China's 2024 Economic Outlook[1]

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Abstract: *In 2023, while there were structural highlights in China's economic operation, issues like insufficient effective demand and weak expectations remained prominent, leading to a discrepancy between macroeconomic data and micro entities' perceptions. Since the third quarter of 2023, measures such as the optimization of the real estate sector and additional issuance of 1 trillion yuan in government bonds have boosted confidence. Looking ahead to 2024, a rough estimate suggests that China's GDP growth rate could reach 5%. It is expected that the contributions of final consumption and net exports to GDP growth in 2024 will likely be lower than in 2023, leaving capital formation the main factor determining whether a higher economic growth rate can be achieved.*

The key to China's macroeconomic policy in 2024 should be to significantly increase the fiscal deficit ratio and expand the scale of government bond issuance to provide sufficient funds for broad infrastructure investment. The challenge the Chinese economy is facing is not an either-or between cyclical problems and structural problems, but rather what kind of macroeconomic policies to implement and what kind of economic structural reforms to undertake. For China, maintaining an inflation rate of 3%-4%, or even slightly higher, is deemed appropriate.

I. China's Economic Growth Target for 2024 Should Not Be Lower Than 5%

The GDP growth target set at the beginning of 2023 was around 5%. Given that the GDP growth rate in 2022 was only 3%, a target of 5% is a goal with considerable leeway. Based on the economic data currently available, it is a foregone conclusion that China's GDP growth rate will exceed 5% in 2023.

Although we hope for a higher GDP growth rate for China, compared to other countries in the world, China's economic performance in 2023 is still commendable. In 2022, the total retail sales of consumer goods decreased by 0.2% year-on-year, while from January to November 2023, it increased by 7.2% year-on-year. The rebound in retail sales indicates a considerable recovery in China's consumer spending. From January to November 2023, fixed-asset investment grew by 2.9% year-on-year, lower than the 5.1% in 2022, of which investment in manufacturing grew by 6.3%, lower than the 9.1% in 2022. However, it is encouraging that investment in the manufacturing sector's subdivisions such as electrical machinery and equipment manufacturing, instrument manufacturing, automobile manufacturing, and high-tech industries grew by 34.6%, 21.5%, 17.9%, and 10.5% year-on-year, respectively. The rapid growth of investment in these segments of manufacturing is inspiring.

The reasons for the cooler perception of microeconomic entities and weaker social expectations are multifaceted. From a

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macroeconomic perspective, if the Chinese government had set a higher economic growth target and implemented more expansionary fiscal and monetary policies in 2023, China's GDP growth rate might have been higher, and the increase in household income might have been faster, microeconomic entities would probably have a more optimistic perception and social expectations would probably be stronger.

Without complex econometric models or other quantitative models, we can make a rough estimate (a back of the envelope calculation) of the GDP growth rate that China could achieve in 2024. After determining the proportions of the various components of total demand in GDP at the end of 2023, assuming the growth rates of final consumption, capital formation, and trade surplus in 2024 equal the year-on-year growth rates of retail sales, fixed-asset investment, and trade surplus from January to November 2023, we can calculate the GDP growth rate for 2024. Assuming a 0% growth rate for China's trade surplus in 2024, and a final consumption growth rate equaling to the retail sales growth rate from January to November 2023 (7.2%), we can deduce the required capital formation growth rate to achieve 5% and 6% GDP growth rates.

In my opinion, China's economic growth target for 2024 should not be lower than 5%. Since China's GDP growth rate can reach 5% in 2023, a 5% growth target for 2024 is a more genuine 5%, excluding a considerable base effect. Considering that the global economic growth rate in 2024 will be lower than in 2023, achieving a 5% economic growth rate in China would be a commendable outcome.

It should be emphasized that China's GDP growth rate largely depends on policy. Currently, China is in a state of low inflation, and adopting expansionary fiscal and monetary policies will not lead to runaway inflation, at least in the short term. The Chinese government should fully utilize this most important policy space to strive for the highest possible economic growth rate. This could effectively reverse the continuous decline in GDP growth rate and dispel the pessimistic expectations about economic growth.

II. Whether China Can Achieve a Higher Economic Growth Rate in 2024 will Mainly Depend on Investment, Particularly Infrastructure Investment

In 2023, the growth in consumer demand was the primary driver of economic growth. The growth rate of total retail sales of consumer goods from January to November 2023 was 7.2%, partly due to the low base in 2022. However, this growth was largely due to the rapid growth of the catering industry. With the catering industry returning to normal growth, the growth rate of total retail sales in 2024 is likely to be lower than in 2023. Additionally, due to factors like a weak stock market, declining real estate prices, and local government fiscal constraints, China's final consumption growth in 2024 may be lower than in 2023.

Net exports' contribution to GDP growth significantly decreased in 2023, and it is estimated that net exports will make a limited contribution to GDP growth in 2024.

The contributions of final consumption and net exports to GDP growth in 2024 are likely to be lower than in 2023. Consequently, whether a higher economic growth rate can be maintained in 2024 will primarily depend on capital formation.

Will the growth rate of capital formation in 2024 exceed that of 2023? A key question is whether real estate investment growth will continue to decline in 2024 after falling by approximately 10% and 9% in 2022 and 2023, respectively. Currently, there are signs that the decline in real estate investment is narrowing, but it is expected to continue decreasing for some time in 2024. The drag of real estate investment on GDP growth will diminish, but it is unlikely to make a significant contribution. Although investment in high-tech and emerging industries is encouraging, cumulatively speaking, these rapidly growing emerging investments still account for a very small share and contribute to growth only marginally. Manufacturing investment growth in 2023 was significantly lower than in 2022, which is likely related to the decline in real estate investment.

Therefore, whether the growth rate of capital formation in 2024 can exceed that of 2023 depends on whether the growth rate of infrastructure can be significantly higher than in 2023.

The growth rate of infrastructure investment depends on project reserves and the availability and cost of funds. According to CF40's research, as of November 2023, based on the investment growth rates in the three major industries of manufacturing, real estate, and infrastructure, the investment amount in infrastructure was 20.5 trillion yuan (21.2 trillion yuan for the full year of 2022); the year-on-year growth of infrastructure investment from January to November was 8.0%. Of the amount, investment in the production and supply of electricity, heat, gas, and water increased by 24.4% year-on-year from January to November; that in transportation, storage, and postal services increased by 10.8%; and that in water conservancy, environmental, and public facility management industries decreased by 1.1%.

The water conservancy, environmental, and public facilities management industries are the main business areas of local government financing vehicles (LGFVs). Their investment downturn might be related to the resolution of hidden debts. The National Bureau of Statistics announced that the year-on-year growth of infrastructure investment excluding electricity, heat, gas, and water production and supply industries from January to November was 5.8%. My rough estimate is that if the final consumption growth rate in 2024 is lower than in 2023, achieving a 5% GDP growth rate might require infrastructure investment growth to reach double digits.

China's per capita income is only one-fifth of that of the United States, but its population is four times larger. There is no issue of infrastructure investment saturation in China, especially in fields such as healthcare, elderly care, education, scientific research, underground utility tunnels, and urban transportation. China's stock of infrastructure is far behind developed countries and, in some aspects, even behind some developing countries.

Infrastructure is a public good. Investment in public goods generally does not yield commercial returns or generate cash flow, and funding for infrastructure investment can only mainly come from government budgets. Government budgetary funds primarily include general public budgets (including central government transfer payments to local governments), expenditures from land transfer income, and special bonds. In 2022, budgetary funds accounted for 20.3% of infrastructure investment. In budgetary funds, the most low-cost source – general public budget expenditures of the central government – accounted for less than 1%. Due to the decline in real estate prices, land transfer income, which accounts for about 40% of local government fiscal revenue, has sharply decreased. At the same time, local governments are facing a daunting task of debt resolution. In this context, to stimulate economic growth and improve economic structure, it is inevitable for the central government to increase general public budget expenditures and transfer payments to local governments.

Infrastructure investment may not yield short-term commercial returns but should be efficient and of high quality. Many scholars oppose increasing infrastructure investment mainly for fear that local governments will engage in "vanity projects," "white elephant projects," or "tofu-dreg projects," which would waste resources and even foster corruption. These concerns are valid. However, they pertain to how, not whether infrastructure investment should be carried out.

Ensuring the efficiency and quality of infrastructure investment is a significant challenge for government governance capabilities. Before launching new infrastructure investment plans, the government must consider all aspects, including project initiation, financing, supervision, and acceptance. If there is no institutional and ideological guarantee for efficient and high-quality infrastructure investment, other considerations are moot.

III. Finding the Starting Point for a Virtuous Cycle of Consumption and Investment

From the perspective of increasing aggregate demand, both consumption and investment are important components. Given their proportions in GDP, an increase in the growth rates of both can lead to an increase in GDP growth.

However, from the perspective of economic growth, the nature of consumption and investment is entirely different. Investment implies an increase in capital stock, and an increase in capital stock leads to higher potential economic growth rates. An increase in potential economic growth means that households can enjoy more consumption under other unchanged circumstances. Therefore, the choice between consumption and investment is essentially a choice between consuming now or consuming more in the future. If we want to consume now, then we could reduce investment; if we want to consume more in the future, then we could increase investment.

The proposition that "consumption is a function of income" means that to increase consumer demand, we should first increase household income. A more comprehensive description is: "Consumption is a function of income, income expectations, and stock of wealth." Among all the variables determining consumption, income is the most important one. Income expectations are largely determined by current and previous income and can also be influenced by certain significant non-economic external shocks.

If, on one hand, we acknowledge that "consumption is a function of income," and on the other hand, we hope to stimulate economic growth by increasing consumption, is this logically consistent? As Professor Li Shi said, "For low-income groups, stimulating their consumption is clearly unrealistic, as some of them are in debt; for middle-income groups who face unstable employment and income, as well as increasing family expenses, it is also unrealistic to expect this group to increase consumption; for high-income groups, it is difficult to stimulate their consumption through certain measures, and they are a minority and unlikely to play a significant role in promoting social consumption. Therefore, to increasing household income, we must return to the source: increasing the economic growth rate.

At a given income level, redistributing income through tax and subsidy policies can reduce wealth disparity, thereby reducing the overall savings tendency of the household sector and increasing consumption demand. Given the still significant wealth disparity in China, the government needs to make greater efforts in this area.

At the same time, the government should "make a bigger cake," creating a virtuous cycle of "income growth – consumption growth – income growth." In this cycle, income growth is the starting point. The starting point for income growth is the growth of some special types of investment that do not depend on income growth (i.e., are not a function of income), especially narrow infrastructure investment, technological upgrading investment, and healthcare and education investment that lack commercial returns but are vital for economic development and national security, thus requiring government-supported funds. These investments can be referred to as broad infrastructure investment.

In a context of weak expectations, sluggish economic growth, and falling prices, the growth of broad infrastructure investment, which can create a "crowding-in effect" and drive other profit-oriented investments, is particularly important for kickstarting economic growth. The "virtuous cycle of mutual reinforcement between consumption and investment" should be: "Growth in broad infrastructure investment – growth in various investments – income growth – consumption growth – income growth – growth in investment and consumption – income growth."

If the growth in consumer spending is not based on sustained income growth and stable expectations of such growth, even government subsidies may lead households to save the extra income for future needs. In short, unless there's an unexpected positive external shock (like a major technological breakthrough), the virtuous cycle of economic growth needs to be initiated by the growth of broad infrastructure investment.

The disposable income of Chinese households is a debated topic in academia. The National Bureau of Statistics has published two sets of data on disposable household income. One set, obtained through household surveys, calculates the national per capita disposable income multiplied by the population. According to this data, China's disposable income to GDP ratio in 2022 was 43%, which appears low. The other set, derived from the flow of funds table, shows the ratio to be 59.3% in 2022.

Professor Xu Xianchun has pointed out that statistics based on flow tables are more accurate because household surveys tend to underrepresent high-income households due to their lower cooperation levels. Although the National Bureau of Statistics has made adjustment using tax data, the figures are still relatively low. To calculate the total disposable income and its share of GDP, we should use the disposable income from the flow of funds table, not the household survey estimates.

Since the 1960s, the disposable income to GDP ratio in the U.S. has generally hovered between 70%-75%. China's ratio is lower than most developed countries, but the gap is not as large as some analyses suggest. For instance, in 2022, Japan's ratio was 56.22%, and Denmark's was 46.1%, both lower than China's ratio calculated based on the flow of funds. The UK's ratio was 61.47%, only slightly higher than China's. Simple comparisons between different countries, given their varying national conditions, are not sufficient to illustrate the issue.

Increasing disposable income implies reducing taxes and social security contributions. However, China's macro tax burden is in the middle to lower level among major global economies. Therefore, while China could consider further increasing the disposable income to GDP ratio, it's not clear that simply reducing the tax burden on households would address the current issue of insufficient effective demand in China.

A related issue to the household disposable income is the savings rate. Given a fixed income distribution structure, the savings rate is determined autonomously by households themselves. Due to cultural and institutional reasons, China's savings rate is higher compared to other countries. A higher savings rate in China implies a strong desire among households to accumulate wealth, whether due to "precautionary motives" or other reasons, providing ample loanable funds for business investments. This situation should be seen as an advantage, not a weakness of the Chinese economy. However, if households have a strong desire to save while businesses are reluctant to invest, it could lead to economic slowdown under the fallacy of composition until savings and business investments balance out in a recession.

National savings comprise household savings, corporate savings, and government savings, where corporate savings equal retained earnings, and government savings equal government revenue minus government spending plus government investment.

According to the World Bank, China's savings rate in 2010 was 51.1%, which is excessively high. However, it has declined over the years, reaching 45% in 2016. In 2021, China's savings rate rose to 46.1%, likely related to the pandemic. According to World Bank data, in 2021 (or 2022), the savings rates in Ireland, Singapore, Luxembourg, Norway, and Switzerland were respectively 64.1%, 60.1%, 52.1%, 49%, and 38.4%; in East Asia and Pacific, it was 39.1%; in middle-income countries, 35%; and in upper-middle-income countries, 38.3%.

Different countries have different situations and statistical standards, and mere comparisons of national savings rates do not seem sufficient to assess whether a country's savings (or consumption) rate is rational or not. There is no strict theory to determine the rationality of China's overall consumption level. Whether China undervalues consumption and overestimates savings is a more complex question when geopolitical considerations are factored in. As long as savings are voluntary behavior, they are reasonable. The key is to transform savings into investments, and households could thus increase assets and eventually increase income from assets.

In summary, under current circumstances, the priority should be to break the Maastricht Treaty's "3%" and "60%" taboos, significantly increase the fiscal deficit rate, increase government bond issuance, and provide sufficient funds for broad infrastructure investment. These measures are necessary to reverse the downward trend in GDP growth and pessimistic market expectations about economic growth. Only by doing so can a virtuous interaction between investment, consumption, and economic growth be established.

IV. China Should Be Able to Stabilize the Real Estate Market in 2024

In July 1998, the State Council issued a notice on "Further Deepening the Reform of the Urban Housing System and Accelerating Housing Construction" to put a full stop to housing allocation, launch the monetization of housing distribution, and establish and improve a multi-level urban housing supply system mainly consisting of affordable housing. In 2003, it was again emphasized that "First, the government's primary responsibility is to provide low-price housing for those who can't afford to buy or migrant workers; second, the government should build affordable housing mainly for the middle class; third, while high-end housing mainly relies on market regulation, macro-control is necessary to prevent speculation and market chaos." In 2003, the real estate industry was identified as a pillar industry. In 2014, real estate investment reached a peak of 14.43% of China's GDP.

I don't believe there is a severe bubble in China's real estate market, but I do think there is a problem of resource misallocation in the industry.

In 2013, I pointed out in an article that there were serious structural problems in China's real estate investment. The urban household home ownership rate in China reached 102%, while in the U.S., it was below 70%. The per capita housing area in China was 32.9 square meters, while the median family housing area in Hong Kong was 48 square meters. China had 696 five-star hotels, with 500 more being built or newly completed, growing at an annual rate of over 15%. Now five-star hotels are expanding to second and third-tier cities. There are countless high-standard office buildings built for government use at all levels in China. As of 2013, China had 360 skyscrapers, with possibly several times this number under construction or planned.

Of course, due to the lack of reliable statistics, the above figures might not be accurate. But it is certain that real estate development and investment accounted for too high a proportion of fixed asset investment and GDP. My concern was that the Chinese economy had become too dependent on real estate investment, and reducing the growth rate of real estate investment at that time might have led to a hard landing of the economy. But maintaining the growth rate of real estate investment might have led to a more severe hard landing in the future. I think China is currently dealing with this challenge.

The continuous rise in China's real estate prices is the result of supply-demand imbalance. Due to the unique nature of real estate, demand includes not only the pursuit of a better life but also investment and pure speculation. The lack of other investable assets, imperfect tax systems (such as the absence of inheritance tax, capital gains tax, property tax), and opacity of property (including the absence of a financial registration system for public officials) have amplified investment and speculative demand in real estate. From the supply side, there are restrictions on land supply (some of which are necessary), and local governments continuously raise land prices through the "bidding, auction, and listing" process, indirectly pushing up housing prices.

Income growth lags behind housing price growth – China's ratio of housing price to average family income ranks among the highest in the world. High housing prices have caused dissatisfaction among middle and low-income groups. To meet rigid demand and prevent social problems from worsening, the government has taken a series of measures (such as the so-called "six restrictions") to curb the rise in housing prices. The "success" of government real estate regulation often means a decrease in real estate prices, which, after some lag, leads to a decrease in the growth rate of real estate investment. Since real estate investment significantly contributes to economic growth, once real estate investment growth slows down, the government adjusts policies to curb the decline in real estate prices. Due to the government's eventual abandonment of price control in favor of maintaining economic growth, the market gradually forms the expectation that housing prices only rise and never fall. This expectation undoubtedly strengthens speculative demand in real estate and, in turn, drives up housing prices.

From the second quarter of 2014 to 2015, the growth rate of real estate investment continued to decline, almost entering negative growth. As Mr. Ma Guangyuan pointed out years ago, if the government had not intervened too much in the decline of real estate investment growth at that time, allowing market mechanisms to play a regulatory role, China's real estate might have landed in 2016 (albeit a bit "hard"), thus avoiding the continuous sharp rebound in real estate prices since 2016.

"There's no feast that doesn't end," and the adjustment of China's real estate market will happen sooner or later. What is uncertain is when and to what extent it will happen. Between 2008 and 2010, 2011 and 2012, the first quarter of 2013 to the first quarter of 2014, the second quarter of 2014 to the end of 2015, and 2016 to 2021, real estate prices and investment fluctuated. In the past, the fluctuation occurred every 2-3 years, but since 2016, the housing prices continued to rise for 6 years. During this period, China experienced the COVID-19 pandemic, continued economic slowdown, weakening expectations, population aging and declining birth rates, and rising vacancy rates of houses (couples will inherit houses from both parents), among other changes. The demand for housing as an investment and for speculative purposes has reached its peak.

In fact, the growth rate of China's real estate price index has been declining since 2019. Falling sales have led to falling prices, which is good for those who have rigid demand but bad for investors and speculators. The fall in housing prices has suppressed real estate investment and speculative demand, further increasing the downward pressure on prices. The decline in housing prices and the reduction in sales revenue have become a major issue for real estate developers.

However, the real estate industry has not yet completed its historical mission. With urbanization progress and reform of the household registration system, there are still opportunities for further development in real estate. For a considerable period in the future, the real estate industry is likely to be in a state of recovery and preparation for future growth.

High leverage and high turnover are key features of real estate finance. In addition to their own funds, bank loans, stock and bond market financing, and asset securitization, real estate developers also rely on pre-sale revenue from commercial housing and advance payments (accounts payable) from construction units. According to CF40's estimates, in 2021, pre-sale income from off-plan sales accounted for 50.1% of the sources of real estate development funds.

With the decline in housing price growth, reduced sales income has made it difficult for real estate companies to repay various forms of external funds on time. Although their assets still exceed liabilities, some companies have faced liquidity crises. Financial institutions have become cautious due to credit issues, making it difficult for real estate developers to solve liquidity shortages in financial markets. Real estate companies are forced to sell properties and other assets at reduced prices, increasing the risk of insolvency. A large number of bankruptcies in real estate companies could lead to a break in the societal debt chain, impacting related upstream and downstream enterprises and even banks. Avoiding the transformation of liquidity shortages into insolvency and widespread bankruptcies among real estate developers is the biggest challenge we will face in 2024.

Different countries have different mechanisms by which real estate risks lead to financial crises. In the U.S., the financial crisis originated from subprime mortgages, which do not exist in China. Data shows that development loans and mortgage loans account for 5.6% and 16.4% of total bank loans, respectively, so mortgage-backed loans are unlikely to pose significant problems.

Due to turnover challenge, real estate developers could not deliver properties to buyers who have paid pre-sale funds. The "guaranteed delivery" policy is the right policy, especially for projects aimed at rigid demand. However, how to ensure that real estate developers who face liquidity crises, default risks, or bankruptcy deliver the houses? If developers fail to deliver, while buyers legally need to repay loans, social stability could be affected. Will buyers refuse to repay bank loans? To ensure house delivery, the central government may have to provide sufficient financial support.

Drawing from the U.S. government's experience in handling the subprime mortgage crisis, preventing real estate developer bankruptcies can be approached from three angles:

First, government or other companies (usually capable state-owned enterprises) should inject funds into real estate companies in exchange for equity. However, due to developers' existing debts, capable companies may be reluctant to take over. As Mr. Gao Shangwen suggested, temporary nationalization of these companies could be considered under specific circumstances.

Second, purchasing various financing bonds issued by these companies and providing short-term loans to help them resolve liquidity shortages and avoid bankruptcy by preventing liquidity crises from transforming into insolvency.

Third, central and local governments or state-owned enterprises could purchase unsellable properties to prevent further declines in housing prices and acquire project assets from real estate developers to prevent unfinished projects. On this basis, drawing on Singapore's public housing experience, governments could provide affordable and public rental housing for the public.

The foundation for all these solutions lies in the financial strength of the central government and the capacity of the central bank to expand its balance sheet. Former Governor of the Bank of Japan, Masaaki Shirakawa, suggested establishing a residential housing financial platform directly managed by the central government. This platform would act as a real estate industry revival institution, directly purchasing "guaranteed delivery" projects from failed real estate companies to ensure a smooth resolution of delivery risks. Foreign experiences are worth studying.

Considering that continued negative growth in real estate investment in 2024 is highly probable, I believe various restrictions on real estate sales (such as the "six restrictions") should also be lifted in different regions.

In summary, if we formulate a feasible plan for the debt resolution of real estate companies based on lessons learned both domestically and internationally, taking into consideration China's actual conditions, China should be able to stabilize the real estate market in 2024. The current liquidity crisis in the real estate market is unlikely to trigger a financial crisis in China.

V. Increasing the Fiscal Deficit Rate is the Key and Further Easing Monetary Policy

"China announced an additional 1 trillion yuan in government bond issuance for 2023, increasing the fiscal deficit rate from 3% to 3.8%." This is a very important and praiseworthy measure. This move signals that the Chinese government will no longer regard the Maastricht Treaty's "3%" and "60%" fiscal rules as inviolable.

Of course, according to the International Monetary Fund's concept of "general government deficit," China's ratio of general government deficit to GDP has long exceeded 3%. Due to the particularities of China's fiscal system and budget structure, and corresponding debt repayment arrangements, the concept of "general government deficit" needs further clarification.

However, amid a low inflation environment for over a decade, China must implement more expansionary fiscal and monetary policies, especially fiscal policies. Only in this way can China potentially reverse the continuous decline in economic growth and weak market confidence.

Without access to detailed numbers, it's hard for outsiders to offer specific suggestions. However, I believe that fiscal spending in 2024 should increase significantly. If there is sufficient project reserve, increasing the fiscal deficit rate to 4% or even 5% should not be a problem. The government should and can further increase the fiscal deficit rate and the ratio of government debt to GDP on top of the 2023 level.

Regarding monetary policy, given the prominent issue of insufficient effective demand in China, it is necessary to further relax monetary policy. Monetary policy should focus on specific targets and rely more on interest rate policy, without incorporating asset price regulation, such as housing prices, into its objectives. Monetary policy, being a short-term macroeconomic tool, should not be expected to precisely target specific economic sectors. Money flows towards higher interest rates, and structural monetary policy inevitably leads to arbitrage activities. For example, consumer loans can easily be used to prepay mortgages, and loans granted to state-owned enterprises may be re-lent to private enterprises at higher interest rates. Except in special circumstances, the allocation of funds should be determined by commercial banks, not the central bank.

The so-called monetary policy space includes the capacity to lower interest rates and expand credit. The possibility of such space fundamentally depends on China's inflation situation. If inflation in China is low, there is room for further relaxation of monetary policy.

While there is still room for further easing monetary policy, such as potentially further reducing the reserve requirement ratio, its impact on financial resource allocation, the renminbi exchange rate, and the profitability of the banking system should be taken into consideration when it comes to implementation.

Interest rate cuts positively affect the stock market, real estate market, bond market, and local government debt resolution. However, without expansionary fiscal policy as a precursor, further easing of monetary policy can only stimulate aggregate demand to a limited extent. In a low inflation environment, the “precautionary motive” of households and the “risk aversion motive” of businesses can weaken the stimulating effect of lower interest rates on consumption and investment. For instance, commercial banks have recently lowered deposit interest rates, but the reduction does not seem to significantly encourage consumer spending. Meanwhile, commercial banks also face “a scarcity of quality assets.” When investment returns are low, the intensification of arbitrage activities, “moral hazards,” and “adverse selection” also hinders further interest rate reductions by commercial banks. The widening gap between the growth rates of M2 and M1 (high M2 growth but low M1 growth) indicates that new loans are mainly transformed into households’ and businesses’ savings deposits, not used to buy goods and services.

The key to China’s macroeconomic policy in 2024 should be to significantly increase the fiscal deficit ratio and expand the scale of government bond issuance. Low interest rates can create favorable conditions for government bond issuance. Given China’s current situation, the conditions for large-scale issuance of government bonds are in place. The lower the bank interest rates, the lower the cost of issuing government bonds. If government bond sales encounter difficulties, the government can implement a China-style “quantitative easing” policy, where the central bank purchases government bonds in the secondary market.

VI. Structural Reform and Adopting the Right Macroeconomic Policies Are Not Contradictory

I have emphasized on many occasions that China still has considerable room to implement expansionary fiscal and monetary policies. There are many reasons for this, which I will not elaborate on here. If a country with an inflation rate near zero does not have room for expansionary fiscal and monetary policies, then no country does.

The so-called “cyclical problems” in China’s context generally refer to issues related to macroeconomic regulation, such as fluctuations in prices and economic growth, and whether to implement expansionary or contractionary macroeconomic policies.

What are structural problems? There seems to be some ambiguity in the understanding of this concept. The dictionary definition of “structure” is the arrangement and configuration of the various parts that make up a whole. Marx is said to have first proposed the concept of “economic structure.” In the 1990s and 2000s, some European scholars established a new discipline called “Structural Economics.” The founders of this discipline took “economic structure” as their subject of study, which includes three elements: technology owned by producers, resource endowments, and consumer preferences. The task of “Structural Economics” is to provide a national accounting framework that includes these three elements and to use it to analyze issues such as the impact of an increasing share of services on economic growth rates. The concept of “factor endowment structure and its changes” is a core concept in Professor Lin Yifu’s “New Structural Economics.”

In a 2016 article, I wrote: China faces complex economic problems, including issues related to growth models, economic development, industrial policy, income distribution, employment, price levels, balance of international payments, demand structure, fiscal and monetary policy, corporate governance, financial regulation, financial deepening and liberalization, population, social security, industrial organization, and regional economies. For convenience, when discussing short-term or long-term economic growth, economists often categorize these issues into two broad categories: structural reform and macroeconomic demand management (or regulation). Issues beyond macroeconomic policy are termed “structural problems.”

It is clear that China's economy is not facing an either-or between cyclical or structural problems, but rather what kind of macroeconomic policy should be implemented and what kind of economic structural reforms are needed. These are two different fields that require different expertise. Scholars in different fields study problems in their respective areas and can only propose professional solutions within their fields of expertise. The question of whether China's economy faces cyclical or structural problems is a false dichotomy.

"Structural reforms with an expansionary effect can also have immediate results." I agree with this view. We all remember clearly that in 1983, when China introduced the household responsibility system in agriculture, the issue of grain shortage was quickly resolved. Deng Xiaoping's southern tour in 1992 led to a rapid rebound in China's economy. Implementing the correct macroeconomic policies is a necessary condition for the sustained and stable growth of China's economy, but not a sufficient one. Of course, macro-control and reform are not unrelated. In fact, without the "rectification of wrongs" at the Third Plenary Session of the 10th Central Committee of the Party, nothing would have been possible.

Emphasizing the importance of structural reform does not reduce the importance of formulating the right macroeconomic policies. However, structural reform is not a tool for macro-control and usually does not have specific macroeconomic policy goals. The specific impact of a particular reform on the macroeconomy needs to be analyzed in detail. In summary, each issue should be analyzed specifically to avoid generalization.

VII. As a Developing Country, China should Maintain an Inflation Rate of 3%-4% as an Appropriate Level

Monetary policy goals are divided into ultimate goals and intermediate goals. The ultimate goal of monetary policy can be either a single goal or multiple goals. China's monetary policy has multiple ultimate goals, including maintaining price stability, promoting economic growth, promoting employment, and maintaining a basic balance of international payments. In practice, China's monetary policy also includes goals such as exchange rate stability, financial stability, and efficient allocation of funds ("precise targeting"). Most Western countries adopt a single goal – targeting the inflation rate.

Having too many goals can lead to neglecting some at the expense of others. After 2005, with the reform of the RMB exchange rate system and the increase in RMB exchange rate flexibility, the central bank has de-emphasized the goals of exchange rate stability and international balance of payments stability.
In economics, economic growth and employment promotion are generally consistent goals. In China's past practice, one of the most important purposes of increasing economic growth, besides its own significance, is to create sufficient employment.

For various reasons, including statistical reasons, we mainly consider two goals in practice: price stability and economic growth. However, there is a conflict between price stability and economic growth. An increase in economic growth rate is often accompanied with an increase in inflation rate, while curbing inflation tends to lead to a decline in economic growth rate. Therefore, there is a trade-off between the two. The difficulty in formulating macroeconomic policies also lies here.

China's current economic situation is somewhat unique. Since 2012, as economic growth rates have continuously fallen, China's inflation rate has also been in decline, entering a state of low inflation.
In this scenario, policymakers of macroeconomic policies need not worry about the trade-off between inflation and economic growth. The simultaneous decrease in economic growth and inflation rates clearly indicates that China should implement vigorous expansionary macroeconomic policies.

Traditionally, China's GDP growth target has been a point target (except in 2020), and the inflation target also appears to be a point target (though specific targets were not set in some years). Although each year's government work report usually proposes to control the overall price growth rate at around X%, in practice, no extra measures are taken if the inflation rate increases below the target rate. In the minds of the public and the government, the lower the prices, the better.

Inflation is decided by the "supply-demand gap" in the overall economy. Continuous price declines reflect an "insufficiency of effective demand" in the overall economy. For various reasons, including those related to statistics, an excessively low inflation rate (the measurement indicators vary), such as below 2%, also indicates insufficient overall effective demand. That's why, as long as the inflation rate is below 2%, developed countries' monetary authorities adopt expansionary monetary policies (mainly lowering interest rates) to try to increase the inflation rate to 2%. A total demand slightly higher than total supply, maintaining mild inflation, is more conducive to economic growth.

For developing countries, the inflation rate that reflects the overall supply-demand balance should be higher than in developed countries. One reason is that inflation rates in developing countries are often overestimated. For example, the price of a product last year was 100 yuan, and this year it's 200 yuan, but the price of this product may not have increased because, due to improved quality, the unit product's use value is twice that of the original product. In China's case, maintaining an inflation rate of 3%-4%, or even slightly higher, should be appropriate. If the inflation rate is below 2%, China's macro authorities should even more resolutely implement expansionary fiscal and monetary policies.

Most Western countries follow a single inflation target system. In China's case, it's not enough to decide monetary policy stance based solely on the deviation of the inflation rate from its target; GDP growth rate (and corresponding employment) must also be considered.

Under the current circumstances, whether based on economic growth or inflation rate considerations, China should implement strong expansionary fiscal and monetary policies. Otherwise, if economic growth has not yet recovered and inflation rate suddenly rises due to some external shock, the difficulty of macroeconomic regulation will greatly increase, and the window of opportunity to reverse the continuous decline in economic growth may close.