China will Need Exogenous Money for Economic Recovery[1]

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Abstract: *Endogenous and exogenous money are the two types of money creation mechanisms. Credit is a type of endogenous money that reflects the intrinsic kinetic energy of economic operations, whereas exogenous money, which is usually created by fiscal policy, reflects the government's policy direction rather than the result of the economic system's operation. Is endogenous or exogenous money more important as China restarts its economy?*

Wei: Will China require more fiscal or credit money as it resumes its economic recovery?

Peng: The Central Economic Work Conference in late 2022 proposed that stable growth is the key, with the main line being "boosting confidence and domestic demand". Policies should play a synergistic role, balancing short-term growth and long-term strategies, with cyclical policies expected to be stepped up and structural policies accelerated.

As I understand it, "increasing the strength and efficiency" of the fiscal policy refers

[1] *This article is based on Fudan Finance Open Class 91 and has not been confirmed by the interlocutors. The views expressed herewith are the interlocutors' own and do not represent those of CF40 or any other organizations. It is translated by CF40 and has not been reviewed by the interlocutors.*

to the increase in the budgetary deficit that has a multiplier effect on boosting domestic demand. "Precise and powerful" monetary policy means that the transmission mechanism of policy finance is driven more by precise and powerful policies, including some subsidies and policy concessions. **Therefore, I believe that fiscal efforts will be increased, while monetary aggregates will not necessarily be increased, and the overall policy-oriented financial approach will be maintained. The innovative implementation of policies is worth looking forward to.**

The height of economic recovery depends on the rebound in demand. In the short term, the industrial or supply chain will be affected, the labour participation rate will decrease, endogenous money (supply) growth will fall, and both supply and demand will be hit. In the medium term, the economy's autonomous momentum will increase, and both supply and demand will recover, with the height of the recovery depending to some extent on the rebound in domestic demand.

Over the past three years, the problems with corporate and individual balance sheets have been reflected in the debt problems of local governments, city investment groups, and enterprises. **The repair of balance sheets, or the rebound of the economy, will depend not only on the abatement of the impact of the pandemic but also on macro policies to facilitate the financial situation of enterprises and, in particular, individuals.**

There are several problems with the effectiveness and constraints of credit compared to finance.

1. With the poor performance of balance sheets, enterprises or individuals debt under great debt pressure will not resort to pro-cyclical endogenous (credit) monetary injections, **whereas exogenous (fiscal) monetary expansion can achieve counter-cyclical adjustment and promote growth more efficiently through initiatives such as tax cuts and government purchases.**

2. The increased liquidity from lending into private debt has a limited stimulus on consumption. In contrast, **fiscal expansion can materially increase liquidity into the net assets of the private sector, with a significant stimulus to consumption.**

3. Expansion of bank lending can bring about a financial cycle of debt, as in the case of the debt problems with China's real estate developer and city investment groups in the last two years, **while excessive fiscal expansion can bring about an inflationary financial cycle,** which is the problem facing the US today. These are the ultimate constraints on expansion.

Wei: What form do you expect the fiscal boost to take? What fiscal policy combination is the best to enable the 2023 economic goals?

Peng: The first question is about what we WILL do, and the second is about what we SHOULD do. Our past fiscal boosts have been mainly manifested as infrastructure investment and corporate tax reduction, among others. **Ideal fiscal policy should focus on where the market fails.** In that sense, there are two aspects for fiscal policy today to exert force: first is to support middle- and low-income groups and boost consumption; second is to promote technological innovation by stepping up R&D investments with government intervention where there is a lack of risk-taking ability or willingness among market institutions.

Wei: What are the differences between China today and the U.S. during the subprime crisis in terms of credit, especially real estate lending? What roles does policy finance play in driving economic growth? What fiscal moves are necessary for the next step?

Peng: China has intensified financial regulation since the 5th National Financial Work Conference in 2017, marking the start of the second half of the country's financial cycle. As a matter of fact, accumulated real estate lending had already started to shrink before Covid, which only exacerbated that adjustment process. There is no credit collapse in China, and it will not experience any systemic financial crisis like the 2008 subprime crisis in the U.S.

The subprime crisis in the U.S. was marked by the surging debt repayment burden on non-financial private sectors as a proportion of newly-added bank loans. It meant that funds were flowing massively back to the banking system from the real economy, which pushed the U.S. economy into a recession with a credit crunch. But **debt repayment by the private sector relative to newly-added loans remains stable in China now.**

Hence, the downward adjustment of the Chinese real estate market has yet to have major spillovers on other sectors, nor has it impacted the general economy via the financial system. The real estate lending situation is worrying, of course, but **it has not evolved into a systemic risk because policy finance has been propping up credit expansion.**

Policy finance includes infrastructure lending, manufacturing lending, inclusive finance lending, and green lending, etc. It now accounts for 60-70% of total newly-added loans, doubled from 30% before Covid, partly indicating its importance in coping with the pandemic-induced blows and boosting credit demand. **Policy finance is not entirely finance, though: it can be taken as a quasi-fiscal move.** It's similar to fiscal policy but not entirely fiscal, since the debts still need to be repaid.

In conclusion, over the past three years, fiscal expansion in China has been generally limited. Fiscal policy needs to be more proactive to deliver a decent economic rebound in 2023.

Wei: According to the Keynesian approach that favors expansionary policies, fiscal force should intervene in the economy by cutting taxes and raising government spending or purchases. In contrast, the theory of Ricardian Equivalence argues the opposite.

The theory maintains that attempts to boost an economy by increasing debt-financed government spending will not be effective because investors and consumers understand that the debt will eventually have to be paid for in the form of tax hikes or spending reductions. When businesses or households see the government increase spending or reduce taxes, they would worry that the government will reverse the policy in the future to address the debt issue and thus refrain from consumption. Do you think this theory is applicable or not? Will it weaken the effectiveness of the fiscal policy?

Peng: Personally, I don't think the assumption of Ricardian Equivalence is reasonable. The theory assumes that all people are rational and forward-looking and care about the younger generation just as they do for themselves.

In fact, **debt issue involves two dimensions: first, whether there is a default on the debt; second, whether the allocation of physical resources is excessive.** Default risk seldom constrains major countries like the U.S. which has international currency, and China, with capital account control.

From the first dimension, government debt is much more sustainable than private debt. Debtors in the private sector are clear. For example, if an individual takes out a mortgage through a bank, the individual is the debtor; if an enterprise takes out a mortgage through a bank, the enterprise is the debtor. Public debtors are the younger generation because, unlike the private sector, the government will not be constrained by debt repayment in the short term under normal circumstances due to its ability to allocate economic resources, impose taxes, and print money.

Indeed, for a small economy with a high degree of financial liberalization, if the government relies on market-based finance, it will encounter some shocks, as the U.K. did in 2022. But China is a country with a massive economic scale and capital account control; **the constraint of debt service is not a major problem at the moment.**

From the second dimension, when the government has excessive resources and allocates physical ones through debt, it might lead to higher inflation or lower efficiency of resource allocation than the private sector, which is related to the spending structure of the government. **Suppose the government deficit spending is used to improve public services like education, health care and R&D that can help boost future growth. In that case, the government's ability to repay debt can actually be enhanced.**

Wei: It is, in fact, a type of investment.

Peng: Therefore, I believe that reasonable allocation of physical resources will not be a heavy constraint on the government's ability to repay debt. Instead, **inflation will be the real constraint**. Just like in the U.S., if debt expands rapidly in the short term, inflation will rise and become a hard constraint as the aggregate demand is too strong to be met by supply.

Wei: Companies may feel reluctant to borrow if they see a lot of uncertainties in the future. For one thing, the expectation of future orders will obviously affect enterprises' willingness to invest and borrow. For another, the cost of borrowing will also affect the intention to borrow. A particular case of China is that the country has a large number of state-owned enterprises, which means it has more channels of delivering funds to enterprises in addition to the banking system. Will this channel be utilized in 2023?

Peng: The channel of state-owned enterprises is possible, but its role is, after all, limited. Whether in terms of GDP share or employment and innovation rate, private enterprises, especially SMEs, still outweigh state-owned enterprises. So, to me, a more effective approach would be policy-based finance, such as financial support for science and technology innovation, manufacturing, infrastructure, green transition, etc. This is what the financial sector has been doing in the past two years and something that deserves more effort in the longer term.

Wei: What is your view on today's local debt? Is it a serious risk? Is there a way to solve it? Is there a need for central government intervention?

Peng: A large portion of local government debt is borrowed from local government financing vehicles (LGFVs). LGFV projects are unsustainable because of the mismatch between financing costs and investment returns. Many investments have gone to local infrastructure and other public sectors, projects that produce very low returns despite commercial operations. However, the financing terms of these debts may be non-standard financial products, and some of the financing costs in earlier times even exceeded 10%. Although the costs have come down over the years, it's still market-oriented financing.

Under the current institutional environment, it is hardly possible that China will encounter large-scale local debt defaults. LGFVs have the endorsement of local governments and commercial financing terms. Over the past years, some investment institutions have seen very good returns precisely because of their deep involvement in LGFVs. Therefore, local debt is not only a matter of financial risks but also a matter of social equity.

The financial history of China and other countries shows that the solution to the debt problem cannot go to two extremes - neither disorderly default, completely having creditors bear the losses and resulting in a systemic crisis, nor absent of any default, having the debtors bear the losses and producing a large number of zombie enterprises.

There are two ways to let default happen: first, a certain share of enterprises default according to market rules; regulators intervene at a later stage, and government bailouts roll out to stabilize confidence; second, the government intervenes before the outbreak of a crisis, in the negotiations between creditors and debtors about debt restructuring, with both sides bearing part of the losses. For example, rolling over the debt and lowering the effective interest rate to reduce the debtor's burden and the creditor's losses.