The Economics of China

Macroeconomic Policy: Instruments and Outcomes

Fall 2020

Macroeconomic Policy: Instruments and Outcomes

- The Objectives of Macroeconomic Policy:
  - **Good macroeconomic policy is that which provides "full employment" of resources and stable prices**.
  - That is, (economic) growth with low inflation.
  - Full employment of resources means that actual output is at or near maximum "potential output".
  - Full employment does not necessarily mean that the unemployment rate is zero.
  - This is because among other reasons, at any point there will probably always be some people searching for jobs.

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- The Objectives of Macroeconomic Policy:
  - In principle, **macroeconomic policy cannot push (short-run) real growth above the (short-run) potential growth rate** for a sustained period of time.
  - Hence, it is important to get the potential growth rate right.
  - Problem? There are different estimates for the "potential" growth rate.
  - For example, recent estimates for the potential growth rate in China range between 4% and 8%.
  - The growth target set in the 13th Five-Year Plan (2016–2020) implies a 6.5% annual growth rate.

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- The Objectives of Macroeconomic Policy:
  - Shocks to the economy are inevitable and can be negative or positive, domestic or foreign.
  - For example, oil prices worlwide may drop due to discovering significant new reserves.
  - Therefore, **another aspect of macroeconomic policy is "stabilization policy."**
  - This means keeping the disruptions from shocks at minimum.

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- The Demand Side and Macroeconomic Policy Instruments
  - **Potential output** is usually determined by the **"supply side"** of the economy.
  - That is, in any given year for example, the amount of physical and human capital available, the size of the labour force, and the level of "productivity", determine the maximum amount of output that the economy **can produce**.
  - **Actual output**, what the economy **actually produces**, and therefore the level of employment and capital utilization, is determined by the **"demand side"**.
  - Macroeconomists usually divide aggregate (total) demand into four components: private consumption (C), private investment (I), government expenditure[1] (G), and net exports (X − M).

[1] includes government spending on "consumption" and on investment

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- The Demand Side and Macroeconomic Policy Instruments
  - In any given year, **Actual GDP = C + I + G + (X-M)**
  - Recall that full employment means bringing actual GDP at or near potential GDP.
  - Policymakers can achieve this using macroeconomic policy instruments, namely: fiscal, monetary and exchange-rate policy.
  - Each of these instruments can affect one or more of the aggregate demand components.
  - This, in turn, plays a role in determining the overall price level and the inflation rate.

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- Fiscal, Monetary and Exchange-Rate Policies, in a nutshell.
  - Fiscal policy has to do with taxes/subsidies/transfers (T) and government spending levels (G).
  - private consumption investment .
    T can affect the levels of C and I (and G!).
  - In addition, G directly affects actual GDP, and can spillover to other demand components through "multiplier" effects.
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  - Monetary policy has to do with "money supply" and interest rates.
  - This affects I and C mainly, but can also have indirect effects on G and (X-M).
  - Finally, exchange-rate policy has to do with the value of a country's currency which mainly affects (X-M).

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- Expansionary vs. Contractionary Policies.
  - Expansionary policies (to increase demand) include:
    - (1) monetary policy lowers interest rates or increases the growth of money and credit.
    - (2) fiscal policy yields a larger budget deficit (higher G and/or lower taxes).
    - (3) the domestic currency depreciates (or is set at a lower value).
  - Contractionary policies (to decrease demand) include:
    - (1) monetary policy increases interest rates or decreases the growth of money and credit.
    - (2) fiscal policy yields a lower budget deficit (lower G and/or higher taxes)
    - (3) the domestic currency appreciates (or is set at a higher value).

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- Macroeconomic Policy in Action:
  China's response to The Global Financial Crisis, 2008–2009:
  - Starting in the United States, "The collapse of Lehman Brothers on September 15, 2008, marked the beginning of full- fledged crisis" globally.
  - Subsequently, "China's prompt and aggressive policy-making began to have an unmistakable effect on China's economy and the world".
  - China "announced a 4 trillion RMB ($580 billion) fiscal stimulus program".
    v. stimulate.
  - "The response to the November 2008 stimulus decision was remarkably rapid".
  - "By January 2009, there were clear signs of increased investment activity".
  - In addition, monetary policy encouraged increased demand.
  - "The excess (above-normal) lending in just the first half of 2009 was equal to 14% of GDP".

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- The Success of China's response to The Global Financial Crisis: **Beyond Standard Macroeconomic Policy**
  - Why was the response rapid and how did investment increase in a middle of a global financial and economic crisis?
  - "Private investment demand ordinarily would drop in the face of reduced external demand and increased uncertainty".
  - The answer is in China's political and economic (state-capitalist) system, at least in part.
  - Recall that the banking system is predominantly state owned.
  - "State-owned commercial banks were instructed to carry out a relaxed credit policy to support increased investment".
  - Also recall that local officials are "evaluated and promoted on the basis of the success of local economic development".
  - Hence, a "typical local government has a queue of projects waiting to be approved".
  - This in turn means that "the response to the increased availability of credit was rapid".

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Table 18.1
Stimulus package investment plan (November 2008).

	Billions of RMB	Composition
Earthquake reconstruction (previously committed)	1,000	25%
Transport and power infrastructure (railroads, roads, airports, electricity grid)	1,800	45%
Rural village infrastructure	370	9%
Environmental investment; natural areas	350	9%
Affordable housing	280	7%
Technological innovation and structural adjustment	160	4%
Health and education	40	1%

Source: Naughton (2009).

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- "Legacies of the Chinese Stimulus Program"
  - While GDP growth was low or even negative (like -2.5% in the U.S.), GDP growth in China "rebounded to 9.2% for all of 2009".
  - "Moreover, Chinese policy contributed to global economic recovery".
  - "Chinese demand for imports began to recover in the second quarter of 2009".
  - "The big negative contribution that net exports made to China's growth in 2009–2010...was a positive contribution to the rest of the world, rebalancing the global economy and contributing to the recovery of global demand".
  - "China 'gave back' the increase in net exports that had fed its growth in 2005–2007 in a way that was timely and significant".
  - Meanwhile, there was an increase in local governments' debt in China.

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- Overall Assessment of Macroeconomic Policy in China after 1978.
  - In the 1980s and 1990s, China faced "bursts" of high inflation.
  - Eventually, with the development of the the People's Bank of China (PBC) as a central bank and the achievement of monetary discipline, price stability was achieved.
  - Inflation rate dropped from 10.1% (1983 through 1996) to 2.0% (1997 through 2016).
  - China has not experienced a major recession since 1990, and the unemployment rate has been stable at around 3-4% since 1997.
  - Rapid growth and full employment of resources have been achieved with moderate inflation, especially since 1997.
  - This indicates that China's macroeconomic policy has been successful overall during that period.

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- Macroeconomic Policy After the High-Growth Era.
  - Since 2012, "Chinese macroeconomic policy has been consistently expansionary".
  - "credit has grown rapidly".
  - "Fiscal deficits expanded in 2015 and 2016".
  - "Currency depreciation was allowed until the policy became unsustainable in late 2016".
  - It seems that Chinese "macroeconomic policy-makers are leaning hard against the tendency of the economy to slow down after the end of miracle growth".
  - "Today, labor-force growth has dropped rapidly, while overall demand for labor is still high, and there are not as many reserves of underutilized labor as before. This creates a new dynamic in labor markets: unemployment may become less of a problem, but macroeconomic policy-makers may eventually face a more challenging trade-off between unemployment and inflation".