Q&A with Xiao Gang and Liu Yuanchun on the 2020 Government Work Report[1]

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Abstract: In this interview, Xiao Gang and Liu Yuanchun offered their understanding on a range of issues mentioned in the 2020 Government Work Report just published, including not setting a target for GDP growth, the issuance of the special national debt of one trillion yuan and the special transfer payment among other topics. They commented on the expansionary fiscal and monetary policy proposed and regarded them as sufficient and sustainable.

I. The relationship between growth and employment has changed, and the primary goal at present is to secure employment

Q: The 2020 Government Work Report (hereinafter referred to as the Report) does not set a target for economic growth, but specifies a target for the unemployment rate. But growth and employment are usually correlated. How to understand this change?

Xiao Gang: First, the situation in the first and the second quarter of this year is very special, and there is no precedent in the history. There is much uncertainty with the development of the COVID-19 pandemic. Setting a target for GDP growth would be rather inappropriate at the moment.

Although the government did not set a GDP growth target, it set a goal for employment. Traditional thinking holds that to maintain growth is to secure employment, **but now the relationship between the two has actually changed.** GDP growth does not ensure a high employment rate anymore. Now in this case, maintaining a high employment rate does not necessarily correspond to GDP growth. We should encourage entrepreneurship as it can create more employment opportunities. For example, Internet celebrities create jobs and economic value. **So we can say that entrepreneurship can create**

[1] This interview was published in Chinese on May 24, 2020.

employment opportunities as well as promote economic growth. In short, the new changes taking place in the relationship between employment and growth is an important factor.

The most important task at the moment is to secure employment, which is in line with addressing the pandemic shock. Dropping the GDP growth target can make people focus their attention on securing employment, so in this year's report, the employment target is very clear, with quantitative indicators, and being put as top priority.

Of course, not setting a GDP growth target does not mean GDP growth is not necessary or important. In fact, we can roughly get an implicit growth rate through calculation.

Liu Yuanchun: First of all, it is clear in the Report, which is also a consensus that one of the most important reasons for not setting a GDP growth target is that the pandemic development and the economic and trade environment are still facing huge uncertainties. I want to emphasize that this uncertainty is super large, not the uncertainty in the general sense. On the one hand, we haven't developed sufficient understanding of the pandemic and the virus. We are not certain about whether there will be a second or even a third round of outbreaks in the future, which will directly affect the overall environment for economic growth in all countries. On the other hand, the measures taken by various countries in response to the epidemic are also facing many political, economic, and social pressures and uncertainties. Therefore, what we are faced with is a super uncertainty.

Second, in the face of such uncertainties, our best move is to stick to the bottom line thinking, which can be reflected in the "six guarantees" in the government work report. To implement the "six guarantees", we cannot simply focus policy objectives on the GDP growth rate. Although the GDP target is still very important in terms of total volume of the economy, it is difficult to truly reflect the various challenges and structural contradictions during such a special period featuring profound structural transformation, huge external shocks and significant adjustments. In China, there is actually a tendency to take GDP growth as the only goal. Governments at all levels tend to go for GDP targets at all costs, thus ignoring the main contradictions and major challenges they face. **So the best way is to focus on the "six guarantees", and tackle the problems directly with bottom line thinking.**

Third, President Xi Jinping stated when participating in the Inner Mongolia delegation's deliberations that our policy must be centered on the people and take people's wellbeing as the starting point. In the face of the pandemic impact, we must ensure the safety of people's lives and their wellbeing. This is why we cannot simply take GDP growth as the only goal. In addition, our policies must be coordinated, matched, and consistent with high-quality development.

However, not setting a growth target does not mean that there is no target at all. It does not mean that we will give up the goal of building an all-round well-off society, nor give up requirements for economic growth. In fact, the "six guarantees" already implied certain growth targets. To ensure that the surveyed unemployment rate does not exceed 6%, the registered unemployment rate does not exceed 5.5%, and more than 9 million newly added urban jobs are needed, and the GDP growth rate must be at a level of about 4% according to our calculation. **But what I want to emphasize is that during this special period, our policy is to make every effort and and utilize all the resources to create employment. The traditional relationship between the unemployment rate and economic growth is likely to change significantly. In other words, achieving the employment goal does not guarantee a certain growth rate.** However, we cannot allow a growth rate goal to sidetrack the priority goal of maintaining employment. Therefore, setting an unemployment rate target becomes very important.

At the same time, CPI is also a very important indicator for people's wellbeing. Setting an inflation target means the government is highly concerned about this issue. There is much concern over whether the expansionary policy will lead to inflation. In fact, the world is faced with a risk of deflation. When it came to China, the PPI has seen negative growth for three consecutive months, while the CPI has dropped significantly during the same period. The core CPI and the purchasing power parity are already at a very low position. At present, the lack of effective demand is a core problem facing the economy. The pressure of deflation may increase sharply in the next stage, especially in the industrial sector. PPI has witnessed negative year-on-year growth for three months, **showing signs of depression in the industrial sector** which may cause continuous decline in corporate profitability.

Q: To secure employment, we must first protect market players. A series of arrangements have been laid out in the Report. In addition, the Report also mentioned that we must use every means to expand employment. Are there any pioneering ideas on how to secure and expand employment?

Liu: Securing employment actually takes place on several levels. The most important one is to protect market entities by expanding effective demand, which means ensuring market entities have stable orders. Only in this way can we have the base to secure employment. Therefore, the Report first comprehensively reviews the macro policy package for stabilizing economic fundamentals.

Second, in addition to expanding demand, we also need to adopt a series of unconventional methods to secure employment. The first is to provide assistance to small and medium-sized enterprises to prevent large-scale bankruptcies, the goal of which is to protect employees and ensure production. In this regard, the Report mentions a series of fiscal and monetary policy arrangements. Second, **it is necessary to alleviate employment pressure by postponing employment through college enrollment expansion**. So this year China will expand the enrollment of higher vocational education by an additional two million. It will also put in place skill training of 35 million person-times, which will also considerably help relieve the pressure on employment. These are what we call relatively passive employment policies. **Finally, it is very important to expand and consolidate our safety net** and devote more resources to unemployment relief, unemployment subsidies, and assistance to the poor.

Just as mentioned in the Report, innovative attempts to expand employment are widely needed and have already been implemented in various cities. For example, in Chengdu, it was illegal to set up stalls in streets before the virus outbreak, but during this special time, stalls are allowed as a practice of flexible employment. At the same time, it is necessary for the government to innovate, to further delegate power, improve regulation and optimize government service so as to reduce various administrative costs of enterprises.

II. The expansionary fiscal policy is appropriate and sustainable, and the utilization of funds may test governance capacity at grassroot level

Q: In terms of fiscal policy, there are views that the current fiscal expansion is not sufficient. What is your opinion?

Xiao Gang: I think the fiscal expansion is appropriate and sufficient. Why? In addition to the newly added deficit of 1 trillion yuan and the 1 trillion-yuan special government bonds, it is also proposed in the Report that tax cuts and reduction of fees for enterprises will exceed 2.5 trillion yuan this year, which can substantially benefit enterprises. Local government special bonds will also increase by 1.6 trillion yuan this year to be used mainly for infrastructure construction, which that can spur consumption and promote employment.

In addition, a lot of measures have been taken in terms of flexible and moderate monetary policy this time. For example, the growth rate of M2 and social financing is set to be significantly higher than last year, and the loans made by large banks to small and micro enterprises is set to increase by 40**%. I think the combination of a proactive fiscal policy and a flexible and moderate monetary policy is sufficient.** I have repeatedly stated the point that bullets cannot be fired all at once. At present, there is still much room for macro policy maneuvers, such as lowering the reserve deposit ratio and interest rate.

The current policy arrangement is appropriate as it has increased economic relief and assistance on the one hand, and can be sustainable in the long term.

Liu Yuanchun: We made many calculations about how much stimulus is needed to meet the needs of securing employment, safeguarding people's livelihood and protecting market players. As I mentioned just now, to create more than 9 million new jobs in urban areas, the GDP growth rate needs to reach a level of around 4%. This requires a certain amount of policy support to boost the economy by two to three percentage points, which can be translated to **about 5 trillion-yuan fiscal arrangements.**

So what does the Report say about additional fiscal expenditure? There is an increase in deficit of 1 trillion yuan, in addition to 1 trillion yuan of special national bonds and 1.6 trillion of local government special debt. What else? There is also tax and fee cuts of at least 2.5 trillion yuan this year**. The overall scale of fiscal growth is about 6.1 trillion yuan, which is expected to boost consumption and investment by about 3 percentage points.** According to our calculation, the size of the entire disposable fund will reach about 35 trillion yuan in 2020. This shows that the scale of the Chinese government's fiscal expenditure as a percentage of GDP is very high, much higher than that of Europe and the United States. Newly added fiscal expenditure alone has reached about 6% of GDP. This scale is not low compared with the rest of the world. In addition, we must take fiscal sustainability and future debt risks into account. Therefore, I would say the current fiscal arrangement is moderate in scale with controllable risks. It is a medium-term plan and features unconventional approaches.

This arrangement may be regarded as not sufficient by some market participants. However, only through scientific calculations based on the problems we are facing, and forward-looking judgments on future pressure and risks, can we develop sound policy arrangements.

Q: The Government Work Report mentioned “special transfer payment,” the purpose of which is to ensure the 1 trillion-yuan special government bonds and the 1 trillion-yuan fiscal deficit could truly reach local areas in China. What issues should we pay our attention to when using the “special transfer payment” mechanism?

Liu Yuanchun: The purpose of these 2 trillion-yuan funds is to ensure the operation of the grassroot government bodies, **but the problem is whether these city- and county-level governments have the capability required to assess and manage the funds. This may prove to be a test for governance at grassroot level.** For instance, if the funds are distributed through conventional means, they may not reach the groups hit the hardest. This is where local governments should step in and innovate.

Q: The Government Work Report mentioned that “all types of surplus, idle and carryover funds that should be taken back will be withdrawn and reallocated”. How should we reactivate the large amount of inefficient idle funds of state-owned institutions, which has been a long-discussed issue? The reform of the housing provident funds, as one of the ways to mobilize these funds, has been heatedly discussed recently. What are your suggestions on this?

Liu Yuanchun: There are indeed large amount of fiscal funds sitting idle in the hands of state-owned institutions, especially government organizations, which has resulted in the low utilization efficiency of fiscal funds as a whole. To address this issue, the government started to seek ways to revitalize the existing funds a few years ago.

Budget pressure will be higher for China this year, and the government will not only strengthen fiscal efforts, but also improve fiscal efficiency. Improving efficiency indicates adjusting structure, which involves three aspects: first, adjustment between central and local government expenditures; second, adjustment between urgent and non-urgent projects; third, adjustment between existing and additional fiscal resources. This is why the Government Work Report touched upon the issue of surplus, idle and carryover funds. Improving the turnover and efficiency of the massive idle funds in government institutions is an important component of a more proactive and impactful fiscal policy.

In addition, there are also a large amount of public savings, pension funds and housing provident funds of state-owned enterprises (SOEs) which are being kept and used in outdated and inefficient ways. In practice, many small- and micro-sized enterprises do not participate in the housing provident fund scheme, or the contribution differ considerably among different industries and companies with different ownership, which has been widely criticized as a cause of the widening income gap. This, plus the low efficiency of the funds and its failure in supporting housing consumption and promoting economic reproduction, gave rise to the call for reforming the current housing provident system.

There are many voices for the reform of the housing provident system, but the core of the debate is whether or not this scheme has completed its historical mission of supporting employees' housing needs. The answer is partially completed. Some advocate that the regime should be cancelled entirely, though it will meet much resistance. Another suggestion is to cut the minimum deposit rate of the housing provident funds from 5% to 3% so both firms' burden and inequality could be reduced. Beyond this, some suggest turning the housing provident funds into corporate annuity which functions as insurance funds in a broad sense. In my opinion, reform of the housing provident system should be progressive. The government could explore targeted and innovative measures for different sectors and regions in this process.

III. Controversy over whether innovating monetary policy instruments is a temporary move or not

Q: While the Government Work Report says that M2, the broad measure of monetary supply, and social financing should grow "notably" faster than last year, what does the word "notably" imply? What level of growth rate could be seen as being "notable"?

Xiao Gang: Indeed, "notable" is not a precisely measurable indicator, which I think should mean a minimum growth rate of 2 percentage points. In fact, the growth of M2 was 8.7% at the end of last year and 11.1% in April this year, while the growth of social financing was 10.7% last year and 12% at the end of April. Both indicators have realized "notable" growth in this case.

Liu Yuanchun: This is an important reflection of China's monetary policy stance, that is, the prudent monetary policy should be more flexible. The growth rate of M2 was 2.4% up in April this year from the end of last year, and the growth of the stock of social financing increased by 1.3% in April this year from the end of last year, which may indicate that there is further room for the two indicators to increase, **especially for loans and bond securities**.

Q: The Government Work Report mentioned for the first time "to develop new monetary policy instruments that can directly stimulate the real economy". What are the potential policy instruments?

Xiao Gang: I believe it is a meaningful move that the Report calls for the development of new monetary policy instruments that can directly stimulate the real economy, because this will improve the transmission mechanism of the monetary policy.

We haven't yet seen what these instruments will look like, but I think we could refer to some of the tools used by the Federal Reserve to direct funds to the real economy, such as the Special Purpose Vehicle (SPV), the Commercial Paper Funding Facility and so on. The People's Bank of China (PBOC), China's central bank, has also taken some moves to provide credit support to private firms—for instance, the PBOC introduced instruments such as credit risk mitigation warrants and credit protection contracts to support bond issuance by private enterprises, which are initially partially funded by the PBOC and managed by market-based professional institutions. Another measure which has already been put forward but is rarely used at the moment, is the equity financing facility for private firms.

Therefore, I believe there are many ways to innovate. We have already had some experience and can also learn from international experiences. This is one of the highlights of this year's Government Work Report, and we should continue our exploration in this area.

I don't think these arrangements are temporary. Traditionally, monetary policy focuses on adjusting aggregate economic indicators, but in practice, it also functions as a tool for adjusting structure, not only in China, but also in other countries. I believe these arrangements are extensions of the function of monetary policy and represent a step forward for monetary policy theory, and therefore not just temporary measures.

Liu Yuanchun: The potential means could be reflected in the forms of refinance, rediscount and special epidemic relief loans provided by the central bank to designated financial institutions for targeted use.

Some of the recent practice in Europe and American could be summarized as: 1) the fiscal authority injects funds; 2) the central bank allots funds; 3) special funds (especially funds for epidemic relief and economic recovery) are established, and then directed to the real sectors in need. This injection mechanism goes beyond conventional financing tools in that it is more straightforward and convenient, and can take effects instantly. Of course, there could be side effects as a result, but **these**

are only unusual arrangements and unconventional policy measures for getting over the pandemic.

Q: Some believe that directing funds to the real economy is a fiscal move in essence. What is your opinion on this?

Liu Yuanchun: Not exactly. If we look at the United States and European countries, which have taken extraordinary measures under the pandemic's blow, their central banks can lend directly to commercial institutions and businesses, and directly purchase the bonds of some businesses, including high yields bonds. These measures will channel funds directly to the real economy. But China is a bit different, because Article 30 of the Law of the People's Republic of China on the People's Bank of China stipulates that the central bank shall not lend to local governments and government agencies, non-bank financial institutions, or other organizations and individuals. However, in exceptional cases, it may lend to certain non-bank financial institutions under the authorization of the State Council.

China could consider the following moves. **First, in the second half of the year, it could further extend the special loans it has given out in the first half of the year; second, the State Council may authorize the PBOC to lend directly to businesses, but policymakers will have to wait and see before making the decision; third, the Chinese government could establish a special relief fund and inject money into it with the support of the PBOC, and channel those money to local authorities. This is what the European Union is doing, and China may do the same, but again, it will have to wait and see.**

These are the new monetary policy instruments that can directly stimulate the real economy. Uncertainties remain as to what China plans to do in the next step, but better coordination between monetary and fiscal policies so as to channel funds directly to businesses in need is undoubtedly a choice worth considering.

Q: In order to boost effective investments, the Report has clarified that "priority will be given to new infrastructure and new urbanization initiatives and major projects", and stressed to "support private enterprises in participating in projects on an equal footing", and "ensure that projects are up to standard so that they do not create any undesired consequences". What institutional arrangements would need to be improved to avoid undesired consequences brought by overinvestments?

Liu Yuanchun: First, we must select high-quality projects. For example, China has launched infrastructure REITs. To ensure that these investment activities are market-based, rule-based and capital-based, and create a level playing field, we must choose projects that are up to scratch.

Second, for a lot of the new infrastructure projects, investors act at the same time as operators. That means private enterprises will have to engage themselves in every aspect of the projects to stay in the game under the pressure of market competition.

Third, we have to bring new operators to the table, explore more fund sources, and introduce new investment and revenue models. Of particular note, we must probe for new fund sources other than those of the traditional infrastructure projects. In other words, the keys to the success of new infrastructure projects are who should carry them out, and how they are carried out. China can of course learn from the experiences of Western countries, but it also needs to innovate based on its own practice in the past few years.

IV. Small and mid-sized banks face challenges in capital replenishments, and the pace and intensity of supporting policies must be carefully controlled.

Q: The 2020 Report has proposed many measures to step up the financial supports for businesses to keep them afloat, such as postponing principal and interest repayments on loans, and encouraging banks to substantially increase loan renewals without repayment of principals, etc. That has stirred some worries about the non-performing loan ratios of financial institutions, especially small and mid-sized banks.

Xiao Gang: That’s true. We are at a unusual time, and we have to take extraordinary measures, but meanwhile, risk prevention mustn’t be ignored.

Businesses and banks share weal and woe. If banks do not surrender part of its profits to help the real economy out, they will only end up with more risks when businesses become badly off or even collapse. But at the same time, small and mid-sized banks must attach great importance to risk control. That’s why the Report talked about how to help these banks replenish their capitals. In addition, small and mid-sized banks also need to improve their corporate governance, risk management and pricing abilities. Therefore, **it’s important to make well-rounded policy arrangements to support the sound operations of these banks.**

Q: What are the risks worth special attention in China's economy and financial sector currently?

Liu Yuanchun: First is that **growing bad debts have placed greater strains on the capital replenishments of small and mid-sized financial institutions**.

Second, the budgets of local governments are under huge pressure due to the pandemic, adding to **the risks of ballooning government debts and implicit debts. We must stop them from striking back.**

Third, the macro leverage ratio may swell in the foreseeable future, so we need to think about how to cushion its negative impacts and handle the consequent spike in the pressure to repay principals and interests. To that end, it's important to **further reduce the interest rate** so that the debt to GDP ratio can be kept relatively low.

Fourth, China is likely to see **tremendous cross-border capital inflows and outflows** because of the global financial turmoil and the fluctuations in the exchange rate of emerging economies. This is worth special attention at this critical period of time.

Basically, through the past years' efforts, China has already dissolved and curbed some of the financial risks it faced, but we must continue that endeavor to fight against the mounting uncertainties in the economy right now.

Q: What should Chinese policymakers pay special attention to in formulating fiscal and monetary policies now to prevent against financial risks?

Xiao Gang: We must adopt policies with proper intensity at a proper pace.

As a matter of fact, small- and micro-sized enterprises in China have stayed rather resilient. Back in February and March, the credit demands of small- and micro-sized enterprises, self-employed individuals, and consumers all plunged. In sum, these borrowings declined by around 60%. But according to my survey, **after the May Day holiday, the growth in borrowings by small- and micro-sized enterprises and the self-employed almost returned to pre-outbreak level**, which showed that these businesses are getting back on their feet again, that the economy is going back to normal, and that consumer spending is picking up. Of course, different sectors are seeing upturns to various extents, but the general picture is improving.

Against this backdrop, it's important to control the strength of our policies. I suggest to roll out policies in a tailored, phased manner instead of "all out at once". Things change fast, and uncertainties are on the rise, and we must adjust and improve the policies accordingly.

Q: You have proposed to ramp up the development of internet banks and improve their capacities to serve small- and micro enterprises. How to promote the sound and disciplined development of online banks?

Xiao Gang: All internet banks must go through strict approval procedures before they get licensed. But even if they get the licenses, it does not necessarily mean there are no risks, because it requires a lot of conditions to do online banking successfully, such as adequate capital and strong technological capacities. That's why we need to continue to enhance regulation on online banks.

I would like to stress a feature of online banks here, which is that **they actually lend a rather small amount of money to each of their clients on average—**30,000 to 40,000 yuan, according to my survey. In a recent dialogue with an online bank in China, it came to my attention that the bank wanted to lift its credit ceiling to about 100,000 yuan. But to be honest, that is still a very small amount. This low credit limit is one of the reasons why online banks can keep their risks in check. If they had elevated the limit to millions of yuan, like some of the P2P platforms used to do, I don't think the internet banks in China can be where they are today.