The Economics of China

Monetary Policy and The Financial System in China

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Monetary Policy in China

- What is money supply?
- One definition of money supply is currency in circulation (i.e. cash) plus current or chequing deposits in banks.
- What is monetary policy?
- Loosely speaking, it is managing money supply (and therefore interest rates and the exchange rate) in the economy.
- Monetary policy must be conducted in a way that meets macroeconomic policy objectives of price stability (official goal in many places) and full employment.
- Monetary policy may affect the outcomes of 财政. fiscal policy.

Monetary Policy in China

- In a typical market economy, **money supply is determined through an interaction between the central bank and commercial banks.**
- The central bank first "creates" money by buying assets (this usually includes government bonds, loans to commercial banks, and foreign currency).
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- The proceeds from the central bank's purchase of assets become either currency in circulation or deposits in commercial banks (hence part of money supply).
- Commercial banks in turn use these deposits to "buy" assets (usually by making loans).

Central Bank → Commercial Bank → Assets (loan).

- Again, proceeds from the commercial banks' purchase of assets become part of the money supply and so on.
- **How much do commercial banks add to money supply?**
- It's determined by the fraction of deposits they keep as **"reserve"**.
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Monetary Policy in China

- In principle, "commercial banks are required to maintain deposits at the central bank equal to a fixed proportion of their total deposits".
- In some countries, like China, this is determined by the central bank through a **"required reserve ratio"** (rr).
- The additional money supply "created" by commercial banks is referred to as the **"money multiplier"** (MM).
- There is a "simple" direct relationship between rr and MM.
- **MM = 1/rr.**

Monetary Policy in China

- The previous discussion gives us two basic policy instruments that central banks can use to "control" money supply:
  - **Direct "money creation"** through buying assets.
  - **Setting and adjust rr**, which determines the size of the money multiplier which in turn determines the "upper limit" for the additional money supply created by commercial banks.
- A third tool that can and is used by central banks is **interest rate targets.**
- "Raising or lowering official interest rates, thus indirectly changing the supply of base money. The central bank provides credit to commercial banks, so lowering the interest rate will increase borrowing by commercial banks from the central bank."

Monetary Policy in China

- In advanced economies like the United States and Canada, interest-rate targeting has been the main monetary policy tool used over the past three decades.
- This has not been the case in China.
- **In China, "quantity instruments (have been) more important than interest-rate instruments".**
- "changes in base money, driven by changes in foreign-exchange reserves, have been large".
- In addition, "PBC[1] has regularly adjusted the required reserve ratio".

[1] People's Bank of China.

Monetary Policy in China

- Also, in advanced economies like the United States and Canada, monetary policy-making is independent (in principle) from the government.
- That is, once the governor of the central bank is appointed, he or she is responsible for making monetary policy decisions.
- In contrast, "in China monetary policy decisions are made by the premier and are ratified by the Standing Committee of the Communist Party Politburo".
- "In practice, the PBC is extremely influential and often will have the premier's ear".

The Financial System in China

- A few concepts about any financial system first.
  - What do we want from the financial system?
  - One thing we want is to "efficiently" channel savings into productive investments.
  - "two main types of financial institutions that transfer funds from savers to investors: **banks and capital markets**".
  - Banks act as intermediaries between savers and borrowers.
  - Financial (capital) markets provide direct finance since borrowers "obtain funds directly by selling bonds (fixed-income securities) or stocks (ownership claims)".
  - 经济主义
  - Does a laissez-faire financial system do what we want it to do?
  - Check out the Great Depression of 1929 (starting with a stock market crash in the U.S), Great Recession of 2009 (starting with the Financial Crisis in 2007-2008) and the other financial crises in between.[2]

[2] You can also check "Stabilizing an Unstable Economy", a book by Hyman Minsky.

The Financial System in China

- A few concepts about any financial system first.
  - The financial system creates financial 衍生物 assets (such as stocks and bonds in addition to bank deposits).
  - When financial assets increase relative to GDP, this is called **"financial deepining".**
  - When the financial system creates more and more different types of financial assets, this is called **"financial broadening".**
  - "Until around 2009, the **financial system in China** could be summarized in two words: **'deep' and 'narrow'**."

The Financial System in China

- The financial system in China is "deep" because the ratio of financial assets to GDP has increased to one of the highest in the world (211% in 2016).
- The financial system has been dominated by banks; capital markets have been less important.
- As a result, the financial system in China has been "narrow", since the main types of financial assets were simply bank deposits.
- Also, "since nearly all the important banks are state owned, China's financial system is also state dominated".

The Financial System in China

- With this state-dominated financial system, China:
    - is "an extremely high-saving economy" (the saving rate in China was 49% of national income in 2014).
    - was able to maintain high levels of investment for decades of miracle growth.
    - did not have to rely on foreign borrowing like other developing countries.

The Financial System in China

- "The high saving rate can be mechanically explained by three factors"
  - "**household saving rate is high**, and households account for almost half of total saving".
  - Overall, the government has also been "a net saver".
  - Finally, "business income is a relatively high share of national income, and all of business income is saved and re-invested".
- "Corporate net income was 21% of GDP in 2014 in China, compared to about 10% of GDP in 2013–2015 in the United States, during a period of historically high profits".

The Financial System in China

Table 19.1
Simplified flow of funds.

	Household (trillions of RMB)	Business (trillions of RMB)	Government	Total domestic
Value added	15.7	43.9	4.8	64.4
Total disposable income	39.1	13.2	12.2	64.5
Savings	14.9	13.2	3.6	31.7
(Saving rate)	38%	100%	29%	49%
Gross capital formation	7.7	19.3	3.4	30.3
Net financing + acquisitions	7.2	–5.6	–0.2	1.4

Source: *SYC* (2016, table 3-21).

The Financial System in China

- Recent trends in the financial system in China:
  - Rapid increases in 合计的 aggregate debt ("China's aggregate nonfinancial debt has increased from 179% of GDP in 2012 to 236% of GDP at the end of 2016").
  - A recent increase in nonperforming loans (between 2012 and 2016, although numbers looked worse in 2007).
  - Increased role of "shadow banking".[3] An example is Alibaba's Yu'e Bao.
  - These trends mean that there is an increase of risk in the financial system, which may lead to a financial crisis.

然后阿里就被查水表了
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[3] As defined in the textbook, "Shadow banks are institutions that do the same thing as banks but without being subject to the same regulatory oversight as banks".