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Global Macroeconomic Paradigm Shifts and Policy Options

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After the COVID-19 pandemic, the global economy has been facing major upheaval, with old paradigms being shattered and new ones taking shape. Behind the shift in macroeconomic paradigms is the rise of economic nationalism, wherein, amid slowing growth, multiple countries have been intensifying government interventions, aiming to enhance their national economic competitiveness. This is specifically manifested through policies to promote fiscal expansion, trade protection, and energy independence. The shift in macroeconomic paradigms signals a reshaping of the international division of labor and a realignment of global industrial chains and capital flows. As the Chinese economy faces the dual challenges of a complex external environment and an internal transformation of momentum, policy options should aim to improve expectations, with short-term policy support measures and long-term commitments in reform and transformation; structural reforms need to be complemented with countercyclical macroeconomic policies.

Global Macroeconomic Paradigms: Undergoing Major Transformations

Since the outbreak of the COVID-19 pandemic, the global macroeconomy has been gradually transitioning from an era of “great moderation” to an era of “great divergence” and “great volatility.” Specifically, this transition is marked by the shift from “three lows and one high,” namely, low interest rates, low growth, low inflation, and high debt, to “three highs and one low,” namely, high inflation, high interest rates, high debt, and low growth.

The first is high inflation. The COVID-19 pandemic and the Ukraine crisis led to a significant rise in global inflation, and the green transition, deglobalization, and fiscal expansion have further pushed up long-term inflationary pressures. According to the IMF’s *World Economic Outlook*, in 2023, the inflation rates for advanced and developing economies are projected to be 4.6% and 8.5%, respectively, which are 2.8 and 3.8 percentage points higher than the average for the three years before the pandemic (2017-2019). Second, high interest rates. With the central banks of major economies continuing to raise interest rates, overseas markets are entering a high-interest-rate era, with the yield on ten-year US Treasury bonds reaching highs of 5% at one point. Economic resilience and inflation stickiness imply that interest rates in developed countries will remain significantly higher than before the pandemic ("higher for longer"). Third, high debt. During the pandemic, the advanced economies increased fiscal stimulus efforts, which led to a rapid rise in government debt levels. In the most severe year of the pandemic, 2020, government debt-to-GDP ratios in the United States, Europe, and Japan increased by 25, 22, and 13 percentage points, respectively. However, in the United States and some European countries, after the fiscal stimulus measures, nominal GDP growth rates significantly increased, and debt ratios have declined somewhat. Fourth, low growth. The COVID-19 pandemic brought unprecedented shocks to the global economy, resulting not only in the most severe recession since the Great Depression but also leaving deep "scarring effects" on the economy due to its prolonged duration and widespread impact. Additionally, medium- to long-term structural factors such as slowing technological progress and deglobalization may have also weighed down on growth.

It is worth noting that the "three highs and one low" are only current signs—uncertainty surrounds their future evolution. Key variables influencing their course will include the development of artificial intelligence (AI), as represented by ChatGPT. AI has been one of the most influential technologies in the past decade, especially since 2023, when market speculation propelled AI's popularity to new heights. However, the risks hidden beneath this prosperity should not be overlooked. According to the Artificial Intelligence Maturity Model published by Gartner, we are currently still in the early stages of the artificial intelligence technology cycle. There is uncertainty regarding the timing and effectiveness of the implementation of AI technologies such as generative AI, natural language processing, basic modeling, and others. If there is no significant technological change and widespread application, the main dilemma in the global economy under the new macroeconomic paradigm will be paltry growth, in which case various countries will shift their focus away from figuring how to "expand the pie" to figuring how to "divide the pie."

Economic Nationalism: The Essence of the New Macroeconomic Paradigm

Behind the shift of macroeconomic paradigm is the resurgence and revival of economic nationalism. The idea of economic nationalism can be traced back to the mercantilist school of thought in the seventeenth century; it began to influence policies in the nineteenth century, and became a widespread consensus among nations in the 1930s. Economic nationalism refers to a series of policy propositions aimed at supporting and protecting a national economy in the context of global competition. Its ultimate goals are to promote national independence and strengthen state power. Therefore, as long as it aligns with national interests, economic nationalism can allow for closed regulations and self-sufficiency while at the same time encourage free trade and promote capital mobility. Usually, economic nationalism models exhibit the following three characteristics: (1) an emphasis on security as a priority, with a focus on military and economic security; (2) a priority on technological competition, in the belief that technology is crucial for security, independence, and national identity; and (3) the view that industrialization is a necessary means to enhance national power.

In recent years, with the exacerbation of wealth disparity caused by globalization, deepening concerns over unemployment sparked by technological advancements, and the heightened importance of national borders highlighted by the impact of pandemics, economic nationalism has regained popularity in various countries. In the United States, for example, since Joseph R. Biden took office, the country's economic stance has swiftly shifted from the "Washington Consensus" of "small government, big market" to the "New Washington Consensus," which emphasizes strengthened government intervention and safeguarding national security. The current economic nationalism primarily manifests in the following three areas.

The first is a transformation in the macroeconomic policy coordination framework. The strength of government intervention is increasing, and policy choices are shifting from monetary dominance to fiscal dominance. During the pre-pandemic “great moderation” era, fiscal policy was relatively tight due to fiscal conservatism. For example, when the United States in 2011 had still not fully emerged from the 2008 global financial crisis, it began implementing fiscal austerity, which triggered the “debt ceiling crisis.” Europe’s initial response to its debt crisis also involved reducing borrowing. However, the pandemic shattered the existing macroeconomic policy paradigm in the West. Western countries significantly increased fiscal expansion efforts. According to the IMF’s broad deficit criteria, the average annual fiscal deficit rate in the United States exceeded 10% from 2020 to 2022 (with a cumulative deficit exceeding 30% over three years), and the average annual deficit rate in European countries was around 7% (with a cumulative deficit exceeding 20% over three years).

The second is a reversal of globalization, which is being influenced by various factors. On the one hand, the dividends of globalization have not been fairly distributed, leading to a certain extent of wealth disparity and the prevalence of populism. While globalization helps promote improvements in efficiency, the division of labor along global value chains inevitably leads to a significant shift in job opportunities. Traditional manufacturing job opportunities in developed countries decrease, while wealth accumulation in the multinational corporations’ home countries increases. The income of the high-income class rises faster, while the welfare of the working class diminishes, leading to resistance from some people. On the other hand, geopolitical competition among major powers has accelerated the counter-globalization trend. Measured by nominal GDP, the ratio of China’s economy to the United States reached as high as 77% in 2021.

Finally, there is the green transformation and energy independence. The green transformation, besides being a solution to climate issues, is also linked to development strategies and energy independence. Essentially, it involves countries reducing their dependence on fossil fuel imports and increasing the independence of their energy supply. China has long been a major energy importer, so it has consistently promoted energy transformation. Following the Ukraine crisis, developed economies represented by European countries accelerated their efforts to reduce dependence on Russian energy, further strengthening their determination to achieve energy independence. Since 2022, Russia's share of oil and natural gas imports to the European Union has continued to decline, from an average of 9.5 million tons and 8.6 million tons respectively per month to 1.6 million tons and 2.5 million tons per month in the second quarter of 2023. Solar and wind power generation in the EU surpassed natural gas for the first time in 2022, accounting for approximately 22% of total electricity generation. Achieving energy self-sufficiency has also been a policy goal of recent US leaders. Thanks to the shale oil revolution, the United States surpassed Saudi Arabia as the world's largest crude oil producer in 2017, achieving energy self-sufficiency and becoming a net exporter of crude oil and refined petroleum products.

The Restructuring of Capital Flows and Industrial Chains

Financial capital and industrial capital are highly interconnected and complementary. Generally, financial capital circulates before industrial capital, which then follows suit in overall distribution. Due to the influence of the new macroeconomic paradigm, global capital flows have changed compared to the past. According to the criteria of the 6th edition of the IMF's *Balance of Payments and International Investment Position Manual* (BPM6), foreign capital (i.e., the liability side in capital and financial accounts on the BOP table, which reflects foreign residents' net purchases of domestic assets) has been continuously flowing out of China since the third quarter of 2022. As of the second quarter of 2023, the cumulative net outflow amounted to US$69.36 billion. Meanwhile, during the same period, the United States, Japan, and India witnessed net inflows of US$13.3696 trillion, US$1.0793 trillion, and US$1.7148 trillion respectively.

From the mid- to long-term perspective, it is worth paying attention to whether the decoupling of financial capital will further lead to the decoupling of trade and industry. Countries are increasingly emphasizing both security and efficiency in their industrial chains, and even prioritizing security to some extent. Against this backdrop, developed economies tend to place their industrial chains in geographically adjacent peripheral areas or allied countries, achieving what is called “nearshoring” or “friendshoring.” For example, China is the largest source of imports for electromechanical vehicle products in the United States. However, following trade friction between China and the United States, the US import share from China of this category decreased from 27% in 2018 to 21% in 2022. During the same period, the import shares from ASEAN and Mexico increased by 5% and 1%, respectively. China’s market share in the United States is thus being taken over by ASEAN and Mexico.

In addition, it is important to note that with the resurgence of economic nationalism, the advantages of the traditional major powers will become more pronounced. In the era of globalization following World War II, small countries could integrate into the global economic system on an equal footing with the major powers, breaking through the limitations of domestic demand scale and enjoying economies of scale on a global scale. However, under the current influence of geopolitical conflicts, intensified technological competition, and a slowdown or even reversal of the global division of labor in industry, countries are becoming more reliant on their domestic markets. Large countries, leveraging their vast domestic markets, population, and economic scale, possess greater advantages in industry, energy transformation, and other areas, but small countries with limited domestic market size and high dependence on external demand may have to align themselves with major powers and strengthen their own scale by relying on industrial chains dominated by major powers in their regions, before they participate in international competition. Over time, this trend may lead to the emergence of several global technological, financial, and industrial networks, each dominated and separated by major powers.

China: At a Critical Point in the Transition between Old and New Driving Forces

China is not only influenced by the global macroeconomic paradigm shift but also faces the challenge of transitioning between old and new drivers of growth. The old models of urbanization and industrial growth have achieved significant success but are becoming unsustainable. China is currently going through structural turning points in terms of demographic shifts, real estate, leverage rates in the household sector, and globalization, and all of these are increasing resistance on economic growth, so there is an urgent need to find new drivers of growth. While guided by the ideology of high-quality development, we need to pay attention to two drivers of transformation: green transformation and digital transformation.

Regarding green transformation, the carbon neutral technological revolution helps reduce China's traditional reliance on fossil energy imports and promotes new energy as a new growth point for exports. China is at the global forefront of green transformation. For example, the penetration rate of new energy vehicles in China was 35.1% from January to November 2023; production volume was 8.426 million vehicles, including 1.091 million exported vehicles.

As for digital transformation, due to the replicability, shareability, and inexhaustibility of data, the digital economy has low marginal costs and increasing returns to scale, which helps better stimulate economies of scale in the Chinese market. The digital transformation of industry will lead to changes and adjustments in production methods. Currently, the penetration rate of China's digital economy (online retail sales as a proportion of total retail sales) has reached 31%, giving rise to new forms of business in the digital era such as the "gig economy" and "platform economy." At the same time, digital transformation may significantly impact traditional industries, necessitating appropriate responses to issues such as creative destruction and the distribution of benefits.

Policy Options

During the global macro paradigm shift and China's economic transformation, policies should focus on improving expectations and enhancing confidence as core objectives, and structural reform may be crucial. However, structural reform is a long-term task, and in the short-term, the economy inevitably suffers pain. Therefore, the emphasis should still be placed on countercyclical macroeconomic policies to cushion the impact of structural reform and to guide social expectations reasonably.

On the fiscal policy front, the central government should actively leverage its balance sheet to counter-cyclically drive up leverage in the private sector. In the current macroeconomic situation, characterized by weak overall demand, fiscal policy can stimulate aggregate demand by shifting away from the investment stimulation of the past to consumption stimulation. This would include increasing transfer payments to vulnerable groups, enhancing subsidies to encourage childbirth, and so on, in order to improve resident expectations and boost consumption. Simultaneously, further tax reductions and relief measures, as well as increased support for the redevelopment of "urban villages," can be implemented to support business operations, drive investment in the corporate sector, and ultimately establish a virtuous cycle for policy, residents, and enterprises.

On the monetary policy front, the People's Bank of China should lower interest rates to reduce the risk premium for the private sector. With inflation levels below the target, monetary authorities can utilize conventional monetary policy tools to increase the pace and intensity of interest rate cuts and reserve requirement reductions. For example, by implementing policies on interest rate cuts and reserve requirement reductions in order to release liquidity, market interest rates can be driven down, thereby reducing the overall level of risk premiums. At this juncture, through the coordinated easing of monetary and fiscal policies, the pressure of a sole aggressive monetary policy action exacerbating depreciation of the renminbi can be avoided. Furthermore, the People's Bank of China can further streamline the transmission of monetary policy, lower existing loan rates, and effectively reduce the debt costs of economic entities.

All these macro policies cannot replace reforms. In the medium to long term, structural reforms should continue to be deepened to promote the green and digital transformation of the economy. Economic transformation requires a concerted effort in technological innovation, improvement of the business environment, and financial support, with all three areas reinforcing each other. Technological innovation and the development of new quality productivity rely on financial support. China needs to increase its support for future industries such as network communications, artificial intelligence, and new energy. It should implement more extensive and inclusive industrial policies to incentivize enterprises to increase research and development investment and improve innovation levels. Meanwhile, stimulating innovation among enterprises requires a healthy and favorable business environment, so the government should boost confidence in the private sector by improving property rights protection systems, optimizing administrative public services, and other means. More financial resources should be precisely allocated to innovative and green enterprises, as well as other real sectors of the economy, fully leveraging the unique advantages of finance in nurturing new drivers of growth.

The author, Miao Yanliang, is the Managing Director and Chief Strategist of China International Finance Corporation Ltd., and Executive Director of its Research Department. The content of this essay has been selectively abridged from the original, published in *Guoji jingji pinglun* (*International Economic Review*), 2024.1, under the title "Shijie jingji mianlin de zengzhang tiaozhan yu zhengce yingbian zhuanbian" ("The Challenges to Growth Facing the World Economy and Changes in Policy Response").

Translated by Thomas E. Smith