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CF40 Policy Brief

The Macro Policy Mix to Boost Economic Climate

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Abstract: In 2023, China's real GDP growth rate was 5.2%, hitting the annual growth target and surpassing the 2022 figure by 2.2 percentage points. The nominal GDP growth in 2023 was 4.6%, slightly down by 0.2 percentage points compared to 2022, with the GDP deflator at -0.5%.

Looking back at 2023, China's economy recovered, with resilient manufacturing investment, further optimization of export product structures, and accelerated transformation of the service industry. However, post-pandemic 'scars' continued to drag on consumer demand. Compounded by factors such as the unexpected downturn in real estate, regulatory policies on certain industries, and others, endogenous market dynamics remain weak, inflation relatively low, and economic growth potential unfilled, calling for more robust counter-cyclical adjustment policies from the government.

In actual economic operation, the growth of government-led expenditure (2.4%) was lower than that of private sector expenditure (5.1%). The policy rate cuts were less than the decline in inflation, leading to a 2.4 percentage point increase in real interest rates, which creates a misalignment between market expectations and the implementation of macroeconomic policies.

Looking forward to 2024, insufficient demand remains the main challenge for economic operation. To achieve desirable economic growth and inflation target for 2024, a 'double 11' aggregate control policy is needed. Government borrowing should increase by more than 11 trillion yuan. Policy rates should be reduced to lower real interest rates. The PSL tool should be fully utilized to maintain reasonable government investment, and social financing should grow at a rate of no less than 11%.

I. The Main Challenge for Economic Operation in 2023 is Still Insufficient Demand

In 2023, China's real GDP growth rate was 5.2%, hitting the annual economic growth target and exceeding the figure from 2022 by 2.2 percentage points. The total economic volume rebounded and improved, with continuous structural optimization. Manufacturing investment remained resilient. The structure of export products was further optimized, and the transformation of the service industry accelerated.

Figure 1: Real GDP Growth

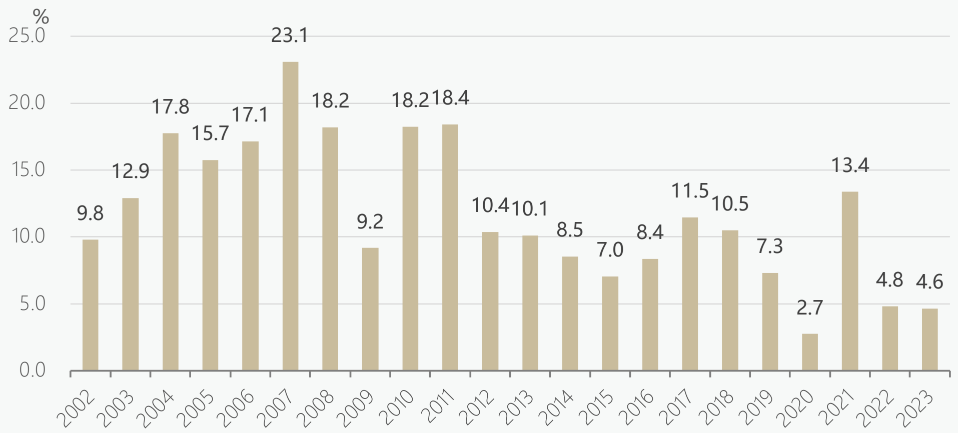
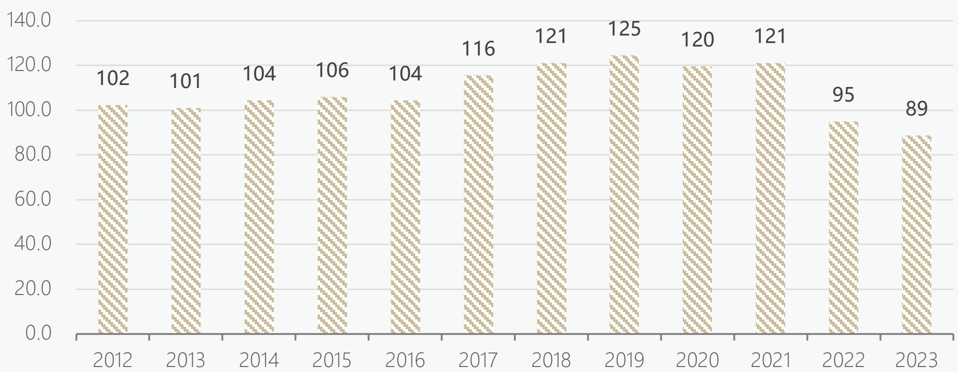


Figure 2: Consumer Confidence Index Monthly Average



Source: National Bureau of Statistics

On the other hand, the nominal GDP growth rate in 2023 was 4.6% year-on-year, slightly lower than 4.8% in 2022, marking it the second lowest year in the past two decades, only higher than that of 2020. The nominal GDP growth, which represents the combined income of households, businesses, and the government, is a more accurate reflection of the feelings of economic entities. In the face of insufficient demand, the drag caused by price factors led to a slight decline in the nominal GDP growth rate, resulting in worse feelings of economic entities and also undermining their expectations.

From the perspective of three major demands, final consumption in 2023 contributed 4.3 percentage points to GDP growth, capital formation 1.5 percentage points, and net exports -0.6 percentage points. In 2023, consumption, investment, and net exports accounted for 53.7%, 43.1%, and 3.1% of GDP respectively. The proportion of consumer spending increased, while the proportions of investment and net exports declined.

Figure 3: Contributions of three major demands to GDP growth

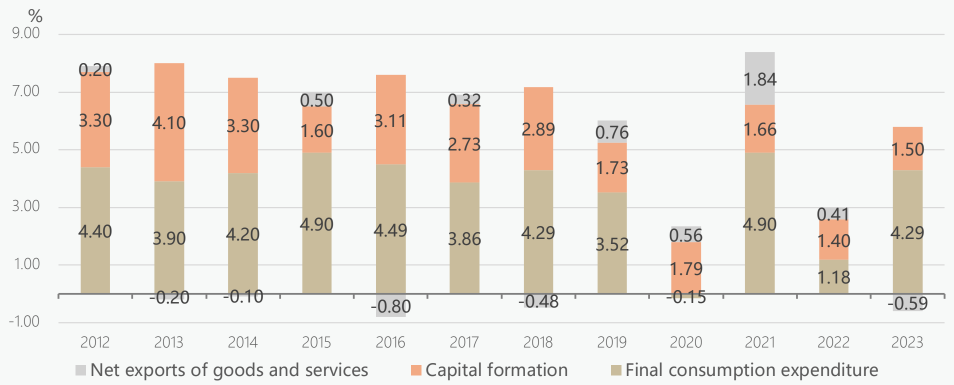
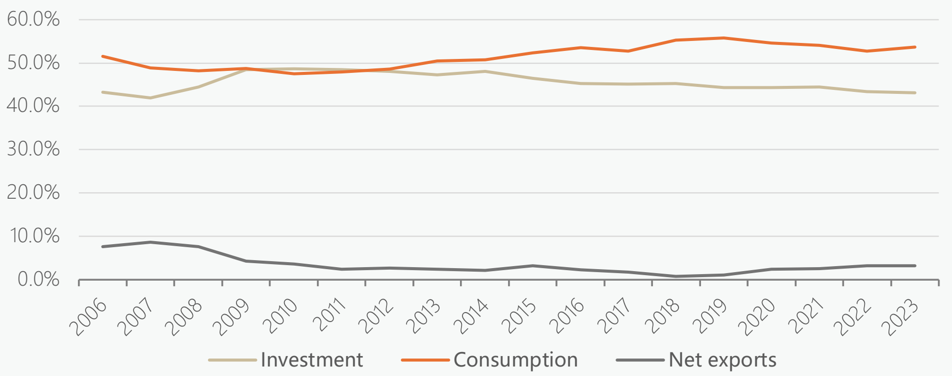


Figure 4: Share of three major demands in GDP



Sources: WIND; authors' calculations

From the perspective of spending entities, we categorize total expenditures into three parts: government-led spending, private sector-led spending, and net exports. We employed two methods for this analysis. One involves calculating government-led expenditure by adding the broad fiscal expenditure from the four sets of accounts (including the general public budget, the government-managed funds budget, the state capital operations budget, and the social insurance funds budget) with government-led infrastructure investment. Then, private sector expenditure is calculated by subtracting government-led expenditure and net exports from the GDP, we derive. The other method is based on the data from the flow of funds accounts, dividing the GDP (measured by the expenditure approach) into six parts: government consumption, government investment, household consumption, household investment, business investment, and net exports. In this framework, government-led expenditure equals the sum of government consumption and government investment, and private sector expenditure is the aggregate of household consumption, household investment, and business investment.

Figure 5: Expenditure Growth of Different Entities

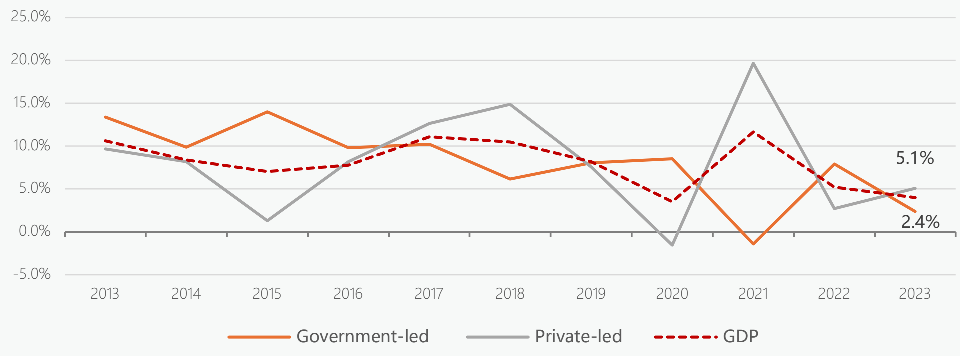
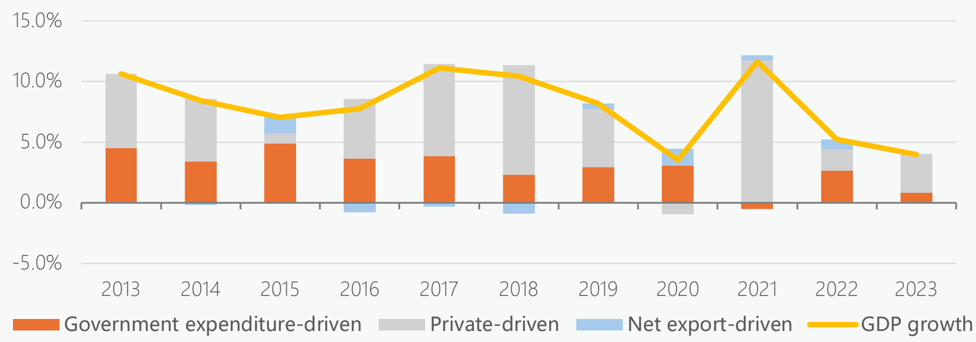


Figure 6: Decomposition of Economic Entities based on Expenditure Method of Measuring GDP



Sources: WIND; authors' calculations

The results from both methods indicate that the growth rate of government-led expenditure is significantly lower than the GDP growth rate. The decline in the growth rate of government-led expenditure, rather than that in private sector expenditure growth, became the primary drag on demand in 2023. In 2023, the growth rate of government-led expenditure fell to 2.4%, with general public budget expenditure (excluding infrastructure investment) growing at 3.5%, basic government fund expenditure at -14.6%, and government-led infrastructure investment at 6%. The growth rate of government-led expenditure was lower than the nominal GDP growth rate, and 2.7 percentage points lower than the 5.1% growth rate of private sector consumption and investment expenditure, shifting government expenditure from a driving factor to a dragging factor. By comparison, during 2013-2019, the growth rate of government expenditure was on average 1.3 percentage points higher than that of private sector expenditure.

The low economic climate is manifested in the combination of low inflation and high pressure on employment. In 2023, the urban surveyed unemployment rate averaged 5.2%, and in 31 major cities, the rate was 5.4%. Overall, the unemployment condition improved compared to 2022 but remained above pre-pandemic levels. In 2023, China's CPI rose by 0.2% year-on-year, a decrease of 1.8 percentage points compared to 2022. The core CPI, excluding food and energy prices, increased by 0.7% year-on-year, falling by 0.2 percentage points from 2022. The PPI growth rate also remained in negative territory, and the fourth quarter turned from flat growth to decline, cumulatively falling by -3.0% year-on-year. The GDP deflator for the entire year of 2023 was -0.5%, significantly lower than the previous year's 1.8%.

The Phillips Curve provides a theoretical framework for understanding the short-term relationship between inflation and economic growth: if the economy faces insufficient demand, inflation falls and economic growth will be below potential speed. Data from 2013 to the present[1] show a correlation of approximately 1:1.1 between core CPI and actual GDP

1 We excluded the data from 2020 and 2022, and used the two-year average GDP growth rate for 2020-2021 to replace the actual GDP growth rate for 2021 in our regression analysis.

growth rate and about 1:1.2 between core CPI and GDP deflator growth rate. In 2023, China's core CPI was 0.7%**. If the core CPI growth in 2023 reached the desirable level of 2%, and demand was at a relatively reasonable level, the real economic growth rate for 2023 would be 1.4 percentage points higher than the actual real GDP growth rate, and the nominal GDP growth rate would be 3.0 percentage points higher than the actual nominal GDP growth rate.** This roughly corresponds to an increase of 3.8 trillion yuan in nominal GDP. Based on the income distribution pattern of the past decade, the incomes of households, businesses, and the government would increase by 2.3 trillion, 900 billion, and 600 billion yuan, respectively.

II. Four Reasons for Lower-than-Potential Economic Growth

The pandemic-induced shocks on the balance sheets of households, businesses, and the government in China still lingered on. Compounded by factors such as the unexpected downturn in the real estate sector, and regulatory policies on certain industries, endogenous market demand remained weak. Government-led expenditure growth was significantly lower than private sector expenditure growth, and policy rate cuts were far less than the decrease in inflation, leading to a significant rise in real interest rates. Neither government expenditure nor monetary policy played an effective countercyclical adjustment role.

First, the depth and duration of the real estate market correction exceeded expectations. At the beginning of 2023, the market and policy levels generally expected the real estate market adjustment to come to a halt, but instead, the decline remained significant. Built on a lower base in 2022, China's real estate investment in 2023 dropped by 9.6% year-on-year, sales area decreased by 8.5%, and the newly started construction area cumulatively fell by 20.4%. The decline was even more significant among the top 100 real estate companies according to data released by CRIC, with a 16.5% year-on-year decrease in sales volume and a 20% decrease in transacted land area in 300 cities as well as an 18% fall in transaction volume.

There are multiple reasons why the real estate market did not stabilize as expected. Based on international experience, the duration and magnitude of China's real estate adjustment are not particularly abnormal. Two research reports by CF40[2] both pointed out that it generally takes 3-5 years for other countries to emerge from the impact of a real estate crisis, with some cases (like Japan) possibly needing 8-10 years or even longer. The impact of real estate on the macroeconomy is hard to eliminate before the correction is completed. Moreover, real estate companies generally face strict financing constraints, whether they have already defaulted or not, and struggle to obtain effective financial support in the capital market. This may be an important reason why real estate companies cannot self-rescue and the market struggles to recover spontaneously.

Second, local governments face increasing pressure to maintain a balanced budget and declining revenues led to a decrease in government-led expenditure. On one hand, the downturn in the real estate market caused continued plunge in income from land transfer. From January to November 2023, local government fund revenues in China totaled 481.79 billion yuan, a decrease of 81.28 billion yuan compared to the same period in 2022, down by 14.4% year-on-year. Of this, income from state-owned land transfer was 420.31 billion yuan, 91.43 billion less than the same period in 2022, a decrease of 17.9%. The decline is almost the same as that in the land transaction volume among 300 cities reported by CRIC.

On the other hand, to better contain the growth of local government's hidden debt, regulatory authorities stepped up the rectification of local financing platforms, further constraining the financing conditions for local governments. From January to November 2023, the net financing scale of local government financing vehicle (LGFV) bonds was 1.0573 trillion yuan, a year-on-year decline of 19%. Additionally, the decline in revenue from the real estate and other industrial sectors led to a slowdown in tax revenue growth. As a result, the total expenditure of general public budget and

2 CF40 Working Paper on ''The Long Tail - A Cross-Country Perspective on the Bursting of the Real Estate Bubble' and CF40 Policy Brief on 'Long Tail 2: A Cross-Country Observation of Real Estate Markets After the Bursting of the Real Estate Bubble'.

government funds from January to November 2023 only reached 3.21643 trillion yuan, 160 billion yuan less than the same period last year. Based on this, China's broad fiscal expenditure in 2023 is expected to be 36.7 trillion yuan, a year-on-year growth rate of -1%, **significantly lower than the 7% growth of broad fiscal budget expenditure stated in the government work report at the beginning of 2023.**

Third, the nominal interest rate decrease was less than the decline in price levels, leading to a significant rise in real interest rates. In 2023, the People's Bank of China lowered the reserve requirement ratio twice by a total of 0.5 percentage points and reduced policy rates such as reverse repo operations and the Medium-term Lending Facility (MLF) by 20 and 25 basis points respectively. However, while the central bank was reducing nominal interest rates, the decline in China's price level was faster. In December 2022, China's year-on-year CPI growth rate was 2.1%, but by December 2023, it was only -0.3%, a decrease of 2.4 percentage points. This means that China's real interest rate rose by 2.4 percentage points compared to the end of 2022. An increase in real interest rates raises the demand for savings and suppresses investment demand, exacerbating the issue of insufficient demand.

Fourth, the decrease in government, business, and household spending formed a negative feedback loop, intensifying the problem of insufficient demand. In an economy, each sector's income depends on the consumption or investment expenditure of other sectors, and the amount of expenditure is influenced by income, thus creating a mutually-reinforcing feedback loop between income and expenditure. Once trapped in a negative feedback loop of income and expenditure, the issue of insufficient demand becomes pronounced. In this case, macroeconomic policies need to actively play a countercyclical adjustment role to break the negative feedback loop and prevent expenditure from falling. Monetary policy should reduce interest rates and adopt other means to lower the debt expenditure of the private sector, increase asset valuations, help the private sector improve its balance sheet, and boost private sector consumption and investment expenditure. Fiscal policy should increase nominal fiscal spending to stabilize aggregate demand, at least ensuring that fiscal expenditure growth exceeds nominal GDP growth. However, in 2023, China's monetary and fiscal policies did not show significant countercyclical features, but instead exhibited some procyclical tendencies, thus reinforcing the negative feedback loop of expenditure decline in various sectors.

III. The Policy Mix to Hit the Growth Target for 2024

China's economy has realized the growth target set at the beginning of 2023, but if the issue of insufficient demand is not addressed, China's growth potential will always remain underutilized. As pointed out in the recent Central Economic Work Conference, further boosting the economic recovery requires overcoming several difficulties and challenges, including insufficient effective demand, overcapacity in some industries, weak social expectations, numerous hidden risks, bottlenecks in the domestic economic circulation, and increasing complexity, severity, and uncertainty in the external environment. Among these difficulties and challenges, insufficient demand is the most pressing one, as overcapacity in some industries, weak social expectations, financial risks, and various hidden dangers are highly related to it and are largely manifestations of an environment of insufficient demand. Resolving the issue of insufficient effective demand will alleviate or even eliminate many other difficulties and challenges.

Expanding aggregate demand, whether it's boosting consumption or investment demand, must be reflected in credit expansion. With credit growth, households, businesses, and governments will have more money in their pockets, leading to increased spending and income, and subsequently rise in profits and investments. At present, credit expansion should mainly rely on three pillars: first, fiscal policy support by increasing bond issuance; second, monetary policy support by lowering policy interest rates; and third, stabilizing the real estate market to prevent further slump. From international and historical experiences, solving the problem of insufficient demand requires strong countercyclical policy to boost credit expansion.

First, the fiscal policy must play an active role to increase government

bond issuance by not less than 11 trillion yuan. Assuming the economic growth target for 2024 is an actual GDP growth rate of 5%, a GDP deflator of 1.5%, and a nominal GDP growth of 6.5%, the scale of broad fiscal expenditure (public fiscal expenditure + government fund expenditure) required to achieve such a target should be about 40 trillion yuan. Considering the other potential risks in the future, the government needs to raise at least 11 trillion yuan in debt so as to realize the annual nominal growth target. The calculation logic is as follows:

A nominal GDP growth rate of 6.5% is equivalent to a nominal GDP increase of 8.2 trillion yuan. Based on the relationship between the nominal GDP increase and the increase in broad fiscal expenditure from 2012 to 2019, an 8.2 trillion yuan rise in GDP requires an expansion in broad fiscal expenditure of about 3 trillion yuan. The scale of broad fiscal expenditure for 2024 should be about 40 trillion yuan.

To achieve 6.5% nominal GDP growth, China's public fiscal revenue growth rate in 2024 should be around 5.1%, where tax revenue, influenced by the ongoing implementation of tax cuts and fee reductions, is expected to grow slower than the nominal rate, at 5%. Non-tax revenue growth, matching the nominal GDP growth rate, is estimated at 6.5%, lower than the rates in 2022 and 2023. Under these circumstances, the projected scale of public fiscal revenue is 23 trillion yuan, with tax revenue contributing 19 trillion and non-tax revenue 4 trillion.

Government fund revenue will depend on the stabilization of the real estate market. Assuming that real estate companies maintain their current exit rate from the land market, based on the experience of 2023, government fund revenue in 2024 will be about 1 trillion yuan less than in 2023, amounting to approximately 5.7 trillion yuan.

In summary, the total scale of China's broad fiscal revenue in 2024 is estimated to be 29 trillion yuan. To make the broad fiscal expenditure intensity match the 6.5% nominal growth, **a broad fiscal deficit of 11 trillion yuan needs to be filled through government borrowing.** If the real estate market does not stabilize in time and companies accelerate their exit, leading to a further decline in government fund revenue, the corresponding broad deficit gap will widen. Moreover, with the global economy facing continued downward pressure in 2024, external demand may further decline, creating a new gap in total demand. It should be noted that the broad government debt growth mentioned here only includes funding support for government-led infrastructure investment. To make infrastructure investment growth match the GDP growth target, financing from policy and commercial financial institutions is also needed.

Increased government borrowing of 11 trillion yuan, equivalent to 8.2% of GDP, will not exert pressure on fiscal sustainability. Given China's current low inflation rate and private sector savings exceeding investment, government borrowing to increase expenditure will not lead to inflation. The measure will not crowd out private sector expenditure but will also stimulate it, making fuller use of economic resources. CF40's macroeconomic report for the fourth quarter of 2022, "*Counter-Cyclical Public Sector Spending and Government Debt Sustainability,*" pointed out that if China's broad government debt/GDP is maintained at the current level, the corresponding deficit rate is between 6-7%. During periods of countercyclical policies, the deficit rate can be significantly higher than this average level.

Second, policy interest rates should be substantially reduced, and the target for the growth rate of social financing should be above 11%. Proactive monetary policy is crucial for overcoming insufficient demand. To boost the core CPI through monetary policy, it is necessary to lower real interest rates. Only by reducing real interest rates can a monetary policy environment conducive to private sector investment and consumption expenditure be created. Therefore, monetary policy in 2024 should be more proactive, with greater adjustments in policy rates, and should move ahead of the market to sharply reduce real interest rates.

Policy rate cut is a measure of aggregate control and also a macroeconomic policy with laser focus. This approach creates a financial environment more favorable for investment and consumption, allowing hundreds of millions of investors and consumers to choose how to expand their spending. According to our conservative estimates, by significantly lowering policy interest rates, households, businesses, and the government can reduce their annual interest payments by no less than 6 trillion yuan, while simultaneously increasing the valuation of financial assets by at least 15 trillion yuan. This would significantly improve the cash flow and balance sheets of various sectors, providing more funds and confidence for consumption and investment.

The Central Economic Work Conference proposed that 'the scale of social financing and the money supply should match the expected targets of economic growth and price levels,' implying the need for expectation management. Currently, this translates to using monetary policy to avoid deflation expectations and to narrow the divergence between the scale of social financing and inflation. According to the research by CF40[3], over the past five years, more than 10 trillion yuan of the newly added social financing was used for interest payments on existing debt. Only by realizing an increase in social financing after deducting interest payments can we support higher GDP growth. Based on the benchmark since 2022, where approximately every 4 yuan of new social financing translates into 1 yuan of new nominal GDP, a nominal GDP growth of 6.5% in 2024, with an increase of 8.2 trillion yuan in nominal GDP, would require new social financing of about 44.8 trillion yuan, **equivalent to an 11.4% growth rate in the stock of social financing**. To achieve this goal, in addition to stepping up government borrowing and private sector borrowing through lower policy interest rates mentioned above, it is also necessary to fully utilize the PSL (Pledged Supplementary Lending) policy tool to support infrastructure and old city renovation investments, which involves a scale of about 2-3 trillion yuan annually.

Third, both supply and demand sides need to be strengthened to stabilize the real estate market. Research by CF40[4] indicates that China's real estate enterprises resemble 'shadow banks' with real estate development businesses. As an atypical shadow banking system, the scale of assets and

3 Zhu He, Guo Kai, 'Where is the Money?" May be the Wrong Question', CF40 Policy Brief

4 Zhu He, Guo Kai, 'On the Shadow Banking Nature of Real Estate Enterprises', CF40 Policy Brief

liabilities in China’s real estate sector has already surpassed the sum of some existing licensed financial institutions. The real estate industry is facing a prominent liquidity crisis, with some enterprises struggling with solvency and having negative net assets. The real estate sector is a pillar of China’s economy, and its challenges are systemic. It is urgent to transform the approach to real estate debt resolution, which has mainly focused on ‘ensuring delivery of properties’ and the ‘principle of locality,’ to a more holistic, systemic method suitable for handling financial risks. Specifically, this involves, first, endorsing real estate enterprises with government credit to prevent a ‘run’ on them by banks and other financial systems, helping them restore normal financing channels. Second, improving the cash flows of real estate companies by lifting purchase restrictions, lowering mortgage rates, and offering preferential loan rates to first-home buyers, as well as other measures such as helping developers liquidate assets like commercial residential buildings and parking spaces.

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