China's Prices and Policies Under Global Inflation

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There are various indicators to measure the overall price level, each reflecting price fluctuations from different dimensions and aspects, including CPI, PPI and GDP deflator. From the perspective of monetary policy, to maintain currency stability, the focus is on changes in the overall price level after excluding the influences of technological advancements, improvements in the quality and quantity of goods and services. In other words, the focus is the relative changes in monetary prices. Since the 1980s, the world entered a period of low inflation and even experienced low-interest rates with low inflation for some time. However, in recent years, major global economies, except for China, have experienced inflation again. The causes of this round of inflation are complex, involving both cost-side and demand-side factors, accompanied by structural ones. China used to be a significant contributor to global low inflation and is currently experiencing quasi-deflationary conditions in the global inflationary environment.

I. Price Trends Since China's Reform and Opening-Up

1. Four Rounds of Inflation (Pressure) and Their Governance Practices

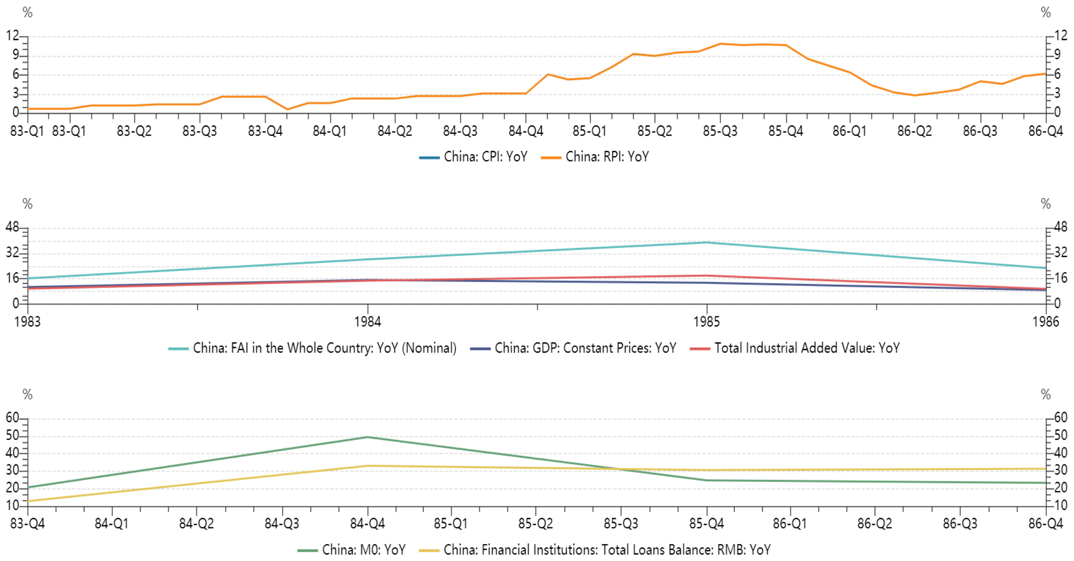
Since the Reform and Opening-Up in 1978, China has experienced four significant rounds of inflation, which were effectively managed through reforms and macroeconomic policies, particularly through successful monetary and financial policies.

a. Inflation and Its Management In 1984

In 1984, building on the successful reforms in rural economy, China accelerated the reform of its urban economic system and promoted the establishment of specialized banks in the financial sector. Against this backdrop, China experienced its first inflation since the initiation of reform and opening-up. The year-on-year growth rate of retail prices surged from 3.1% in December 1984 to a peak of 10.9% in September of the same year and remained above 10% for the remaining four months. This was linked to excessive expansion in investment, consumption, and bank credit in 1984. Industrial production increased by 16.3% that year, fixed asset investment in units of comprehensive ownership grew by 24.5%, wage-related cash expenditures rose by 26.2%, significantly surpassing the 13.6% growth in national income for the year. Bank loans increased by 32.8% year-on-year, rising by more than 20 percentage points, and cash injection amounted to 26.2 billion yuan, 2.9 times that of the previous year. This substantial increase in bank loans and cash injection was related to the new credit fund management method introduced that year. According to the new credit fund management method, financial institutions were allowed to issue a large amount of loans and inject cash at the end of 1984 in a bid to secure a higher base.

In response, the Chinese government (State Council) issued the 'Urgent Notice on Strictly Controlling Fiscal Expenditure and Vigorously Organizing Monetary Tightening' in November 1984, implementing economic and monetary contraction policies. The main measures included strict control of fixed asset investment, stringent control of fiscal budget expenditures, and the use of the newly established central banking system and credit management system to implement monetary and credit policies to tighten the money supply.

The policy effects were extremely significant. After more than a year of efforts, by 1986, the growth rate of fixed asset investment had declined to 18.7%, dropping by more than 20 percentage points. Wage-related cash expenditures grew by 20.8%, falling by 5.4 percentage points. The year-on-year growth rate of retail prices decreased to around 6%, and the money supply growth dropped to 12.3%.



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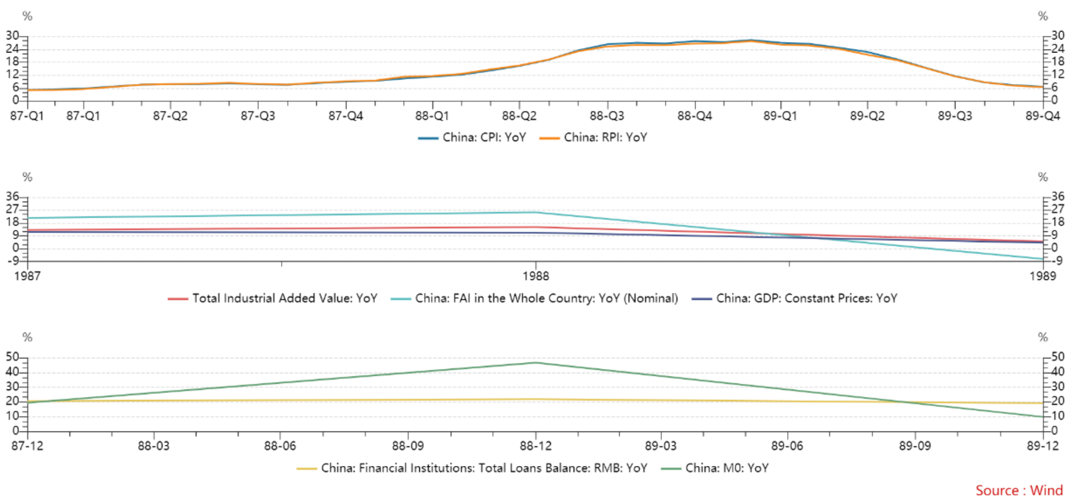
b. Inflation and Its Management in 1988

1988 marked the most severe inflation in China's history after the initiation of reform and opening-up. The year-on-year growth rate of retail commodity prices reached its peak in February 1989 at 27.9%, and the overall retail commodity price increase for the entire year of 1988 was 18.5%. The Consumer Price Index (CPI) rose by 18.8% that year. In August of the same year, there was a frenzy of commodity purchases from south to north, leading to a run on deposits in banks, causing negative growth in urban and rural residents' savings deposits for that month.

This inflation was related to the government's push for demand expansion and breaking through price barriers during the economic transition process. China's coastal regions began participating in the international economic cycle of 'import more, export more,' while the central and western regions had to catch up. The nation as a whole pushed for comprehensive price increases. In 1988, industrial production increased by 20.8%, and fixed asset investment grew by 23.5% year-on-year, leading to extreme shortages in energy, raw materials, and transportation capacity. In terms of monetary credit, bank loans increased by 16.8% year-on-year, and cash injection reached nearly 68 billion yuan. The year-end money supply growth rate increased by 46.7%, second only to the 49.5% growth rate in 1984.

To manage this inflation, the People's Bank of China, under the leadership and support of the State Council, implemented a contractionary monetary policy. The State Council issued the 'Decision on Further Controlling Currency and Stabilizing Finance,' supporting the People's Bank of China's monetary tightening measures. The People's Bank of China adopted a combination of direct and indirect controls to achieve monetary credit contraction. Specifically, they intensified control over the total amount of monetary credit, reinstated mandatory planning management for loan sizes, and utilized indirect control tools such as statutory deposit reserve ratios, deposit and lending interest rates, and special deposit accounts.



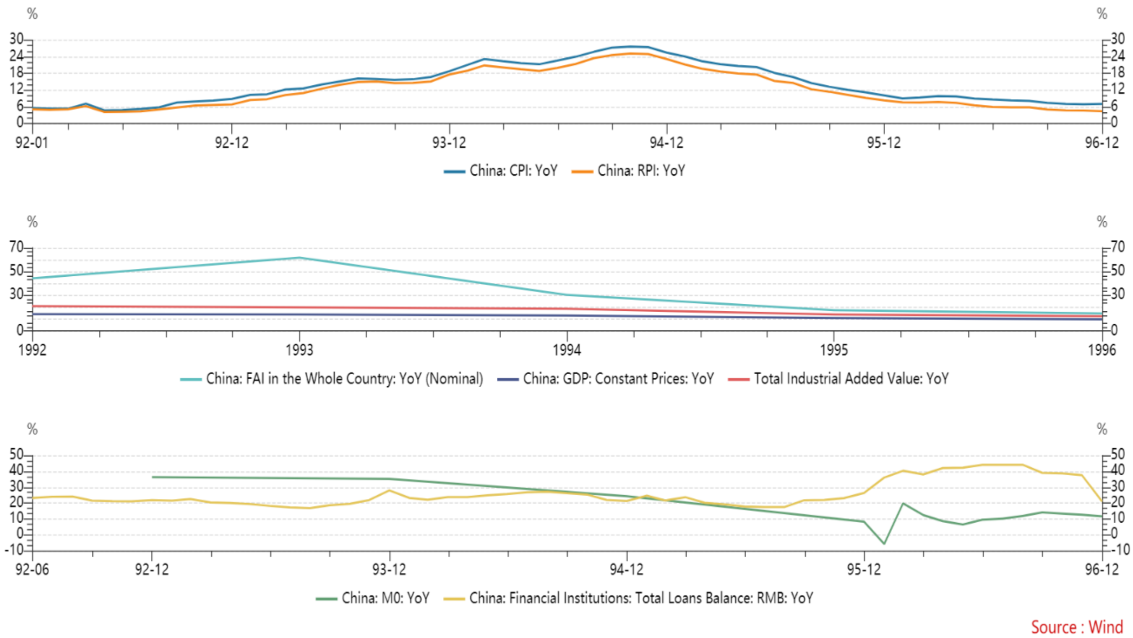
The primary approach was to use monetary credit tools to manage inflation, which was more direct and effective but had significant side effects. The People's Bank of China only took measures to control inflation from August 1988. By September, savings deposits started to rise, and industrial production and fixed asset investment began to decline from November. In 1989, the year-on-year growth rate of bank loans decreased to 17.5%, and cash issuance dropped to 9.1%. Meanwhile, industrial output decreased by 6.8%, and fixed asset investment declined by 11%. The GDP growth rate plummeted from 11.3% in 1988 to 4.1%, but CPI remained high at 18.0%. By 1990, GDP growth continued to decrease to 3.8%, and CPI dropped to 3.1%. The economy entered a recession, with insufficient industrial activity, increased employment pressure, and severe accumulation of unsold goods.

c. Inflation and Its Management in 1993-1994

In 1992, Deng Xiaoping's Southern Tour Speech inspired the market vitality, leading to a real estate and development boom in the latter half of the year. Fixed asset investment surged by 61.8% year-on-year in 1993, causing widespread tension in infrastructure and basic industries. Retail prices increased by 13.2% in 1993 and rose by 21.7% in 1994. Consumer prices rose by 14.7% in 1993 and 24.1% in 1994. Retail price growth reached its peak in November 1994 at 25%, and consumer price index growth hit its highest point in September 1994 at 27.3%. Cash injection and credit growth rates were also high during these years, with a year-end money supply growth of 36.4% in 1992, 35.3% in 1993, and 24.3% in 1994. Financial irregularities such as chaotic fundraising, lending, and interest rate hikes emerged, with a large amount of credit flowing into real estate and stock markets. This round of inflation was accompanied by a significant and rapid devaluation of the Chinese yuan against the US dollar, depreciating by 45% from November 1992 to May 1993, further exacerbating domestic inflationary pressures.

The inflation in 1993-1994 was caused by economic overheating. To address this, the central government and the State Council implemented 16 comprehensive measures to eliminate inflation caused by economic overheating. In the financial sector, efforts focused on rectifying the financial order and employing financial tools to enhance macroeconomic regulation. Measures included cracking down on illegal activities such as chaotic lending, fundraising, and interest rate hikes. The 'Three Guarantees' policy was implemented to protect state-owned enterprises, key construction projects, and agriculture. Interest rates on deposits and loans were raised twice, and efforts were made to encourage savings and accelerate cash circulation.

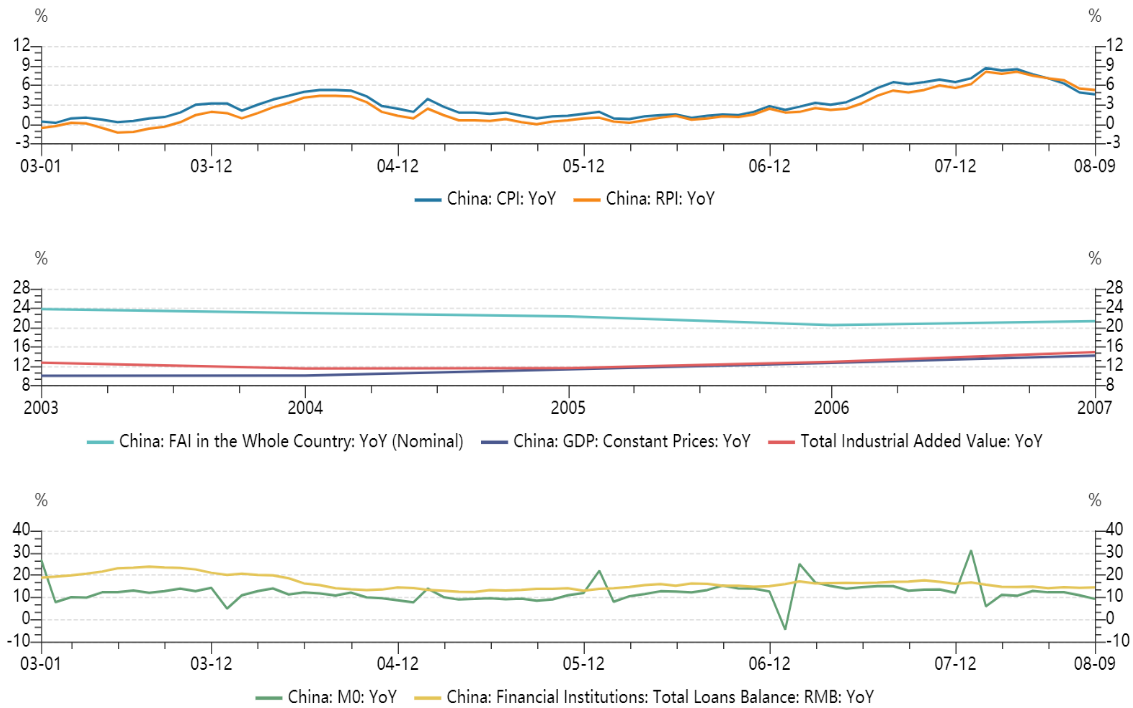
The inflation in 1993-1994 lasted for a relatively long period and was effectively controlled only in 1996. In that year, the year-on-year retail price increase dropped to 6.1%, the consumer price index growth rate decreased to 8.3%, and the economic growth rate fell to 9.7%. However, in 1997, China faced the Asian financial crisis, leading the country into a practice of managing deflation.



d. Inflation Pressure and Its Management in 2004 and 2007

In 2002, China joined the WTO, initiating deep integration with the global economy. In 2003, China started the market-oriented process for real estate, and local governments began urban development, accelerating infrastructure construction. With China's sustained high-speed growth, labor and input factors such as industrial raw materials and energy became relatively scarce, leading to a rapid rise in global commodity prices. This, in turn, affected China's Producer Price Index (PPI) and Consumer Price Index (CPI) through imports, resulting in significant inflation pressures at the end of 2004 and the beginning of 2008. The year-on-year growth rates of all industrial prices reached their respective peaks in October 2004 (8.4%) and July 2008 (10.03%). Similarly, the year-on-year growth rates of the consumer price index reached their peaks in July 2004 (5.3%) and February 2008 (8.7%). Persistent inflationary pressures existed from 2003 to the first half of 2008, which were related to China's excessive trade surplus, overly rapid growth in fixed asset investment, and excessive monetary and credit expansion during this period. This round of inflation pressure was also accompanied by the continuous rise in real estate market prices and the appreciation of the RMB exchange rate.

To address this inflationary pressure, the People's Bank of China implemented a prudent monetary policy, using a combination of open market operations, reserve requirement ratios, benchmark interest rates for deposits and loans, and reforms in the interest rate and exchange rate systems to maintain relative market stability.



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2. Uniqueness of China's Inflation Mechanism and Governance Methods

a. China's inflation is always related to some form and degree of supply constraints, often accompanied by economic and social structural adjustments and the development of industries (factors).

The three major inflations in China all occurred during periods of economic scarcity. The inflation pressures in 2004 and 2007 were related to China's real estate, infrastructure, and export growth, causing relative shortages in global commodities. Before the reform and opening-up, China established a relatively complete heavy industrial system. After the success of rural reforms, shortages emerged in light industry, followed by shortages in durable goods, all accompanied by shortages in infrastructure and basic industries such as transportation and energy. During inflation and its governance, China not only utilized idle land, labor, and environmental resources but also established a relatively complete and competitive industrial system. Consequently, industrial and social structures changed accordingly. After prolonged high growth in fixed asset investments, China faced overcapacity and deflation. China initiated the process of real estate marketization, which, in turn, improved infrastructure. China also joined the WTO, integrating into global development. Prolonged high growth depleted China's previously abundant low-cost labor force and created a substantial demand gap for global energy and raw materials. This led to rising prices in the service industry, energy, and raw materials. As China gradually integrated with the world, the RMB exchange rate appreciated, accompanied by rising domestic prices of non-traded goods such as real estate.

China's experience with inflation provides an insight: sometimes, economic and social structural adjustments need to be achieved through inflation (asset bubbles). Inflation can be seen as a dynamic improvement for market insufficiencies, one of the mechanisms for economic structural adjustments. Overlooked and unseen values, once widely recognized and restored in supply (with limited supply elasticity, typical products being real estate, infrastructure, and public services such as hospitals and education), can impact relative price systems within specific time frames. By supporting price increases in deficient areas through monetary expansion, inflation triggers adjustments in the relative price system, achieving significant adjustments in the benefit structure and, consequently, in social structure, all in an environment with relatively minor pains.

b. Price Barrier Breaking and Release of Suppressed Price Pressure during Transition

China's inflation is related to its transition from a planned economy to a market economy. Under the planned economy, there was no price system, and all material circulation was closed and operated under administrative commands. With the shift to a market economy, there was a gradual allowance for supply-demand relationships outside the system, leading to the emergence of a price system outside the planned economy framework. In times of scarcity, besides price adjustments, supply-demand relationships were balanced through non-market methods such as rationing and queuing.

As market prices were liberalized, especially during the significant price barrier-breaking in 1985, many supply-demand gaps that were previously balanced through non-market methods were now balanced through price increases. This led to a substantial rise in prices, making implicit inflation explicit. However, China's experience also showed that during significant periods of supply-demand relationship adjustments, especially when price controls and other balancing mechanisms were in place, there were motives such as market manipulation that prolonged the adjustment period to maximize the interests of certain entities. Examples include rent-seeking and speculative behavior during the period of China's dual-price system, and control over land prices and the real estate market during periods of significant real estate price increases.

Prices reflect the process of discovering and acknowledging value, as well as imbalances in supply and demand. Therefore, major economic transformations, technological changes, and other processes lead to price adjustments, which are necessary for upgrading and transforming the economy. During significant adjustments in the domains and mechanisms of supply and demand, prolonged or short-term inflation often occurs. Compared to implicit mechanisms for supply-demand balance, the price mechanism is the least dissipative mechanism for value. However, up to now, China still experiences some implicit inflation, indicating the need for attention to the ways in which pressure is released.

c. **Non-Market Goals and Soft Budget Constraints Exacerbating Inflation**

Entities with non-market goals and budget soft constraints are outsiders in a market-oriented economy. They can inject additional demand into the economy beyond economic cycles, but they can also lack constraints, leading to greater economic fluctuations. The theory of financial cycles, to some extent, regards the central bank-dominated financial system as an outsider in the market economy, exacerbating economic cycles. In the process of China's economic development, different types of entities with non-market goals and budget soft constraints existed at different times. Typically, local governments and state-owned enterprises (SOEs) are considered entities with non-market goals and soft budget constraints. However, during periods when bankruptcy mechanisms were not well-established, there were specific historical periods where regular enterprises and individuals also transformed into entities with non-market goals and budget soft constraints. This transformation occurred especially when there were rigid redemption requirements for individuals and implicit government unlimited liability.

Impulses for investment and habitual investment, as well as the expansion of consumer funds (related to benefits for state-owned enterprise employees, among other factors), have consistently been important driving factors for inflation during periods of scarcity. China's market entities have not reached the legal sense of an independent legal person according to corporate law. Decision-making and risk-bearing are not entirely independent, and to some extent, market entities also possess non-market goals and budget soft constraints. Therefore, not only during scarcity periods and not only in China but also in more developed areas of market economies, factors related to social welfare and the protection of vulnerable groups still exist. These factors lead to non-market behaviors, such as the rise in wages due to labor unions and rigid expenditures on social welfare. These factors, when combined with supply shocks, can contribute to demand-driven inflation, forming a self-realizing loop of inflation.

d. Monetary Credit Always Supports Inflation to Some Extent

Every inflationary episode in China has been accompanied by a significant increase in monetary credit. During the inflations in 1984 and 1988, when the commercial banking system had not yet been established, credit was strictly controlled through planned directives. The expansion of monetary credit mainly manifested as a substantial increase in supportive cash injections driven by market demand. In the inflations of 1993-1994 and 2004-2007, there were instances of 'financial chaos' and a substantial increase in credit volume.

China's experience with inflation demonstrates that whether under planned directives or in relatively market-oriented environments, China's monetary credit system has adopted decision-making mechanisms with selective characteristics. Consequently, there have always been sufficient reasons and inherent drivers supporting later-stage inflation. However, given that China's economy and finance are continually evolving, especially within a multi-layered and multidimensional management system employed by the government in economic and financial domains, it is not suitable to introduce a rule-based monetary policy framework. The specificity of China's monetary policy transmission is discussed in the following section.

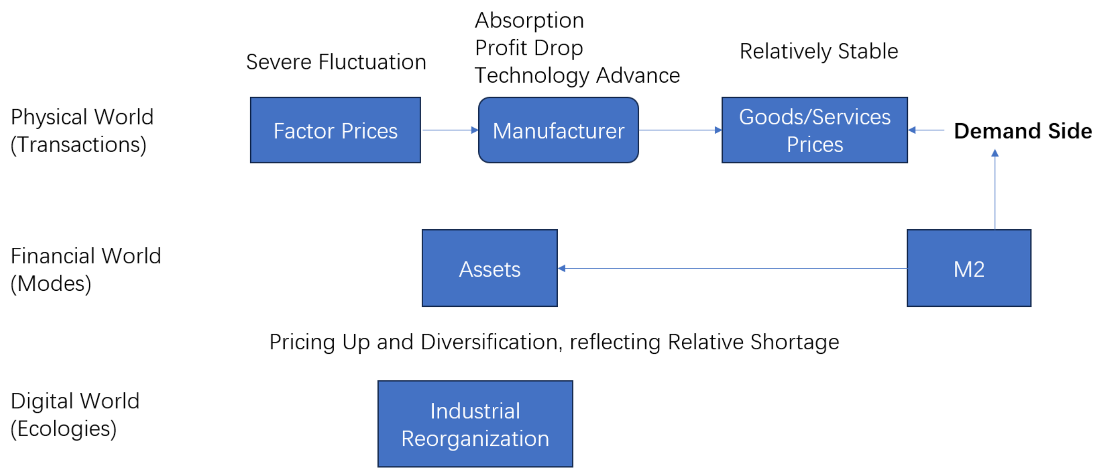
e. Inflation is Both a Result and a Means; Governance is Needed for the Self-reinforcing Loop of Inflation

Analyzing various factors and their impact on inflation comprehensively, inflation only becomes a possible candidate for "getting out of control," or in other words, requiring governance when it forms a self-sustaining inflation cycle. Countries generally experience self-sustaining inflation triggered by the 'wage-price' cycle. China has also seen 'wage-price' cycles at different times. However, apart from this, China has witnessed a unique 'consumption-investment' cycle that leads to sustainable price increases. Developing countries often have low income levels, but to enhance long-term economic growth, they need to increase savings to expand investment and raise per capita capital stock. Some specialized equipment also needs to be imported. Therefore, it is necessary to delegate authority and offer incentives to stimulate the enthusiasm of microeconomic entities, expanding the consumer fund while simultaneously increasing investments for future higher economic growth.

China has adopted two specific approaches, in addition to balancing macro policies. One approach is to slow down the demand for foreign exchange and savings funds required for capital imports through the 'three reductions and one supplement.' The other approach involves implementing market-oriented transitions sector by sector, known as the 'scissors strategy.' Historically, China has used the 'scissors strategy' to redistribute the benefits of rural market reforms to urban and industrial sectors, mitigating potential inflationary pressures. Later, it used the 'scissors strategy' in areas such as the northeast and coal-rich provinces, differentiating costs to alleviate price shocks. During the period of massive real estate development, cross-subsidies were achieved through the price differentiation of industrial land, effectively managing the inflationary impact.

3. Financialization has Impacted the Price Transmission Mechanism

Observing the inflation in 2004 and 2007, as well as the price recovery after the economic recovery in 2008, phenomena like "flour being more expensive than bread" have appeared. The financialization of commodities has significantly influenced the traditional price adjustment mechanism. Commodities are no longer just 'goods' but have prominent 'asset' characteristics, and their prices are mainly based on anticipated fluctuations. With ample market liquidity and expectations of increased demand for commodities during economic recovery, commodity prices adjust rapidly in a short period. This leads to two consequences. First, it reduces the enthusiasm of commodity producers to quickly resume production. In the current environment, increasing production cannot further enhance profits and might even reduce them. This hampers the proactive expansion of production by commodity producers, affecting the rate at which supply-demand gaps are filled. Second, the price adjustment mechanism along the industrial chain shifts from demand-driven profit to cost-sharing, decreasing price adjustment efficiency. In normal adjustment logic, when demand slightly recovers, lower upstream prices can provide a price difference (profit) for the recovery of end-demand. However, commodity prices preemptively reflect the economic recovery effect, causing an inverted price difference. This not only inhibits demand recovery but also squeezes profits in the midstream industry, turning economic adjustments into inefficient cost sharing.



When observing prices within a broader framework, at least three parallel worlds of prices can be identified. One is the prices denominated in currency formed by the supply and demand of goods and services in the physical world. The prices in upstream factor markets and their conversion and absorption by manufacturers in the middle and downstream become the supply in the market for goods and services. Market demand is influenced by purchasing power derived from income and wealth conversion and also by purchasing power created by the financial system's credit creation. The former is related to structural issues like income distribution and aging, while the latter is related to the expectations and capabilities of the financial system. Another world is the financial world, where the supply side consists of asset providers, including securitization of existing wealth and capitalization of future projects, and the demand side consists of asset seekers. Supply and demand form asset prices, which represent the pricing and competition for future economic models. The physical world and the financial market merge and influence each other. The third world appears in the digital space and represents competition based on rule-formed ecosystems.

4. The Uniqueness of China's Monetary Policy Transmission

Examining the history since the People's Bank of China specifically exercised central banking functions in 1983, China's financial system and monetary regulation methods have undergone several adjustments. There is still no universally recognized indicator to measure the efficiency of monetary policy transmission, but from empirical observations, the transmission of monetary policy has been relatively smooth during two periods.

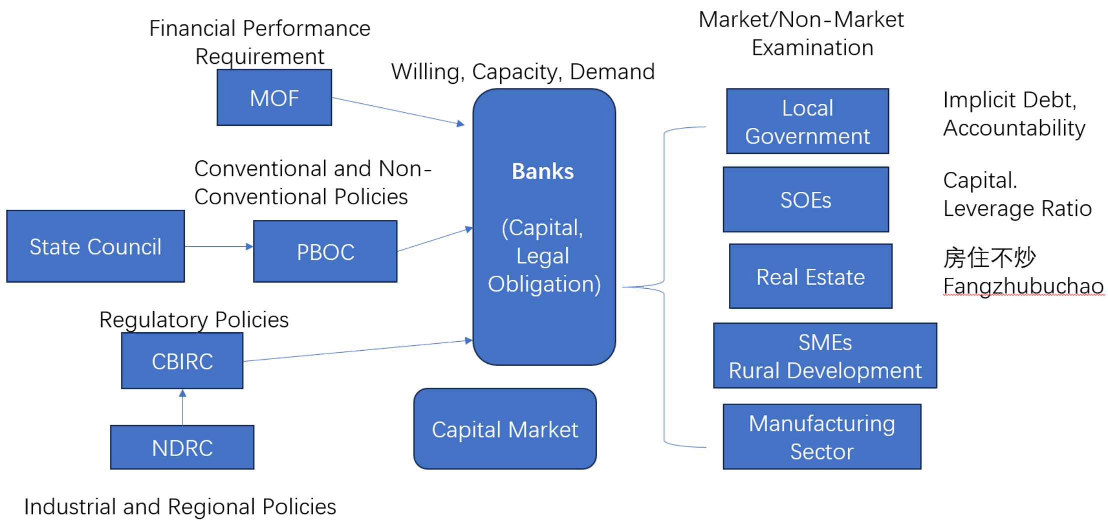
First is the period of strict scale control. During this time, China's monetary policy and financial regulation were unified within the central bank. China did not allow inter-corporate financing, except for exemptions for personal financing. The capital market was underdeveloped, and financial activities were concentrated within the banking system. Under strict industrial policy, controlling credit expansion and credit scale, in reality, controlled money supply and market behavior. However, this approach also brought rigidity and faced the dilemma of "over-effective transmission," as it was influenced by the saying, "once loosened, chaos follows; once tightened, stagnation occurs."

Second is the period when foreign exchange deposits dominated money supply. During this time, the transmission of monetary policy was essentially a bottom-up reverse induction. Enterprises obtained foreign currency due to trade surpluses, and under strict and proportionally enforced foreign exchange conversion and settlement regulations, they had to sell it to banks (foreign exchange settlement). At this point, deposit money was created. After banks received US dollars, they were required to settle with the central bank, forcing the central bank to inject base money. Excessive base money promoted domestic credit expansion. The central bank had to freeze a portion of this expansion by establishing a "reserve pool" through statutory deposit reserve ratios and issuing central bank bills, ultimately achieving controlled credit expansion and monetary supply. During this stage, the overall monetary environment was loose, and the central bank mainly implemented relatively effective "tightening" policies. Monetary policy transmission was smooth.

During other periods, China's monetary policy transmission efficiency was not satisfactory. Of course, the reasons are multifaceted. Many periods fell under policies that aimed for a loose monetary policy, resulting in weakened efficiency. The breadth and depth of financial markets expanded significantly, reducing the controllability of credit expansion influenced by money supply. Additionally, Chinese financial institutions were more concerned about non-economic factors and financial stability than financial efficiency. They were less sensitive to policy adjustments aiming at interests. China has implemented numerous reform measures to enhance efficiency, such as expanding the monetary statistical scope, adjusting monetary regulation frameworks and methods, shifting from scale management to proportional restrictions, then to price corridors, and partially returning to scale control. Efforts have also been made to establish government bond yield curves and strengthen the linkage between the credit and bond markets. While the efficiency of monetary policy transmission has marginally improved, it is still plagued by inefficiencies.

If we step outside the Western black-box approach (which essentially assumes that microeconomic entities are independent and interest-driven actors) in studying the monetary policy transmission mechanism, penetrate the organizational black box of financial institutions and enterprises, and return to behavioral analysis, we will find that China's monetary policy transmission, to some extent, is not policy transmission but rather coordination and cooperation among government departments. It is not market analysis but a complex and uncertain game analysis (China's current focus of the game is not between market entities but between market entities and government regulatory agencies).

We can use the following diagram to illustrate the government management behind the operation of China's financial system.

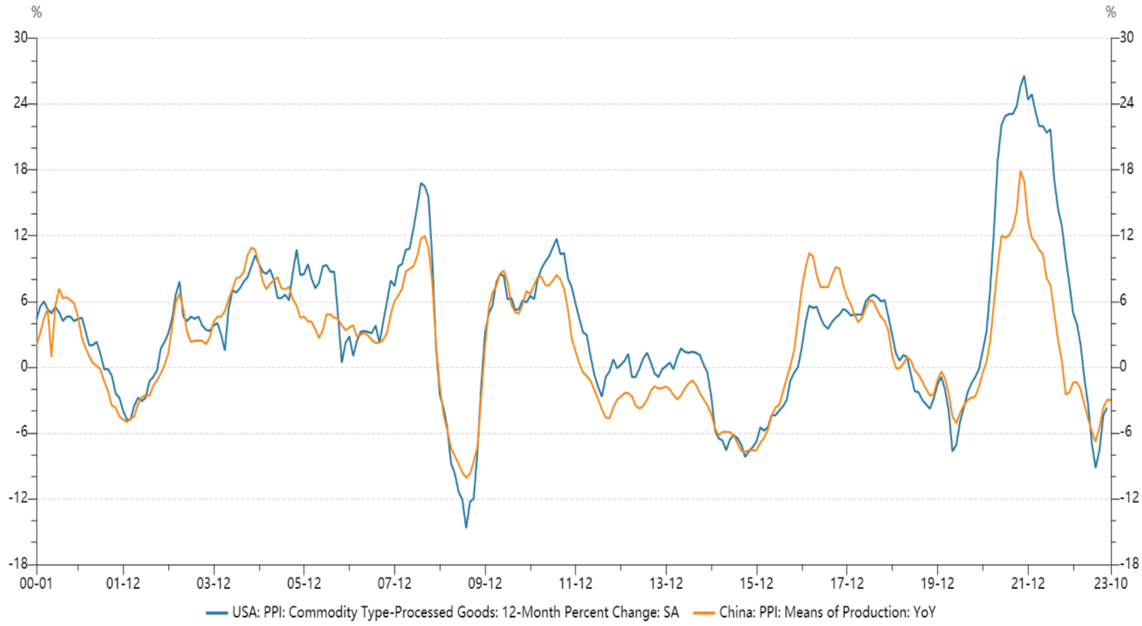


Therefore, each of our controls and policy adjustments is not only an adjustment of market behavior but also a significant adjustment of the entire management system. Policy coordination and integration have always been the focal point and challenge of government work.

From the perspective of monetary policy transmission, we can attribute this phenomenon to the insufficient implementation of micro-subject market-oriented reforms; it has not yet "grown up." In recent years, reforms in micro-subjects and financial markets, as well as macro-control and regulatory system reforms, have been optimizing and changing the interaction between the market and the government. The aim is to transform it into an interaction among market entities, allowing the government to relatively transcend. However, up to the present, China's monetary policy transmission still reflects the result of the complex evolution of a system that combines adjustments in market behavior, optimization of government management, financial stability, and leadership promotion. Especially in an environment where administrative management predominates and paternalism is prevalent, it is premature to rely too much on the independent maturity of micro-subjects. It is still necessary to continue adhering to the primary analysis of monetary policy transmission based on game theory.

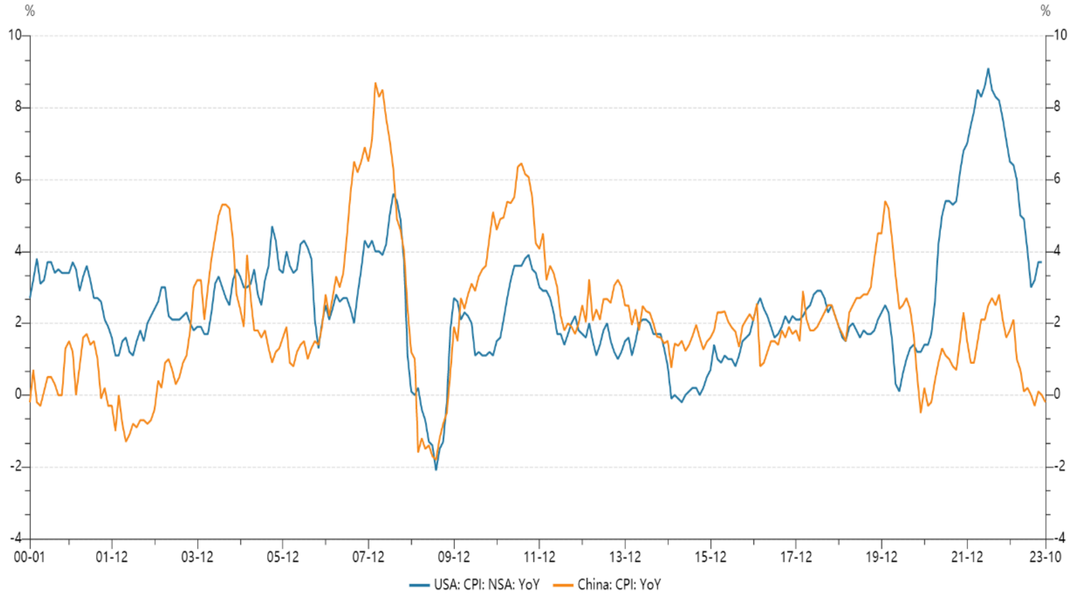
II. Prices and Policies within the China-U.S. Framework

Analyzing China's inflation also requires an analysis within the China-U.S. framework. When the economies of China and the United States operate in a China-American manner, the price trends in both countries are highly correlated. The price indices of production materials are closely related, primarily influenced by commodity prices determined by the international market. The fluctuation range of the U.S. Producer Price Index (PPI) is slightly higher than that of China's PPI.



Source : Wind

However, the correlation in price trends measured by the year-on-year growth rate of Consumer Price Index (CPI) between the two countries is not as strong as the correlation in price trends measured by production material prices. Clearly, the CPI fluctuations in the United States have been relatively stable since 2000, whereas China's CPI has experienced significant fluctuations. Specifically, from China's full accession to the WTO in 2002 to the outbreak of the pandemic before 2020, there was a strong correlation in the year-on-year growth rates of CPI between the two countries. However, after the outbreak of the pandemic, there was a notable deviation between the CPI trends of China and the United States. Since 2022, the United States has even entered a high inflation zone, while China has been hovering on the edge of deflation.



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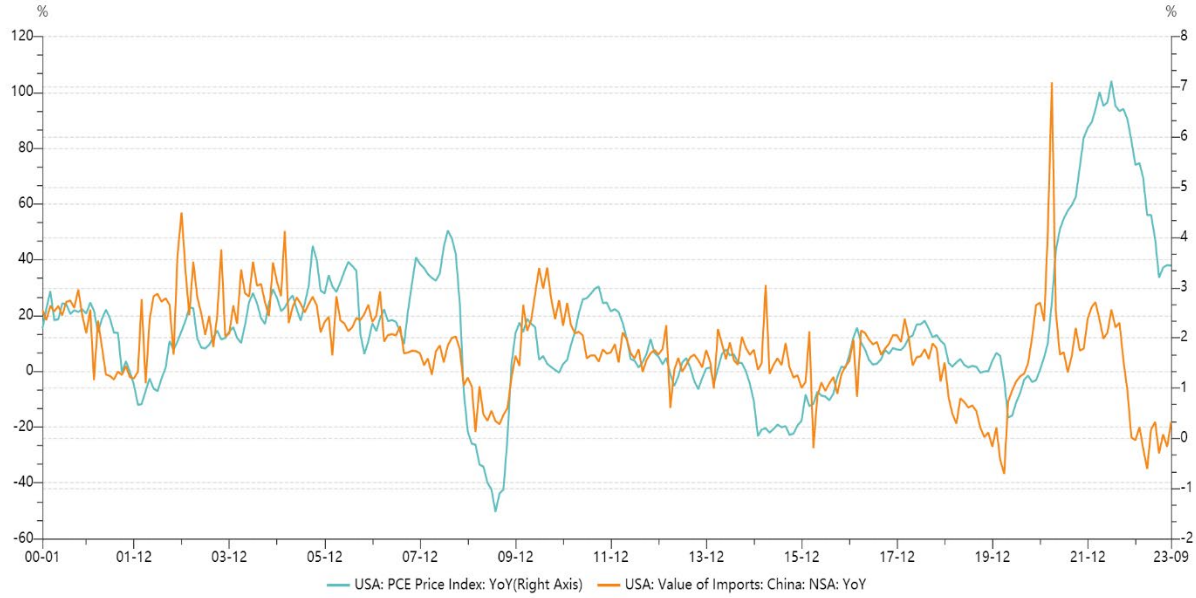
Further observation of the relationship between the year-on-year growth rates of consumer spending in the United States and the year-on-year growth rates of imports from China reveals a strong correlation between the two. However, this correlation weakened after 2021.



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III. China's Prices and Policies in the Current Stage

1. Main Features of China's Economic Operations

a. Differentiated Recovery in August, Yet Fragile Foundation

In August, there was a differentiated recovery in social retail sales (up by 4.6% YoY, accelerating by 2.1 percentage points), industrial value added by enterprises of a certain scale (up by 4.5% YoY, accelerating by 0.8 percentage points), the service industry production index (up by 6.8% YoY, accelerating by 1.1 percentage points), and improvements in the year-on-year and month-on-month comparison of goods import and export. The Consumer Price Index (CPI) and Producer Price Index (PPI) also showed slight improvements, partly due to robust summer tourism spending after strict control of extracurricular tutoring in August and some companies replenishing their stocks due to extremely low raw material inventories.

However, the economic recovery's foundation remains fragile, with the possibility of relapses. Recent indicators reflect signs of insufficient intrinsic economic vitality:

M1 growth rate continues to decline. In August, the M1 growth rate was only 2.2% YoY, 0.1 and 3.9 percentage points lower than the end of the previous month and the same period last year, respectively. M1 is more reflective of economic activity; its low and declining rate indicates subdued economic activity.

Bulk commodity futures prices have diverged. While earlier increases in bulk commodity futures reflected restocking behavior in the raw materials sector, recent prices have shown significant divergence. Prices of domestic demand-supply-related commodities like rebar and hot-rolled coil have decreased significantly, while commodities related to overseas markets such as steel, coking coal, petroleum, etc., have remained strong. This indicates weak domestic supply and demand.

Fixed asset investment continues to decline, especially in the real estate sector, where most indicators related to development and sales are still decreasing.

b. High M2 and Social Financing Growth, Low Inflation and GDP Growth, Widespread Micro-Entity Debt Swaps

In August, M2 grew by a high 10.6% YoY, social financing increased by 9% YoY, but CPI and PPI were only 0.1% and -3%, respectively. Corporate weighted average lending rates have reached their lowest point in available data history, yet monetary easing has not significantly stimulated economic growth. Correspondingly, various micro-entities have engaged in widespread debt swaps. Residents continue to increase savings and reduce various loans, the government is conducting comprehensive debt swaps, and businesses are observed swapping high-interest-rate debt for lower-interest-rate debt. China's low interest rates and monetary expansion primarily support these micro-entity debt swaps.

c. Macroeconomic Liquidity is Reasonably Abundant, but Micro-Entity Liquidity is Scarce

In August, the interbank RMB lending and repurchase rates were 1.71% and 1.76%, respectively, indicating relatively abundant liquidity in the money market. However, corporate receivables and bills remain high, and in some regions, private enterprises are reluctant to undertake government projects due to their inability to handle project debts. The situation is worsened by the partial collapse of China's private lending market. Many private enterprises are struggling to repay debts, and regions where private lending was once active now witness borrowers openly refusing to repay, disrupting the market's credit mechanism. Foreclosed property numbers have rapidly increased this year; enterprises facing liquidity shortages are selling properties, exacerbating liquidity scarcity, especially for micro and private enterprises.

d. Market Confidence is Still Insufficient and Fragile

Market confidence remains low recently, reacting sharply to negative news while showing sluggish responses to positive news and recent macroeconomic growth. Several concerning trends include:

Continuous outflow of foreign capital: The People's Bank of China's disclosed Foreign Direct Investment (FDI) hit historical lows, dropping by a significant 87.1% compared to the same period in 2022. Securities markets have witnessed continuous net outflows of northbound funds in the third quarter (accumulating a net outflow of 123.951 billion RMB from August 1 to September 26). Long-term funds that invested in China have largely exited, with a noticeable decrease in attention to the Chinese market, primarily from short-term investment hedge funds. Several international investment institutions have recently withdrawn their operations from Shanghai, reflecting not just concerns about short-term economic fluctuations but also questioning China's medium to long-term issues, such as population, debt, real estate, etc., with growing pessimism about China potentially experiencing "Japanization."

Lack of confidence in domestic asset markets: "Sell on the peak" behavior is widespread. The stock market continues to fluctuate, often unexpectedly. There have been multiple market fluctuations inconsistent with policy intentions, showing brief upward trends in response to policies but quickly dropping afterward. After the introduction of the "recognize the house, not the loan" policy in the real estate market, the number of second-hand listings increased rapidly, but the duration of increased transaction volumes in the secondary market is limited. This is related to the need for the sale of existing properties before purchasing new ones and reflects low market confidence.

Continuous pressure on RMB/USD exchange rates: Due to a strong US dollar index, significant interest rate differentials between China and the US, and the window for international students' tuition payments, the RMB/USD exchange rate has been continuously depreciating recently. The central bank has taken several measures, including issuing central bank bills in Hong Kong and reducing the reserve requirement ratio for domestic US dollar deposits. However, the effects have been limited. The market is concerned that outflows of northbound funds, withdrawal of institutions, and increased relative RMB supply through currency swaps with some countries are adding pressure on the RMB/USD exchange rate. China's domestic gold prices are significantly higher than international gold prices, reflecting the not fully reflected pressure of RMB depreciation against the US dollar (international board gold price 453.8 RMB/g, implied RMB/USD exchange rate 7.43; international board gold price 473.1 RMB/g, implied exchange rate 7.74).

2. Fundamental Factors in the Current Economic Trends:

a. Pains and Differentiation Under Structural Transformation:

China is currently undergoing unprecedented structural changes. Various sectors are undergoing significant transformations, such as the rapid development of the digital economy, environmental protection industries, especially new energy vehicles, and some high-tech sectors. However, the current GDP measurement method might not fully reflect these new contributions. Additionally, the transformation in the real estate industry, changes in export patterns, and the impact after the relaxation of pandemic control measures create significant challenges. In an environment where market differentiation is severe and predicting pains and possible nonlinear changes is difficult, forming consensus on the situation and policy responses is challenging.

b. Rapid Decline in Real Estate and Exports:

China is transitioning from an economic model supported by "real estate + exports" and debt to a model supported by "investment + consumption" and equity. However, real estate and exports remain vital components of China's economic growth. The simultaneous significant decline in both areas creates substantial demand shocks for the Chinese economy in the short term. The new economy and post-pandemic consumption rebound are not sufficient to offset these shocks. Additionally, existing debts built upon previous demand levels face real pressure. Hence, there is a sudden emergence of significant "demand gaps" and "risk exposure."

Special attention needs to be given to the secondary impact of the real estate market adjustment on China's financial system. Considering China's relatively high down payment ratio and strict control over developers' development loans, the direct impact risk of real estate market adjustments on the financial system is generally controllable. However, real estate is an essential channel for credit expansion in China. Rapid contraction may lead to a shrinkage in credit creation. The value-added of the real estate industry and its upstream and downstream industries accounts for a high proportion of China's GDP. Its adjustment, especially coupled with a decrease in exports, reduces demand and has a multiplier effect on the national economy. Additionally, China's real estate market is closely related to the land market, and fluctuations in land finance have a significant impact on local governments' fiscal revenues and debts. Therefore, considering various indirect impacts, the rapid adjustment of the real estate industry will inevitably bring a secondary shock to the financial system, a risk that needs high attention. This is also a matter of concern domestically and internationally.

The secondary impact involves multiple aspects and lasts for a long time. Therefore, measures should be taken comprehensively in various areas, including the real estate industry, the financial industry, and macro demand, to alleviate risks and offset the shrinkage in demand effectively.

Land finance is related to China's significant increase in infrastructure and urban operation demands. However, considering that the latter has become quite mature, the so-called "land finance gap" mainly reflects historical stock deficiencies rather than future additional demands. China's land revenue has been somewhat pre-empted by capitalization in a historical sense, and there is already a "boundary." Many local governments are actively establishing various government-sponsored industrial investment funds, promoting the establishment of local modern industrial systems, reflecting deep-seated changes in government behavior logic. Therefore, as long as there is a breakthrough in the previous understanding of demand stimulus means and debt, China has the conditions to creatively mitigate the adjustment shock risks in real estate, land finance, and debt.

c. Micro Entities Adopting Risk-Averse and Low-Desire Behavior Patterns:

China's micro-entity behavior patterns have undergone significant changes, profoundly affecting the assessment of economic trends and policy effects. In an environment of high uncertainty due to a large number of unpredictable and uncontrollable factors over a long period, Chinese economic entities have exhibited characteristics of being risk-averse and having low desires. Enterprises, residents, and governments have significantly reduced their risk preferences and increased risk reserves. For example, residents are increasing precautionary savings and downgrading consumption, businesses are reducing risk investments, and governments are focusing on immunity from responsibility, among other behaviors. China has also witnessed certain low-desire social characteristics, such as the emergence of the "Three-Not Youth" (those who do not get married, do not buy houses, and do not have children) and various "lying flat" phenomena. Currently, China is promoting structural adjustments in the economy under the expectations and reality of "living tight," leading to profound changes in micro-entity behavior patterns.

3. Debate on Three Economic Policy Approaches:

In the face of the complex current economic situation, there are three debated policy approaches in China:

a. Intensifying Short-term Demand Stimulus:

This approach argues that insufficient demand is the primary contradiction in the current economic operation. Short-term changes in economic structure or the short-term stimulating effects of structural policies are not significant. To avoid economic "shock," it is necessary to adopt demand-stimulating policies, even if they might have significant side effects or limited effectiveness.

b. Structural Reforms to Break the Stalemate:

This approach believes that short-term policies need to be considered within the framework of long-term growth. The effectiveness of demand stimulus policies has become increasingly limited in recent years and cannot sustain economic growth. Since some types of structural reforms have significant demand-stimulating effects, it is suggested to focus on fundamental structural reforms to achieve stable and high-quality economic growth.

c. Seeking Solutions Outside the Economic Sphere:

This approach, predominantly advocated by overseas experts, suggests exploring solutions beyond the economic domain since there seems to be no clear short-term or long-term solution in the economic field.

The debate on policy approaches reflects significant differences in the comprehensive assessment of China's economic mechanism and state. In reality, China's current economic operation lies between the short-term and long-term. China's potential growth rate is gradually declining, and some structural changes in recent years have exacerbated the rate of potential growth decline. It is generally believed that this year's economic growth, especially measured by the two-year average growth rate, is below the potential economic growth rate. There are still idle resources, such as unemployment and excess production capacity, which are reflected in low inflation. This implies that China still has room to increase economic growth through demand stimulus policies. However, it is challenging to determine whether China's current "unemployment" and "excess production capacity" can still be absorbed into economic growth or if they are ineffective and need to be eliminated. The concept of potential growth is not easily visible and is highly comprehensive, making it difficult to assess the situation and form a consensus.

In reality, the current difficulties and challenges in China's economic operation result from a combination of systemic, structural, and cyclical problems. The catch-up economic growth driven by factor inputs, especially the economic cycle supported by "real estate and exports" and debt, is unsustainable. China needs to shift toward innovation-driven high-quality development. This requires China to build institutional mechanisms and modern industrial systems compatible with high-quality growth. However, the past economic growth model and economic cycle have left behind an economic structure and debt burden that are no longer sustainable. This manifests as structural contradictions and risks in real estate, debt, and financial institutions. Additionally, the past three years of pandemic and the technological blockade from the United States, along with the industry chain differentiation strategy of "China+1" have placed additional demand shocks on China.