back.
—Interest rates were raised and the returns on long-term deposits were pegged to inflation to encourage the public to hold more illiquid savings deposits.
—To supplement the measures to control growth of bank credits, (the counterpart of the money supply,) administrative orders were issued to restrain construction works and investment in real estate and property development.

As a result, the growth rate of M1 declined from 34 percent in the first half of 1993 to about 20 percent later in the year. However, the growth rate of M2 was still high. The interest rate indexation was a daring experiment. Latin American experience shows that indexation may worsen inflation by forming a cost-push vicious cycle. However, in China the policy was very successful in persuading consumers to hold money in the form of long-term savings deposits. In other words, owing to interest rate index-ation, even though the growth rate of broad money was still quite high, growth of cash that was ready to chase goods slowed down significantly.

Figure 2. The Growth Rate of Money Supply (%)
In 1994, the PBC declared that starting from the third quarter of the year, the money supply (rather than its counterpart, bank credits) was planned to become the intermediate target of monetary policy. However, the dramatic upsurge of foreign exchanges fueled strong expansion of reserve money. This, combined with the continuous expansion of domestic credits, caused the growth rate of M2 to shoot up to almost 35 percent by the end of 1994. The declared change in targeting was put on hold.

In 1995 the government continued its tight macroeconomic policy. With all its sincerity in carrying out market-oriented reform, faced with persistent inflation, pragmatism persuaded the government to go back on many reform promises and plans. Even administrative measures were used to clamp down on the reckless spending activities of banks and other financial institutions. The main policy measures taken in that year include the following:

—Further tightening the control of bank credit, and extending control to enterprises and non-bank financial institutions, to reduce the growth rate of the money supply.
—Continuing the policy of interest rate indexation.
—Re-introduction of administrative price control methods in urban areas.
—Raising the central bank's lending interest rate to banks. This was done twice, and the interest rates of bank loans to enterprises were raised correspondingly.

In 1995, the growth rate of the money supply at last fell in comparison with the previous year. For example, the annual growth rate of M2 was 29.5 percent, 5 percentage points lower than in 1994.

In 1996, after more than two years of monetary tightening, inflation fell significantly at last. Faced with a considerably lower growth rate, the consensus was that, while continuing to be vigilant about inflation, some impetus to economic growth should be given. Now the new monetary policy was called "moderately tight" monetary policy. To signal the adjustment of monetary policy, the central bank cut the interest rates on loans to enterprises twice and increased the spread between interest rates on loans and deposits. In 1996, while the growth rate of M2 continued to decrease, that of M1 began to increase. This pattern became even more marked in the first half of 1997. The increase in growth rate of M1 means that the liquidity of the banking system has increased.

In the first half of 1997, owing to the increasing slowdown of the economy and improvement in inflation situation at the same time, a heated debate occurred on whether the government should cut interest rates further. Initially, the call for loosening monetary policy was rejected. Later in the last part of 1997 and early 1998, after it became increasingly obvious that the possibility of a successful soft landing may easily turn into a disastrous hard landing, the Chinese government finally
changed the course of monetary policy from contractionary to expansionary.

An interesting development in 1998 was that monetary policy, which on the whole had been quite effective in bringing down inflation, was found to be impotent in breaking deflation and reflating the economy. Measures taken since 1998 aimed at reflating the economy are as follows.

— Ceilings on commercial bank loans are eliminated; only indicative plans will be given to commercial banks and the latter are actually allowed to extend credits so long as prudent rules are followed.
— The requirement for excess reserves has been eliminated; commercial banks are allowed to use reserve money with the central bank for payments and settlements.
— Reserve requirements are reduced and so are interest rates on reserves and excess reserves.
— Interest rates on the central bank's re-lendings to commercial banks are reduced.

Interest rates on deposits with commercial banks and those on loans by commercial banks are reduced.

Despite the central bank's best efforts in trying to increase the money supply so as to stimulate growth of the economy, the money supply failed to increase according to the central bank's plan, and expansionary monetary policy failed to create enough impetus to revitalize the economy.

2. Reasons for the ineffectiveness of monetary policy

The ineffectiveness of monetary policy can be attributed to a breakdown of the two key links in the money supply process and the failure of the transmission mechanisms of monetary policy. Firstly, under deflation, the monetary base becomes an endogenous variable. The central bank failed to manipulate the monetary base. Against the wishes and the best efforts of the central bank, by the end of 1998, high-powered money (HPM) fell by 4.7 percent compared with previous year. In contrast, in 1997 when monetary policy was tighter, high-powered money increased by 14 percent over the previous year. The causes for the abnormal behavior of high-powered money can be explained by the change in the central bank's assets. In China, the assets consist mainly of the central bank's loans to commercial banks, and foreign exchange reserves. The changes in the central bank's assets in 1998 can be shown as follows (Table 1).

| Table 1. The Quarterly Changes in High-Powered Money and the PBC's Assets in 1998 |
|-----------------------------------------------|-----|-----|-----|-----|
| High-powered money                           | 7.0 | 9.2 | -4.7| -4.7|
| Currency                                     | 3.86| 2.41| 4.16| 1.09|
It can be seen from the table that in the first two quarters of 1998, the main source of HPM growth was the increase in net foreign assets (foreign exchange reserves). In the third and fourth quarters, while the contributions to HPM growth of increased foreign exchange reserves decreased significantly, the contribution of central bank credits to commercial banks turned negative. Consequently, the monetary base shrank in the last two quarters of 1998. Under normal circumstances, a loosening of the reserve requirement would lead to increases in demand by the commercial banks for central bank credits, so that the commercial banks in turn can increase their own credits to enterprises. However, due to several important changes in the economy, the first link in the money supply process, (the central bank's ability to fix the quantity of some reserve assets, *) was broken. There are two most important causes for this breaking down. Firstly, Chinese banks have accumulated a huge amount of non-performing loans (NPLs), and the government has tightened the regulation and supervision of their lending activities. Heavy penalties have been imposed on bank managers who are responsible for the creation of new NPLs. As a result, commercial banks have become much more concerned about loan safety than profitability. Banks are very reluctant to lend to most enterprises, because of the risks. Secondly, many enterprises do not want to borrow either.

Thanks to the high debt-equity ratio, enterprises with a relatively good credit rating are cautious in borrowing and do not wish to further increase their debt burden, and enterprises with a low credit rating cannot obtain loans anyway. According to a survey covering 170 large and medium-sized state-owned enterprises, 118 enterprises did not apply to banks for loans at all. Among those enterprises, 27.4 percent already had too much inventory and too heavy a debt burden, 45.3 percent expected banks would reject their requests, and 10.6 percent obtained finance through other channels. * When commercial banks do not want and/or can not increase their credits to the public, and hence do not want to borrow from the central bank, what can the central bank do to increase re-lendings to commercial banks? In 1998, despite the fact that the central bank lowered the reserve requirement for commercial banks from 13 percent to 8 percent and eliminated the excess reserve requirement, in the fourth quarter of 1998, the actual reserve ratios of all major banks were higher than 15 percent. This shows that commercial banks did not need funds at all. They preferred to let their surplus money lie idle, with low interest, in the vaults of the central bank. In 1997, the main contributing factor to the increase in reserves was the increase in

<table>
<thead>
<tr>
<th></th>
<th>3.11</th>
<th>6.75</th>
<th>-8.92</th>
<th>-5.53</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserves</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PBC's assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net foreign assets</td>
<td>10.5</td>
<td>7.11</td>
<td>3.03</td>
<td>1.32</td>
</tr>
<tr>
<td>Claims to banks, etc.</td>
<td>1.6</td>
<td>1.08</td>
<td>-8.6</td>
<td>-6.78</td>
</tr>
</tbody>
</table>

Source: People's Bank of China.

Note: The figures for HPM are growth rates. Other figures are percentage point contributions to HPM growth.
foreign exchange reserves. To neutralise the effect of increase in foreign exchange supply on the exchange rate, the central bank injected a large quantity of currency into circulation, to soak up the excess foreign exchange.

In 1998, due to the influence of the Asian financial crisis, China's net increase in foreign exchange was very small. The government had to rely mainly on the open market operations (OMOs). However, the absolute amount of bonds the central bank could sell was limited. This situation changed in 1999 following the development of the money market and bond market, the total transactions of government bonds between the central bank and financial institutions through the OMOs was 707.6 billion yuan, a 3 fold increase over the previous year. The net increase in the monetary base resulting from the OMOs was 192 billion yuan, which constituted 52 percent of the increase in the monetary base (Dai Gen-you, 2001).

As the second link of the money-supply process, according to textbooks, there should be a stable money multiplier which, when applied to the quantity of reserves, would determine the quantity of bank loans, and thus the quantity of bank deposits. * This link was broken too. The monetary multiplier has never been stable in China. In 1998, quarterly figures for the multiplier varied from just over 3 to more than 4. * The variability of the multiplier in China has rendered this concept not very meaningful.

In 1999, the central bank did eventually succeed in increasing the monetary base by 380 billion yuan. Included in this increase, 190.7 billion yuan resulted from the open market operations, and 80.3 billion yuan from buying foreign exchange on the inter-bank foreign exchange market. However, despite the increase in the monetary base, the growth rate of M2 in 1999 was less than 15 percent. In contrast, the growth rates of M2 in 1996, 1997 and 1998 were 25.3 percent, 17.1 percent and 15.3 percent, respectively. This means that this time, the monetary multiplier shrank. The main cause behind the shrinking of the multiplier was reluctance by banks to lend. Another development in 1999 was that the growth rate of M0 and that of M1 in that year were 20.1 percent and 17.7 percent, respectively, much higher than in the previous two years. The increase in the growth rates of M0 and M1 was probably a result of the lowering of interest rates on household savings deposits, and of disintermediation.

During the period of deflation that began in late 1997, the effects of changes in the money supply and in interest rates, on real variables such as investment and consumption, were rather weak. In a period of inflation, the central bank can effectively bring inflation under control by tightening credit ceilings on commercial banks, and as a result of the trade off between inflation and lower growth rate, growth rate would drop, through the credit availability and other transmission mechanisms. However, during the deflationary period of the past several years, owing to structural problems, such as low productivity and profitability, lack of exit mechanisms, high debt-equity ratio, and overproduction in the previous period, enterprises were not responsive to the easier access to bank credits and lower interest rates. The relaxation in monetary policy failed in some areas to lead to increases in investment demand.
Instead, the capital market tended to absorb the increased liquidity. For example, in 1997, with the euphoria of China's coming restoration of sovereignty over Hong Kong, in contrast to the falling prices in the real sector, assets prices, especially stock prices increased drastically. In May of 1997, the average price-earning ratios of the 595 companies listed in Shenzhen and Shanghai stock exchanges were 47.74 and 51.62, respectively. In the same period in 1996 the corresponding figures were 18.20 and 23.75, respectively. The growth rates of the stock price indices in the two stock exchanges were 162.14 percent and 117.25 percent, respectively. Obviously, the newly available funds found their way to the stock exchanges rather than to the real sector.

To prevent the creation of a bubble economy, the government blocked the flow of funds from the banking sector to the stock exchanges by forbidding commercial banks to participate in the bond repurchase market. From 1998 to 1999, despite the fact that the central bank managed to maintain a growth in the money supply of around 15 percent, the real economy failed to respond to the increase, and the growth rate of GDP fell persistently during this period.

In 2000, China's central bank continued its expansionary monetary policy. However, despite government's efforts to increase the money supply, the growth rate of M2 was around 13 percent in 2000, lower than in the previous years. On the other hand, the growth rates of M0 and M1 maintained their high growth rates of 20 percent, since the last quarter of 1999. Owing to the weak link between expansion of the money supply and growth of the economy, the central bank has actually stopped targeting the growth rate of M2. The issue of shifting from money growth targeting to inflation targeting is not yet on the table. With the current extremely low inflation, all the government has been concerned about so far is to obtain a growth rate of higher than 7 percent, and all other considerations are of just secondary importance.

3. Interest rate policy

In developed countries, "the most important control instrument of the central bank is a short-term interest rate and this influences the behavior of commercial banks by determining the price at which they lend." (Allsopp and Vines, 2000, p.7). Interest rate policy is also an important instrument of monetary policy in China. Since 1999 the inter-bank money market has assumed a much more important role in influencing the liquidity and interest rate structure in the economy than it had before. However, owing to the fact that in China, except for a few interest rates such as the interest rates on the inter-bank money market, most interest rates are fixed by the central bank. As a result, in China there does not exist a benchmark interest rate equivalent to the Fed funds rate in the US, the bank rate in England and the official discount rate and overnight call rate in Japan. Though market forces determine a few key short-term inter-bank interest rates, these rates cannot influence the whole interest rate structure of the economy automatically via a certain ripple effect. The important interest rates that
would have direct impact on the real economy are those on household savings deposits and bank loans to enterprises. Bank loans to individuals such as mortgages are a very recent phenomenon. Since May of 1996, in order to prevent the economy from stumbling, the central bank began to lower interest rates. From 1996 to 1999, the central bank lowered interest rates seven times (Table 2). Especially, since July of 1997 to November of 1998, the central bank cut the interest on one year loans to financial institutions (re-lending rate) 4 times. Before the first interest rate cut on the first of May 1996, the interest rate on one-year savings deposits was 9.18 percent. After seven cuts, the same interest rate is now 2.25 percent.

Table 2. Changes in Interest Rates Since 1995

<table>
<thead>
<tr>
<th>Time</th>
<th>96.5</th>
<th>96.8</th>
<th>97.10</th>
<th>98.3</th>
<th>98.7</th>
<th>98.12</th>
<th>99.6</th>
</tr>
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<tbody>
<tr>
<td>Required reserves</td>
<td>8.82</td>
<td>8.28</td>
<td>7.56</td>
<td>5.22</td>
<td>3.51</td>
<td>3.24</td>
<td>2.07</td>
</tr>
<tr>
<td>Excess reserves</td>
<td>8.82</td>
<td>7.92</td>
<td>7.02</td>
<td>5.22</td>
<td>3.51</td>
<td>3.24</td>
<td></td>
</tr>
<tr>
<td>Relending (loans to financial institutions)</td>
<td>10.98</td>
<td>10.62</td>
<td>9.36</td>
<td>7.92</td>
<td>5.67</td>
<td>5.13</td>
<td>3.78</td>
</tr>
<tr>
<td>Rediscount</td>
<td>6.03</td>
<td>4.32</td>
<td>3.96</td>
<td>2.16</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>One-year time deposits</td>
<td>9.18</td>
<td>7.47</td>
<td>5.67</td>
<td>5.22</td>
<td>4.77</td>
<td>3.78</td>
<td>2.25</td>
</tr>
<tr>
<td>One-year capital formation loans</td>
<td>10.98</td>
<td>10.08</td>
<td>8.64</td>
<td>7.92</td>
<td>6.93</td>
<td>6.39</td>
<td>5.85</td>
</tr>
</tbody>
</table>


The lowering of interest rates in 1999 failed to stimulate investment and consumer demand in a significant way. According to the author's study, the interest elasticity of consumer demand in China is low, due to the special features of China's institutional arrangements (Yu Yong-ding and Li Jun, 2000). Furthermore, in recent years, in response to the changes in the money supply and interest rates, households adjusted their portfolios to hold more stocks and bonds, rather than changing their propensity to consume.

It seems that owing to the insensitivity of the real economy to changes in interest rates, in order to stimulate the economy, interest rates should be further reduced. Especially, when we take into consideration the fact that the Chinese economy was suffering from deflation, the real interest rates were not as low as they seemed to be. However, the possibility that a further cut in interest rates may lead to another surge in stock prices, * and the worsening of capital flight, has made the Chinese government very cautious about further cuts.

Although the contribution of interest rate cuts to economic growth was not very obvious, on the whole, the cuts were conducive to improvement of the economy as a whole. Firstly, interest rate cuts greatly reduced the debt burden of enterprises. The decrease in debt burden helped enterprises to improve their financial situation and their profitability, which in turn, encouraged and enabled enterprises to increase their investment. Secondly, interest cuts provided opportunities for adjustment of the
interest structure. Since 1998, the spreads between commercial banks' lendings to enterprises and their borrowings from the central bank and the public have increased. Increase in interest rate spread in favor of commercial banks is conducive to improvement of management, and provides banks with more incentive to lend. Thirdly, the cuts in interest rates encouraged funds to flow into the government bond and public corporation bond markets. In fact, the demand for government bonds has been high. In recent years, households have been queuing up to buy government bonds. Consequently, the cost to the government of the use of expansionary fiscal policy has been reduced. Of course, a more fundamental reason for the low yield of government bonds and public corporation funds is the high savings rate in China. Anyway, the expansionary monetary policy, especially the low interest rate policy, has harmonized quite well with an expansionary fiscal policy. In view of the failure to achieve a stable money-supply process, and reliable transmission mechanisms, China sooner or later will officially turn away from money supply targeting, and interest rates will become a much more important monetary instrument. To bring interest rates into full play as the most important monetary instrument, a further liberalization of interest rates is inevitable in the near future.

III. China's Fiscal Policy —Also in Response to N. Lardy's Argument

Since the second half of 1998, while maintaining an accommodating monetary policy, the government has shifted the emphasis of macroeconomic policy from monetary policy to fiscal policy, due to the ineffectiveness of the former in revitalizing the economy. The table below shows that because of the adoption of expansionary fiscal policy, compared with the year-end of 1997, China's budget deficit/GDP ratio in the year-end of 1998 jumped by 49 percent (Table 3).

<table>
<thead>
<tr>
<th>Year</th>
<th>Expenditure (billion yuan)</th>
<th>Revenue (billion yuan)</th>
<th>Deficit (billion yuan)</th>
<th>Deficit/GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>740.8</td>
<td>793.8</td>
<td>53.0</td>
<td>0.78</td>
</tr>
<tr>
<td>1997</td>
<td>865.1</td>
<td>923.4</td>
<td>58.2</td>
<td>0.78</td>
</tr>
<tr>
<td>1998</td>
<td>987.6</td>
<td>1079.8</td>
<td>92.2</td>
<td>1.16</td>
</tr>
<tr>
<td>1999</td>
<td>1137.7</td>
<td>1313.6</td>
<td>175.9</td>
<td>2.14</td>
</tr>
<tr>
<td>2000</td>
<td>1338.0</td>
<td>1587.9</td>
<td>249.9</td>
<td>2.80</td>
</tr>
</tbody>
</table>


As a result of the continuation of expansionary fiscal policy in 1999, the budget deficit was dramatically increased from 92.2 billion yuan in 1998 to 176 billion yuan in 1999, a 91 percent increase. Meanwhile, the budget deficit/GDP ratio increased from 1.16 percent in 1998 to 2.14 percent in 1999, an increase of 84 percent.
In 2000, while the government continued its expansionary fiscal policy, a new feature emerged: China's tax revenue increased dramatically. Government revenue rose to 1338 billion yuan, a 17.6 percent increase over the previous year. This rapid increase in tax revenue was attributable to an improved macroeconomic situation, the improvement in tax collection, the increase in exports and imports, and the increase in stamp tax on transactions in the stock markets.

The experience over the past two and a half years shows that expansionary fiscal policy was effective. The increase in government expenditure in public works since the second half of 1998 did succeed in bringing about increases in the growth rate of investment. However, expansionary fiscal policy failed to bring about self-sustained growth of the economy. In fact, whenever the government slowed down its injection of financial resources into public works, the growth rate of investment would slow down in tandem.

A consensus among Chinese economists was that to place growth on a self-sustainable basis, China has to speed up structural reform, which includes establishing a decent social safety net, improving the governance of SOEs, clearing NPLs, and preparing enterprises in different industries for the WTO entry. However, as the experience of other Asian economies has shown, restructuring will inevitably have a negative impact on growth in the short run. There is a problem of trade-off between growth and restructuring. As far as fiscal policy is concerned, the Chinese government has been quite successful in combining the two in a way that growth and restructuring supplement each other. China's government expenditures were used mainly in building infrastructure, reforming the social security system, and, more recently, developing the economically backward western regions. This means that the increase in government expenditure not only constitutes extra effective demand, but also provides finance for the restructuring directly. For example, on the one hand, the Chinese government made it crystal clear that public money would not be used to prop up sick enterprises and save them from bankruptcy. On the other hand, it has speeded up the efforts in establishing a social safety net in line with the best practice of advanced countries and China's reality. The reform of the social security system has paved the way for the deepening of SOE reforms in the future. This time, the Chinese government is very conscientious in using market mechanisms to ensure that public money will be used more efficiently. When the government has decided to support a certain project, it will finance it only partially. The contractors whoever they are have to find the bulk of the finance themselves on financial markets, and subject their projects to the scrutiny of market forces.

Some economists have serious doubts about China's fiscal sustainability. For example, in his refutation to Stephen Roach, the Chief economist at Morgan Stanley Dean Witter who once argued that "China's non-performing loan problem should properly be viewed as a government solvency issue—hardly problematic with total government debt unlikely to exceed 50 percent of GDP at any point in the next five years", *
Nicholas Lardy, an American expert on the Chinese economy, argued that "These sanguine views fail to take account of four factors: the level of government revenues relative to gross domestic product (GDP); the substantial buildup of treasury debt in recent years, the large and growing stock of non-treasury government debt, and the size of non-performing loans, not only in the four major state-owned banks but throughout the financial system.*

The author basically agrees with Mr. Roach's judgment. It seems to me that Mr. Lardy's propositions exaggerate the weakness of China's fiscal position and miss the point. Firstly, the decline of government revenues relative to GDP from 1978 to 1995, to a large extent, was a result of economic reform, and is transitional. The decline can be reversed in due course, as long as a decent GDP growth rate can be maintained, which is just what China has been achieving. In fact, as can be deduced from Table 3, between 1996 and 2000, the average annual growth rate of government revenues was 19 percent, much higher than that of GDP. Even more remarkably, in 1999 and 2000, the growth rates of government revenues were 21.6 percent and 20.8 percent, respectively. *

As a result, government revenues relative to GDP have increased from 10.7 percent in 1995 to more than 15 percent in 2000. This increase has continued for four years in a row and is accelerating rapidly, and hence cannot be dismissed as a one-off event. The trend is very clear: the proportion of government revenue as a component of GDP has been increasing steadily.

Figure 3. China's Debt/GDP Ratio

Sources: Research Group for Fiscal Issues during the Tenth Five-Year Plan, State Development Planning Commission, Reference for Economic Studies, July 16, 1999

In considering China's fiscal sustainability, one important factor must be taken into consideration. That is, the savings behavior of Chinese households. One of the most important features of the Chinese economy so far is the high savings rate of Chinese households. As long as this savings behavior does not change much, the government will encounter no serious problem in selling government bonds. Mr. Lardy must know
that despite the fact that the interest rates on government bonds today are very low, Chinese households are still queuing up for government bonds. In Japan, despite the zero interest rate and an extremely high debt balance/GDP ratio of 140 percent, Japanese are still buying Japanese government bonds, and the yield of 10 years government bonds is still as low as less than 2 percent. There is no convincing evidence or thorough economic rationale which shows that China will face a fiscal crisis in, say, 5 years' time.

IV. Concluding Remarks

Since reform and opening up, China has obtained remarkable achievement in economic progress. Despite all its problems, China's macroeconomic management of the economy is a successful story. China has maintained a high growth rate for more than two decades. Now China has to prepare itself to face financial and fiscal instability in the near future, but all its problems are surmountable. As long as China is able to maintain social stability by establishing a decent social safety net and arresting the further widening of inequality, China's future will be very bright indeed.

References


Source: China & World Economy Number 6, 2001 http://www.iwep.org.cn/