

Avoiding the impact of deflation and deflation expectations on economic growth

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This paper predicts that the Chinese economy will unlikely encounter inflation in the short term. The major risks posed to China currently are deflation and downward pressures. Macro-regulations should have a clear orientation, combining stable growth with prevention of deflation, and integrating demand-side regulation and supply-side structural reform. The focal point of the demand-side management is to set a reasonable bar for the growth rate of the economy and the rise of price levels in order to stabilize and guide market expectations. Policy makers should adopt a moderate and directional regulatory monetary policy, setting appropriate policy objectives for the prevention of deflation, as well as make use of a variety of policy measures. China should implement a structural fiscal policy in a proactive manner, giving extra dynamic ability to the implementation of policies so that they can be more effective. Afterwards, through a deep reform of the supply-side, China can reinforce economic restructuring and boost economic growth. Policy makers should pay close attention to the reform of key areas such as state-owned enterprises, land supply, finances, taxation, and prices.

Keywords: deflation, deflation expectation, economic growth

1. Forward

Currently, the world economy is experiencing a difficult time recovering, haunted by sluggish demand in the international market, weak prices of bulk commodities, depressed trade and investment, and growing risks of global deflation. The downturn of the world economy has had a relatively big impact on the Chinese economy. The aggregate demand in the Chinese market is prominently insufficient for optimal performance. In 2015, the growth rate of China's fixed assets investment dropped to 10%. The GDP growth rate of 2015 fell to 6.9%, heralding a downward trending economy. China's Consumer Price Index (CPI) in 2015 increased by only 1.4% compared with the previous year, while Producer Price Index (PPI) has experienced negative growth for 46 months, with deflation becoming increasingly forecasted. In the face of the mixed impact of deflation expectations and economic downturn,

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China must work out countermeasures as soon as possible to clarify the orientation of effective macro-policy, to prevent deflation, and break the vicious cycle caused by the combination of deflation expectations and economic downturn.

2. Clarifying the orientation of macroeconomic regulations

In order to clarify the orientation of macro-economic regulations, we need to analyze and pinpoint current economic trends. There is a divergence of opinion about whether China will encounter deflation in the near future (one to two years), and whether deflation or inflation is more likely to occur. The divergence has an impact on the choice of macro-economic policies. There are three major opinions on this matter in the extant literatures.

The first view is that China does not have deflation, and there is little chance deflation will happen in the future (Zhou, 2014; Ma, 2015; Zhong, Li & Su, 2015). Their arguments are based on the following facts: (1) China's CPI, instead of going down, is on a moderately upward trajectory, and real estate and stock prices are on a decline; (2) pork prices, which have significant impact on CPI, are likely to go up somewhat, while service prices will remain high as labor costs keep rising; (3) there is ample money supply and aggregate credit; (4) consumption is on a sharp rise; (5) The risk of imported inflation is still high; and (6) price reform is accelerating, pushing up prices even further.

The second view is that China is not currently experiencing deflation, but the risks for it happening in the future remain high (Li, 2015; Zhuang, 2015; Zhang & Wang, 2015). According to this view, the following may be contributing factors: (1) Insufficient domestic demand, falling external demand, and huge excess capacity; (2) downward shifts in the price for bulk commodities; (3) tighter monetary policy; (4) new business models that reduce the prices of commodities.

On a third view China is, to some extent, prone to deflation, and the risks are growing (Zhang, 2015; Qiu & Liu, 2015; Huang, 2015; Pan, 2015). The reasons are thought to include the following: (1) PPI is on a continuously downward trajectory, and deflation has emerged in various sectors of production. The transmission mechanism of deflation could exacerbate the situation. (2) The general price level is going down, rates of economic growth and money supply are declining. (3) The negative correlation between CPI and PPI has covered up the problem of deflation, but consumption cannot be a sustainable drive for economic growth. (4) Experts with this view are critical about other opinions in terms of the tendencies and risks of deflation. Their arguments are also based on perspectives such as partial economic bubbles, money supply, money in circulation, CPI, and PPI.

It must be noted that all three views are credible. They illustrate different judgments over the tendencies of the Chinese economy, and offer different perspectives on the

observation of deflation and inflation.

An economy can alternate between deflation and inflation, but over a certain period of time, only one of them will prevail. The period when an economy stays in between, experiencing neither deflation nor inflation, is usually brief. Generally speaking, inflation emerges with expanding demand and an overheated economy; while deflation comes when there is insufficient effective consumer demand and an economic contraction. One of these will occur unless there is a powerful force in the economy driving prices up, resulting in stagflation.¹ Recent years have seen the continuous decline in the growth rate of the Chinese economy, indicating rising downward pressure, and insufficient aggregate demand. This is why most economists believe the Chinese economy is exposed to the risks and pressures of deflation. However, by a chief mark of deflation (for example, a six-month-long decline of general price level), the Chinese economy is not in the midst of deflation, though risks are growing because (1) PPI has been falling for 46 months in a row, with no sign of recovery in sight; (2) CPI growth is on a downward trend; and (3) the GDP deflator is coming close to a negative number. In the near future, factors that might raise prices are basically being maintained by weak demands both at home and abroad. For example, the rise of labor costs will be held up by factors such as a sluggish market, difficult business operations for companies, and weakening demands for labor. The impact of commodity prices such as pork on food prices may be limited by overproduced food products, greater downward pressure on prices and substitutions for products. A large amount of money in stock can boost the general price level, but will continue to be held back by a stagnant real economy that faces difficulties in absorbing excess liquidity. Prices of bulk commodities in the international market have dropped to a relatively low level, and a rebound is unlikely, considering the international market is in a recession and the US dollar is going strong. Meanwhile, the continuous fall of PPI will gradually influence CPI. The speedup of investments and the continuous decrease of corporate profits will impact household income and growth of consumption, restricting the rise of CPI. Therefore, in the next two years, it is unlikely there will be a new round of inflation. Deflation is likelier.

Now, we need to make sure macro-regulation or macro-policies have a specific direction so that we can offset or reduce the impact of some economic trends. We cannot prevent deflation and inflation at the same time, or else market entities, especially investors, will find themselves lost. In light of the current major task, which is to stabilize economic growth, we should raise the flag of preventing deflation in hopes of avoiding huge deflation risks that might give weight to downward economic pressures. If we clarify the orientation of Chinese policy to prevent deflation, will it be

¹ One of the major causes for the stagnation in developed countries during 1970s and 1980s is the spike of oil prices.

able to lead market expectations? My answer is yes. First, refusing to acknowledge the risks of deflation won't dissolve expectations for deflation. If we leave the market to operate on its own, such expectations will probably become stronger due to the impact of inertia. Second, an ambiguous policy will inevitably sway economic performance. Uncertainties in the economy will grow if our policy oscillates between fighting deflation and fighting inflation. Third, we should make it plain to the outside the risks of deflation, flagging the importance of prevention, in order to stabilize market expectations, which, at the very least, can avoid the self-fulfilling prophecy. China suffered deflation from 1998 to 2002,¹ during a period in which economic growth was compromised. The government introduced a series of macroeconomic regulations and controls, but it was not these policies, but rather two significant events, that led the Chinese economy out of deflation and into rapid growth. One was China's accession into the World Trade Organization that spurred overseas market demand, the other was the booming domestic housing demand after the housing system reform. What China went through during that period of time reveals the difficulty of dealing with deflation. Now, China is exposed to dual pressures from deflation and economic downturns, which are periodic and also transformative in different phases. Besides, there is no sign of a new significant event that could drastically change the aggregate demand. Thus, the slowdown of economic growth and the pressure of deflation might last longer than before, which necessitates more clearly oriented macroeconomic regulations that can combine stable growth with low deflation, short-term policies with medium and long-term policies, and demand-side holistic regulation and control with supply-side structural reform.

3. Reinforcing comprehensive demand-side regulations and controls

In order to deal with the pressures and risks inflicted by deflation, China needs to implement demand-side regulations and controls, which includes creating demand. This is a major measure of macroeconomic regulation and control to prevent deflation and stabilize economic growth, and an important foundation for all other relevant policies including supply-side structural reform. Comprehensive regulations and controls refer to the combination of regulating aggregate demand and adjusting the demand structure, as the Chinese economy is exposed to risks of deflation and economic slowdowns. The situation is caused by both periodic and structural factors, so the regulation and control over demand should be based on coordinated measures that increase aggregate demand and restructure the economy as needed. In the latest round of the international financial crisis, the developed world has put into place new approaches for dealing with

¹ The increase rate of CPI was negative from April 1998 to January 2000, and from March to December, 2002.

deflation and boosting the economy, and has also developed new theories regarding how to do so. In particular, the US has managed to solve its predicament of deflation, with economic growth and employment rates now back on track. The US experiences deserve further investigation. In the near future, China should ramp up comprehensive demand-side regulations and controls on the basis of national conditions, drawing lessons from international experiences and aiming to deal with the problems. China should focus on the following aspects in designing its responses.

3.1. Setting reasonable targets for economic growth and rises in prices

In the annual Government Work Report, the Chinese government sets targets for economic growth and price rises for the whole year. As the economic downturn gains momentum, these two targets not only reflect the government's assessment of future economic conditions, but also influence social expectations. In order to prevent the economic growth from being stunted by deflation and expectations of deflation, China must study and make use of these two expectations. When the Japanese economy was hit by deflation, some mainstream economists came up with a solution: asking the Japanese government to announce a inflation target or an objective of counter-deflationary measures. Krugman (1998), Bernanke (2000) and Posen (1998) all suggested that there should be an inflation target that was big enough or long-term enough inflation target as a commitment to future inflation. This could be an important link, or even the foundation of an anti-deflation policy. The solution can help establish inflation expectations among the public and break the vicious cycle of deflation and deflation expectations, and guide the economy out of a liquidity trap. Although many economists, during their theoretical analysis and field research, have doubted the efficacy of such a policy, no one has identified its likely drawback or negative side effects. Currently, the growth rate of the Chinese economy is still on a trajectory of medium-to-high-speed development, and CPI is still positive. However, as the economic downturn gains strength, and if there is no countermeasure in terms of macroeconomic regulation and control to offset the repercussions, growth might slump and stall. Deflation expectations have a major impact on demand, dragging down investment, curbing economic growth, and impacting prices significantly. If a deflationary spiral is formed, it will lead to a debt-deflation spiral, generating shocks on the economy and the financial market with far-reaching consequences. Under such circumstances, it is necessary and important for the government to set clear goals and guiding targets of economic growth and price rises with the public to improve or stabilize deflation expectations and boost investors' confidence.

If China's GDP and the per capita income in 2020 are to be double those in 2010, the annual growth rate of GDP in the 13th Five-Year Plan Period should be 6.5% or more. It is quite difficult to realize such a growth rate in the first two or three years,

and China now has no leeway because it is not only a political imperative, but also something that have consequences for the level of confidence among the public and long-term economic trends. China can set the expected economic growth rate for next year and the year after next at three different levels: 7%, around 6.5%, and somewhere in between. Under the first scenario, social confidence will likely be stabilized, but bigger pressures will ensue. The actual GDP growth rate for 2015 is 6.9%; it will be harder to sustain a 7% growth rate in 2016 as the situation both at home and abroad is turning out to be more complicated. Under the 6.5% scenario, pressure will be relieved, but it will be difficult to energize market expectations and boost the public's confidence, and more pressures for realizing the objectives of the 13th Five-Year Plan will be revealed in the latter part of the period. Under the third growth rate target, China will face less difficulty. On the one hand, the country can maintain the public's confidence and market expectations, while on the other hand, it can potentially avoid difficulties in the process of fulfilling the target of economic growth, which will engender positive conditions for development for the next few years. Generally speaking, the third option is optimal all things considered, and the only problem with it is that the expected GDP growth rate is set within a range, which may create problems for the budget, money supply, investment, import and export levels, and employment. The solution could be to apply the median level as a parameter to gauge other relevant macroeconomic indexes, and as a foundation for market regulations.

The potential trajectory of a price rise does not only affect the process of economic growth, but also has an impact on the prospect of doubling China's GDP and per capita income in both cities and rural areas by 2020. If CPI experiences negative growth during the 13th Five-Year Plan Period, and the GDP deflator becomes negative, China's GDP at current prices won't be doubled if the annual growth rate reaches 6.5% or a little bit beyond. This year and next year, China's CPI will increase by less than 2%, or perhaps as low as 1%. However, the expected rate of the rise of the general price level should be no less than 3%. This could generate some leeway for price reform, for example, that might elevate price level. Besides, it could encourage Chinese society to have certain expectations for inflation, which can prevent deflation expectations from strengthening and demand from shrinking, and reduce these factors' impact on the economy so that investment, consumption, and economic growth can be boosted.

3.2. We should adopt moderately easy and targeted monetary policy

To deal with the impact of deflation and deflation expectations on economic growth, monetary policy is the most important policy in macroeconomic regulation. China should draw lessons from the experiences of other countries, identify trends in international monetary policies, and take into account a general picture of the Chinese economy in its efforts to determine the direction and focus of the right monetary

policies for the country. The US Federal (Fed) Reserve employed ‘Unconventional Monetary Policies’ (UMP) to cope with the US economic recession and its deflationary risks, and achieved good results. The practice was also endorsed by the majority of economists. Although the Chinese economy is very different from the US economy in terms of economic background and policy framework, many measures adopted by the US deserve consideration when thinking of the Chinese context. First, the Federal Reserve put into practice Quantitative Easing (QE) step by step, and balanced administrative intervention against the role of the market. From 2008 to 2014, the Federal Reserve carried out 4 (or 3.5) rounds of QE, from which the institution had a clear view of how the policy worked. By doing so, the market could play its role more effectively, and a cumulative effect was formed. Side effects of such a policy were also reduced. Second, the Federal Reserve implemented ‘Operation Twist’ in an effort to expand leeway for monetary policy. Through open market operations (buying and selling treasury bonds), the Federal Reserve came up with an innovative approach called “buy long, sell short”, which, on the one hand, helped the Fed fend off the risks of expanding its balance sheet, and on the other hand, increased space for QE by restructuring bond terms. Third, the Fed continued making expectations to lead the public’s expectations. In six years from 2008 to 2014, the Fed announced prospective and guiding policies eight times, promising ultra-low interest rates. By proactively establishing exchanges with the market, the Fed managed to lead the public to a reasonable expectation about interest and inflation rates, minimizing the impact of deflationary tendencies and deflation expectations on economic operation. Fourth, by combining monetary policy, fiscal policy, and industry policy, the Fed, through QE, backed the implementation of fiscal policies (higher spending and lower taxes) to boost the development of industries and the rearrangement of economic structures. These UMP can serve as reference for China to prevent risks of deflation and the impact of deflation expectations. Although China’s monetary policy still belongs to a conventional policy framework, it is worthwhile to learn from the Fed about how to deal with the relationship between the government and market, and how to devise flexible policies.

Currently, monetary policy varies in different countries. The US has parted with the Euro Zone in terms of monetary policies. The Fed has already put an increase of interest rates on its agenda, and the Euro Zone is busy carrying forward a new QE. This leaves China with difficulties in choosing the right monetary policy. According to the trends of the global economy, we can make a bold expectation that in the next two to three years, most countries will continue applying a monetary easy policy. The Euro Zone’s QE is still approaching, and US effort to raise interest rates is unlikely to last long. Since most economies are still in recession, international trade and investment remain sluggish. The appreciation of the USD will have an impact on US exports and economic growth. The Fed will likely find the interest rate hike cycle slow

and tortuous. Generally speaking, China has a relatively stable environment to carry forward the moderately easy monetary policy.

In recent years, China's monetary policy has been considered "prudent". In 2015, the policy was announced to "moderately easy and targeted monetary policy", which renders the implementation more flexible. The author believes that since the lack of aggregate demand and structural conflicts co-exist, if the risk of deflation can be confirmed as higher than inflation in the near future, China should implement a moderately easy and targeted monetary policy, as to prevent deflation, lessen deflation expectations, and stabilize economic growth. It is more in line with the trend of economic growth and easier to guide market expectations to replace "tight-fitting" with "moderately easy" in terms of monetary policy. "Moderately easy" still means "steadfast and solid", but has more pertinence and is more positive. Targeted regulation of monetary policy means China should continue carrying forward the easing of structural policy that began in 2014. China should raise more credit support for the development of agriculture, rural areas, service industry, emerging industries, medium and small-enterprises, mergers and acquisitions, and technical transformation. Meanwhile, China should exercise restraint over credit support for industries that have excessive capacity.

For the near future, China's central bank should continue making use of conventional monetary policy, but it must re-orient the policy in the direction of preventing deflation and stabilizing economic growth. We should clarify the orientation of basic policy to avoid vagueness or swinging. The key measures include the following: (1) China should effectively increase the supply of currency. China must cut the reserve ratio requirement in accordance with the changes in outstanding funds for foreign exchanges. There is still much room for China to maneuver under this policy, so it should take quick actions to meet the changes of the economic situation. Encouraging commercial banks to implement asset-backed loans, policies should allow them to use a larger part of their credit funds and enhance their flexibility in using money. China needs to streamline and reinforce activities in the open market, and readjust the pro-cyclical propensities and activities of these commercial banks. (2) China should cut the benchmark interest rate in a timely fashion. A continuous cut of costs of capital in real economy is important to ensure monetary policy can suit economic changes, and that economic regulations are gaining momentum. China's interest rates have been basically market-oriented thus far. Since the deposit interest rates for commercial banks are generally going up, CPI is likely to decrease. There is space to lower deposit interest rates, and net interest margins can be narrowed down as well. If expectations for deflation are strong, the equilibrium real interest rate, under which resources are optimally allocated and the economy can maintain a reasonable growth rate, could continuously decline, even dipping below the real interest rates (the nominal interest rate minus the inflation rate). Therefore, China must keep an eye on

investments and the trajectory of medium- and long-term loans of enterprises in real economy, make timely cuts to the benchmark interest rate, guide the downward shift of the market interest rates, and encourage social investment, particularly medium and long-term investments. (3) China should maintain the stability of RMB exchange rate. The exchange rate is a latent and additional monetary policy, which is used by the majority of countries, in a direct or indirect way, to regulate their economies. The RMB exchange rate should be kept in a balanced range, and China must deal with the moderate devaluation of the yuan against the USD and maintain a stable connection with a basket of currencies. This should benefit China's exports, and won't hamper the internationalization of RMB. In this way, China can strike a balance between economic development, short-term adjustments, and medium and long-term strategies. (4) China should closely monitor and analyze the tendencies of M2, total social financing, and the scale of credit, especially medium- and long-term loans, in order to pinpoint the changes of social capital needs and reinforce the regulation of monetary policies. (5) China should actively engage in targeted regulations, which feature China's current monetary policy and reflects the dual needs for stable growth and restructuring under the economic "New Normal". As for industries, enterprises, and investment projects for which the monetary policy needs to offer support, the central bank will work with other departments such as the National Development and Reform Commission to draw up a catalogue of them. Commercial banks will be urged to implement the catalogue under the scrutiny of China Banking Regulatory Commission.

3.3. China should implement more proactive and structural fiscal policy

Fiscal policy plays the dual roles of adjusting supply and demand. Proactive fiscal policy can expand aggregate demand and advance structural adjustment to stabilize economic growth and improve deflation expectations. The problem is how to properly enforce a fiscal policy to achieve better results.

A number of things are important for developing proactive fiscal policy. First, it requires proper evaluation of fiscal deficit-to-GDP ratio. In the Government Work Report in 2015, the ratio was raised from 2.1% in 2014 to 2.3% in 2015. In fact, the real fiscal deficit-to-GDP ratio has reached 2.7%, if we consider fiscal carryover funds and the current year's balance of payments. In 2016, China should adopt more proactive fiscal policy and increase the deficit. The deficit ratio should exceed 2.7% instead of staying at 2.3%. All these years, China has held up the EU threshold, treating 3% as the red line for deficit ratio. Even amid the latest round of international financial crisis, the highest deficit ratio, which was seen in 2009, was only 2.8%. Many experts have raised doubts over the rationality and feasibility of the EU threshold (Chen, 2015). Some have even proposed raising the alert line up to 4.5%, higher than the 3% adopted by the EU, but still lower than the 7% adopted by the US and 6.2%, adopted

by Japan (He, 2015). The suggestion deserves more consideration. In order to stabilize growth and prevent risks, China can consider raising the annual deficit ratio to 3%.

Second, China should advance local debt replacement. Last year, a policy that allowed local governments to issue bonds to replace local debts was a major push towards proactive fiscal policy. It is equivalent to treaking the debt repayment deadline, and in effect results in debt restructuring and securitization of government assets. In 2015, local governments replaced debts worth 3.2 trillion yuan. In addition to the newly issued 600 billion yuan worth of local debts, 3.8 trillion yuan was freed up for use by local governments. This measure can clarify the exact amount of local debt, relieve local governments from escalating risks, reduce their pressures of repayment, and lower the costs of debt (reduce the payment of interests). This way, local governments will be able to engage in proactive fiscal policy in a more cooperative manner. Since the beginning of China's reform and opening-up, especially after the adoption of the system of tax sharing in 1994, local governments have played an important role in promoting economic growth. The last two years have seen an economic slowdown and a reshuffle of the real estate market, which has greatly hampered the growth rate of local fiscal revenues, especially fees from land transfers. The heavy debts have compromised local governments' ability to do their job. Under the "New Normal", it is necessary to carry out effective ways to pull these local governments out of the heavy debt pressures, and help them offer better public services and improve the local environment, which is in line with a proactive fiscal policy and can serve the purposes of ensuring stable economic growth and adjusting structures. In the next three years, there are about 15 trillion yuan worth of debts waiting to be replaced. By advancing debt replacement and optimizing its mechanisms, China can promote the transformation of fundraising platforms for local governments and standardize the means and mechanisms of investment and fundraising to enhance the validity and sustainability of such a proactive fiscal policy.

Third, China should put available funds into good use. Available funds account for a large proportion of government funds, which, if unused, will not only result in funding shortage but also prevent newly added funds from playing their part. In order to address this issue, the State Council issued the *Plan for the Coordination of the Use of Fiscal Funds*, putting forward 10 concrete measures. However, the implementation didn't go as well as expected. New money had nowhere to go, even before the old money was spent. The problem has something to do with the management system of fiscal expenditures. For example, regulations over the expenditures on scientific research are not in line with international norms. As a result, a large sum of money cannot be spent, and scientific researchers are unwilling to apply for projects. In order to put into use the available funds and add more financial sources of the proactive fiscal policy, China should ramp up the coordinated use of funds, and push forward the reform of public property management so that the fiscal expenditure system can better

meet the new needs of society.

In order to make good use of proactive fiscal policy, China should coordinate the expansion of fiscal expenditures with tax cuts. The expansion of fiscal expenditures could stabilize economic growth and promote economic restructuring. Such a structurally proactive fiscal policy aims to stabilize economic growth better by pushing forward restructuring. In the near future, expansion of fiscal expenditure should focus on the following areas: (1) investment in public spheres should be boosted, and the Public-Private-Partnership (PPP) model should be more widely adopted by deepening reform and employing market-oriented approaches; (2) stronger support should be given to key areas of development, including economic transformation and upgrades, entrepreneurship and innovations; (3) expenditures on social security, education, science, culture, health and sports should be increased, and people's consumption structure optimized and demand boosted. Tax cuts¹ aim to boost production and stabilize economic growth. In 2015, enterprises, especially small businesses, felt more relieved after the implementation of a round of structural tax cuts and a universal reduction of fees. In order to carry out more proactive and structural fiscal policy, China should expand the scope of structural tax reduction to cover all business entities. Meanwhile, the government should put more efforts into structural tax reductions in order to regulate aggregate and structure of economy. This would encourage enterprises to increase investments, guide market expectations, and provide greater incentives for development.

4. Promoting supply-side structural reform

The central government has recently proposed to promote supply-side structural reform, which has been subject to varying interpretations. The author believes that supply-side structural reform plays an important role in stabilizing economic growth and soothing deflationary pressures. There are a number of reasons. First, China's economic downturn and deflationary risks are structural problems. China's economic structure, especially its industrial structure, is so ill-founded that the supply cannot properly meet the demand, and the country's industrial capacity is seriously excessive. There is also a lack of certain service industries, and resources are inefficiently allocated. Economic growth remains on a downward trajectory. The Producer Price Index (PPI) is on a slump, and structural deflation results in further deflation expectations, which greatly raises the risk of economy-wide deflation. These structural problems cause aggravated quantitative conflicts, which will impose heavy pressures on deflation. Second, demand-side regulation should be coordinated with

¹ In nature, tax cut is a supply policy, not demand policy. According to Laffer curve, economic activities are stimulated by dramatic tax cuts. Arthur Laffer became a representative of the supply-side economists, and a member of Reagan's Economic Policy Advisory Board.

supply-side management. Xi Jinping stressed in a meeting of the Leading Group for Financial and Economic Affairs, “while we expand the aggregate demand, we should also strengthen supply-side structural reform.”¹ When quantitative problem and structural problem exert mutual influence, demand-side regulation and supply-side management become equally important. Demand-side regulation can create conditions for supply-side management, and the improvement in supply can increase demand. Demand-side regulations are better at addressing short-term problems, while supply-side management places emphasis on medium- and long-term problems. Going forward with supply-side structural reform does not obviate the need for demand-side regulation. It should be noted that although we should refer to some theories of supply-side economists when formulating policies about supply management, China’s current situation is quite different from that of Western countries during the 1970s recession, when supply-side economics and Reaganomics were adopted to deal with stagnation. Due to universal stagnation in the Western world, demand-side management did not work, so Western countries had to resort to a supply-side approach. Now, most countries are exposed to the risks of deflation, and China is also affected by structural conflicts, so regulating the aggregate demand and improving the structure of supply are both important. During the 1970s recession, supply-side policies in the U.S. and UK included four aspects: drastic tax cuts, radical reductions in social welfare payments, tight monetary policy, and reduction of government regulation. Currently, China has adopted the first and fourth policies, while the second and third policies are not appropriate under the circumstances. As for preventing deflation and guiding market expectations, China should keep improving social welfare and adopt a moderately expanding monetary policy to boost the steady growth of demand. Third, China can boost restructuring and economic growth by deepening supply-side reform. More specifically, this would involve reducing the costs of investment, improving the environment for development, stimulating the vitality of enterprises, promoting the rational movement and allocation of capital, labor, land, technologies and management, facilitating the adjustment and optimization of the industrial structure, economic transformation, and the efficiency of resource allocation, and speeding up the growth of total factor productivity and economic growth. In the process of fulfilling these goals, China should depend on the market. At this point, the improvement of the structure of efficiency of supply is still hindered by institutional problems that make the implementation of many government policies difficult. Therefore, we should put more efforts into supply-side structural reform, overcoming the institutional shackles, boosting innovations in the supply system, and reinforcing the role of market in distributing resources. This should allow supply policies to have an impact on economic operations, which can promote economic growth.

¹ Quoted from the issue of December 7, 2015 of the *Shanghai Securities News*.

In order to prevent deflation and stabilize economic growth, supply-side structural reform should focus on streamlining administration and delegating power to lower levels, allowing more private capital into more spheres, and speeding up the improvement of the factors markets. Furthermore, the government should deepen reform in the following key industries and areas. The first area is state-owned enterprises and state-owned economy. This is an important link to revitalizing the micro-economy and speeding up industrial transformation. It is particularly important to deepen reform of the property rights system in state-owned enterprises, strengthen support for mixed ownership, and increase the proportion of shareholding by non-state-owned institutions. Monopolies are another target of reform, where competition should be introduced through multiple channels to help increase resource allocation efficiency. In terms of the management of state-owned capital, China priority should be shifted to capital management. At the current phase of development, adjustments should be made in the distribution of state-owned economies, such as the transferring of some state-owned capital from traditional industries, especially manufacturing, into new industries. It will also be important to encourage mergers and acquisitions of enterprises from different industries, regions, and with various ownership structures. Zombie enterprises should be shut down, especially state-owned ones, while inspiring industries with excessive capacities to be revamped so they can prosper again.

The land supply system for non-agricultural industries is the second area in which deepening reform should be a priority. The country should adapt to greater mobility of factors and the re-allocation resources, and advance reform of the management system of the land for non-agricultural construction. It will be important to counterbalance the low prices of industrial land, high prices of land for commercial services, and the rapid rise of real estate land prices. Efforts should be made to rearrange the model and structure of the industrial land supply, reinvigorate the available land in urban, industrial, and mining areas, promote the rational allocation and usage of land resources, explore the potentials of traditional industries, and support the development of new industries.

The third area for deepening reform is the financial sector, where greater efforts should be made to encourage more private financial enterprises and toward diversification. There should be more private financial institutions, especially private banks. The monopoly of state-owned financial institutions should be broken. This will be the precondition for the marketization and internationalization of the country's banking industry, and for the coordinated development of the financial sector and the real economy. An institutional environment must be created that is conducive for the development of companies providing financial services, such as private banks, security companies, and insurance companies. Greater support and clear guidance for private financial investments are needed for promoting a competitive environment for multiple investors, elevating the service quality of financial institutions, and lowering the cost

of fundraising.

Fourthly, reform should focus on improving the relationship between the central government and the local governments in terms of the distribution of public finances and tax revenue. With the decline of many local industries and shifts in the real estate industry, fiscal revenues and income from land sales for local governments have fallen dramatically, and the central-local framework of tax distribution that has lasted for more than 20 years has met new challenges. It certainly will take a while for the central government and the local governments to change the current system significantly. However, small steps should be put on the agenda as soon as possible. New sources of fiscal revenues should be found and cultivated as soon as possible. Besides debt replacement, various measures should be taken to help alleviate the local governments from debt pressures, and to help them play their due roles in providing public services, improving the market environment, strengthening social security, and promoting economic transformation.

Fifthly and lastly, the country should deepen reform of resource-consuming products and services. In the face of the rising pressures of deflation, reform of the pricing mechanisms is urgently needed. Fear of inflation should not be allowed to distort prices, which should reflect social costs, including resource and environmental costs, and the level of profits. China should reveal the network of vested interests covered by problems such as enterprise losses and fiscal subsidiaries. The pricing system of resource-consuming products should be reformed so as to correct the imbalance in which prices of market-oriented products fall, while those of monopoly-provided products remain high. This could minimize the impact of non-market elements on certain industries and economic operation. This will also help resource-driven enterprises reduce costs, and facilitate the transformation of production-driven enterprises, and reform of resource and environmental taxes. The reform of the pricing system of public services can make the price level better reflect the supply-demand ties, attract private capital into public spheres, inspire the government to find innovative ways to provide public services, increase competition by encouraging the government to buy services from the market, increase the efficiency and quality of government services, and accelerate the reform of social undertakings.

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