China's Monetary Policy Choice

Zhang Jun, *School of Economics, Fudan University*

I. "New Normal" of Chinese Economy under the Current Monetary Policy

China's economic operation has been fluctuating greatly in recent years. The whole world is paying close attention to the changes of China's economic growth, especially whether it will be back on track.

After the global financial crisis in 2008, China's macroeconomic policy has been unstable, changing from expansion to tightening, which has hindered the full use of production capacity and resources. Overcapacity is always accompanied by growth rate decline, which not only has a negative impact on economic growth, but also leads to overcapacity in a large scale in some industries (especially in the energy industry, heavy industry and chemical industry).

If the short-term fiscal policy changes led to the economic downturn, however, why has it lasted so long? A relatively convincing argument points out that China's monetary policy is accounted for decline in economic growth. The new administration has not given up the previous administration's prudent macroeconomic policies. Instead, they hope that the current economic downward pressure can stimulate the shift to an economic development pattern mainly driven by household consumption. They call the current slowdown in China's economic growth as "New Normal".

II. Conflict between the Actual Situation of High Interest Rates and Domestic Demand

It's a stable growth of GDP, not a dramatically drop of it that makes sure a smooth transition of economic structure. But the reality is that though China continues to carry out structural adjustment, the economic deflation lasts with a sharp decline in demand. CPI (consumer price index) growth rate remains below 2%, while the negative growth of PPI (producer price index) has lasted for 44 consecutive months.

The capital liquidity in China is very high, which, measured by M2, a common index of money supply, is already twice of China GDP, but corporate lending cost has kept rising. At the same time, the government has maintained high interest rates over 11% even after the PPI is adjusted. The interest rate of shadow banking sector has reached 20%, and some

China's economic growth rate continues to drop because of China's monetary policy. The new administration hopes that current economic downward pressure can facilitate a shift in the economy towards greater reliance on household consumption, and devotes to change the economic development mode from being driven by investment and export into being driven by consumption and service. The government should carry out low interest rate monetary policy to ensure the stability of economic fundamentals.

private lending rates are even higher.

Of course, the result of high rates is the high financing cost, which makes many manufacturing companies fail to maintain its minimum profit. In addition, the closure of local government financing platforms and local borrowing limits implemented by the central government lead to the lowest level of capital spending on infrastructure investment in history. Macroeconomic tightening policy has also greatly weakened the growth in real estate industry. Due to the economic downturn, local governments and businesses fail to pay interest, having no choice but to borrow from shadow banks to fulfill repayment. As a result, risk-free interest rates will be raised again, leading to a vicious circle.

Suppressed by high interest rates, the domestic demands need to be expanded to reverse the economic downturn trend. Why doesn't the government take measures to cut interest rates? The answer is obvious that it is committed to shift the current development pattern from being led by investment and export to being led by consumption and service.

III. Ensure Economic Stability by the Low Interest Rate

But can China achieve the re-balance driven by consumption as it assumes? After all, this kind of re-balance has never really been realized by those rapid growing East Asian economies, which are quite similar to China's economic growth pattern, in their high growth phase in history.

In view of the above-mentioned facts, China's top policymakers should pursue a loose monetary policy and reduce the real interest rate for the current deflation, if necessary, or even take dropping the real interest rate to zero into consideration. There is still a certain amount of leeway if China takes this action, which not only can reduce the existing debt burden, but more importantly, once the economy is growing faster, the debt can be rolled over.

Most of the bank loans are deposited in the infrastructure and other real assets in China, which is quite different from the situation in Europe, so it’s better for China to expand domestic demand than rushing to de-leverage. The key is how to take full advantage of interest rate cut to stimulate demand so as to reduce the financial risk of high leverage and reconstruct local government debt. Moreover, lower interest rates can promote the development of domestic capital market, which is very important for the innovation of small and medium enterprises to obtain equity financing.

There is no doubt that China still need to clean up and swap debts, while a structural reform should be carried out step by step. But policymakers must be aware of the dangers posed by high interest rates. In order to prevent further decline in growth, ensure the stability of the domestic economy, and maintain the momentum of global economic recovery, it is high time that the government carried out an easing monetary policy.

Translator/Wang Hui