Reassessing the Financial Function of Fiscal Policy[1]

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Abstract: *The buying and selling of government bonds by the central bank have many benefits, such as addressing the inversion of growth rates, adjusting government debt structure, and promoting financial structural adjustment. Therefore, it is necessary to reassess the financial function of fiscal policy. First, from the perspective of the relationship between fiscal policy and currency, the central bank's purchase and sale of government bonds help to better leverage the role of fiscal policy in the monetary policy transmission mechanism. To lift operational restrictions in the primary and secondary markets, ideological liberation is necessary, otherwise, it will be difficult to achieve synergy between fiscal and finance. Second, from the perspective of the relationship between fiscal policy and capital market, the central bank's purchase and sale of government bonds contribute to the development of capital markets and the improvement of capital market infrastructure. The risk-free assets provided by public finance serve as the pricing benchmark for the capital market, and the yield curve of government bonds is an important part of the capital market infrastructure. Currently, the structure of social financing in China is reversed, and the central bank's buying and selling of government bonds provide an opportunity to adjust the structure. Third, the central bank's purchase and sale of government bonds helps to promote the integration of fiscal policy and monetary policy. In the new landscape, it is necessary to adjust the relationship between public finance and the central bank, strengthen the coordination between fiscal and monetary policies, and promote a more reasonable financial structure that is better suited to the needs of reducing uncertainty at the new stage.*

As one of the tools in the toolbox of monetary policy, the purchase and sale of government bonds by the central bank is a common practice, but it has caused an unusual reaction in the industry. This may be related to the long-standing relationship between public finance and the central bank. The market jokingly refers to them as "Finance Dad and Central Bank Mom" who have long lived separately but are now starting to reconcile and dream together. The market has many expectations for the central bank's purchase and sale of government bonds.

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I. Background of the central bank's buying and selling of government bonds

Firstly, there is an unusual phenomenon in the current domestic economy: an inverted growth rate, where the nominal GDP growth rate calculated at current prices is lower than the real GDP growth rate calculated at constant prices. In the first quarter, China's nominal GDP growth rate was 4%, lower than the real GDP growth rate of 5.3%. Compared to last year's nominal GDP growth rate of 4.6% and real GDP growth rate of 5.2%, the inversion is further deepening. While China's 5.3% real growth rate in the first quarter is impressive globally, the inversion is worth pondering because it indicates that the improvement of insufficient demand is not as good as expected, and the task of expanding and strengthening the "internal circulation" remains challenging.

Secondly, the structure of government debt is inverted, which means the size of central government debt is smaller than that of local government debt, rare in market economies. Currently, the central government has realized that this situation is unsustainable and is adjusting the government debt structure by gradually increasing the proportion of central government debt and controlling or maintaining local government debt. This year, the central budget has allocated an additional 100 billion yuan in local special bonds compared to last year, while issuing 1 trillion yuan in ultra-long-term special bonds, with the possibility of increasing the amount at any time depending on the situation.

Adjusting the government debt structure requires increasing the issuance of government bonds. Then the question is, how to determine the scale of government bond issuance? Is the government's fiscal deficit the only criterion? Why is it difficult to circulate the previously issued government bonds deposited in large banks? From the market perspective, the low liquidity of the government bond market indicates that the capital market is not sound and that the yield curve of government bonds is difficult to play a role.

Thirdly, there is an issue with RMB assets. To promote its internationalization and achieve global circulation, RMB assets should have good liquidity. If government bonds, as risk-free assets, are in a status of deposit, RMB will also face problems during the promotion of internationalization.

Overall, the central bank's buying and selling of government bonds is beyond open market operations and involves reversing the inverted growth rate, adjusting the government debt structure, and promoting financial structural adjustment. Therefore, besides from the perspective of the central bank or finance, the country needs to consider multiple factors, at least expecting the buying and selling to play a dual role.

II. The relationship between fiscal policy and monetary policy transmission mechanism

From the perspective of currency circulation, the central bank's buying and selling of government bonds helps to better leverage the role of fiscal policy in the monetary policy transmission mechanism. Many interpretations in the market view the buying and selling as a form of massive liquidity injection, akin to China's version of quantitative easing (QE), which is a misunderstanding. From practical experience, fiscal policy and the central bank are closely linked. Although the Law of the People's Republic of China on the People's Bank of China requires the central bank to maintain independence, this independence is relative. In 1997 and 2007, China issued special government bonds twice, and regardless of the formality, the bonds were essentially purchased by the central bank, showcasing excellent coordination between fiscal and financial sectors. The current balance of over 1.5 trillion yuan in government bonds on the central bank's balance sheet is the result of purchasing special government bonds in the past, with no further adjustments thereafter.

According to the current situation, fiscal and financial sectors are drawing closer to each other. Structural monetary policies, financial rescue operations, subsidized loans, and other measures reflect the continuous strengthening of coordination between fiscal and financial sectors. However, overall, the coordination remains insufficient. During the early stages of reform and opening up, there was a debate about the "large fiscal, small banking" model. In reality, China's fiscal policy currently follows a "small fiscal" model, failing to fully utilize the financial functions inherent in fiscal policy. From the perspective of the relationship between fiscal and monetary policies, fiscal policy is one of the important mechanisms in monetary policy transmission. However, in the past, fiscal and financial sectors were used to discussing their respective policy transmission mechanisms. In reality, fiscal revenue and expenditure regulate currency circulation. When taxes are collected, the base currency is withdrawn into the treasury, and when expenditures are made, the base currency is released. Therefore, understanding fiscal revenue and expenditure from the perspective of currency circulation will help us better grasp the changes in the relationship between fiscal and monetary policies.

How can fiscal policy play a better role in the monetary policy transmission mechanism? The central bank's buying and selling of government bonds is an important consideration. The People's Bank of China Law stipulates that government bonds can only be traded in the secondary market. However, the distinction between primary and secondary markets is not clear-cut because of the unclear definition. The two special treasury bond issues in 1997 and 2007 were operated with banks acting as intermediaries, in the form of the People's Bank purchasing treasury bonds in the secondary market, but in reality, the bonds were purchased directly in the primary market. Therefore, regarding the buying and selling of government bonds in the primary market as a red line is overly dogmatic, artificially setting up barriers that may hinder the synergy between fiscal and financial sectors when needed. It is necessary to reflect on the traditional perception and rigid understanding concerning "overdraft".

From a legal perspective, the purpose of restricting fiscal overdrafts is to prevent vicious inflation. However, in reality, fiscal overdrafts are subject to budget constraints, and fiscal budgets must be scrutinized by the National People's Congress, otherwise, expenditures cannot be made. From this perspective, there is no need to panic about fiscal overdrafts, nor should the boundaries between the primary and secondary markets of government bonds be seen as impassable red lines. It is necessary to liberate thinking and reconsider. Internationally, central banks can directly purchase government bonds, stocks, or even corporate assets, but the specifics depend on the practical situation, and such measures may not be necessary at all times. The so-called conventional and unconventional policies are not absolute, depending on changes in circumstances and how they are defined. Once a new norm is established, what was once considered unconventional may become conventional, such as deficit policies which were unconventional decades ago but are now conventional. In this regard, we should have a full understanding of the financial functions of fiscal policy and a new understanding of the relationship between fiscal and monetary policies to better leverage the role of fiscal policy in the transmission of monetary policy and promote effective coordination between fiscal and financial sectors.

III. The relationship between fiscal policy and capital market structural adjustment

From the perspective of the capital market, the central bank's buying and selling of government bonds provides an opportunity to promote the adjustment of the social financing structure. In the past, under the concepts of central bank independence and monetary policy independence, fiscal policy and finance have become "two-skinned". An important financial function of fiscal policy is to provide risk-free assets and liquidity tools for the capital market, and financial wealth for the people. However, for a long time, China's fiscal policy has not fully embraced this idea. The issuance of government bonds by the fiscal sector has mainly been to cover deficits, with little consideration given to whether the types of bonds are suitable for the current capital market needs, reflecting an insufficient understanding of the financial functions of fiscal policy.

The society also needs to enhance its understanding of the financial functions of fiscal policy. The risk-free assets provided by fiscal policy act as the pricing benchmark for the capital market. One of the important infrastructures of the capital market is the yield curve of government bonds. In the analysis of U.S. monetary policy, the first thing to consider is the changes in the yield of US ten-year government bonds. However, China pays little attention to the yield curve of government bonds, indicating that the financial functions of fiscal policy are not given full play and that the infrastructure of the capital market is not sound, resulting in a reversal "or counter-adjustment" of China's capital market, especially the bond market, in the social financing structure, with a decrease in the proportion of direct financing and an increase in the proportion of indirect financing. China's financial reform has always emphasized the need to continuously increase the proportion of direct financing, but the current changes in the financing structure are contrary to the goals, and the problem has become increasingly serious. It is significant to stay vigilant against the continuation of this trend, and the central bank's buying and selling of government bonds provide an opportunity to address this problem.

The central bank's buying and selling of government bonds is a good way to shift towards price regulation. Optimizing the price reference system can also create favorable conditions for improving the liquidity of the bond market. These issues are interrelated. Although the buying and selling of government bonds cannot directly influence the social financing structure, it can play an indirect role, conducive to forming a market-recognized interest rate corridor and benefiting the development of the capital market and the soundness of capital market infrastructure. From this perspective, rethinking the financial functions of fiscal policy also requires a reevaluation of the relationship between fiscal policy and the capital market.

IV. The trend towards integration of fiscal and monetary policies

The buying and selling of government bonds by the central bank is a way to transfer seigniorage tax, whether in the primary or secondary market. Seigniorage tax is rarely discussed in academia and focused on in the market. However, with economic and social development and the growth of social wealth, the currency will naturally increase, and the seigniorage tax will arise accordingly. Generally, issuing currency represents a profit without cost, which is essentially the concept of seigniorage tax and undoubtedly should be considered as national income. Other countries have clear regulations on seigniorage tax, but China has yet to clarify the relationship between fiscal and financial policies in this regard.

Whether through direct means, indirect means, or other channels, the key is that the buying and selling of government bonds provides a channel for transferring seigniorage tax. The seigniorage tax is also related to currency overissuance, as overissuance could potentially lead to inflation. However, at least for now, China is not facing inflation caused by currency overissuance, and instead, the depreciation of assets during the transformation and upgrading of industrial structure is more worthy of attention. While inflation is difficult to control, asset depreciation is even more challenging, and it is more difficult to handle asset depreciation than currency depreciation. Flow issues only affect short-term situations, while stock issues determine future trends.

Globally, developed countries are currently experiencing inflationary cycles, whereas China's situation is the opposite. While developed countries are continually raising interest rates, China is continuously lowering interest rates. From the perspective of economic performance, China and developed countries are showing opposite trends, which deserves further exploration and reflects issues with the coordination of fiscal and monetary policies.

In practice, the trend overseas is towards the integration of fiscal and monetary policies, rather than how to coordinate them. For example, in the United States, the establishment of SPV companies, funded by the Federal Reserve, while the Treasury Department considers how to use the funds, represents an integrated operational model. In the new economic landscape, especially against the backdrop of a stair-step decline in global economic growth, strengthening the integrated coordination of fiscal and monetary policies and leveraging their combined efforts can at least play a role in reversing the current situation.

In all, the buying and selling of government bonds by the central bank is not merely a matter of fiscal or monetary policy, nor is it solely related to coordination between fiscal and monetary policies, but rather a question of how to reverse the situation in an economic landscape entirely different from before. We should not ignore the risks hidden behind the inverted growth rate. In this context, the relationship between fiscal and monetary policies, as well as the relationship between fiscal policy and currency, are bound to undergo adjustments, which will be more conducive to harnessing the roles of fiscal policy and the central bank. More importantly, it is necessary to enable the financial market to play a better role in promoting the financial structure in China to make it more rational and better suited to the needs of the current new development stage.