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Original Paper

China's Currency Sterilization and Fiscal Centralization

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Abstract

During the late 1980s and early 1990s, the Chinese economy experienced painful tradeoffs between high economic growth and low inflation: stimulating GDP growth would cause severe inflation spikes, while controlling inflation rates would seriously contract GDP growth. In 1994, the Chinese government initiated a series of macroeconomic reforms to revitalize the Chinese economy. After that, the inflation dropped steadily and eventually achieved the "soft landing" in 1996. The high GDP growth rate has also been stabilized. This research elucidates two core components embedded in China's 1994 program: currency sterilization and fiscal (revenue) centralization. The results suggest that classic economic models with nominal rigidity postulation may not be compatible with the Chinese economy.

Keywords

economic development, currency intervention

1. Introduction

During the late 1980s and early 1990s, the Chinese economy experienced painful tradeoffs between high economic growth and low inflation, or the "groundhog day growth pattern" nicknamed by Yu (2013): Stimulating GDP growth would cause severe inflation spikes, while controlling inflation rates would seriously contract GDP growth (Figure 1a). In 1994, the Chinese government initiated the currency intervention (CI) policy among other exceptionally aggressive macroeconomic reforms to revitalize the Chinese economy. After that, the inflation dropped steadily and eventually achieved the "soft landing" in 1996. The high GDP growth rate has also been stabilized (Figure 1b). This section elucidates two core components embedded in China's 1994 CI program: currency sterilization and fiscal (revenue) centralization.

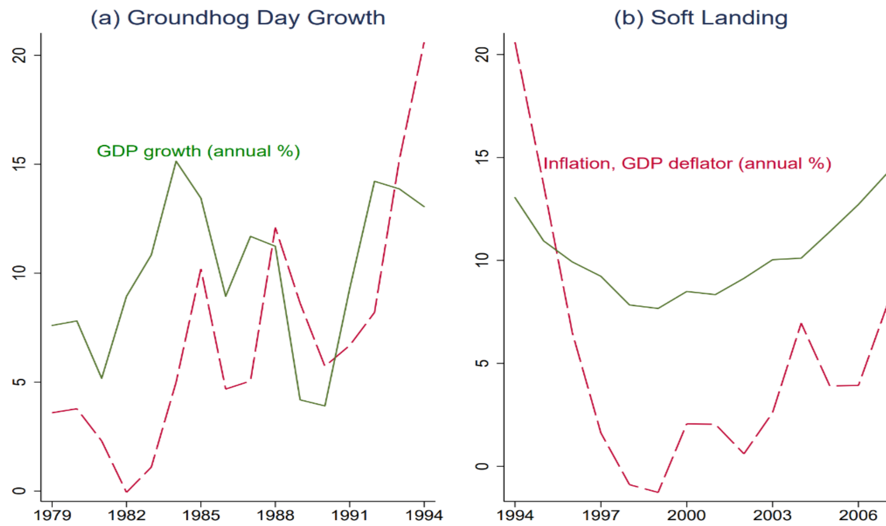

Figure 1. China's Inflation and Economic Growth before and after 1994

Data Source: World Development Indicators.

2. China's Currency Intervention

When the People's Bank of China (PBoC, central bank) embarked on the CI program in 1994, its initial objective might be to stabilize domestic economy from previous financial disarrays Goldstein (2009). In incipient years of CI, the official exchange rates of RMB against major international currencies were around their equilibrium levels. For example, the trade (current account) surplus to GDP ratios was only below 1.5% during 1994-1996. It climbed to around 4% in 1997, but then declined back to below 1.5% in 2001. After 2002, the trade surplus ratio eventually rose steadily, mounting to 10% before the 2008-9 global financial crisis. The net capital inflow (capital account deficit) also developed in a similar pattern (Figure 2).

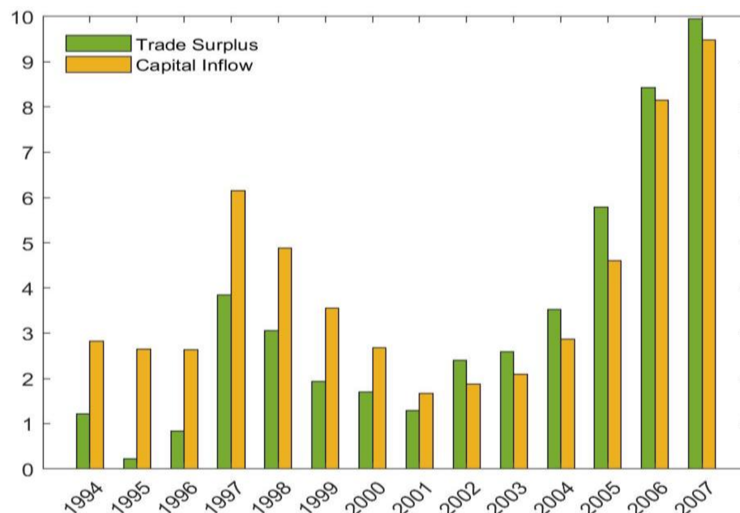

Figure 2. China's Current Accounts and Capital Inflows (% of GDP)

Data Source: World Development Indicators.

To mitigate the inflation pressure imposed by the FX funds issuance, the PBoC conducted a sterilization policy to restrain the growth of money supply. In the beginning, the PBoC controlled the scale of the base money by curtailing its holdings of domestic financial assets. After depleting this capacity, the PBoC further heightened the required reserve ratios (RRR) to influence broad money supplies (Jin et al., 2015). Figure 3 illustrates PBoC's FX funds-to-the reserve currency ratios and RRRs from 1994 to 2007. In 1994, the FX funds-to-monetary base (reserve currency) ratio was around 25%. It first crawled slowly to 41% in 2000 but then surged up and attained its upper limit (around 100%) in 2005 (Panel A). Since 2006, the PBoC began to adjust the RRRs frequently to continue sterilizing the FX funds issuance. By the end of 2007, the RRR had practically doubled its 2005 level. It even outstripped the 1994 level when China was in serious financial disarray (Panel B) (Note 1).

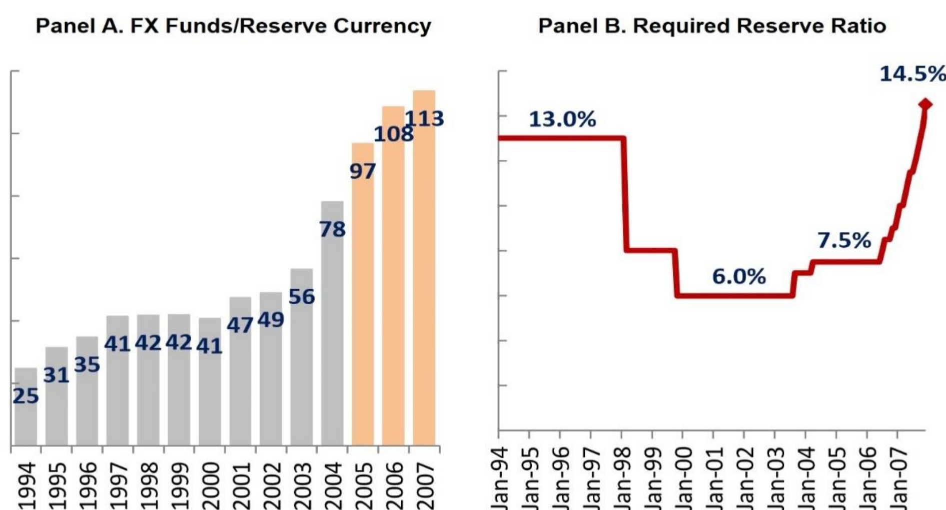

Figure 3. China's FX Funds Shares and RRRs

Data Source: PBoC.

3. Fiscal Centralization

The persistent currency sterilization during CI had greatly tightened the PBoC's monetary conditions in operating the government securities market. To address this issue, the Chinese authority further overhauled its fiscal system in the 1994 reforms.

Since 1978, in order to conform to its market-oriented economic reform and opening-up policy, the Chinese authority enacted several modifications to its fiscal system. First, it reformed the foreign tax system during 1978-1982 and then replaced profit delivery with taxes in 1983. After 1985, the Chinese authority instituted a tax farming system, the Fiscal Responsibility System (FRS), to allow local governments to keep revenues above their stipulated amounts. However, the FRS soon proved problematic. In subsequent years, the central government grappled with huge budget pressure, and its fiscal power also plummeted (Shen et al., 2012).

To restore its fiscal power, the Chinese authority launched a drastic fiscal system, the Tax Sharing

System (TSS) in the 1994 Reform. Compared with the FRS, the TSS more clearly delineated tax categories and rates. It also categorized larger proportions of tax revenues to the central government (Jin et al., 2005). For example, Figure 4 contrasts the revenues and expenditures of the central and local governments of China from 1978 to 2007. It shows that albeit fiscal expenditures changed smoothly, fiscal revenues experienced a phenomenal centralization after 1994. From 1993 to 1994, the ratio of the local revenue to GDP plummeted from 10% to 5%, yet the central revenue ratio spurted from 3% to 8%. As a result, the ratio of the central revenue to the local revenue nearly quadrupled, jumping from 30% to 120%.

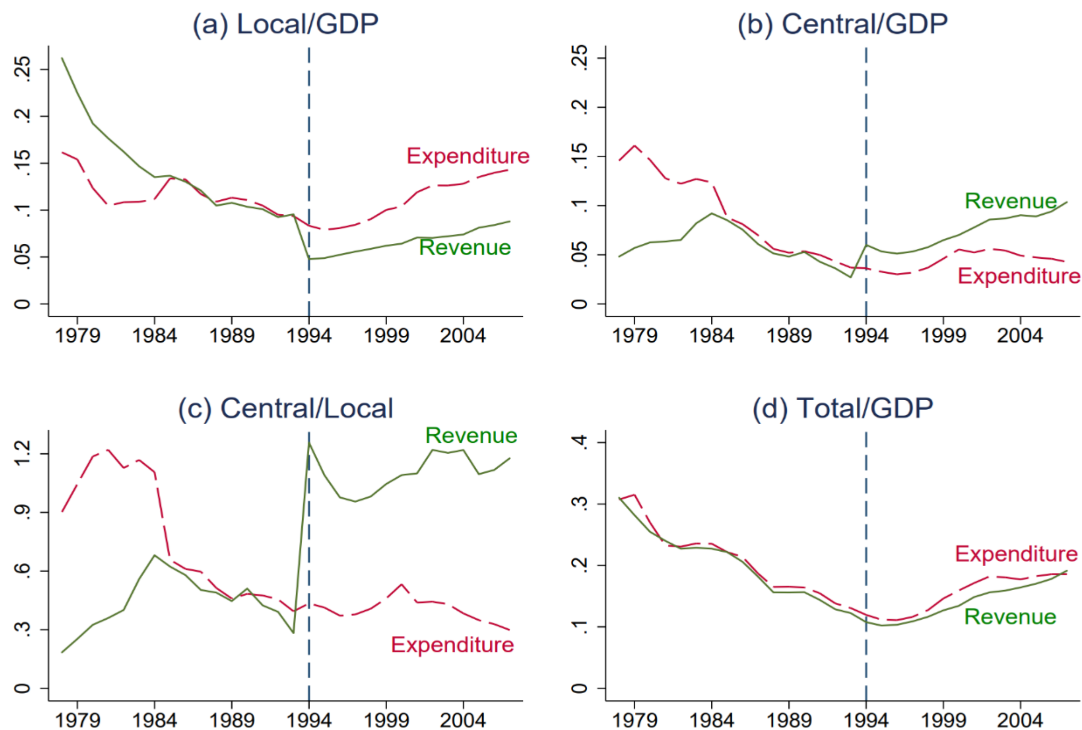

Figure 4. Revenues and Expenditures of the Central and Local Governments of China

Data Source: National Bureau of Statistics of China.

4. Concluding Remarks

In developed countries, the central government bonds are generally regarded as the benchmark instruments in the financial system. In China, however, the persistent currency sterilization and fiscal centralization in sustaining CI had greatly constricted the operation of the government securities market. This further deteriorated the liquidity and efficiency of other financial instruments in the economy. In response, the Chinese private entities had formed a "savings glut" to hedge against financial risks and invest in high-productivity projects (Corden, 2009; Song et al., 2011). From this perspective, the postulation of fast financial markets adjustment or nominal commodity price rigidity in standard macroeconomic frameworks might not be sustained by the persistent CI.

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Note 1. The trend continued until the outburst of the 2008-9 global financial crisis. Since 2009, the PBoC has been trying to cease the currency sterilization and roll out a fresh round of reforms to integrate China's financial markets into the international financial system. See Lombardi and Wang (2016) for reference.