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## **CHINA WATCH**

### **Fully Understanding China's Macroeconomic Control Policy Space**

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# Fully Understanding China's Macroeconomic Control Policy Space

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In the past few years, the impacts of the pandemic and a complex, ever-changing international situation have presented higher demands on the timeliness of China's macro control policies. An understanding of "policy space" is crucial in the process of formulating macro control policies. We can neither spend too much, due to the need to reserve policy space for unforeseen difficulties, nor cling stubbornly to ineffective methods while disregarding changes. We need to look at policy space from a dynamic and developmental perspective. In cross-cyclical and counter-cyclical adjustments, we need to have a comprehensive and systematic understanding of policy space for macro control in order to get a better grasp of the strength of policies, make good and adequate use of macro control policies, and provide strong support for the smooth operation of the economy.

## 1. There Is No One-size-fits-all Standard for Policy Space

From a horizontal perspective, there is no specific applicable standard on the issue of macro control policy space for any country at any time. However, some arguments on "red lines" in policy space seem to have taken a deep hold on people's minds. We can take government debt as an example. The 1992 *Treaty on European Union*, or "the Maastricht Treaty," made rigorous restrictions on EU member states' fiscal deficit and total public debt, so that they respectively could not exceed 3% and 60% of a country's GDP. This commitment was further reaffirmed in the EU's *Stability and Growth Pact* of 1997, followed by Council Regulations (CE) nos. 1466/97 and 1467/97, which have specific provisions on monitoring member states' budgets and introduced penalties for

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breaching fiscal discipline, making the regulations enforceable. However, the two 3% and 60% red lines strongly depended on the general growth expectations and government debt situation of EU countries in the 1990s.

As the situation changed, some countries began to question whether this fiscal discipline was too rigid. In particular, after Germany and France's fiscal deficits exceeded the 3% red line in 2002, their deficits expanded repeatedly thereafter. At the same time, the finances of other major member states such as the United Kingdom and Italy were not ideal. Finally, under the weighted majority voting mechanism, Germany and France violated fiscal discipline without being punished. By 2003, the *Stability and Growth Pact* was already existing in name only, and after confirmation through formal legal procedures, the era of one-size-fits-all fiscal discipline officially ended. Since then, the government debt-to-GDP ratio of the United States, Japan, and major developed countries in Europe has usually exceeded the red line of 60%, which prompted people in all walks of life to begin to reflect on the issue.

In 2010, after the 2008 global financial crisis, two Harvard professors, Kenneth Rogoff and Carmen Reinhart, proposed the 90% red line theory. That is, when the government debt-to-GDP ratio exceeds 90%, then economic growth will slow down significantly. This again attracted widespread attention, but it also caused a lot of controversy. In particular, three researchers from the University of Massachusetts, Thomas Herndon, Michael Ash, Robert Pollin, strongly criticized the former study.

*Thus far, we are far from any consensus on whether there is a commandment-style "red line" or threshold for government debt levels.*

Since the outbreak of the pandemic in 2020, Europe and the United States have implemented ultra-loose fiscal and monetary policies, and even relegated their original focus on fiscal discipline to the back of the mind. According to the International Monetary Fund (IMF), in 2020, the ordinary government debt-to-GDP ratio of the United Kingdom has reached 104%. In France, it is 115%, the United States, 134%, and Japan even as high as 254%. At least, before inflation became a serious problem, economists in Europe and the United States had a high degree of consensus on the current round of fiscal and monetary stimulus. *The historical evolution of developed*

*countries has repeatedly refreshed our understanding of the government debt ceiling, and so far, we have not seen a clear ceiling.*

Strangely, however, many developing countries have government debts that are significantly lower than the 60% red line, and yet they have experienced the eruption of government debt crises. For example, Chad in Africa had a central government debt-to-GDP ratio of only 47.9% in 2020, but it was already in a deep debt crisis that year. There are many other countries in a situation similar to Chad's.

*Clearly, government debt significantly lower than either the 60% or 90% red lines sometimes cannot prevent debt crises, but if it is higher than the 60% or 90% red lines, it will not necessarily lead to a debt crisis.*

In fact, the macroeconomic environment varies greatly from country to country, and the applicable debt ceilings are also completely different. The matter of debt ceiling specifically depends on a country's economic growth expectations, debt maturity structure and interest rate level, consumption and investment attributes of debt, national net savings, domestic and foreign debt ratio, debt currency structure, and other conditions.

In some countries, economic growth expectations are weak, the debt maturity structure is short-term, the debt has been unable to form effective investment, the country as a whole lacks net savings, it has difficulties in the balance of payments, and it is heavily dependent on external debt. Here, even if the ratio of government debt to GDP is significantly lower than 60%, a debt crisis will inevitably occur.

However, in the case of China, government debt is low in terms of external dependence, the debt maturity structure is reasonable, the international balance sheet has been running a surplus for many years, foreign exchange reserves are huge, economic growth is expected to be stable (especially when "stable" is the byword of policy expectation), and the local currency has even grown into a reserve currency.

*Therefore, we should not be bound by the outdated dogma of the United States and Europe. We must see that China's macro policy still has considerable room, and that it can fully provide strong support for the economy's smooth operation.*

## **2. Policy Space Does Not Necessarily Diminish with Use**

From the perspective of vertical cross-cycle adjustment, the macro policy space does not follow the law of conservation. *Policy space does not necessarily diminish with use, and it may even become larger. On the contrary, using policy space too sparingly, or not using it at all or using it too late, may actually make the overall policy space smaller.*

In this regard, the crises experienced by Sweden and Japan offer good lessons.

Sweden in 1991 and Japan in 1997 both experienced severe banking crises, and a large number of bankruptcies occurred in their banking industries. The response measures taken by the two governments were generally similar: in the first stage, liquidity was provided to banks in difficulty, deposits were fully guaranteed, and market confidence was stabilized. Then banks were nationalized (recapitalized through injections of government capital), restructured, and merged; and non-performing assets were transferred to state-owned asset management companies, which then sold them.

But the timing of the two countries' actions was completely different: Sweden's government acted quickly and decisively to prevent the crisis, and in the bailout, the government directly took over the banks. Japan, however, did not realize the seriousness of the crisis until many years after it occurred, and it took several years after that before it formally introduced policy measures. Similarly, three years after their respective crises occurred, in Sweden more than 50% of Swedbank's losses had been confirmed as write-downs, but in Japan, in comparison, only 10% of its bank losses had been.

In his book, *Economic Policy: Theory and Practice*, Jean Pisani-Ferry, who served as economic advisor to President Macron and others, compares the rescue plans of Sweden and Japan. His conclusion is that the Swedish government's strong measures brought its economy back on track relatively quickly, and its policy space was actually consolidated. However, Japan delayed bank restructuring, resulting in a longer banking crisis and a far higher budget cost of government bailouts than in Sweden.

Meanwhile, the loan reluctance of Japanese banks further increased the bankruptcy rate of enterprises, which turned originally high-quality loans into non-

performing assets. This required more capital to be injected into the banks, which created more government debt. Companies were insolvent and hid their balance sheets, then used subsequent profits and government bailouts to repair those balance sheets, leading to what Richard C. Koo, Chief Economist at Nomura Research Institute, calls the “*Great Balance Sheet Recession.*” At the same time, Japan’s GDP growth experienced long-term stagnation. Since the GDP is the denominator of the debt burden ratio, this means that the debt burden ratio is also continuing to rise, so that policy space is further reduced.

Japan has always been stingy with fiscal policy space. In 1996, when the ratio of Japanese national debt to GDP reached 92%, the Japanese government believed that this ratio was too high. Just as the economy was showing a slight improvement, the then Prime Minister Ryūtarō Hashimoto proposed a financial restructuring plan and announced a consumption tax increase. As a result, Japan fell into recession again in 1998, and then it completely abandoned controlling the fiscal deficit and began to let itself go.

At present, the ratio of Japanese national debt to GDP exceeds 250%, but because of the zero interest rate and negative interest rate policy, the fiscal pressure on the Japanese government is no longer obvious. This outcome is rather ironic. If Japan had strongly blocked the crisis when it had first erupted and stabilized market confidence and growth expectations, its government debt would not have ballooned to today’s levels. However, even though Japan’s government debt levels are so high, the economy has still been able to remain stable for a long time. This is far beyond what most economists had previously expected.

China encountered its most difficult year of the 1990s in 1998. At that time, the non-performing loan ratio in the banking industry was quite high—on the verge of widespread bankruptcy by international standards—and the economic growth rate was also significantly weakened. Economists at the time still worried that “China’s fiscal situation may deteriorate rapidly, making it difficult for the government to rely on expansionary fiscal policies for a long time,” or, “The M2 to GDP ratio is too high,” or,

“Due to the aging of the population, environmental pollution, labor productivity declines, and other reasons, China’s long-term growth potential is declining.”

From today’s point of view, Chinese government debt at the time could not meet the evaluation standards of the World Bank and the IMF’s Debt Sustainability Framework (DSF), and whether or not the policy space was ample was not raised. If we refer to the IMF’s prescriptions for the countries of Southeast Asia at the time, China definitely would not have been able to adopt an expansionary fiscal and monetary policy, and should rather have implemented a tightening fiscal and monetary policy. At that time especially, the understanding of “M2/GDP ratio is too high” had already become popular in China, and this could have hindered monetary policy from playing its due role.

*Fortunately, China’s macro policy has not been bound by these dogmas since then.* Due to the active expansion of fiscal policy and the strong rescue and rectification of the financial system, this series of decisive measures blocked the signs of the crisis, effectively stabilized macroeconomic and financial fundamentals, and provided a good starting point for the next round of economic prosperity at the beginning of the new century.

### **3. Policy Space Is Also Subject to External Influences**

In the foregoing discussion of policy space, we have focused mainly on the horizontal and vertical perspectives. In addition to these, however, the interconnectedness of the international economy and changes in the external environment will also dynamically affect China’s policy space. In particular, the dislocation of internal and external economic cycles and the rhythms of foreign policy implementation may have an impact on China’s policy space. But *how external shocks affect policy space also depends largely on how we respond.*

From mid-2015 to 2016, US monetary policy shifted from reducing quantitative easing to raising interest rates, while China’s domestic financial risks were being constantly exposed and downward pressure on the economy increased. At that time,

China's macro control policy space was obviously squeezed, and for a time the monetary easing policy was placed in a dilemma.

Since the end of 2021, the economies of China and the United States have once again been in a state of cyclical dislocation. The US Federal Reserve launched its first round of interest rate hikes in mid-March, but among China's macro control policies, the main task of monetary policy has been to maintain reasonably ample liquidity. Against this background, the interest rate spread between China and the United States has recently narrowed significantly, even approaching 30 basis points at one point, thus reaching a historical low. Even so, *the RMB exchange rate did not face the depreciation pressure it did in 2015 and 2016, and even showed a certain strength, which also means that there is still considerable room for monetary policy to adopt a "self-directed" framework.*

In this context, it is also important to understand how the RMB exchange rate deviates from interest rate parity. There are at least two reasons for this deviation:

*First, the trade surplus is strong.* In the first two months of this year, China's trade surplus was US\$116 billion, a nearly 20% year-on-year increase, and the scale of the surplus reached a record high. Behind the surplus was the continued overheating of demand in economies such as Europe and the United States, while the supply was insufficient. This output gap has been further reflected in greater inflationary pressures. By contrast, China's inflationary pressure has clearly tended to be weak, and we even face insufficient demand. *Therefore, the strong trade surplus supports the formation of the RMB exchange rate, and from a deeper perspective, the logic of purchasing power parity is actually at work.*

*Second, the deviation of the exchange rate from interest rate parity can also be observed from a risk perspective.* The growth forecast for the United States itself is constantly being lowered. In October 2021, the IMF predicted that the United States' growth rate in 2022 would be 5.2%, but in January 2022, the IMF lowered its forecast to 4%. Since then, international investment banks have also lowered their growth forecasts for the United States. In early March, the Federal Reserve Bank of Atlanta's model projected that the US annualized rate would fall to 0.1% in the first quarter.



Clearly, the United States' current decision to raise interest rates was passively introduced against a background of unsatisfactory fundamentals and significantly weakened growth expectations, due to upward pressure on inflation, which generally raises market risks, so this is a *“bad” rate hike*.

China, meanwhile, has set a higher growth rate target, and the policy to stabilize the economy for this purpose is a *“good” easing*. This will help reduce risks, stabilize China's growth expectations, and boost investor confidence.

This contrast between risk in China and the United States also explains to a certain extent the deviation of the RMB exchange rate from interest rate parity. Due to the support by the factors described above, the comfort zone of the Sino-US interest rate gap has been significantly lower than the historical level of 80 basis points, while China's monetary policy space is still relatively large.

*In sum, macro control policy space varies from country to country, from time to time, and from situation to situation.* The red line on government debt exceeding 60% or 90% is neither a necessary nor a sufficient condition for a debt crisis to occur.

*On horizontal comparison,* China's macro control policy space is quite sufficient. *From a vertical perspective,* cross-cycle adjustments require us to reserve policy space for future difficulties, but we should also not be too stingy with policy space because of this.

*As for the domestic and foreign environments,* China's macro control policy space also meets the conditions for adhering to a *“self-directed” framework*. As long as we use it properly and correctly grasp the timeliness of macro control, then on the basis of enhancing market expectations and boosting market confidence, the force of macro policy itself can improve economic growth expectations, thereby further expanding future policy space, improving market confidence, and forming a virtuous circle.

Translated by Thomas E. Smith