

# History, fiscal and monetary policy of china



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World's economy has been driven by China's potential on being the biggest worldwide products supplier. Economists and governments are concerned about the sustainability of their growth and the possibility of an eventual crisis caused by high inflationary pressures and speculative bubbles. China is actually the world's emerging power, capital flows and liquidity has increased in astonishing levels and this has been translated as money supply growth. Sustaining these high levels of growth require high control measures that are achieved by interlocking government's and China's Public Bank objectives as national aims. In this review we will be able to acknowledge how macroeconomic instruments are used, as main tools, to provide the compulsory control in order to sustain its outstanding growth and development rates.

## **China's historic background**

China may be the oldest civilization in the history of mankind, at least that is what scientist affirm after a number of archaeological discoveries which reveal that there are rests of formed and buried humans with different tools in some regions of what we know today as China. However according to Chinese records one of the first Chinese dynasties was the Xia dynasty which took place between the XXI century B. C. until the XVI century B. C. This means that China might be a unified country even before the creation of The Bible ad even before of the current Judeo-Christian history we know by now. A civilization much older than Greeks and Romans and perhaps contemporary to the Egyptian civilization. After this dynasty the Shang dynasty overthrew the previous one and was much more documented than the first with archaeological remains of cities, carriages, and weapons.

However it took around 600 year for a Reunified and Strong China made available for all its citizens (a definition far ahead age) some common standards for the time such as written characters, literature, currency, a system of common laws to resolve conflicts, paths and ways for armies and peasants among other facilities.

China was affected and modified over the years by endless wars, coups, emergence of new dynasties and invasions of nomadic peoples such as the Mongols in the XIII century of our era, for example: these nomadic tribes where leaded by Genghis khan a violent and cruel general who charged against all Chinese cities and conquered one by one some in the battlefield and some other yield to his increasing and rising power. His empire was so big that he reached East Europe. Although The Mongols were so powerful in arms proportions, they were not as organized and as civilized as the Chinese people. An example of their decay was the social class division within The Mongol Empire where the Chinese were mistreated just as slaves and these led to massive riots and revolts.

Soon after The Mongol Empire felled, other dynasties overcame and ruled in monarchies all over the Chinese territory, and many historical events happened throughout the centuries such as the development of the “ Silk Road”: a commerce path which connected Asia with Europe where goods such a silk and other fabrics were trade as well as jars and precious stones. However this route did not appear at once. Both ends of the roads were built in different times, perhaps eras. The western side was first known and improved by Alexander the Great in the XV century B. C. and later the eastern side was developed by India and China. Although there is not an only <https://assignbuster.com/history-fiscal-and-monetary-policy-of-china/>

route, which crosses the taklimakan desert, and the Gobi desert it is clear that these were the passageways of many commodities of the time and a great amount of money and power remained there. Another event of great importance and influence in China was the Opium war, this in fact might be one of the responsible facts that affected and led to current Chinese situation. In the XIX century China impose heavy duties on Opium which was imported from Turkey and India, at first the weed was used as a medicinal remedy, however the people started to use it in a recreational way. Over the years the abuse of Opium led to the corruption of the army and other Chinese institutions. Great Britain took advantage of this weakness and established a war with China and easily defeated Chinese troops and forced them into a treaty where Hong Kong and other cities were ceded to the British Empire. After this came another war where France and the United States managed to workout treaties with China as well for the trades of all kinds of goods.

Nevertheless China was still plummeting thanks to imperial corruption and excessive violence by emperors. Plus, many western ideology penetrated young minds of students and peasants and by 1911 they overthrew the last emperor creating The Republic of China.

Still the fight for power and land control by wealthy people created inequality of great proportions. And so in 1921 the Chinese communist party was founded and among its creators was Mao Zedong, the son of a peasant, voluntary helper of Perkin's library and director of a primary school, organized the "red army" and began to fight battles against the nationalists party. Although they made a truce and joined forces to expel the Japanese

forces during World War Two, in 1949 he finally defeats the nationalist army and the Popular Republic of China is created. By 1954 he named himself president of China. Mao adopted the socialist model of the Soviet Union (URSS) as he redistributed land for farmers and peasants, empowered an enormous industry and centralized bureaucracy. China was instantly a big ally of URSS but it did not last because Mao's idea of communist was detoured somehow by his own idea of what Communist was and could be. In Mao's mind he wanted to achieve the industrial capacity of production of developed countries but he failed. Instead corruption, anarchy and violence reigned during his presidency and in a comeback to communist values many Chinese public servers were arrested or executed. The riots of the youths protesting were dismantled and bad seen in public eye, some liberties were restricted like freedom of speech.

When Mao died (1977) an old time member of the communist party took over control: Deng Xiaoping. He once went to jail under orders of Mao Zedong but when he returned to Chinese politics was convinced that China needed a different model at least in the economic matter. We can say pretty much that by that time under Deng's presidency an approach to free market and more liberal industrialized China we know these days began. He was pioneer in returning to allow Chinese people to own their lands, his idea of a strong communist china was not on the economy but in the culture as he assured that a cultural revolution was necessary for the country's success. Therefore in schools and universities a collectivist model of life was imposed and students all over China were taught to think in their country's needs before an individual cause a full integrated and productive nation could give

many more benefits to their people. Thanks to these strategies Chinese economy expanded and flourish in a way never seen before in the country, loans were permitted to farmers and other small business entrepreneurs who wanted to build factories. International investors were fully allowed by 2003 under Jian Zemin president. These investors outsourced their products with China building new and technological factories and an industrialized China emerged as the big supplier of the world. Leaving behind the bad quality of their products now a days China's industries are well known for being producers of many well-known brands around the world. Nevertheless lately China has been accused of enterprise spying and violation of patents and intellectual property, without many results.

As we can see China's history is so diverse and rich that there is not a proper way to analyse it the way we have known ours. This millenary civilization has proven also that they can overcome many difficulties. We can notice this now a days as this country merges two economic models that were thought to be the antithesis of the other and has proven to do so successfully, It is also hard to know what will come for china but we can assure that living conditions and living style of regular Chinese people has considerably improved in the last 20 years and is seems it will continue.

## **Monetary Policy**

Monetary policies are normally settled and framed by country's central banks. Policies must be aligned and deployed in accordance to the goals and objectives that are being pursuit. A simple aim to control inflation, manage rates of unemployment, affect aggregate output or in some cases influence on exchange rates, can be some of their intentions.

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Monetary policies, as any other policy needs instruments to be able to manipulate, in order to attain the desired effects in the economy, as consequence of the system's complexity. Central Banks deal specially with interest rates, monetary base (money supply), reserves, discount window lending or arranging a currency board. As any other policy, monetary authorities must consider the time lags for the multiplier to take place, and determine their perspective. Should it adopt a short-term or long term perspective? Are they looking forward to ease money supply growth in order to decrease unemployment rate, depreciate local currency and promote their local exports competitiveness abroad? Should they respond reactively with interest rates to inflationary pressures and economic overheats, augmenting leverage rates for the private sector and at the same time spurring foreign investment?

### **Control of the money supply**

Many studies based on China's economic development and growth, match in their hypothesis for China's main macroeconomic objective " aimed at continuing to achieve economic growth, while keeping inflation at a minimum" (Seki, M. Nakayama, S. & Suzuki Y. 2006).

Yu Yong-Ding's review of China's Macroeconomic Development and Policies in the 1990's, also sustains the hypothesis stated above. From this article we can see how China has been continuously attempting it's sustainable growth (10. 1%, annual average) keeping inflation at a minimum (Chart 9) since the past 2 decades. China's highest rate of inflation was evidenced in 1994 (24. 1%). Yong-Ding attributes this upshot to three main causes. First, shortage resulted from previous years massive capital flows translated to substantial

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growth of the monetary base (Figure 2). Second, price liberalization. Third, the sterilization policy deployed by the Public Bank of China (PBC), a policy that has underpin world's currency wars. In this situation, the PBC reacted with restricting its monetary policy, controlling and reducing its monetary supply, increasing interest rates and the minimum reserve ratio.

In the past decade, it was observed a very similar behavior of China's PBC macroeconomic reactions towards inflation and economic growth. Osamu Tanaka in his research of China's Macroeconomic Policy Shift in 2008, which he refers to, as the political process from tightening to easing, recalls the macroeconomic policy trends. In 2003, PBC tightened its monetary policy and raised the minimum reserve rate, in response to overheated investment, by 5 basic points, from 7% to 7.5%. This decision was accompanied by an interest rate hike (benchmark rate hike) of 0.27% (Chart 17). In this decade the PBC had a policy of revaluating gradually the renminbi (RMB) currency. China has realized how dependant they were on foreign demand for their exports. Every crisis, such as the Asian crisis in 1997 and the Subprime crisis in 2008, have both undermine China's economic growth, specifically because of their effect on lessening aggregate demand. They required stimulating indoors consumption, diversifying their risk. Revaluating the renminbi gradually prevents import inflation, which becomes absolutely desirable when global commodity prices are rising.

Another way to reduce money supply is open-market operations (OMO's), where governments are able to purchase or sale government securities in the open market. PBC has leverage this tool as mechanism for the sterilization policy mentioned before. To manage their increasing liquidity



and make a sterilize intervention to prevent their currency appreciation, they not only purchase T-bills from other countries such as United States, where they own most of their debt (\$907 billion of \$4. 3 trillion)[1], they also carry out repurchase of bonds and bills in order to enhance the efficiency of the OMO's. James R. Barth in his book *China's Emerging Financial Markets: Challenges and Opportunities*, says " The Chinese Government issued CNY 1, 550 billion Special Treasury Bonds to domestic commercial banks on the inter-bank bond market to purchase US \$200 billion foreign exchange for the National Foreign Exchange Investment Company as operating capital", supporting the above. From this, we can see how PBC and the government make use of several instruments to manage their money supply, which in consequence alters other economic variables to attain a sustainable growth and target their expected inflation rate.

Window Guidance is also a common monetary instrument used to control overheating of specific sectors in the economy. It is also used to counterbalance the effect of lowering macroeconomic activity by increasing rediscount rates and reserves ratios (Table 1), affecting primarily access to loans. Window guidance has been implemented in China by the PBC halting non-governmental construction loans, to cool down this sector and avoid the creation of a housing bubble. They also conducted window guidance to reduce loans growth from foreign and domestic commercial banks, especially for industries with risk of excess capacity (James R. Barth 2009). Such policies lead to lessen speculation and prevent toxic mortgages. Money supply growth is also controlled as result of tightening lending possibilities.

## **Fiscal Policy**

Now days china is a potential country that can become in the first potential economy around the world, that is what analyst are saying about this growing society and its capacity of adapt to the actual tendencies of the consumer and, evermore, the whole world demand and requirements.

The monetary and fiscal policy are the most important variables that we must analyze and understand, in order to appreciate the natural context of its process and how it is working in crisis time, and into this global environment where every country is trying to reach new markets and customers all around the world, and no matter what their leagues are or how different its culture is, it is still working.

China's fiscal policy, monetary policy, the Yuan and its actual value are polemic topics now days, there are some important economist talking about how China is going to reach this goal on becoming the stronger economy in this changing world.

Even though they have a central bank, a currency controlled by them, their own static and data about inflation and how to control it, and sovereignty of it economy policies, in the other hand its commercial structure it is extremely connected to the world, so they cannot take decisions isolated.

Some important analysts think that now days and future must be focus in the fiscal policy rather than the monetary policy. The fiscal as a central direction has not been important to growth, it was not important when the economy was increasing and with high expectative to its behavior. However the economy slows down and the monetary policy " stop" working in the way it

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used to, the government must look forward and give more importance to the fiscal policy.

The China economist Stephen Green was talking about how fiscal spending can be increased by education and healthcare, and if this action can stimulate economic growth, so it could give a total benefit over the country and a better living system to all its population.

Furthermore, the fiscal policy must be supplementing and good monetary police in order to curb a bubble economy and relegate the currency and press ion from the foreign one.

China who had a prudent monetary policy in 2008, changes to active one over 2009 in order to protected them against the actual economic crisis. They wanted to boost the internal demand. The country increased the government investment, and this money is being destined to agricultural production, housing projects, rural areas, education and healthcare.

They also used the government investment to help the areas that were affected by the 2007 earthquake on the southeast of China. However, they are investing in innovation and technology which are they the most powerful tools for near future commerce and worldwide trading and finally in public in fracture as train lines, roads, airports, ports, etc.

Furthermore, Chinas 'government wanted to change the taxation system and to reduce of the structural taxes for the companies and so the people can keep doing business and face the crisis that they were/are living, and

also an effort to stimulate the public consumption and the firms to invest and create new jobs opportunities.

Basically the main idea about going forward into the fiscal policy is to improve the actual country's infrastructure and support investments in benefit of the technology and innovation, also to support projects where the main ideas is to reduce the energy consumption and the to reduce in the same way the contamination.

China maintained its proactive policy over 2010 and 2011 in order to keep building and improving their main public structure and public good as well, the country were requesting new inversion projects to stimulate the firms and house holding aspiration. They wanted to inspire the people to keep working in the same way they were doing it, without fear to future depression.

China will change its actual proactive fiscal policy to a " prudent" when the time comes, so they can save money and regulate the investment and public good. And by then the country would have improved.

However, there are some economists how thinks that this fiscal policy must have been focused in different plan and structure; acting over the domestic demand, so they could have made the expansion less linked to the investment projects, and government expenditure and all those areas abode. However the fiscal is necessary because there are some areas without the appropriate road or metro systems, so they can control the massive traffic jam that now day they are having because of its demographic growth

Because of this policy China was not affected in a drastic way by the global economic crisis compared with others countries, which made no changes to its monetary and fiscal policy, the prevention an actions at the right time helped China to not going to deep into this economic bubble. Ensuring the welfare of the people, and its future economic well-being.

This past actions demonstrated a well organized government/country and a very strong sense of positivism, encourage and leadership in crisis time. Showing to the world they are prepared to be the new economic leader.

Many economists worldwide claim that China's model is unsustainable because of its inflationary pressures caused by such constant growth. From the previous macroeconomic analysis we can see how China really defeats this hypothesis performing a perfectly countercyclical planned economy, in which there are specific aims and plentiful alternatives to clear the path of possible threats. Policies alignment from each institution has been the essence and the advantage to succeed. China is the world's emerging power and it will continue being so, sooner getting rid of the word emerging.

Source: C. P. Chandrasekhar and Jayati Ghosh. Macroeconomic Policy, Inequality and Poverty Reduction in India and China

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