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Causes and Solutions from the Perspective of Economic Policies: A Study of Chinese Inflation

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Abstract

Inflation plays an important guiding role in the operation of the economy. This article analyzes the three possible causes of China's inflation: the existence of monopoly enterprises, demand exceeding supply, and structural changes. It is suggested that inflation be controlled with flexible fiscal policies rather than rely on IT of monetary police.

Keywords: *Inflation, Consumer price index, Economic policies*

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Background to the Study

Inflation, defined as a general and continuous increase in prices (Gao, 2011), plays a crucial role in China's economic operation. When Consumer Price Index (CPI) has risen by over 5%, it can be regarded as a serious inflation, thus inflicting much damage to an economy (Gao, 2011). According to National Bureau of Statistics of China (2011), CPI of August in 2011 increased by 6.2% making China fail to meet its inflation target of 4%. Inflation has become one of the most significant concerns of an economy. This essay aims to examine the causes of Chinese inflation and explore possible economic policies to address this problem. Causes of Chinese inflation can be explained for different reasons in different periods in China, but inflation will be examined from three principle causes. Other studies (Zhang, 2010; Wu, 2011) have identified cost-push as the main factor of inflation. China is a monopolistic competition market, with the improvement of the living standards of employees that have the desire for more wages, and employers have to raise salaries to maintain adequate workforce. Monopoly enterprises make monopoly prices of certain products to get exceptional profits (Ren and Song, 2009) at the same time generating price increase for some basic raw materials. These factors, taken together, add up to a serious inflationary trend. Also, Auerbach et al. (2010) particularly highlight the impact of demand-pull force in current China. Products cannot satisfy with complicated appetites for the large amount of population. When people's demand exceeds supply, “too much money will end up chasing too few goods” (Goodfriend and Prasad, 2008) and result in inflation automatically. This is why inflation was originally defined as “always and everywhere a monetary phenomenon” (Mishkin, 2007). A further reason for the soaring inflation rate lies in structural changes. A guidance of making price floor in agriculture and concerning farmers' life promulgated by the State Council of China in 2010 has had the effect of food's price ascending as well as promoting consumers' expectations. Overall, these three factors have had the combined effect of continuously increasing products' prices and monetary expansion.

Solutions from the Perspective of Economic Policies

“Although deeper structural reforms may be the key determinants of long-term growth, and economic policies have an important role to play in creating a stable macroeconomic environment that is essential for those reforms to take root.” (Goodfriend and Prasad, 2006). Normally, economic objectives could be achieved by intervention in market mechanism with monetary and fiscal policies (Gao, 2011). Similarly, it is possible to explore solutions to respond inflationary pressures from monetary and fiscal policies in a short term. Evaluation of monetary policies' effectiveness the primary and conventional measure to control inflation is adopting monetary policies to set “a low inflation objective as the new nominal anchor” (Goodfriend and Prasad, 2006) or “inflation targeting (IT)” (Mukherjee and Singer, 2008). In other words, the People's Bank of China (PBC) can put a low inflation rate with the aim of carrying out monetary policies to affect rational people's expectations and behaviour in the market. Specifically, any management of currency in circulation will work around the targeted inflation rate whereby the public can be aware of the changes about products' prices so that they can make decisions with the influence or constraint of this goal, which has been acknowledged as “an effective inflation-fighting strategy” (Mukherjee and Singer, 2008). Monetary policies can be implemented with several instruments to restrict the amount of currency in Chinese market.

1. **Open market operation:** The central bank may sell government bonds in the financial market and begin capital repatriation from companies or individuals to reduce monetary base to adjust money supply when inflation is serious.

2. **Rediscount rate:** Commercial banks will be discouraged from borrowing money from central bank due to the rise of the cost along with the higher rediscount rate.

3. **Reserve requirement:** To avoid further inflation, the PBC can confine credit and lending requirements by raising legal reserve ratio of banks. Goodfriend and Prasad (2008) state, therefore, the legal reserve ratio together with the amount of bank reserves have become factors that set the upper limit to money creation.

Nonetheless, monetary policies have a significant impact on demand-pull inflation rather than cost-push inflation and imported inflation since the practice of monetary rules has inherent limitations (Gao, 2011). As Mishkin (2007) points out "what determines the overall inflation rate is not relative prices for one category of goods and services but rather the balance between overall demand and supply in the economy, which ultimately is influenced by monetary policy", monetary policies can help to solve demand-pull inflation effectively. On the other hand, monetary policies have their limitations. Admittedly, hot money is prone to flow into China with the increase of interest rate, which will worsen inflation. Thus, increasing the interest rate is not always an effective and sustained tool to affect the currency (Zhang and Chang, 2008). Moreover, unexpected financial interventions on commercial banks may bring in problems on the normal operation. These areas could lead to over accumulation of money or reducing the liquidity, which will damage the mechanism of Chinese banking system.

Emphasis on the Flexibility of Fiscal Policies

In addition, fiscal policies working as the function of dominating aggregate demand can contribute to decrease inflation rate (Zhang, 2010). Compared with monetary policies, fiscal policies are effective solutions to cost-push inflation. The mechanism can be explained from three aspects. To begin with, low inflation objective can be achieved by the change of national budget, fiscal expenditures, tax, financial subsidies and bonds (Ren and Song, 2009). Inflation is supposed to be repressed by increasing tax and reducing government expenditures however, Zhang and Chang (2008) found that investment from government should not be cut in case of stagflation under the pressure of appreciation of RMB and slow exporting growth. The current fiscal policies should be prudent fiscal policies abiding by such principles When inflation is severe, tight fiscal policies such as increasing tax and reducing public expenditures should be taken; expansionary fiscal policies should be implemented when government gives priority to addressing economic deterioration rather than solving inflation. These indicate that fiscal policies have the function of flexible adjusting and automatic stabilizers. Furthermore, fiscal policies are effective to tackle sophisticated inflation because there is a multiplier effect (Gao, 2011) on fiscal policies. Fiscal means could be enlarged by multiplier when being applied in the market to improve national income. Another point that cannot be ignored is that fiscal policies can contribute to factors of production, such as labour, technology and public goods. Whether the increase in prices of factors of production becomes cost-push inflation, it fundamentally

depends on the competition between the prices of factors of production and labour productivity linking with technological progress (Zhang and Chang, 2008). Investment, expenditures and subsidies on human resources, technology and infrastructure can enhance the quality of labour and development of technology, which has great significance of raising labour productivity, and thereby could basically curb cost-push inflation.

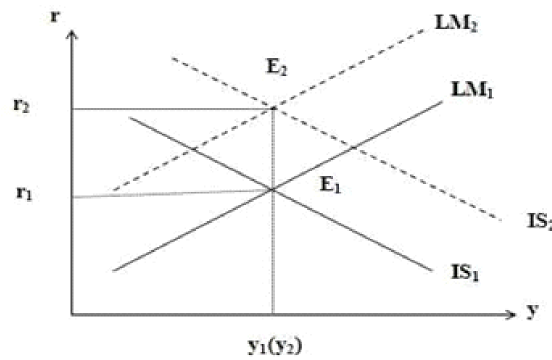

Figure 1. *Macroeconomics*. Beijing: Sciencep.
Source: Ren, B. P and Song, Y., 2009.

Exploration on Monetary-fiscal Policy Mix
Apart from the targeted effects of monetary and fiscal policies, monetary-fiscal policy mix should be emphasized, especially in addressing the inflation of China. According to the theory of Investment-Saving and Liquidity preference-Money Supply (IS-LM) (Gao, 2011), a control synergy can be created with the combination of monetary policies and fiscal policies. Solutions to various economic problems related to demand and supply could be explored and analysed from selecting either ease monetary policy or tight monetary policy and alternative of proactive fiscal policy and inactive fiscal policy (Gao, 2011). CPI is still high ranging from the highest 6.3% to the lowest 4.1%. Therefore, currency in the circulation should be restrained with respect to monetary policies. Whereas inflation is not impetuous and both economic growth and price stability should be taken into account and balanced, proactive fiscal policies can be adopted instead of inactive fiscal policies (Ren and Song, 2009). The mix of tight monetary and proactive fiscal policies can be showed with IS-LM curve in Figure 1. IS1 and LM1 intersect at E1, which is the equilibrium in product market and money market. IS2 represents proactive fiscal policies and LM2 represents tight monetary policies which intersect at E2, which is a new equilibrium after carrying out economic policies. With the mix-policies addressing inflation, the interest rate (r) has risen due to the decrease of currency while national income (y) could stay the same because of proactive fiscal policy.

From IS-LM model, monetary-fiscal policy mix can be an effective measure to cope with inflation not only repressing prices going up but also ensuring not to slow down the economic growth. Si (2002) estimates the IS-LM model of China and concludes that fiscal policies are more significant and effective than monetary policies because China has adopted a managed floating exchange rate regime based on market supply and demand with reference to a basket

of currencies, which makes monetary policies' autonomy insufficient but leads to stable output with fiscal policies. Hence, it is suggested that inflation be controlled with flexible fiscal policies rather than rely on IT of monetary policies.

Conclusion

In summary, this essay has discussed three reasons for inflation in China and analyzed solutions from the perspective of economic policies. Though monetary policies have inflation targeting, and China is facing a dilemma in the application of controlling currency. It will be a sensible choice for the central bank to attempt monetary-fiscal policy mix. However, fiscal policies could present more effectiveness and flexibility with regards to current inflation. There are two main inherent limitations in this essay. First, the analysis of macroeconomic policies which is based on hypotheses of "efficient allocation of resources" and market mechanism imperfect (Fltenstein and Farhadian, 1987) and complies with the main opinions of Keynesian neo-classical synthesis regardless of government failure theory. Additionally, monetary and fiscal policies contain recognition lag, decision lag and action lag (Ren and Song, 2009), which has not been discussed in addressing inflationary problem. There is an urgent need for research on the effectiveness of economic policies incorporating external economic factors, which could help solve inflation accurately and comprehensively.

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