3. The Macroeconomic Situation

Figure 1 summarises the growth and inflation record since 1978 when China embarked on the first steps toward a market economy. There have been two episodes of high inflation, 1988-89 and 1993–95, where the inflation rate exceeded both 10 percent. It is interesting that the output cost of wringing out inflation were very different in both episodes. The drop in inflation from 18.8 percent in 1988 to 3.1 percent in 1990 was accompanied by a 7 percentage point drop in the growth rate; whereas the drop in inflation from 24.1 percent in 1994 to 2.8 percent in 1997 saw less than a 4 percentage point drop in the growth rate.

What accounted for the drastically more favourable tradeoff between growth and inflation in the second episode? In statistical analysis not reported here, we found that the differences in the inflation and growth performance across the two episodes could not be systemically linked to differences in the credit polices that started and then ended the two high inflations. My hypothesis for the different tradeoffs in these two episodes is that consumers' confidence and investors' confidence about China's future were very different in the two stabilisation programs. The 1989–90 stabilisation occurred amid widespread doubt about whether the convergence toward a market economy would continue, if not reversed. Following the unfortunate Tiananmen tragedy in June 1989, economic policymaking returned to the hands of the central planners, and numerous announcements were made about reining in capitalist tendencies. The implementation of the 1994–97 stabilisation, in contrast, occurred after the 14th Party Congress in 1992 had pledged to build "a socialist market economy with Chinese characteristics." This denial of a universal norm for socialism was correctly read as renewed commitment by the Communist Party toward convergence to a market economy.

Our hypothesis is that this difference in anticipation about the future direction of China's economic policy had very different effects on the behaviour of consumers and investors. The heightened confidence in a prosperous future was largely why fixed capital formation contributed over 2 percentage points to GDP growth in 1996–97 compared to the negative 1.7 percentage points in 1989–90; and why consumption

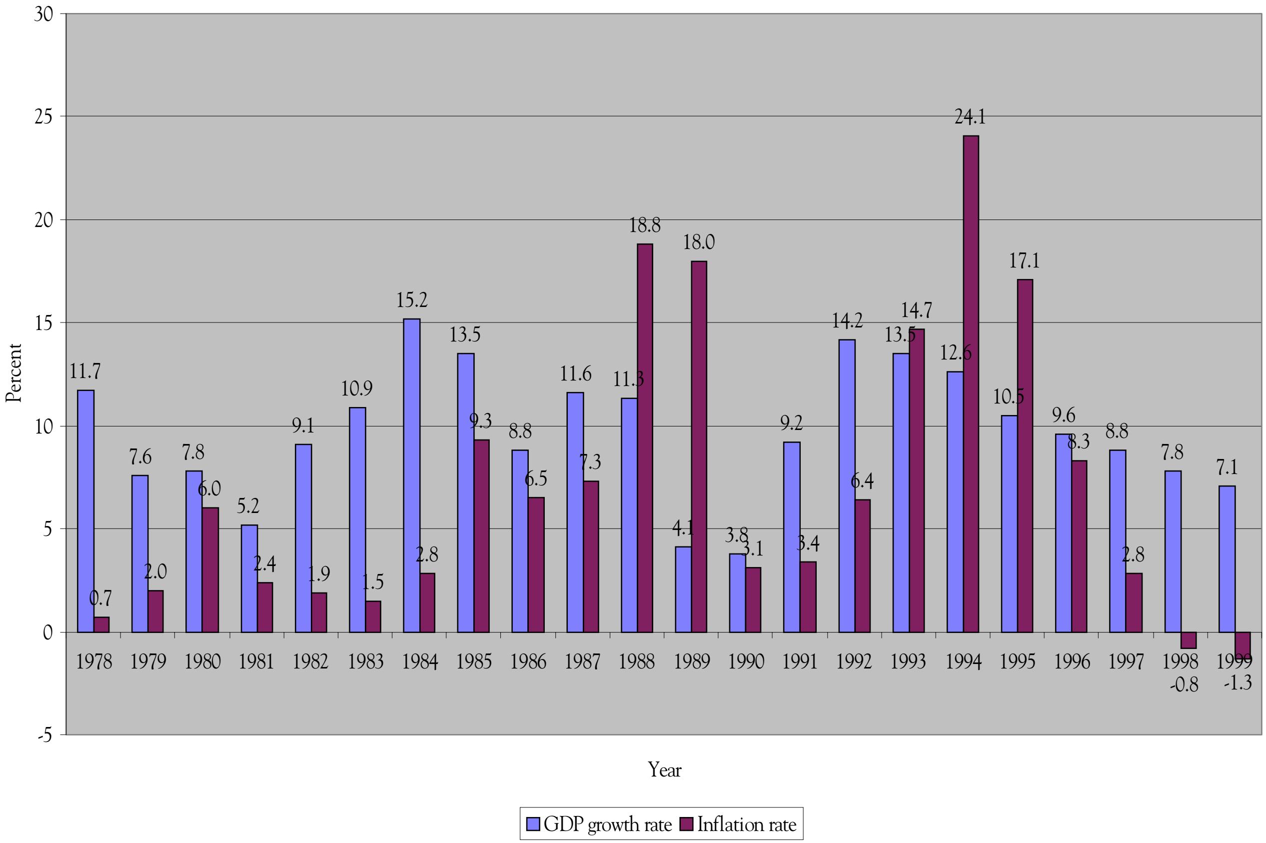

Figure 1. Growth and Inflation in China, 1978–1999

spending contributed an average 4.5 percentage points to growth in 1996–97 versus 1 percentage point in 1989–90 (see Table 1).

Since inflation in 1996 was down to 8.3 percent from 24.2 percent in 1994, and the 1996 growth rate of 9.5 percent almost equalled the average 10 percent growth rate of the 1978–95 period, one could say that the Chinese stabilisation program that started in mid-1993 had achieved soft-landing in 1996. Some observers have used this reasoning to describe the continuation of tight macroeconomic policies until early 1998 to be a case of "macroeconomic policy overkill." While the precipitous plunge in money (M1) growth from an inflationary 43 percent in 1993 to 20 percent in 1996 was desirable, the further drop to 10 percent in 1998:2Q was an overkill, as evidenced by the fall in the <u>level</u> of retail prices since October 1997.[7]

We do not dispute the macroeconomic consequences of the tight monetary policies and the tight controls over investment spending before mid-1998, but we note that these restrictive policies had succeeded in forcing considerable restructuring in the inefficient state-owned enterprise (SOE) sector. Because most loss-making SOEs did not receive their accustomed allotments of credit to continue production (a large portion of which went straight into inventory), the default outcome was that many were taken over by new owners[8] who reorganised the firms and changed the output mix. Our point is that a temporary slowdown in growth is many times necessary in order to force resources to move to a new growth path that would lead to a more competitive economy in the future. We have to recognise in the so-called "macroeconomic policy overkill" the audacity of the top Chinese leadership to choose to dislocate reforms to produce sustained dynamic growth in the future over Brezhnev-style maintenance of the comfortable status quo which would have led to a dismal future.

The "macroeconomic policy overkill" from 1997:1Q to 1998:2Q, in short, reflected a deliberate decision to accept growth rates that were

[7] Except in August and September 1998 when the heavy flooding disrupted supplies in several heavily-populated parts of the country.

[8] In many cases, the new owners were employees of the firms.

Table 1. Sources of Aggregate Demand in China in Reform Period, 1978–1998

	Annual GDP growth rate	*Rural household consumption*	*Urban household consumption*	*Government consumption*	*Fixed capital formation*	*Change in inventory*	*Net exports*	*Total household consumption*
Part A: Percentage Point Contribution to GDP Growth Rate by Each Expenditure Category								
1979–98	9.8	2.4	2.3	1.2	3.3	0.3	0.2	4.7
1988	11.3	3.1	4.1	0.4	3.2	1.7	–1.2	7.2
1989	4.1	0.7	1.3	1.1	–4.0	5.2	–0.1	2.0
1990	3.8	–0.8	0.7	0.4	0.5	–1.0	4.0	–0.1
1991	9.2	0.9	2.2	2.2	4.7	–1.3	0.4	3.2
1992	14.2	2.5	4.0	2.1	8.8	–1.6	–1.7	6.5
1993	13.5	0.5	2.9	1.3	10.5	1.5	–3.3	3.4
1994	12.6	2.1	2.7	1.4	3.0	–0.1	3.5	4.7
1995	10.5	2.9	3.4	–0.2	2.2	1.6	0.5	6.3
1996	9.6	3.7	1.9	1.2	2.7	–0.4	0.6	5.5
1997	8.8	1.3	2.2	1.2	2.4	–0.4	2.0	3.6
1998	7.8	0.6	2.7	1.2	4.5	–1.4	0.3	3.3

lower than the 10 percent average growth rate of the 1978–95 period in order to ensure an acceptable rate of economic restructuring and to moderate the boom-bust cycles of the last two decades. The implicit growth range that policymakers appear to think is compatible with achieving the restructuring and stabilisation objectives seems to be about 7.0 percent to 8.0 percent. When the Asian financial crisis hit in 1998, causing China's exports to fall, and hence rendering growth lower than intended, it was only natural that the government undertook stimulation of domestic demand to reflate the economy.

4. Responding to the Post-1997 Deflation

The government responded to the onset of price deflation in 1997:4Q by cutting the average lending rate from 10.1 percent to 8.6 percent. However, the anticipated surge in credit expansion did not occur. This is largely because of the newfound reluctance of the state commercial banks to extend more credits to its traditional clients, the SOEs — especially the loss-making SOEs — creating a "liquidity trap" phenomenon that we will discuss later.

By early 1998, in the wake of the collapse of several important Pacific Asian economies, Chinese policymakers recognised that stronger reflation was required to offset the coming collapse in external demand. Furthermore, the SOE reform program announced at the 15th Party Congress in September 1997 was beginning to take bite and firms would soon begin to shed excess workers. So, stronger reflation was also desirable in order to induce the establishment of new urban enterprises to soak up the newly released SOE workers.

The reflation program sought to boost aggregate demand by trying to:

(a) increase investment by approving faster the backlog of investment applications;
(b) increase government spending;
(c) loosen monetary policy; and
(d) stimulate private spending through housing reform.