Global Monetary Policy Shifts and China's Economic Countermeasures

CF40 Research Department

Abstract: *Recently, the China Finance 40 Forum and the China Center for International Economic Exchanges jointly held the 6th Bund Summit to discuss the topic Global Monetary Shifts and Their Impact.*

The conference concluded that the U.S. and Europe are entering an interest rate cut cycle. The Federal Reserve's focus is shifting from the risk of persistent inflation to labor market weakness and the prospects for economic growth. The economic situation in Europe is more complex than in the U.S., and the European Central Bank will maintain flexibility in its policy-making. Japan is gradually emerging from long-term deflation, with its monetary policy steadily normalizing.

The Federal Reserve should thoroughly review the lessons learned from its monetary policy since 2020, assess its pros and cons, and enhance the universality of the new monetary policy framework. It should also reevaluate the inflation target, monetary policy tools, and communication with the market. Regarding the inflation target, most international experts believe that the 2% target should not be changed unless absolutely necessary, as doing so could undermine the central bank's credibility.

For China's economy, international experts recommend that China should maintain an loose monetary policy and, if necessary, adopt measures beyond expectations to avoid deflation or prolonged low inflation. Chinese experts believe that the main issue currently facing China's economy is insufficient domestic demand, and that proactive fiscal policy and loose monetary policy are needed to maintain an appropriate nominal GDP growth target.

I. The U.S. and Europe Begin Entering an Interest Rate Cut Cycle, While Japan Emerges from Long-Term Deflation

Former Vice Chair of the Federal Reserve, Donald Kohn, stated that the Federal Reserve is about to shift from a tightening monetary policy to a more loose stance. Recent data shows that although U.S. inflation remains above the 2% target, it is gradually and steadily declining. The imbalance in the labor market between supply and demand has largely eased, as evidenced by fewer job vacancies, reduced competition among employers for workers, and slower wage growth. However, despite stable U.S. economic growth, recent signs of economic slowdown and labor market weakness suggest that the growth outlook is uncertain, and consumer spending may not be sustainable. Federal Reserve Chair Jerome Powell expressed cautious optimism about inflation but is more concerned about potential labor market weakness. In order to achieve a "soft landing" for the economy, the Federal Reserve will gradually exit its tightening monetary policy and begin cutting interest rates, though the specific path remains uncertain.

Former President of the European Central Bank, Jean-Claude Trichet, pointed out that the ECB is in the process of lowering interest rates, but the economic

landscapes in Europe are more complex and more challenging than in the U.S. Over the past period, the ECB has raised interest rates several times to curb persistently high inflation. However, although overall inflation has eased, core inflation remains above the 2% target. European economic growth lags behind that of the U.S., severely affected by the Ukraine crisis in terms of energy and food supplies. The PMI (Purchasing Managers' Index) is low, indicating a lack of momentum. It could hinder the rapid decline of core inflation. Looking ahead, the ECB may formulate policies based on real-time economic conditions, but market expectations will face a 25 basis point rate cut within the next month. Nonetheless, the ECB will maintain flexibility in its policy-making in response to the complex economic landscapes.

Former Governor of the Bank of Japan, Haruhiko Kuroda, noted that Japan is gradually emerging from long-term deflation, and monetary policy is steadily normalizing. Over the past decade, the BOJ implemented quantitative and qualitative monetary easing (QQE) to achieve a 2% inflation target, successfully eliminating deflation. However, inflation remained around 1%, with almost no wage growth. Since 2022, due to rising commodity prices from the Ukraine crisis and the depreciation of the yen, Japan's economy has begun to show new characteristics. The significant rise in inflation has led to wage increases, corporate profits have reached record highs, and the labor market has tightened. These changes indicate that Japan is likely to achieve the 2% inflation target in a stable and sustainable manner, without the need for extreme monetary easing. Moving forward, the BOJ will prudently normalize its monetary policy and gradually raise interest rates to a neutral level (1% to 2%).

II. Reassessing Monetary Policy Framework and Inflation Target

In 2020, the Federal Reserve adjusted its monetary policy framework in response to the low interest and low inflation. However, as the inflation landscape evolves, the Fed must reassess its current policy framework to better address future economic challenges.

Donald Kohn, former Vice Chair of the Federal Reserve, suggested that the Fed should first conduct a thorough review of the lessons learned from the monetary policy it has implemented since 2020 and analyze its pros and cons. While the Fed performed well in addressing high inflation and the economy seems to have achieved a soft landing, there are still areas that warrant reflection.

Second, the new monetary policy framework needs to be more adaptable. It should undergo stress testing to ensure it can handle various economic shocks, including those both from the supply-side and demand-side.

Third, the 2% inflation target should be reassessed. With increasing geopolitical risks and changes in economic structures, the drivers of inflation may shift. It’s imperative to reevaluate whether the 2% inflation target remains appropriate.

Finally, the Fed should reassess its monetary policy tools and its communication with the market. A comprehensive review of the tools used, especially unconventional tools such as forward guidance and quantitative easing, is needed. In particular, there should be a reflection on whether forward guidance on interest rates delayed the Fed's response to inflation. While the Fed has improved transparency and clarity, further study is needed on how to more effectively communicate its policy intentions and actions to avoid misunderstandings.

Sarah Hunter, Assistant Governor of the Reserve Bank of Australia, emphasized the importance of avoiding “false precision” and overly definitive views in economic forecasting. It is risky to focus too much on the precision while ignoring the limitations of models and the complexities of the real economy. For example, although economists have used various models to predict inflation, the persistence of inflation exceeded expectations, highlighting the limitations of central bank understanding. Central banks should

both strengthen their research into the uncertainties in economic forecasting and reveal this uncertainty appropriately when conveying forecast information to the public.

Regarding whether to change the 2% inflation target, Jean-Claude Trichet, former President of the European Central Bank, argued that while adjustments to the monetary policy framework are necessary, the 2% inflation target should not be changed. After the global financial crisis, central banks around the world have reached a consensus on price stability and set a 2% inflation target. This target is a major structural reform of the international monetary system since the collapse of the Bretton Woods system. Central banks have adhered to this target even amid the post-pandemic inflation surge, reflecting the consistency and determination of global monetary policy, which is crucial for economic stability.

Raghuram Rajan, former Governor of the Reserve Bank of India, believes that the inflation target should not be changed lightly, as doing so could undermine the credibility of central banks. If a change is necessary, the timing should be carefully chosen, not made hastily without clear need. The current global inflation is primarily driven by government fiscal imbalances, high investment demand, and the rise of trade protectionism. These factors contribute to persistent inflation and may alter public expectations. Faced with this challenge, central banks need to reassess their monetary policy frameworks to establish a mechanism that can more effectively contain inflation.

III. Policy Recommendations from Chinese and International Experts on China's Current Economic Landscapes

Regarding China's current economy, Donald Kohn recommended that China should first confront its issues head-on, as avoiding or delaying solutions will only worsen the situation. Second, when the sluggish real estate market suppresses domestic demand, other areas should receive increased stimulus to maintain economic growth. Drawing from Japan's experience, Haruhiko Kuroda noted that the biggest challenge Japan faced during its long-term deflation was the failure of translating price increases into wage growth, which ultimately hindered the positive demand cycle. He suggested that given China's current Consumer Price Index (CPI) nearing zero and the Producer Price Index (PPI) being negative, China should maintain a loose monetary policy. If necessary, China should adopt stronger-than-expected policy measures to prevent deflation or prolonged low inflation. Raghuram Rajan mentioned that moderate inflation is an effective way to alleviate housing price imbalances. However, to achieve faster market equilibrium, interventions to prevent housing price declines should be avoided. Only by allowing market mechanisms to function can housing prices stabilize and rise more quickly.

In addition, international experts suggested that China needs to pay close attention to and properly address several long-term structural issues, including demographic changes, the reform of central-local government relations, and balancing the state-owned and private sectors.

Chinese experts agreed that the primary challenge in China's economy is insufficient domestic demand, particularly weak consumption and investment. Unlike the U.S. and Europe, China is facing low inflationary pressure, with both the GDP deflator and PPI continuously negative. Although CPI is positive, it remains low. To boost the economy, China needs to adopt proactive fiscal policies and maintain loose monetary policies to achieve an appropriate nominal GDP growth target, thereby improving domestic demand and restoring confidence in the real economy.

Some Chinese experts also pointed out that fiscal policy is more critical than monetary policy at present. Based on data from July, China's total retail sales of consumer goods grew by 2.7%, and fixed asset investment increased by 3.6%, which is still insufficient to achieve the 5% economic growth target. Although exports have performed well, their relatively small share limits their contribution to GDP. Therefore, more expansionary

fiscal policies are urgently needed, particularly increased infrastructure investment, to meet economic growth targets. China still has significant fiscal room, and the main challenge now is how to sustain economic growth. The strict "3% deficit ratio and 60% debt limit" rules in Europe are not applicable to China's context. In contrast, Japan's experience is more relevant. Specifically, infrastructure investment in China largely depends on local governments, with relatively low participation from the central government. Given this, the central government could consider expanding its fiscal deficit to support local governments in boosting infrastructure investment, thereby stimulating domestic demand and driving economic growth.