A first draft, very preliminary, not for quotation

Chinese macroeconomic management: issues and prospects[1]

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Introduction

Despite all sorts of talking about China's overheating, soft landing and hard landing, China's economic situation has never been so good, since the reform and opening up. In 2005, China's growth rate was 9.9%, inflation was 1.8% percent. This is the fourth year of high growth and low inflation in a row. China's average annual growth rate since 1979 is more than 9.6%. It is fair to say that China has grown faster for longer than any country in history. As a result, China has become the fourth largest economy in the world. In terms of the PPP, China has already been the second largest economy in the world for many years.

Although, on average, China's annual growth rate is high and its inflation is modest, it had never been able to maintain a high growth rate above 9 percent and an inflation rate below 5 percent more than two years in a row. Over the past 25 years, the Chinese economy has been characterized by large fluctuations (Figure 1). China has experienced roughly 3 economic cycles since 1981. The last cycle started in 1996 and ended arguably in 2002. Usually, growth is driven by high growth rate of fixed assets investment (Figure 2), and high inflation would follow high growth with a lag of 4-5 quarters.

Figure 1. China's Economic Growth and Inflation since 1990-

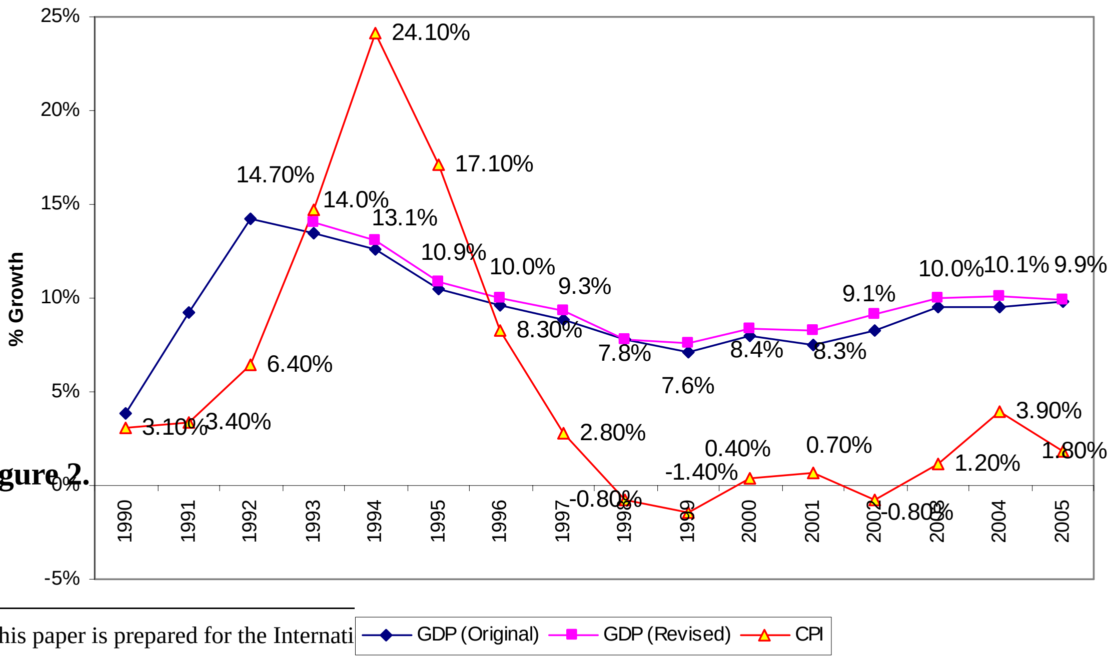

Figure 2.

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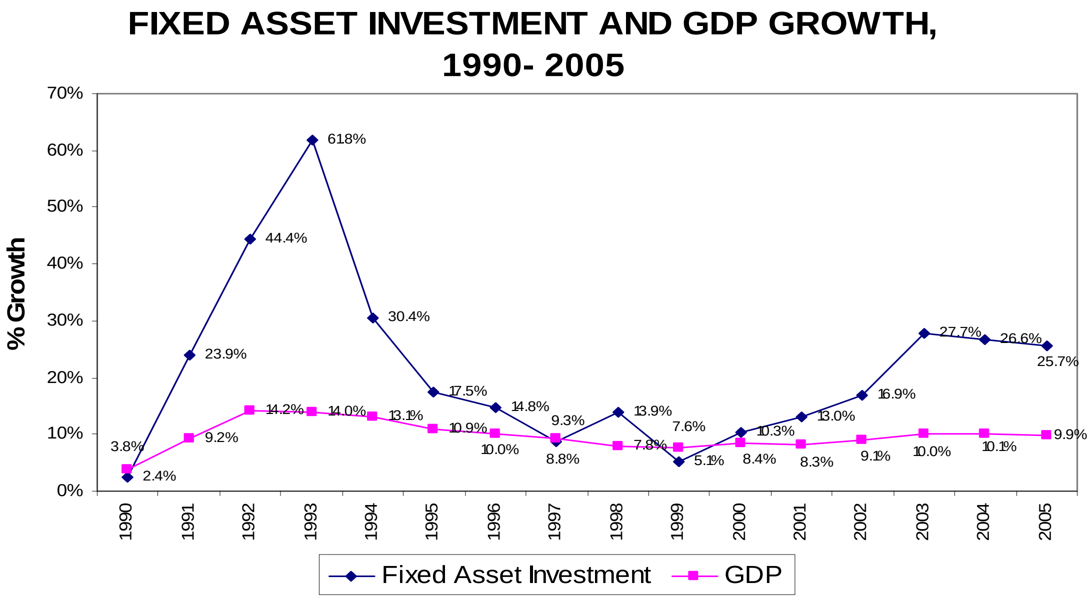
Figure 2

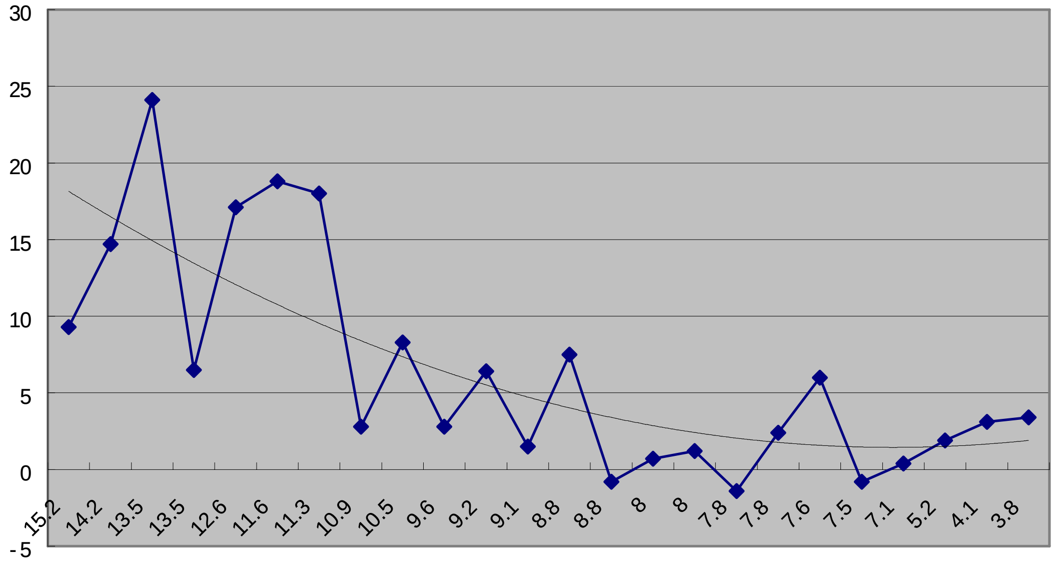


To bring inflation under control, the government would use tight monetary and fiscal policy to cool down the economy. As a result, economic growth would slowdown gradually or drastically leading to high unemployment or and deflation. When inflation is under control, the government would use expansionary monetary and fiscal policy to reflate the economy. In response, the economy would bottom out and a new cycle would begin. Over the past 25 years the Chinese economy has shown a very clear “stop-go” pattern. In this paper on China’s macroeconomic management, emphasis is on monetary policy. The first section provides a historical review of China’s conducting of monetary policy since the later 1990s. The second section discusses China’s fiscal policy briefly. The third section is about China’s growth prospects in 2006. Lastly, concluding remarks are provided

I. China’s Monetary Policy

Officially, the final objective of monetary policy is to maintain the stability of currency value so as to promote economic growth. The stability of currency value means both price stability and exchange rate stability. Therefore, there are three objectives for China’s macroeconomic policy: growth, price stability and exchange rate stability. In practice, the number one objective is to guarantee a minimum growth rate of 8 percent. The number two objective is to keep the inflation rate around 3 percent. Up until recently, the trade-off between growth and inflation existed (Figure 3). However, the correlation between growth and inflation seems not that strong. This is especially true in recent years. In economics, it is generally accepted that in the short-run, trade-off between growth and inflation exists. But in the long-run, the trade-off does not exist. However, in China, so far high growth is accompanied by low inflation. The worry is that in the long-run, would the trade-off will reassert itself?

Figure 3. The trade off between growth and inflation



Note: the vertical axis represents inflation and horizontal represents growth. The data cover the period of time from 1980 to 2002.

The third objective is to maintain the stability of exchange rate of the RMB that previously was pegged to the US dollar and now is referred to a basket of currencies. When capital control was still effective, the PBOC did not need to worry about the peg to the US dollar. Now following the gradual liberalization of capital account, the conflict between exchange rate stability and the other two objectives has become more and more difficult to reconcile.

China's monetary policy in many respects was shaped under the influence of monetarism in the early 1980s. According to monetarist orthodoxy, the authorities should fix the growth rate of the money supply at a rate that would be consistent with a certain unspecified constant inflation rate. It is understood that inflation rate will accelerate with a lag after the growth rate has reached a certain level that by definition is the potential growth rate. According to historical experience in China, when the growth rate is above 10 percent, the inflation rate would surpass 10 percent with four-five quarters' lag and when the growth rate is above 9 percent the inflation rate would surpass 5 percent. Therefore, when the growth rate has reached 10 percent, the government would tighten macroeconomic policy without waiting for too long to allow inflation to accelerate. When the growth rate has reached 9 percent, the government would be very nerves and ready to tight. On the other hand, when the economy is in downturn and the growth rate has fall below 8 percent, the government would adopt expansionary macroeconomic policy to stimulate the economy. If while the growth rate has dropped to 9 percent, the inflation rate often is still high, it is very difficult for the decision makers to judge whether the inflation rate will fall further, without the further tightening of macroeconomic policy. For example, in 1997, when the growth rate was dropping and overcapacity was prevalent, the government was still reluctance to take actions to simulate the economy, for fearing the rebound of inflation. Only when it was already too late was the action taken to shift the contractionary economic policy to an expansionary one. Perhaps, because the government acted too late to shift policy direction from tightening to loosening, China finally entered a period of deflation for 6 years. In the early 2003, when the government had found numerous evidences showing the heating up of the economy, it was uncertain whether the economy had turned around and a tight macroeconomic policy should be adopted. As a result, the government refrained from taking action for the fear of killing off the recovery which was in its initial stage. Only later when the government was convinced that the turn-around had happened, were actions taken. Even so, the government is still very cautious in its tightening for fear of overkill.

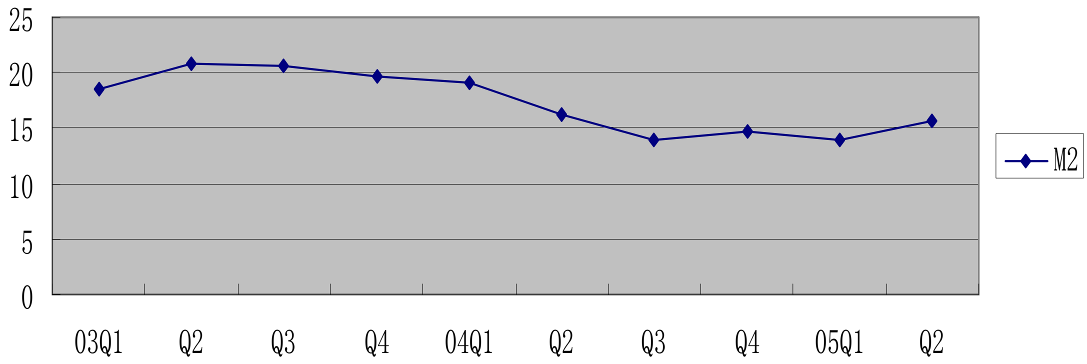
When the direction of the course of actions has been decided, monetary policy will often be the first candidate for being selected to achieve the policy goal of tightening or loosening. In the process of the implementation of monetary policy, there are two key links: the monetary base (high- powered money, HPM) and the monetary multiplier. The authorities should control the monetary base (reserves plus currency), and then through a stable monetary multiplier to control the money supply.[2] After monetary policy has been taken, an immediate question is about how changes in the money supply will influence the real economy. It is assumed that changes in the money supply will influence the real economy via various transmission mechanisms such as the portfolio balance transmission mechanism, the wealth transmission mechanism, the credit availability transmission, and expectation transmission mechanisms[3].

Until now the intermediate objective of monetary policy is the growth rate of money supply rather than some bench-mark interest rates. Each year, the PBOC sets a target for the growth rate of money supply. However, the target is just a policy manifestation, a reference target. More often than not, the PBOC fails to hit the target. When the objective is to tighten money supply in the face of the heating up of the economy, the actual growth rate of money supply will be above the target. When the objective is to loosen the money supply in the face of the cooling down of the economy, the actual growth rate of money supply will be below the target. For example, in recent years the PBOC has set a target of 16 percent for the growth of

[2] Allsopp, C.J. and Vines, D: The Assessment: Macroeconomic Policy, *Oxford Review of Economic Policy,* VOL.16.NO.4, Winter 2000.
[3] Pierce and Tysome: Monetary Economics, 1985.

broad money. However, the growth rate of M2 has been persistently higher than the target (Figure 4). The missing of target, to a large extent, can be attributed to the endogeneity of money supply. Under different circumstances, monetary policy can become very ineffective in very different ways. In China, the ineffectiveness of monetary policy is attributable to the breakdown of the two key links in the money-supply process and the collapse of the transmission mechanisms of monetary policy.

Figure 4. Growth of the Supply of Broad Money



The first link in the money-supply process is the central bank's ability of fixing the quantity of reserve money. The second link is a stable monetary multiplier through which the changes in the quantity of reserve money lead to corresponding changes in broad money. To achieve the target of the growth of money supply by manipulating the monetary base, the PBOC's main instrument is open market operations (OMOs). The financial instruments traded in open market operation are government bonds, central government bills, and financial policy bills. China has a relatively well-developed money market consisting of inter-bank money market, and inter-bank government bonds market where repurchasing and inverse repurchasing (to reduce liquidity) are conducted.

From the assets-liabilities sheet of the central bank (table 1), it can be seen that reserve money can be controlled by changing the quantity of selective entries in the sheet. It is worth mentioning that the most important component of the reserve money consisting two parts: mandatory reserves and excess reserve that are used for the settlement with other commercial banks in the accounts of the central bank. In China, entries most commonly targeted for changes include: loans to commercial banks (relending), government bonds, and, more recently, central bank bills.

Table 1. The PBOC's Assets-Liability Sheet by the end of 2005 (billion CNY)

liabilities		assets	
Currency	2585	Loans to the banking system	782
Bankers' deposits	3839	Loans to the government	29
Reserves			
Excess reserves			
Government deposits	753	Foreign exchange reserves	6214
Central bank bills	2030		
Other liabilities		Other assets	
Own capital	22	Government bonds	
Total liabilities	10368	Total assets	10368

Sources: People's Bank of China

In the early period of the reform and opening up, the most frequently used measure to control the monetary base was to change the central bank relending to commercial banks. When the economy was overheating, the central bank will reduce or even call-back its loans to commercial banks, and vice-versa. Until 1998, the amount of bonds the central bank could trade in OMOs was limited, because the large-scale issuance of government bonds just started in the middle of the year as an important component of the policy package aimed at relating the economy. In 1999 following the development of the money market and bond market and the increase in the issuance of government bonds, the total transactions of government bonds between the central bank and financial institutions through OMOs was 707.6 billion yuan, a 3 fold increase over the previous year. The net increase in the monetary base resulting from OMOs was 192 billion yuan, which constituted 52 percent of the increase in the monetary base.[4]

Since the middle of the 1990s, the increase in foreign exchange reserves has become one of the most important contributing factors to the increase in reserve money (or HPM). In order to control the increase in reserve money, large-scale open market operations have been carried out to sterilize the increase in reserve money caused by the increase in foreign exchange reserves by selling government bonds held by the PBOC. However, since 2002 while China's accumulation in foreign exchange reserves began to speed up rapidly, due to the so-called twin surpluses (Figure 5 and 6), the Chinese economy has shown signs of overheating. Owing to the enormous scale of OMOs aimed at neutralizing the expansionary impact of the increase in foreign exchange reserves, in just a coupe of years, the PBOC sold out all the government bonds it had accumulated as a result of the previous OMOs aimed at increasing money supply to stimulate the economy. In 2003, the PBOC found that it has to create a new type of financial instrument- central bank bills to mop up the liquidity.

[4] Dai Genyou:China's Monetary Policy: Retrospect and Prospect, World Economy and China, No.3, 2001, p15.

Figure 5. China's twin surpluses

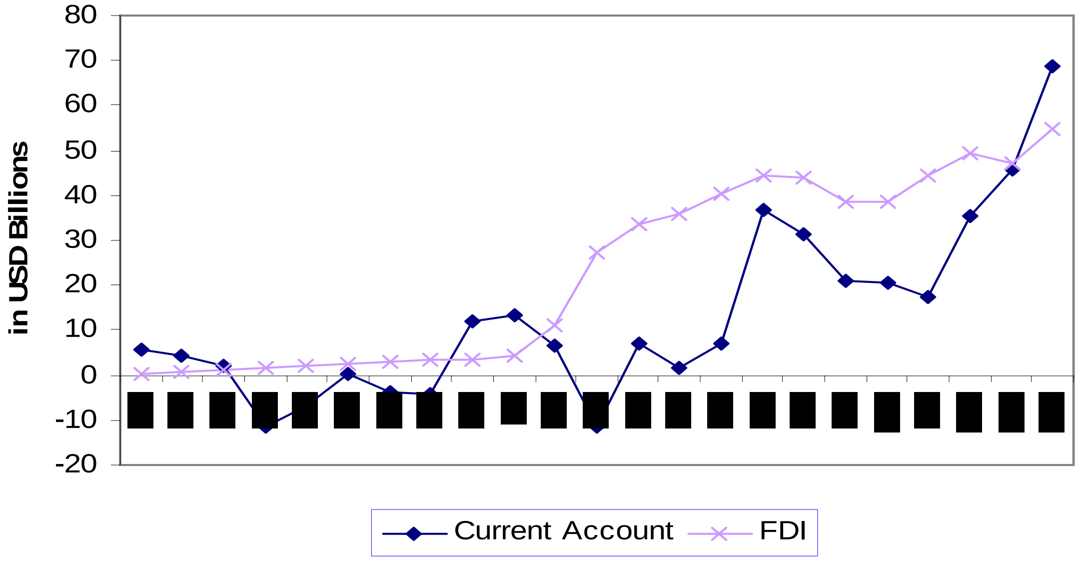
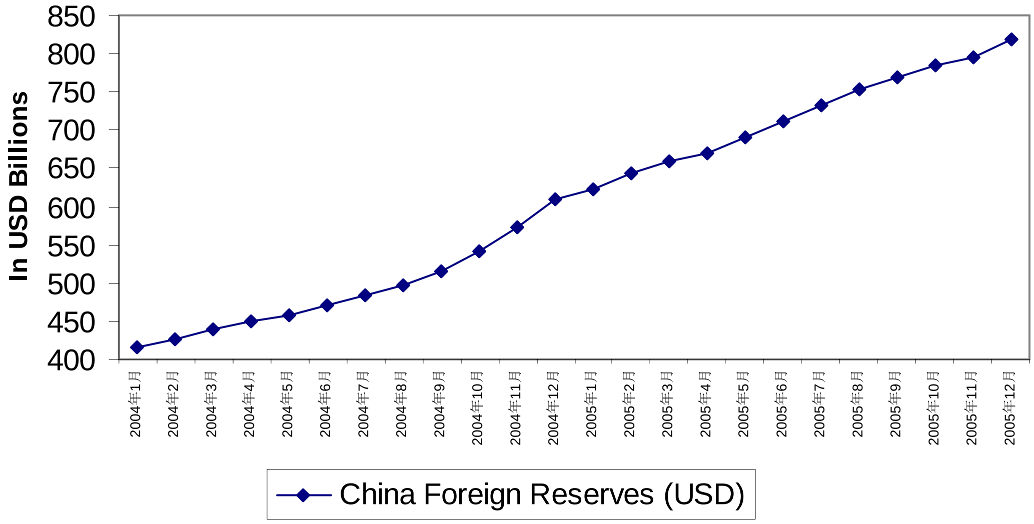


Figure 6. China's accumulation of foreign exchange reserves



As a result, in a short period of three years, the total balance of central bank bill issued reached more than 2 trillion Yuan RMB (see table 1). In contrast, the total balance of government bonds was just 3 trillion Yuan RMB after 10 years' issuance. Most of the central bank bills are short term bills of three month. The burden of rolling-over for the central bank is horrendous. Consequently, the central bank has to give up the attempt to sterilize fully the increased liquidity caused by the increase in foreign exchange reserves. The sterilization is usually partial. As a result, the monetary base often expends at much higher speed than what the PBOC wishes. One important question is whether sterilization can be implemented unlimitedly. This is a debatable question. Theoretically speaking, as long as the interest rates paid by the central bank on its bills is lower than corresponding interest rates of American assets, say, the yields of treasury bills, the central bank should be able to carry on with full sterilization infinitively, and hence to maintain an effective control of the monetary base. However, there are several obstacles to the full sterilization. First, other things being equal, the sale of central bank bills will push up the interest rates in money markets, which in turn will invite more capital inflows and place more pressures on the RMB and hence the need for more sterilization. Second, when the overall financial condition is tight, due to the existence of better options, commercial banks may refuse to buy the low yields central bank bills. As a result, the yields of the central bank bills will be bid up and the central bank may suffer from operation losses, if the changes in the Fed rate are unfavourable. Third, in case that there is no alternative available and commercial banks have to buy the low yield central bank bills, commercial banks' profitability will fall, which will create long-term negative impact on the fragile banking system, which was just showing a better shape after the recent injections of capital by the PBOC. In short, because the limitations on the implementation of sterilization policy, an effective control of the monetary base is very costly, if not impossible.

Essentially, the central bank has only to issue bills to mop up liquidity when the economy is under the threat of inflation. Under an environment of inflation, the issuance of central bank bills will push up the interest rate. As long as the maintenance of the stability of exchange rate is one of the central bank's objectives, sterilization through OMOs cannot carry on indefinitely. Are there other measures available to mop- up the liquidity, which at the same time will not lead to an increase in interest rates in the money market?

Besides OMOs, another important measure that has been taken is to change the reserve requirements (table 2). By raising reserve requirements, large amount of liquidity can be frozen. On 1st of September 2003, the PBOC raised the reserve requirements from 6 percent to 7 percent. The total deposits and total reserves were about 20.5 trillion CNY and 1.6 billion CNY, respectively, by the end of June 2003. Roughly speaking, as a result of the increase in reserve requirements, 150 billion CNY excess reserves were frozen. In fact, the raise of reserve requirements was the first important measure taken by the PBOC since the Chinese economy has bottomed out from deflation that started since 1997, which signalled that the direction of macroeconomic police Later, on 21st o April of 2004, the PBOC raised the reserve requirements by 0.5 percent again.

Table 2. Adjustment of reserve requirements

time	adjustment	purposes
1985	Unified to 10%	
1987	12%	Tightening money supply
1988	13%	Tightening money supply
1998(03/ 21)	8%	Reforming the requirement system
1999(11/21)	6%	Increasing money supply
2003(09/21)	7%	Tightening money supply
2004 (04/21)	7.5%	Tightening money supply

In a typical market economy, the central bank will refrain from changing reserve requirements, because the measure is regarded as too drastic and clumsy. However, this seems not a problem for the Chinese economy. Though the rise of reserve requirements will cause some problems for commercial banks, the latter can adapt to the new situation by various measures. The simplest way by commercial banks in responding to the tightening is to shift a proportion of excess reserves into the account of mandatory reserves. The new liquidity created by the PBOC intervention in foreign exchange market is expected forthcoming soon to satisfy their need for excess reserves, thanks to the increase in foreign exchange reserves. Therefore, what is in question is the effectiveness of this policy instrument, rather than its negative impact on the smooth functioning of the banking system.

The most important condition for the second link in the money-supply process to function properly is the stability of the multiplier. However, this condition, more often than not, cannot be met with China's fragile financial system. Over the past decade or so, the monetary multiplier has been various all the time in the range between 3 and 4. The variations in the monetary multiplier to a large extent are caused by institutional factors that are beyond the control of the monetary authorities. Firstly, Chinese banks have accumulated huge amount of nonperforming loans (NPLs), while Chinese banks have increasingly commercialised and the government has tightened the regulation on and supervision over banks' lending activities. As a result, commercial banks have become much more concerned about the loan safety than profitability and very reluctant to lend because of the risks. In contrast, when commercial banks are able to reduce their non-performing loans and increase the capital adequacy, they become more ready to extend loans to enterprises, especially when they are pressurized by the local governments to lend. In other words, the multiplier is subject to the influence of institutional factors that are undergoing changes, independent of macroeconomic situation. Secondly, many enterprises' demands for loans are also subject to the influence of institutional factors. In 1998, despite the fact that the central bank lowered the reserve requirement for commercial banks from 13 percent to 8 percent and eliminated the excess reserve requirement, in the fourth quarter of 1998, all major banks' actual reserve ratios were higher than 15 percent. This shows that commercial banks did not need funds at all. They would rather let the unneeded funds lay idle with low interest in the vaults of the central bank. After 2003, when the PBOC began to tighten the money supply by tighten the monetary base. Various methods were used by commercial banks to neutralize the impact so as to maintain a high growth of the supply of bank loans. Commercial banks' efforts in neutralizing the effect of PBOC's efforts in controlling the growth rate of money supply have rendered the concept of the monetary multiplier meaningless to a large extent.

In developed countries, "the most important control instrument of the central bank is a short-term interest rate and that this influences the behavior of commercial banks by determining the price at which they lend".[5] Interest rate policy is also an important instrument of monetary policy in China. Since 1999 the inter-bank money market has assumed an increasingly important role in influencing the liquidity and interest rate structure in the economy than before. However, despite the efforts in interest rate linearization, due to the fragmentation of China's money market, so-called ripple-effect of a change in a benchmark interest rate is far from perfect. Furthermore, in China there still is no benchmark interest rate equivalent to the Fed funds rate in the US, the bank rate in England, and the overnight call rate in Japan. Though a few key short-term inter-bank interest rates are determined by market forces, these rates cannot influence the whole interest rate structure of the economy automatically and in a cascading way. The important interest rates that would have direct impact on the real economy are those on household savings deposits and bank loans to enterprises. Bank loans to individuals such as mortgages are a very recent phenomenon. Since May of 1996, in order to prevent the economy from stumbling, the central bank began to lower interest rates. From 1996 to 1999, the central bank lowered interest rates seven times (table 2). Especially, since July of 1997 to November of 1998, the central bank cut the interest on one year loans to financial institutions (relending rate) 4 times. Before the first interest rate cut on the first of May 1996, the interest rate on one-year savings deposits was 9.18 percent. After seven cuts, the same interest rate fell to 2.25 %.

[5] Allsopp, C.J. and Vines, D: The Assessment: Macroeconomic Policy, *Oxford Review of Economic Policy,* VOL.16.NO.4, Winter 2000, P7.

Table 2 Changes in interest rates since 1995

Time of adjustment	Reserve deposits	Excess reserve deposits	Relending (loans to banks)				rediscount
			1year	6months	3months	20days	
1996.05.01	8.82	8.82	10.98	10.17	10.08	9	**
1996.08.23	8.28	7.92	10.62	10.17	9.72	9	**
1997.10.23	7.56	7.02	9.36	9.09	8.82	8.55	**
1998.03.21	5.22		7.92	7.02	6.84	6.39	6.03
1998.07.01	3.51		5.67	5.58	5.49	5.22	4.32
1998.12.07	3.24		5.13	5.04	4.86	4.59	3.96
1999.06.10	2.07		3.78	3.69	3.51	3.24	2.16
2001.09.11							2.97
2002.02.21	1.89		3.24	3.15	2.97	2.70	2.97
2003.12.20		1.62					
2004.03.25			3.87	3.78	3.6	3.33	3.24
2005.03.25		0.99					

The most important development in terms of using interest rate instrument to slowdown the economy happened on 29th October of 2004, when the PBOC decided to raise benchmark interest rates on loans extended and deposits received by commercial banks. The benchmark interest rates on one-year deposits and loans were raised by 0.27 percentage point from 1.98 percent to 2.25 percent and 5.31 percent to 5.58 percent, respectively. It was the first time in 9 years that the PBOC had ever raised interest rates. At the same time, measures were taken to further the liberalization of interest rates. In the money market, the interest rates are determined entirely by market forces. Bands were set to allow interest rates on bank loans and deposits to fluctuate. In fact, commercial banks had obtained the autonomy in charge interest rates on loans as long as the interest rates are not lower than the benchmark interest rates on loans decided by the PBOC. On the other hand, commercial banks have the autonomy to charge interest rates on deposits as long as the interest rates are not higher than the benchmark interest rates on deposits decided by the PBOC. In January 2004 the PBOC announced the further widening of the bands on bank loans and deposits. Commercial banks are allowed to charge interest rates within 1.7 times and 0.9 time of the benchmark loan interest rates. Because there was strong demand for loans by enterprises, the liberalization of interest rates should have led to the hike of the interest rates which were liberalized. However, this failed to happen. Few loans extended by commercial banks hit the up-bound of the interest rates. On the one hand, there was strong demand for credits. On the other hand, the interest rates refused to budge. The failure of interest rates to serve as regulators to allocate financial resources is attributable to institutional factors. For big state-owned enterprises, they have enough liquidity anyway and do not strong need for bank loans. On the other hand, they were targeted costumers of commercial banks and banks wished to provide them with credits even with low interest rates. For small and middle-seized enterprises, though they needed credits desperately, commercial banks were reluctant to provide them with credits, due to the high risks of the loans to those enterprises or risk-aversion attitude of commercial banks. Hence, banks would not extend loans to them, no matter how high are the interest rates. As a result, the disequilibrium in the loan market persisted. In formal market the interest rates were low. In the curb market the interest rates were high. Owing to the failure to achieve equilibrium in the credit market via changes in interest rates, the efficiency of financial resources allocation was low. Enterprises that the brake should place on via higher interest rate did not really feel the pain of tightening.

However, it is worth emphasizing that despite the effectiveness of monetary policy is not satisfactory. It is still a very important policy instrument. At least its announce effect is important. In March of 2005, the PBOC raised the benchmark interest rates on mortgage to slowdown growth of loans to real estate development.

A rather interesting phenomenon is, in several occasions, while the PBOC raises interest rates on benchmark interest rates on loans and or adopted some measures to tighten the financial conditions; it at the same time lowers the interest rate on excess reserves. By doing so, commercial banks are given incentive to reduce their deposits with the central bank. As a result, the effect of monetary tightening is offset by the increase in liquidity in money markets. One of important motivation behind this seemly irrational policy combination is to push down the interest rates in the money market so as to discourage of capital inflows that are betting on RMB revaluation. Besides allocation efficiency, the biggest problem is that due to various constraints, the PBOC cannot raise interest rates as high as necessary, the constraints basically come from the fact that the PBOC is burdened with three conflicting objectives in implementing monetary policy.

II. The Growth Prospects in 2006

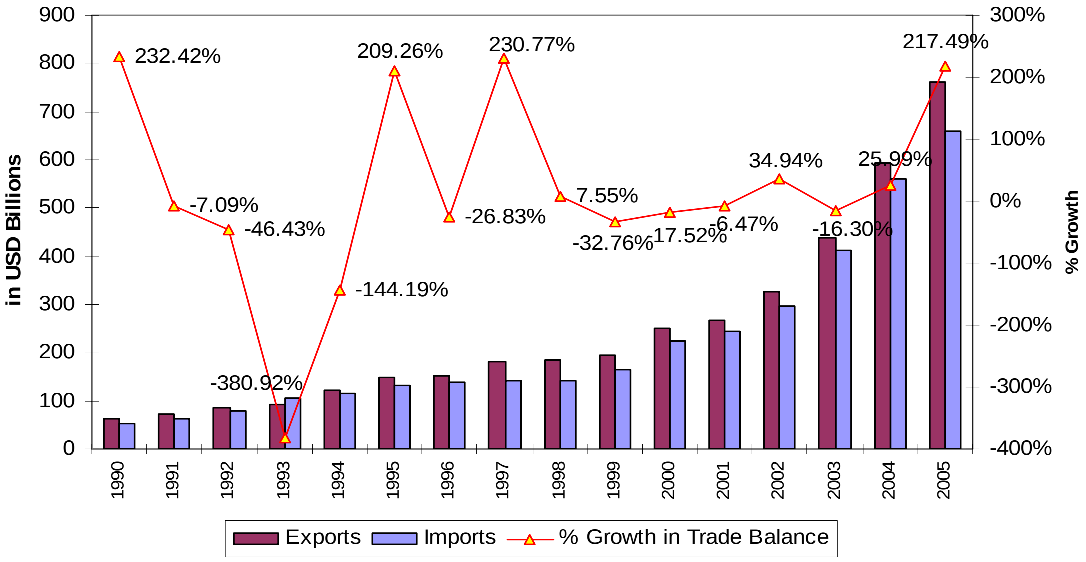
In 2006, China should be able to maintain a high growth rate while keeping inflation under control. So far China's growth rate of investment is still strong; exports have maintained strong momentum, there is no sign of inflationary pressure. On the whole the situation is very good.

However, there are some uncertainties. First, overcapacity in many industries is worsening. Will this lead to deflation or deflation is just hype? Second, what will be local governments' economic policy, while waiting for change of governments at the provincial level next years? Third, what will be the lagged impact on inflation of the high growth of GDP and that of the high growth rate of money supply over the past several years? Fourth, what will be the US policy towards China with regard to China's trade surplus vis-à-vis the United States? Fifth, what will be the external socks China has to face? Will be there another oil price hike as a result of the US bombing Iran?

On the whole, the Chinese economy has weakened starting from early 2005. According to historical experiences, there are three indicators that can be used to measure economic temperature. The first is the growth rate of net export. In the past, more often than not, whenever net export becomes an important contributor to GDP growth, the economy is very likely to have suffered from lack of domestic demand and the economy would slow down later. The second is the price index. All the major price indexes are falling down in 2005. By the end of 2005, CPI was 1.8%. The across-board fall of price indexes indicated that the economy is slowing down. Third is the growth of profitability of enterprises. Usually, profitability is a leading indicator of strength of domestic demand. Faced with a fall of profitability, enterprises will cut back their production and investment. The worsening of economic situation in turn will lead to an accelerating fall of profitability, so that a downward spiral is ushered in. In 2005, the growth rate of profitability fell quite significantly. Although, on surface, it was something like 20%, if the profits from oil, coal and fuel, and a few industries of raw materials were excluded, the overall growth rate of profits of the economy was is very low – 7% or even lower. The fourth is the presence of bottlenecks. Over the last two years, the Chinese economy has been characterized by the prevalence of so-called bottlenecks but the situation has been improved. For example, the shortage of electricity has been eased in 2005. According to NDRC, the supply of and demand for electricity will be basically in balance in 2006. The disappearance of bottlenecks in electricity, coal, gosling, transportation and basic materials such as steel usually is not only the result of the increase in the supply in those bottleneck industries but also the result of the slackening of aggregate demand. More than 80 percent of categories of products, which were surveyed by the Ministry of Commerce are in oversupply. Based on past experience, it is safe to say that the Chinese economy is slowing down. However, the slowdown is not that dramatic. Sporadic rebound cannot be ruled out.

According to official report, in 2005 China's GDP growth rate was 9.9%. The contributions made by investment, consumption and net exports are 48.8%, 33.3%, and 17.9%, respectively. However, this statistics seems questionable. It seems that the contribution made by net exports has been underestimated. According to most foreign observers, the contribution made by net exports should around a third of the total growth (Figure 7).

Figure 7. The growth rate of net exports



Assuming that China would run 1 $US trillion trade surplus in 2006, the contribution of net exports to GDP growth will be zero, due to the high comparison base in 2005. If this is the case, other things being equal, China's growth rate in 2006 would drop to 7%, which is a growth rate of recession, according to China's standard. Furthermore, if the growth rate of net exports turns out to be high, it means the worsening of China's external balances. If the growth rate of net exports drops significantly because of external condition or government policy aimed at rebalancing the economy, growth rates of other components of domestic demand must increase significantly. What are the potential candidates, investment? Not very likely, because growth rate of profits by enterprises is falling. This implies that the growth rate of investment should be lower in 2006. According to the State Bureau of Statistics, in 2005, state-owned enterprises suffered the second largest losses in the history. The total losses amounted to 102.6 billion RMB, an increase of 56.7% over the previous period. In the first two months in 2006 the losses have increased further compared with the same period of last year. According to the State Bureau of Statistics, there were four main contributing factors to the increase in the losses. First, production cost increased significantly, due to the increase in the prices of energy and raw materials. Among 39 major industries, there are 29 industries in which the increase in cost surpassed the increase in the revenues of sales and a half of the industries suffered from falling profitability. Automobile, Chemical and electronic industries suffered greatest falls of profitability. Second, remaining price control over a few resource products and public goods, such as gasoline led to producers such as oil refineries suffered huge losses. The oil refinery industry registered a loss of 22 billion RMB in 2005. Third, overcapacity contributed to the losses or falls in profitability in many industries, which had witnessed the investment upsurge since 2003. Among these industries, are steel, electrolyte aluminum, ferroalloy, coke, calcium-carbide, automobile and copper smelt. The profits of the industries of steel, ferroalloy, coke, cement and automobile fell by 9.1 percent, 94 percent, 77 percent, 68 percent, and 40 percent, respectively. 80 percent of electrolyte aluminum enterprises made losses. Fourth, the lack of property rights of core technology was also an important contributing factor to the fall of profitability of state-owned enterprises. The industry of communication equipment, computer and other electronic equipment manufacturers made only 3.1 billion RMB profit, a fall of 62.1 percent over the previous year. Mobile phone industry suffered losses of 1.6 billion RMB. Chinese mobile phone makers' market share has contracted from 60 percent in 2004 to 40 percent in 2005.

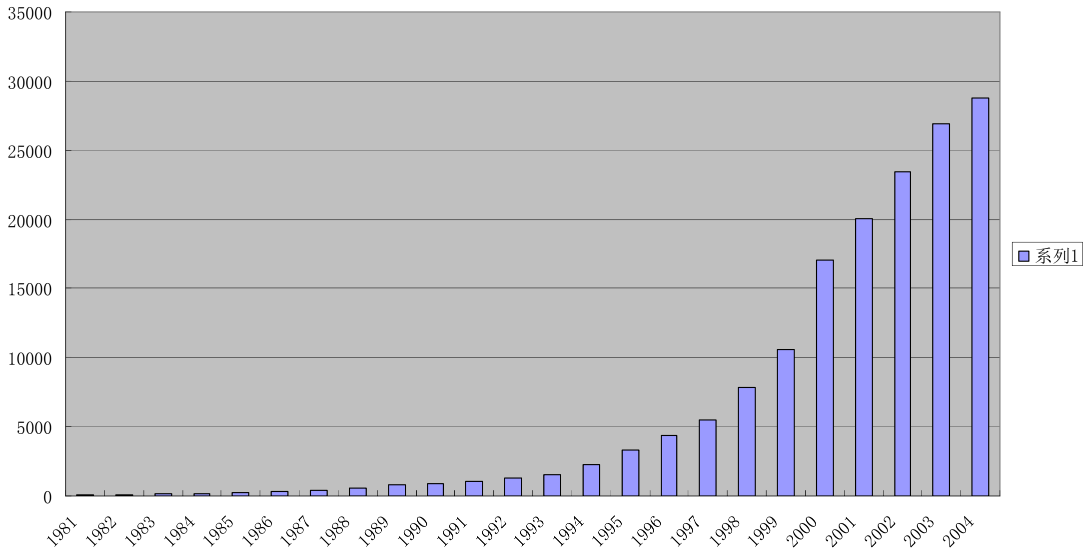
The government hopes that the increase in household consumption will promote growth in 2006. Without an increase in public expenditures, it is not very likely that the consumption demand will increase significantly Therefore, fiscal policy should be more or less expansionary both for the structural reasons and for the maintenance of macroeconomic stability. Monetary policy does not have much room to play in 2006. The PBOC has to reduce the appreciation pressure on RMB. Therefore, there is not much space for the PBOC to raise the interest rate or tighten the money supply, even if it is necessary. International financial markets expect that the RMB exchange rate will appreciate by three percentage points. Right or wrong are the market expectations, the PBOC must keep its benchmark interest rates about three percentage points lower than the Fed funds rate. Capital control is leaky. Sterilization has become a very heavy burden for the PBOC. Hence US interest rates will cap China's interest rates in 2006. On the other hand, the growth rate of money supply has already been higher than its target. Cheap credits will worsen the resource allocation and economic efficiency and hence damage China's long-run growth and short-run economic stability. One important danger in 2006 is that because fiscal policy is tight and too slow to respond to the slowdown of the economy, to maintain a growth rate as high as 9 percent, the PBOC has to maintain a unwarranted loose monetary policy, which in turn will create asset bubble, worsen the resource allocation, and eventually damage China's long stability.

III. Fiscal Policy

Fiscal policy has played a significant role over the past 8 years in maintaining the growth of China's economy. China's government expenditures were concentrated on building infrastructure, reforming state-owned-enterprises, developing the social security system, science and technology, education, agriculture and development of the western regions. The growth-promotion fiscal policy has led to rapid increases in tax revenues relative to the increase in interest payment As a result of expansionary fiscal policy, China's fiscal position improved rather than deteriorated.

After 10 years of expansionary fiscal policy, China has accumulated large amount of debts (Figure 7)

Figure 7 China's debt balance



However, officially, China's debt balance/GDP ratio is still less than 20 percent. Many economists argue that if we take into consideration the so-called contingent liabilities, China's debt balance/GDP ratio is much higher, maybe as high as 100 percent. Chinese government's ability to repay debts is much higher than it appears. However, whether China's fiscal position is sustainable depends on the dynamics of the debt balance/GDP ratio. There are two factors which determine the dynamic path of the debt balance/GDP ratio: the growth rate and the budget deficit/GDP ratio. As long as China can maintain a relatively high growth rate of 7-8 percent, and a budget deficit/GDP ratio of less than 3 percent, following the passage of time, the debt balance/GDP ratio would converge to a limit of less than 40 percent. Incorporating contingent liabilities into the debt balance would merely influence the initial condition of the dynamic path of the debt balance/GDP ratio, and it would not change the limit to which the debt balance/GDP ratio converges. As long as the Chinese government can avoid making fatal mistakes in coordinating macroeconomic policy and economic restructuring so as to maintain a decent growth rate and a relatively low budget deficit, China's fiscal position will be sustainable. Therefore, there is ample room for the government to use expansionary fiscal policy to counterbalance any negative impact on the growth by a tight monetary policy.

VI. The Recent Anomaly

The statistics that is out recently is rather unexpected for many observers. The following are the main economic figures in the first quarter of 2006

- GDP growth rate：10.2%，higher than in the same period of 2005;

- Growth rate of fixed assets investment：27.7%，4.9 percentage points higher than in the same period of 2005；
- Growth rate of Social consumption： 12.8%，the real growth is 12.2%，0.3 percentage points higher than in the same period of 2005.
- Trade surplus:23.3 billion US dollar，a growth rate of 41.4 percent; the growth rate of exports is 197.3 billion US dollar，a growth rate of 26.6 percent；the corresponding figures for imports are 174 billion US dollar，and 24.8 percent；
- Increase in the number of projects of construction (for the first two months in 2006)
    - In- process construction projects: 39.8 percent
    - New start of construction projects: 33.4 percent Growth rate of profits of large-scale industrial enterprises: 21.3%, higher than in 2005.

There are tree things that are a little surprising. The first is Chinese enterprises' ability of defying odd to maintain high growth rate of investment. The lowering of growth rate of profitability has failed to slowdown the growth rate of investment by enterprises. The second is the high growth rate of net exports, despite the revaluation of RMB. The third is the puzzle that while the growth rate has been rising persistently, the inflation rate has shown no sign of accelerating.

As for the first surprise, there are three points to make. First, one still cannot be sure whether this resurgence of investment temporary or long-lasting trend at this moment. High growth rate of investment is not sustainable, without the support by good prospect for profitability. Why investment momentum has been restored while there is prevalent overcapacity. The rebound of growth of fixed assets investment seems attributable to non-economic factors as well as economic factors. In the first year of the 11th five year plan, and in the eve of changes of governments at provincial level, the temptation to invest is too great to resist, as long as there is finance available. In fact, commercial banks that had packed up large liquidity in 2005, were in a rush to extend loans in the beginning of 2006, due to favourable internal (lower NPLs and higher capital adequacy) and external (strong demand for loans).

Second, it is doubtful whether China can maintain a growth rate of net exports that is comparable with the growth rate of net exports in 2005, taking consideration of the turbulence of the world economy, worsening global imbalances and rising protectionism.

Third, the relationship between growth and inflation has being changing. In contrast to historical experience over the past 25 years, in the current economic cycle, while the growth rates of the economy were 9.1 percent, 10 percent, 10.1 percent and 9.9 percent, respectively from 2002 to 2005, the inflation rates were -0.8 percent, 1.2 percent, 3.9 percent, and 1.8 percent, respectively, during the same period of time. In the first quarter of 2006 while the growth rate of GDP was 10.1 percent, CPI inflation eased to 0.8% yoy in March, down from 0.9% in February. However, it is dangerous to be complacent, if the growth rate of money supply is too high, even though the inflation rate is not high, something must go wrong. Now the real estate development is speed up again and so are housing prices in many areas including Beijing.

Concluding remarks

In 2006, China's economic situation will be good. There should be not doubt that the growth rate of Chinese economy can maintain a growth rate higher than 9 percent without causing serious problem in price stability. However, China needs to slowdown the growth rate of fixed assets investment initiated by local government and supported by loose monetary policy. On the other hand, China should also be on guard against the possibility of significant slowdown of the growth rate. The right combination should be a relatively tight monetary policy and a relatively expansionary fiscal policy. However, the multi-objectives of China's monetary policy have deprived the ability of the PBOC to implement a relatively tight monetary policy. To raise the effectiveness of macroeconomic control so as to provide conducive environment for China's structural adjustment while maintain the macroeconomic stability, reform must be carried out with China's macroeconomic management regime.