

China's Macroeconomic Policy: A Policy of Ambition and Pragmatism

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Abstract

This paper examines China's evolving macroeconomic policy as it transforms its economy from a planned to a semi-planned and then to a market economy. By most measures China's post-1978. macroeconomic policy has been a success. China has experienced high and uninterrupted economic growth for forty years often, except for a few years after 1989, with annual growth rates in double digits. How did they do it? In particular, how did they manage to achieve what appears to be over this period a successful macroeconomic policy?

It will be argued in this paper that the definite feature of China's macroeconomic policy is not conventionally defined; it is ambitious but also pragmatic, adopting policies that take into account of China's unique circumstances. China's officials see macroeconomic policy as a means to maintain high employment and price stability, but they also regard it as an important tool to support developmental state policies that contribute to high economic growth and global strategic objectives of the state. While Chinese policymakers implement a policy of gradual economic liberalization, including the development of stock markets and a shadow banking system that offers some flexibility in an otherwise tightly controlled financial system, they have never hesitated to reassert greater centralized control when external and internal developments, such as the global financial crisis and later massive capital outflows threaten macroeconomic and political stability, and/or undermine the country's ability to pursue its core strategic objectives.

Introduction

The focus of macroeconomic policy research is often biased towards the short-run, using fiscal and monetary policies to minimize economic volatility by manipulating demand to counter unexpected demand and supply shocks. China's macroeconomic policy on the other hand is consciously aimed at both the short and long runs, simultaneously to influence both the demand and supply sides of the economy.

Government policy plays a significant role in influencing a country's technical innovation and combating climate change and its effects. Therefore, China's approach to macroeconomic policy is particularly noteworthy as the 2018 Nobel prize in economics were awarded to Paul Romer and William Nordhaus for their work on the supply side of macroeconomics. Romer was awarded his prize for his research on how technical innovation explains growth and Nordhaus, on the economics of climate change. China's technical innovation and climate change projects are important elements in its state developmental policy (SDP) for promoting what it regards as strategic industries. Its macroeconomic policy is to smooth out economic volatility in the face of economic shocks and to support SDPs that contribute to high economic growth and the global strategic objectives of the state.

China's macroeconomic policy is therefore unambiguously ambitious, but it is also flexible and pragmatic. Its policymakers craft policies that are often not in accordance with conventional thinking, but they take into account the country's unique circumstances. These are China's geographical location and size, its level or stage of economic development at a given point in time and constraints imposed by regional or global economic conditions. In reforming the country's previously planned economy its policymakers have implemented a policy of gradual economic liberalization, including establishing stock markets and allowing the development of a shadow banking system with fewer regulations that offers some flexibility in an otherwise tightly controlled financial system. Nevertheless, Chinese policymakers have often been decisive and never hesitated to reassert greater centralized control when external and internal developments, such as the global financial crisis (GFC) and later massive capital outflows threaten macroeconomic and political stability, and/or undermine the country's ability to pursue its core strategic objectives.

Yet policymakers even in the midst of increasing control over capital movements during the GFC were loosening the chains of local governments and encouraging local initiative in a bold move to prevent the economy's growth from slowing or even falling into a recession. One could perhaps describe the yin-yang actions of policymakers during the GFC as macro tightening and micro loosening. Being pragmatic is to recognize that successful macroeconomic policy implementation is more of an art than rigidly following a fixed recipe regardless of circumstances; it is to balance a country's often conflicting objectives given the specific nature of its economy at a particular point in time.

The Renminbi: More of a Monetary Anchor than a Growth Driver

While not underplaying the role of exports in China's economic growth, their contribution has more to do with the management and technical know-how that foreign-invested firms brought into the country than as the key driver of aggregate demand. Data from China's National Bureau of Statistics showed that from 2001 to 2004 the contribution of net exports to the country's growth was no more than 0.7 per cent out of annual growth rates of around 10 per cent (Liew 2009:3). They rose to a peak of 2.6 per cent in 2007, when its current

account surplus reached 10.1 per cent GDP and GDP growth reached 14.2 per cent. At the peak of the GFC in 2009 net exports contributed negative 3.5 per cent to GDP growth. In that year growth in domestic investment of 22.9 per cent compensated for the negative contribution of net exports to produce a growth rate of 9.2 per cent (IMF 2012: 37). The contribution of net exports to GDP growth never reached positive 1 per cent after the crisis and in some years were even negative (IMF 2018: 43, World Bank 2011: 11). Eswar S. Prasad (2016), a former head of the IMF China Division, emphasized this point indirectly in his opinion piece in the *Washington Post* during the 2016 US presidential election primaries where he labelled the idea that cheap exports have been propelling China's growth as a 'myth'. China's domestic demand, especially infrastructure investment in the past and consumption at the present, instead of net exports has been the main driver of its economic growth. The relative importance of domestic demand in China's growth story is consistent with standard trade theory with constant returns to scale, which states that large countries tend to gain less from free trade than small countries. The reason is the gap between the pre-trade and free trade prices are larger for small countries than for big countries, which produce larger specialization and exchange gains for the former. The potential gains of unrestricted foreign trade to large countries can even be smaller when we account for the potential gains from exploiting increasing returns and network externalities through the introduction of strategic trade policy.

Since economic growth is largely domestic and not export driven, exchange rate undervaluation has not been the reason for China's high economic growth. Why is this so when the country's export-GDP ratios are so high? In the preceding years before the global crisis hit Chinese exports the ratios were over 30 per cent; after the crisis the ratios were still over 20 per cent (IMF 2012:37). China's entry into the WTO did bring about a boom in Chinese manufacturing exports, which conferred China the reputation as the 'world's factory' and gave credence to the export-led growth thesis of the China's economy. However, its domestic value-added share in manufacturing exports is very low, lower than that of its major trading partners (Wen 2018). About half of China's exports are based on 'triangular trade', where the final processing and assembling of exports from China's OECD neighbours – Japan and South Korea – is performed in China for dispatch to markets in Europe and North America. A good example to illustrate this trade is Apple products. The then highly popular iPod assembled in China and sold in the USA for US\$299, increased the latter's trade deficit with China by US\$150 for each iPod imported, but the assembly work in China only value-add 'a few dollars' (Linden et al. 2009: 144). Each iPhone or iPad imported into the US from China increased the US deficit with China by US\$229 to US\$275, but cost Apple only \$10 worth of Chinese labour (Kraemer, et al. 2011:6). Lawrence Lau and his colleagues re-estimated the 2015 US trade deficit with China after adjusting for intermediate inputs and came up with a deficit of only US\$132.7 billion, compared to the initial estimate of US\$367.4 billion based on US trade data (Lau, et al. 2017).

China's exchange rate was an important foreign trade policy instrument before the country's liberalization of foreign trade and the reunification of its planned and market based exchange rates in 1994. Non-state firms were free to export and state-owned foreign trading firms, which were making loss exporting at the higher planned exchange rate, no longer had to export at the higher planned exchange rate after 1994; they could export at the lower market rate. Once firms were no longer forced to export at the higher planned rate, the dominance of triangular trade in China's exports with their low domestic value-add and a flexible labour market reduced the importance of the renminbi exchange rate in foreign trade.

It is worth reminding ourselves it is the real exchange rate, not the nominal exchange rate that matters. While Chinese policymakers have some control over the nominal exchange rate, they have limited influence over money wages and therefore the real exchange. China's export sector, which is dominated by foreign-invested firms, has a largely free labour market. Currency fluctuations create uncertainty and are debilitating for foreign trade transactions and when China's financial system was very much underdeveloped without well-developed forward markets and a system of currency hedging, it made sense for Chinese policymakers to peg the renminbi to the dollar, the currency of its major trading partner, as the nominal anchor of monetary policy and had the labour market, with its high degree of wage flexibility and labour mobility, provide real exchange rate flexibility.

In 2002, a year after China was admitted into the WTO, the average manufacturing wage in China was between US\$0.56 to US\$0.67 per hour and the average urban manufacturing wage was US\$0.91 to US\$1.09 per hour (Bannister 2004: Table 7). They were about 3 per cent of the costs in the US, a quarter of those in Brazil and Mexico, and ten per cent of the average costs in Hong Kong, Singapore, South Korea and Taiwan (Banister 2005:32). These were very low wages and clearly made Chinese exports highly competitive in global markets, regardless of the nominal exchange rate.

Money wages tend to be rigid downwards, especially in economies with strong unions. Policymakers therefore favour a currency devaluation to lower the real wage in the event of a negative economic shock that might require an adjustment in labour costs. It does not work quite the same way in the opposite direction when there is a shortage of labour and the pressure is for real wage increases. A cap on nominal currency appreciation could just mean higher nominal wage increases, as the experience of China's export sector demonstrates. Between 2006–2015 as the demand for labour increased in response to the Chinese economy's double-digit or near double-digit growth, the average real wage in China grew by over 100 per cent, (ILO 2016 : 12) and the average real effective exchange rate, except for a small decrease of -0.5 per cent in 2010, increased each year (IMF 2012:37, 2016:39). And despite the renminbi depreciating as a result of recent US tariffs and the overt political pressures on the US Treasury it has not labelled China as a currency manipulator. Currency manipulation is not China's preferred instrument for export promotion.

Pragmatism in the Face of Inflation

Macroeconomics under central planning in China was comparatively simple. Monetary policy and the exchange rate played little role in allocating domestic resources and foreign exchange and there was almost zero foreign investment. The country's economic plan regulated the demand for foreign exchange according to available supply and domestic prices of goods were set according to the planners' choice between the level of open inflation and the amount of forced savings (Liew and Kawaguchi 1995). It is only with economic reform and China's opening up to the global economy, especially since its entry into the WTO in 2001, that monetary and exchange rate policy have become important instruments of macroeconomic policy. Policymakers face a newer policy environment where decisions on foreign exchange, domestic price inflation, the interest rate and capital flows have to be considered together and not easily treated individually.

Price inflation is a particularly sensitive issue in the People's Republic due to the role that inflation played in destabilizing the previous regime, which helped brought it to power. Before 1983 the People's Bank of China (PBC), acted as a commercial bank as well as the

country's de facto central bank. Until January 1978 PBC was under the Ministry of Finance. It was only in 1983 that it officially became China's central bank, with ministry level status. Its position as China's central bank was formally enshrined by the PBC Act of 1995. The Act specifically gave responsibility for monetary policy to the PBC. It was mandated to manage all financial policies under the guidance of the State Council and took over from the Price Bureau the responsibility of maintaining price stability. The PBC to conduct exchange rate policy competently is therefore to manage inflationary expectations as well as foreign trade effectively.

The Mundell-Fleming (M-F) policy trilemma states a country can only have two out of three currency policy choices: free capital mobility, independent monetary policy and fixed exchange rate. It cannot have all three. China did not have to concern itself with the M-F trilemma under central planning. But this changed with China's opening up and it becoming the world's major exporting country. Chinese policymakers, with a pegged exchange rate, had to confront the M-F dilemma in the face of significant inflationary pressures brought about by the rush of current account surpluses after China's entry into the WTO threatened their ability to control the country's money supply.

In 2005–2007, China's current account surpluses hit the heights of 7.1, 8.6 and 10.1 per cent GDP, with net exports contributing in absolute percentages, 2.6, 2.1 and 2.6 per cent to the then double digit GDP growth rates (IMF 2010:31, IMF 2012:37). The Chinese economy in the few years before the GFC experienced the largest shares of net export growth in total GDP growth in the first decade of China's post-WTO entry. Expectations of renminbi revaluation in global markets were heightened and they encouraged large speculative capital inflows, which bypassed capital controls, into China. In the face of the M-F dilemma, policymakers unpegged the renminbi from the US dollar in 2005 and introduced a managed rate, dampening annual inflation with the industrial producers' price index (IPPI) in 2005 increasing a relatively modest 3.1 per cent compared to a 8.2 per cent increase the year before (Liew and Wu 2007:186). Inflation pressures took off again with the massive government stimulus in response to the GFC. The crisis and China's increasing share of trade in the global economy, and attractiveness as a destination for volatile speculative capital flows soon convinced Chinese policymakers the merits of a more flexible, rather than a pegged, exchange rate.

The PBC had, with a pegged exchange rate, sterilized capital inflows selling domestic bonds. But sterilization of foreign asset purchases became more difficult and less effective in controlling the money supply in the face of aggressive monetary quantitative easing (QE) in the developed economies in response to the GFC. Before the GFC Chinese interest rates, reflected by the SHIBOR (Shanghai interbank offer rate), were generally lower than short-term US interest rates, reflected in the 3-month US treasury bill rates, resulting in a profit for the PBC from sterilization. The profit from sterilization turned to a loss for the PBC with QE; the SHIBOR-US treasury bill rate gap changing from a positive approximately 2.5 per cent interest difference to negative 6.5 per cent (Chang et al. 2015: 27). Sterilization was simultaneously becoming less effective in controlling the money supply. In 2000–2006 there was almost complete sterilization; foreign reserves had increased significantly with the monetary base mostly unaffected. But the money multiplier had increased significantly with growing marketization so much so that the money supply, measured by M2, and bank credit had increased in line with the increase in foreign reserves. These developments forced the PBC to turn to raise the reserve requirement ratio (RRR) to limit expansion of the domestic money supply (Cun and Li 2017).

Sterilization is challenging, but it does not mean that managing massive speculative capital inflows and retaining monetary autonomy would be much easier had China adopted a fully flexible change rate, as the experiences of many emerging economies during the QE policy of the advanced economies demonstrated. China's exchange rate and foreign capital flow policy has multi objectives and is constrained by a global financial system that is dominated by the United States and European Union. China's management of its exchange rate symbolizes the pragmatism of its policymakers.

Monetary Policy Against Regional/Global Crises

China's use of monetary policy is ambitious and pragmatic and at times aggressive. Preserving the country's monetary autonomy is the bedrock of its monetary policy and an important reason for China's capital controls. Chinese policymakers want to have the freedom to influence domestic interest rates to achieve the country's long-term economic and security strategic objectives. The Mundell-Fleming (M-F) impossible trinity of international economics has long been accepted by policymakers and this insight had won the Nobel prize for Robert Mundell. But according to Helene Rey, because of the potential massive global speculative capital flows of international banks in the US and EU, a flexible exchange rate is insufficient to guarantee a country an independent monetary policy. The US, especially, is at the core of the global economic system. The rest of the world cannot inoculate themselves with their flexible exchange rates against unfavorable consequences of US monetary policies. They face a 'dilemma'—a country can have an independent monetary policy if and only if its capital account is managed, 'directly or indirectly' (Rey 2013). Thus, when the US responded to the GFC aggressively with QE, emerging economies could not insulate themselves even with flexible exchange rates against excessive expansion of their money supply from massive capital inflows. Rey's 'dilemma' has found support in the research of Blanchard (2016) that examines the policy effectiveness of emerging economies responding to the advanced countries' extreme low interest rate policy during the GFC. In Blanchard's analysis, emerging economies relied chiefly on capital controls in their foreign exchange interventions to shelter their financial systems from the QE policies of the advanced economies.

China faced Rey's dilemma during the GFC, but also in the opposite direction of a heavy pressure on currency depreciation from capital outflows on two other separate occasions: during the Asian financial crisis (AFC) and now, with lower growth expectations that are reinforced by its trade war with the US. In the M-F model large capital outflows are moderated by depreciation of the domestic currency, which allows lower domestic interest rates that would have been the case with a higher exchange rate. But Rey's 'dilemma' suggests that in the presence of large speculative capital outflows the potency of depreciation of the domestic currency in moderating domestic interest rate increases might be seriously compromised, resulting in both a massive currency depreciation and unacceptably high domestic interest rates.

The IMF's prescription for the affected Asian countries during the AFC was deflation. These countries with the notable exception of Malaysia tightened interest rates to stem massive capital outflows. Malaysia's introduction of capital controls during the AFC offered a clear support for Rey's 'dilemma'. Malaysia's introduction of capital controls, criticized by the IMF at that time, saved the country from a severe economic recession. Its close Southeast Asian neighbors, Indonesia and Thailand that did not impose similar capital controls, were

badly hit. The IMF uncharacteristically issued a *mea culpa* when it revaluated Malaysia's capital intervention after the crisis.

China had low foreign currency debt; its problem during the AFC was speculation against its currency driven by economic uncertainty in Asia, even though its increase in growth of exports to the US and EU at that time overcompensated for the fall in its growth of exports to Asia, and its aggregate export growth had not slowed. Its efforts to discourage capital outflows were made difficult by the higher interest rates of the Asian countries. It would be difficult for it to continue with its relatively lower domestic interest rates without its then long-standing capital controls.

China's capital controls have the support of many of its economists. They were previously skeptical of the IMF's push for Chinese capital liberalization and their skepticism was vindicated by the experience of Malaysia. Sun Guofeng, director of PBC's finance institute, and his colleague, Li Wenzhe cited approvingly of Rey's Jackson Hole paper and pointed out that Chinese policymakers' New Macro-Financial Policy Framework (MFPPF), using selective capital controls, partial liberalization of the exchange rate and coordination with foreign central banks are drawn from insights derived from Rey's research (Sun and Li 2017).

Five years before the AFC the increasing prominence given to monetary policy in China's macroeconomic policymaking became clear with the government's decision in 1992 to replace fiscal subsidies with bank loans to state-owned enterprises (SOEs). That policy was both ambitious and pragmatic. Ambitious, because bank loans in theory have to be repaid and the policy could only be successful if SOEs could be reformed into profitable enterprises or sold-off or closed down. The first is economically challenging and the latter, politically difficult. Nevertheless, it was a pragmatic decision because subsidies to some is a tax on others and persistent subsidies in the long-run are a drag on the economy. Concessional bank loans to SOEs provided short-term assistance, but as they had to be repaid, they provided SOEs with the incentive to perform better under the threat of potential bankruptcies.

The important role given to monetary policy in China's was demonstrated by actions of the Chinese government to counter the effects of the GFC. Roubini (2009) calculated that the crisis had hit China hard and that China's growth in the fourth quarter of 2008 on a quarter to quarter basis was close to zero. The Chinese government acted fast and hard, implementing an aggressive RMB4 trillion stimulus package. If an economic shock is isolated to one country or a small number of countries there is a strong argument that, especially for a small economy, monetary policy with currency devaluation is the right policy. As long as domestic costs are contained, demand could be switched relatively easily towards the domestic economy. But during a global recession, every country's currency cannot be depreciating simultaneously. China did not devalue, but it did not want its currency to appreciate either. There should be a universal global demand expansion, instead of each individual country attempting to switch demand. Inflation not deflation should be the way. China's stimulus in response to the crisis was definitely bold and unconventional in comparison to the policy responses of Germany, the UK and the US, where their initial stimuli were prematurely weakened when conservative politicians in these countries were later able to reframe the financial crisis into a fiscal crisis supposedly caused by profligate government spending, when in fact much of the spending were used to bail out failing private banks (Tooze 2018).

Bank credit in China increased by 31.7 per cent in 2009, representing two-thirds of the total government's investment stimulus package. Half of the increase in credit went to new

medium and long-term infrastructure investments in the first six months of 2009, resulting in a year-on-year increase of 42 per cent in lending to infrastructure. Government spending, representing one-third of the total stimulus investment package, increased by 24 per cent in the first nine months of 2009 and created a fiscal balance deficit of 3.1 per cent GDP for that year (IMF 2012: 37, 39; World Bank 2009: 3).

Central government spending on its own would not have been sufficient to generate the stimulus required. It had to rely on local governments and the non-state sector. The fiscal capacity of local governments were generally weak. While policymakers tightened capital controls, in a bold move they loosened the controls of local governments by allowing them to establish local government financing vehicles (LGFVs) to raise funds to lend to private investors or to invest themselves. Policymakers anticipated that such funds would be able to earn a positive rate of return and therefore the stimulus would not be used to invest in unproductive ‘white elephants’. The government’s aggressive stimulus policy was clearly bold. It sought to prevent an economic slowdown, but it also wanted the stimulus to be highly productive, an ambitious goal not easily realizable.

Macroeconomic Policy and Developmental State Policies

China had the advantage in its early reform years as it shifted slowly away from a planned economy of having large number of local profitable SOEs that it could avoid having insufficient demand in the economy. If the central authorities could not collect sufficient tax revenues from the localities, local governments did not hesitate to spend the taxes it avoided delivering to the centre or the non-budgetary revenues of the SOEs that they controlled. The state’s fiscal capacity has not deteriorated with a growing decentralized and market economy; it has managed to reform its taxing powers accordingly. In 1996 China collected 11 per cent GDP in taxes, which was below the average for low-income countries. By 2015 China’s taxes at 21.8 per cent GDP were about equal to the OECD average and above the middle-income average of 18.7 per cent. It was also above that of the US at 18.9 per cent. If social contributions of 6.8 per cent GDP were included, China’s 2015 budgetary revenues would be 28.6 per cent GDP. It would be below the 2012 average of 30 OECD countries, but high for a middle-income country (Naughton 2017). Moreover, as Naughton pointed out, China’s current population is still relatively young. As a result of its low level rate of elderly dependency China’s social security fund has a large and growing surplus.¹

The Chinese government therefore has the fiscal capacity to pursue its economic and strategic objectives, but it has also increasingly relied on a targeted monetary policy. After establishing itself as the world’s major producer of low-technology, low-skilled labour manufacturing products, China began an ambitious program to be competitive in world markets in high-technology products, first to focus by the standards of advanced countries on relatively low but higher knowledge products that it and other developing countries could be competitive in global markets based on their relative factor endowments², but later to develop more ambitious plans to exploit the production economies of scale and network externalities available to its large domestic market to move into producing cutting-edge technology products to compete with advanced countries. Ability to exploit these scale economies and

¹ Surplus in 2015 was 1 per cent GDP.

² Developing countries can be competitive in exports that embody a wide level of technology. Bangladesh had similar factor endowments with China, but its exports embodied lower levels of technology (Rodrik 2006).

externalities in a large domestic market to be competitive abroad, ironically, also meant China could be less reliant on international markets.

Protection of the domestic market and direct state subsidies and preferential loans to ‘potential winners’ are instruments of a SDP. Renewable energy to combat the impacts of climate change is one of China’s targeted sectors for preferential treatment, but one sector where its SDP has clearly been a global success is internet commerce and mobile payments. Alipay and WeChat have become global firms in this sector with Chinese government support. They dominate the mobile payment business in China, which in 2016 has 502 million mobile payments users, 389 million of them urban and 104 million rural (Aveni and Roest 2017), and are expanding their business rapidly overseas.

The use of state support to promote domestic industry in strategic sectors is nothing new and finds theoretical justification from the theories of strategic trade (Krugman 1986). More than twenty years before, US policymakers were alarmed by the rapid progress of European and Japanese high technology firms in global markets made possible by state support. Tyson (1992) highly influential book documented the serious challenge to the US high technology industries from these firms and made a series of policy recommendations to US policymakers. China’s ambitious plans to fund R&D investments in strategic and basic and applied research to the tune of 2.5 per cent GDP by 2020 so as to transform China into a world class high-technology manufacturer, where advances in science and technology would contribute 60 per cent of economic growth (Li 2016:7-10) have caught the attention of US policymakers and politicians from both major US political parties. Officials in the Trump administration labelling China a strategic competitor of the US often cite China’s ‘2020’ project as a major threat to US security.

China’s SDP complements its One Belt, One Road (OBOR), which has a more strategic security focus. Given China’s geographic location, a land route from its borders to Europe would certainly improve its geostrategic position. As of 2015, China had committed over a trillion US\$ to its OBOR initiative (Godement 2015). Chinese policy banks raise funds from commercial banks and then lend them to mostly major SOEs to invest in OBOR projects (John 2017). OBOR and ‘2020’ projects receive preferential loans which means higher cost of lending and less credit available to other, especially private investors. These projects do not have to be funded fully in foreign currencies; many items in these projects will be sourced from China and paid in renminbi, but other items will be paid in foreign currencies and a depreciating renminbi exchange rate will raise the renminbi investment cost of these projects. Although Chinese policymakers have not stated explicitly, both the state directed ‘2020’ and OBOR initiatives require foreign exchange, and China’s capital controls and restrictions on specific outward investments are consistent with these initiatives.

The absolute level of Chinese outbound acquisitions remains very low. For example, in 2015 Chinese companies spent around 0.9 percent of GDP on outbound acquisitions. By contrast, EU companies spent 2 per cent, and US companies spent 1.3 per cent, but they have grown dramatically, from \$49 billion in 2010 to \$227 billion in 2016 (Cogman et al. 2017: 2). China has drawn important lessons from Japan’s overseas investment experience in the 1980s. A report commissioned by Liu He, the director of the office of the Central Small Leadership Group on Finance and Economics, warned of the dangers of allowing Chinese firms to mimic the investment behaviour of Japanese multinationals in the 1980s when the latter paid over-the-top prices, indiscriminately buying up foreign assets like the New York Rockefeller Center with little regard to their potential economic rates of return or strategic value (Zhai et

al. 2017). Major Chinese corporations like Anbang, HNA and Wanda similarly had in recent years gone on a global expansion funded by massive domestic and foreign borrowings. Like the heyday of Japanese corporations' frenzy acquisition of foreign assets in the 1980s, Chinese corporations paid over-the-top prices for many of their foreign assets with little regard on their future economic returns.

Chinese policymakers were at the outset relaxed with the massive outward capital flows. The flows lowered the pressure for renminbi appreciation and was an outlet for domestic savings seeking higher rates of return. But policymakers acted when market pressure was no longer on renminbi appreciation and corporate debt approached levels that could potentially impact negatively on the stability of China's financial system. They enacted regulations restricting investments in non-strategic and speculative assets, which the government perceives to be against the national interest. Notable restricted investment areas are real estate, hotels, cinema, entertainment and sports clubs. Investments in the gambling and the sex industry are banned outright. Infrastructure investments supporting the OBOR initiative, high technology and other strategic investments such as in agriculture and mining continued to be encouraged (OSC 2017). They are assumed to continue to offer high social, if not economic, returns. But corporations like Anbang, HNA and Wanda that had huge debt exposures acquiring non-strategic assets were forced to divest and deleverage.

Debt Exposure from Policy Interventions

China's central government's bold GFC stimulus has left a legacy of local government debt, often parked in LGFVs. The IMF to get a more accurate valuation of government debt in China began to include market borrowings of LGFVs in their calculations of China's public finance.³ The augmented fiscal balance showed a government budget (combined central government and local governments) deficit of around 10-12 per cent GDP, compared to about 5-6 per cent GDP when market borrowings of LGFVs are excluded. Including these borrowings increases total government debt to 56.6 per cent GDP in 2015 and 62.2 per cent GDP in 2016, compared to 41.1 and 44.3 per cent GDP when these borrowings are excluded (Table 1). China's total government debt remains low relative to that of many industrial countries and manageable according to the IMF, but government debt is a serious issue in some localities.

More worrying for the Chinese government is corporate debt and the unproductive use of credit. China's corporate debt at the end of March 2017 was 135 per cent GDP (Lam et al. 2017: 3). Highly leveraged SOEs, including real estate developers and those in sectors with excess capacity, continued to have access to credit; banks still consider them to be credit worthy because of perceived continued government backing. The general preferential treatment given to SOEs and that specifically given to '2020' and OBOR projects have disadvantaged private firms, especially those of small scale. The latter are often profitable, but find it difficult to access credit. SOEs account for one-third of investment, but receive 30 per cent of bank loans (Wu 2017). SOE debt stood at 72 per cent GDP and accounted for 60 per cent of the rise in corporate debt between 2008–2016, despite experiencing a decline in their shares of output and employment from over 40 per cent in the late 1990s to 15–20 per

³ They exclude government assets and therefore measures only gross debt. It does not include the liabilities of SOEs and other state entities. See (Zhang and Barnett 2014: 4) for an extensive explanation.

cent in 2015 (Lam et al. 2017: 3). One RMB increase in China’s GDP now requires four RMB credit (Miner 2016). In the first quarter of 2016 China had the highest credit-to-GDP gap among 23 economies. Its gap of 30.1 is more than double that of Canada (12.1) and more than seven times of Japan (4.1). Germany, United States and United Kingdom all had below trend credit-to-GDP (BIS 2016:22).⁴

Table 1: Government fiscal balance and debt

	2015 Per cent of GDP	2016 (estimate) Per cent of GDP
General government fiscal balance	-4.6	-5.7
Augmented fiscal balance	-10.2	-12.4
Central government debt	15.0	16.0
Explicit local government debt	38.8	41.9
General government augmented debt	56.6	62.2
General government debt	41.1	44.3

Source: IMF (2017: 47–48).

According to one estimate China’s total debt is about 240 per cent GDP. Its debt is comparable to those of advanced economies like Japan and the United States, but much higher than those of emerging economies (Miner 2016). Clearly, much credit in China have not been used productively, but it is difficult to evaluate how much of the preferential credit allocated to SDP and OBOR projects are wasted. Preferential loans and other forms of government support are allocated for many reasons other than for SDP and OBOR purposes. For example, many SOEs that are uneconomic are kept solvent with government support for social stability reasons. Nevertheless, the government is making great efforts to get high debt firms to deleverage and relies on capital controls to prevent interest rates from rising and the renminbi from depreciating too much. Rising interest rates makes deleveraging more difficult and too much currency depreciation increases the renminbi costs of the government’s SDP and OBOR projects.

Shadow banking, that was given a push by the GFC, has injected much flexibility into China’s otherwise highly centralized and slowly liberalizing financial system. It is able to channel savings into underserved and potentially riskier but more profitable sectors of the real economy. It provides private firms access to credit that they could not obtain easily from formal banking and offers investors a range of wealth management products (WMPs) and trust products that offer higher rates of returns than they could otherwise receive from conventional saving instruments. However, regulation in the sector is relatively weak despite growing linkages between it and the formal banking sector. The reason is neither regulatory capture nor regulatory starvation; financial regulators are only lately recognizing the rapid expansion of the sector and the risk it can pose to China’s financial stability. They have now introduced measures such as control the expansion the riskier parts of the system, ensure more accurate pricing of risk in the sector and limit the growth of WMPs.

⁴ Defined as the difference between credit-to-GDP ratio and its long-term trend (BIS 2016:38).

Conclusion

China's macroeconomic policy has been ambitious and at times bold, but pragmatic. It has been flexible and does not always follow the conventional approach favoured by international institutions and many Western-trained economists. Its capital controls, criticised by the IMF and many economists until the IMF re-evaluated its approach to financial crises in the light of lessons learnt from the AFC, is a good example of its pragmatic approach to policymaking. So too is its nominal exchange rate policy that recognizes it is the real exchange rate that matters and exchange rate appreciation in a tight labour market with rising wages does not work in the same way when there is a surplus labour market with rigid wages.

The focus of conventional macroeconomic policy is on the short-run and on the demand side of the economy, despite the policy having a significant influence on long-run economic growth. Paul Krugman famously said that only productivity matters in the long-run, but his words do not seem to have led to many questions over investment allocation decisions when deciding macroeconomic policy. The market alone, it is often assumed, would make the right investment decisions, given appropriate macro policy settings. By contrast, both the supply and demand sides of the real economy are the focus of China's macroeconomic policy. The country's macroeconomic policy is interconnected with its OBOR and SDP, which takes into account the ability of China to use its large domestic market to exploit production economies of scale and network externalities. China's capital controls, besides being used for maintaining general economic stability, are an important tool in its OBOR and SDP. Capital controls allocate scarce capital and foreign exchange away from what policymakers perceive to be non-strategic projects or projects of low profitability to what they consider to be strategic projects with high potential social rates of return.

China's policymakers have been bold during the GFC, going in hard with a massive and sustained stimulus that dwarfed that of the advanced countries, whose policymakers seemed divided and overly cautious. Their stimuli were ended prematurely and replaced in some countries with austerity, with their conservative politicians reframing the crisis as a crisis due to undisciplined and overgenerous government spending. The legacy for China from the GFC and continuing SDP is unfortunately a debt problem that has the potential to threaten the country's financial system.

The GFC has left many advanced countries with a high debt problem; China is not an oddity. No policy is without its downsides; it's difficult to fine tune policy when a country has multiple objectives. Waste is difficult to avoid when the policy imperative, like during the GFC, is to avoid a severe economic downturn. Uncertainties in the economic returns from projects in such a policy environment are often downplayed. Similarly, there are uncertainties in SDP and OBOR projects. There is no perfect information and foresight and any potential returns from SDP and OBOR projects are realized only long into the future. SOEs are behind many SDP and OBOR projects and their debts are a big part of China's debt problem. However, despite much publicized enterprise and social welfare reforms they are also in some localities, especially if they are a significant employer, expected to continue to carry a sometimes heavy share of the local government's burden of social welfare responsibilities that theoretically should no longer be theirs.

China's policymakers have been reforming the country's policymaking institutions since the country's made the decision to transform its economy from one that is planned to one that is market based. Their conduct of macroeconomic policy has been more of an art, applying

selective economic principles and learning by doing as new problems emerge, than as an exact science. So far one could conclude that Chinese policymakers with their ambitious and sometimes bold, but pragmatic approach have on the whole been successful in conducting macroeconomic policy to meet their country's economic and strategic objectives. Whether they can continue to so, relying on a mixture of rules and discretion is an empirical question that can only be answered in the future.

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