

Macroeconomic objectives and policy issues of china



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China's current macroeconomic conditions are sound, with promising prospects for the future. However, there are a few points that must be taken into consideration. Given signs of inflationary pressure, the central bank should raise policy interest rates. Independence of the central bank from the government is also necessary, since the government was deciding credit allocations in the past. Therefore China is the chosen country for this assignment.

Macroeconomic Objectives

China's main macroeconomic objective should be aimed at continuing to achieve economic growth, while keeping inflation at a minimum. Economic growth is important in order to create job opportunities. A growth rate of 8% is thought to create 7 million job opportunities a year, while 10 to 12 million jobs are needed to keep the current rate of unemployment. Excess labor will be supplied from the rural areas, as well as from restructuring SOEs. The rise in unemployment will make the economy vulnerable to social instability. Low inflation will be necessary for a funded pension system to function. At the same time, the country is facing major changes as well. China's accession to the WTO means opening up the economy by reducing trade barriers, and the financial sector will be opened to foreign financial institutes for business with Chinese enterprises, started from 2006. The "gradual reform" policy stance may have been one of the reasons for success, but at the same time, this has left the hard problems unsolved. To name a few, income disparities and non-performing-loan problems need to be tackled with determination, and insufficient disclosure of statistical data makes accurate assessment of the problems difficult. In the proceeding sections, we focus our discussion to

monetary policies, fiscal policies, and exchange rate policies, as we think these three are the most effective policies to obtain this goal.

Macroeconomic Policy Issues

1. Monetary and Credit Policy

The People Bank of China (PBC) should further raise policy interest rates, given signs of an upward trend in inflation. Among the main policy instruments, interest rates seem to be the most effective instrument for controlling inflation, compared to quantitative measures. The use of interest rates as a policy instrument should become more important, as the development of the financial market progresses (Frankel, Jeffrey, 2005). Independence from the central government is a task that is not being dealt with much. Monetary policy is conducted under the leadership of the State Council. The nomination and dismissal of the board is also done by the State Council. Since government projects are still being financed by the PBC indirectly, further independence should prove necessary.

2. Fiscal Policy

Future increase in expenditure is inevitable, but at the same time, it is necessary to keep deficits at a minimum. Further increase in Non Performing Loan (NPL) related expenditures, education, and the expansion of the social safety net is recommended. NPL problem is a major element that may slow economic growth. From 1999 to 2000, four asset management companies were created to clean up NPLs. 1. 4 trillion RMB worth of NPLs were purchased from the four State owned Commercial Banks (SCBs) and China Development Bank. The cleaning up of NPLs will be a fiscal challenge, yet as

the Korean case after the Asian financial crisis shows, it is effective to take drastic approaches against this issue. Drastic measures include disclosure of total NPLs, improvement of internal management and corporate governance. Expenditure on upper secondary education should be strengthened. The Chinese literacy rate was 90.9% in 2000 (www.uis.unesco.org/ev.php). This high literacy rate is attractive to foreign investors, which promotes economic growth and international trade. Further investment in human capital is necessary to gain competitiveness in high value-added products. The share of primary industry is still very high at almost 50% in the Chinese labor market. To smoothly shift labor across sectors, the authorities should provide sufficient training opportunities. A higher level of education will also smooth the shift of labor across sectors.

The coverage of the social safety net should be widened. Over the past twenty years, a market-oriented labor market has emerged. On the other hand, State Owned Enterprises (SOEs) have been downsized. The social safety net is also necessary to smoothly shift labor across industries and reduce social instability. How should the Chinese authorities raise their revenue to finance increasing expenditure requirements discussed above? An adoption of a comprehensive tax, VAT system is recommended for the following reasons. First, administrative costs are low compared to introducing a new tax system. VAT was introduced in China in the 1980s, and shifted the share of revenue from income taxes to VAT in 2004. Second, the VAT is a stable revenue source since it does not fluctuate as much as income tax during economic boom and busts. Despite these reforms, there is still room to widen the coverage of VAT. The best timing of VAT introduction is in

an early phase of economic development (Junko Kato, 2003). European countries succeeded to introduce regressive taxes in the 1960s, while economic growth was still low. On the contrary, Japan and Canada faced hardships. In the Japanese case, the VAT proposal was blocked by strong opposition in late 1970s and mid 1980s. VAT was introduced in Japan in 1989, but the tax rate was low. Japan has compensated their deficit by VAT and suffered a looming deficit with stagnated tax revenue during the lost decade. In addition, the Japanese continued to suspect tax increases when the economy boomed. The difference which differentiates success and failure of VAT adoption is whether the authorities introduce the system during or after a period of high economic growth. We recommend that China should widen the coverage of the VAT system now, given that China is still at a early stage of economic development.

3. Exchange Rate and Regime Policy

On July 21st, 2005, the PBC has announced to revalue the RMB against the dollar by 2% in nominal terms while limiting the daily fluctuation against the dollar to 0.3% (Goldstein, Morris, 2004). In the market, many had thought the appreciation was not sufficient. Within a week after the first revaluation announcement, the PBC denied a further revaluation of the RMB in order to halt appreciation expectation in the market. In August, they announced that they would refer to the basket of major currencies, US dollar, the Euro, the Yen, the Won, and some other currencies of Asian and Western countries. However, estimation suggests that the RMB is still tightly pegged to the dollar. Appreciation pressure on the RMB According to IMF estimates of equilibrium RMB rates, it is uncertain if the RMB is overvalued or

undervalued in the medium run(IMF 2004). However, in the long run, the RMB has been undervalued based on the Balassa-Samuelson approach (Frankel 2005 and Goldstein 2005). This indicates that the appreciation pressure on the RMB would build up as economic growth continues. If the appreciation of the nominal rate lags behind the real rate appreciation, inflation pressure would increase instead. In order to secure price stability, it is unavoidable to further appreciate the RMB. Given this long-term goal, we will come back to the question of how to adjust the RMB. The current Chinese exchange rate regime has two drawbacks. One is the tradeoff between independence of monetary policy and a fixed exchange rate regime. In order to promote the independence of monetary policy and liberalization of the capital market, the economy needs to give up stability of the exchange rate. Another drawback is the accumulation of foreign reserves, which amount to about 7%. On September 23rd, the PBC announced that they would allow 3% daily fluctuations for other currencies except the U. S. dollar. This announcement is thought to be a simple adjustment to the recent fluctuations of dollar against the Euro. This is a result of continuous market interventions to keep the RMB against USD rate stable mainly against the speculative inflows which expect future appreciation of the exchange rate. The large amount of foreign reserves in China contains three major risks: interest rate risks, exchange rate risks, and excess-liquidity risks ([www. worldbank. org](http://www.worldbank.org)). Increasing liquidity in the domestic financial market due to the incompleteness of sterilization accelerated investment, which induced inflation. The implementation of what the Chinese authorities announced on July 21st will result in greater benefits than costs. Benefits of a floating rate regime are simple: gaining the

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independence of monetary policy and reducing three risks due to the further accumulating foreign exchange reserves.

Costs of a floating rate regime are rather uncertain. Increase of exchange rate volatility and possible loss of price competitiveness may cause a negative effect on domestic employment and financial sector stability.

However, magnitude of the net impact on the Chinese economy is far from certain. Should the RMB float freely? In the long run, yes. However, in the medium run, the answer is no. The Chinese authorities should avoid heavy intervention in the foreign exchange market too much as they do now and let the RMB fluctuate within the announced band. Also, the Chinese authorities should actually diversify the reference currencies beside the U. S. dollar in order to lower exchange rate risks.

Structural Issues

1. Banking Sector Reforms

In order to keep sustainable economic growth in China, banking sector reforms are essential to promote efficient allocation of financial resources. In China, the banking sector is dominated by State Owned Commercial Banks(SCBs). The SCBs focus on financial resource allocation to the SOEs based on government credit plans. However many SOEs were unable to repay their loans, and these loans became non-performing. These debts are not fully recorded in the official statistics. If the authorities leave the NPL problem unsolved, and the balance sheet of banks do not improve, then these NPLs will become sources of potential fiscal liabilities. Although the authorities tried to clean up NPLs after the Asian financial Crisis, these steps

were not enough. In 2006, the implementation of the WTO rules will open the banking sector to foreign participants. However, the Chinese financial sector remains in a fragile financial condition. In December 2003, the authorities injected \$45 billion to recapitalize two SCBs, Bank of China and China Construction Bank, yet this capital injection was not effective enough to clean up the NPLs. Learning from other Asian countries, NPLs should be recognized and disclosed with accuracy. The Korean case shows that drastic approaches are effective. On the contrary, the Japanese case shows taking a long time to resolve NPLs worsen the problem. As for the solution of NPLs problems, the Chinese financial sector should improve internal management, audit, and corporate governance. In the past, they lacked sense of cooperate governance. It was not only an issue of the banking sector, but also of Chinese corporations as a whole. Many Chinese enterprises, SOEs, lacked responsibility of borrowing, and many loans became bad loans. These elements have a minus effect on FDI. In addition, the Chinese government should improve legal systems for financial activities, such as banking mergers and closures, deposit protection, and the court system. Also the authorities should strengthen their supervisory regime in terms of financial management. In 2003, the authorities set the China Banking Regulatory Commissions and transferred the regulatory responsibilities from the PBC. However its activities are needs further improvement. These financial institutional reforms have been aimed at expediting competitiveness and efficiency of Chinese banks in the global market. Moreover, since the Chinese authorities are heading toward a more flexibility exchange regime, SWAP and futures markets should be developed to hedge against risks due to foreign exchange transactions. Some progress has been made in <https://assignbuster.com/macroeconomic-objectives-and-policy-issues-of-china/>

strengthening and modernizing the Chinese banking system, however key areas like the improvement of supervisory regime, implementation of corporate governance, and legal systems still remain. The potential losses from NPLs of SCBs could amount to about 13% in GDP. However, much smaller banks like banks in the rural areas must have more NPLs, and the ratio of NPLs may be higher than the SCBs. Why does China have such high levels of NPLs? One of the reasons is nested to their management. Chinese banks have small incentives to monitor their borrowers, and properly lend to profiting projects. Such distortion is historically inherited from the central planning system. Prior to 1984, China had a mono-bank system (In 1984, China established a two-tier banking system, separating commercial banking operations from the PBC. The Central Bank Law and the Commercial Bank Law was enacted in 1994.), and this bank allocated credits decided by the government to SCBs. After 1984, the Chinese government established commercial and policy banks (e. g: Agricultural Bank of China, Bank of China, The China Construction Bank, Industrial and Commercial Bank of China, and Export-Import Bank of China). However, these banks lacked the knowledge to assess project profitability. The second reason is that borrowers tended to lack sense of obligation to repay their loans. They had a sense of implicit guarantee by the government. Therefore, banks had little incentives to monitor their loans.

2. Labor Market Reforms

In order to sustain high GDP growth and mitigate income disparity, the Chinese authorities should reduce restrictions on labor mobility and increase higher investment in human capital (Prasad, Eswar, 2004). Further

liberalization of the household registration system, especially in large cities, will decrease restrictions on labor mobility significantly (www. pbc. gov. cn). Surplus labor in the rural area will further immigrate into the urban area for higher wages and it will enhance efficient allocation of labor resources. Income disparity may widen in the short run; however, improvement in labor market efficiency will enhance higher economic growth for the economy as a whole. In principle, higher wages are a signal of a higher rate of return on education. If labor mobility is further liberalized, less productive rural workers will be motivated to invest in education facing the opportunities to earn higher wages in other sectors than current occupation (www. safe. gov. cn) . The more productive rural labor becomes, the faster they will be able to adapt to new technology. Accumulation of such labor forces will enhance technological changes in the industrial sectors and will fuel further economic growth in the long run. Concrete steps to achieve the above policy targets are as follows. First, construct infrastructure in urban areas to respond to the increase of residents. Second, provide social security to the immigrants from rural areas. Lack of social security has been another restriction on labor mobility besides household registration system. Third, provide education and job training services equally to the children of the immigrants from rural areas. Education opportunity affects location decisions of immigrant labor. As a policy instrument, the central government could subsidize local governments for public education expenditure. Along with direct public support, the Chinese authorities could support the development of a capital market for tuition (www. stats. gov. cn).

3. Income Redistribution Policies

The Gini coefficient was 0.45 in 2001, according to the most recent estimate by the World Bank. This is 37th out of 127 countries in the Gini coefficient ranking in the United Nations Development Program (UNDP). This figure has been steadily increasing since the reform of the economy starting from 1978, although part of this outcome was predictable due to the egalitarianism nature of the socialist economy prior to the reform. Income disparity is also a multidimensional problem, with dimensions such as urban-rural disparities, inter-regional disparities (i. e. coastal-central- western) and inter-industrial disparities. A decomposition of the Gini coefficient shows that income disparities are prominent between rural-urban areas and between industries. The budget transfer system should be reformed to favor low income provinces to decrease inter-regional disparities. The current transfer system is highly regressive, with transfers consisting of revenue returned, specific-purpose, general-purpose, and fixed subsidies. The revenue returned component is the main source of transfer, which is proportional to the tax collected by the provinces. This system was implemented in the 1984 fiscal reform where revenues were centralized, and revenue return was introduced to alleviate objections by high tax collecting provinces. 10 years after the reform, the political costs should be much lower than the benefits gained by social stability. Inter-industrial disparities should be dealt with by strengthening a comprehensive tax system on high productivity industries, and lowering the tax rate on low productivity industries, especially agriculture. The decomposition of the Gini coefficient suggests that the main source in inter-industrial disparity is non-wage income, which is not taxed.

The benefits of social stability should be significantly larger than the costs of <https://assignbuster.com/macroeconomic-objectives-and-policy-issues-of-china/>

distorting taxes. Investment in the rural areas should be strengthened for further industrialization. Ease of migration should also alleviate this problem, although the effects may be limited due to the increase in laid-off workers from SOEs in the urban areas.