

Opinions

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Policy Announcement Effect: The Case of China



Kotbee Shin

Ph.D., Research Fellow, China Team

Korea Institute for International Economic Policy 

Since Mao Zedong manifested the first Five-Year Plan in 1953, the Chinese government has been leading national economic development with subsequent eleven Five-Year Plans up to date. The Plans consists of numeric targets for a variety of economic measures representing the direction and speed of reforms the government is pursuing. The old wisdom says that actions speak louder than words, but China has proved to be a counter-example until recent years. Not long after the announcement of the Plan, the economy was well on course to meet the targets. Even taking into account the fact that China is a country of socialism and can plan and manipulate the economy relatively easily, the achievements of economic planning are impressive in many dimensions, especially in terms of speed. The key factor

for success is policy credibility, which is one of China's historical legacies. While credibility may sound psychological, it is crucial to shape the real economy through expectations on the future state of the economy, based on which agents make their decisions.

Expectations are a tricky subject for policy-makers because they are, by nature, self-fulfilling. For example, if agents believe that the next period's inflation rate will be high, it would be better to consume more in this period rather than the next, which in turn, results in excess demand and then high inflation. Hence, inflation expectation anchoring is as important as inflation targeting in a monetary policy framework as it is relevant to the monetary policy transmission mechanism. Well-anchored expectations increase the effectiveness of policies. Since agents' expectations do not respond to policy, policy-makers can provide the intended stimulus to the economy. On the other hand, poorly-anchored expectations imply the risk of an explosive phenomenon such as Argentina's hyperinflation episode in the 1980s.¹

Keeping in mind that credibility and agents' expectations have a tight link to policy outcomes, I examine China's Five-Year Plan announcements, consumer expectation index and entrepreneur expectation indicator. My main findings are threefold. First, up until the eleventh Plan (2006-2010), policy announcements correspond to the significant improvements of the consumer expectation index. The entrepreneur expectation indicator seems to become more influenced, admitting that the relevant data is only available for the eleventh and twelfth Plans. Second, the sensitivity of entrepreneur expectations to policy announcements depends on firm type. Large firms adjust their expectations in the face of policy announcements to a greater extent than medium and small firms. This sensitivity is proportionate to firm size. Ownership is also a factor that affects the extent of expectation formation's reliance on policy. Last, I find that there is strong co-movement between China's GDP growth rates and consumer/entrepreneur expectation indices, with expectation indices slightly leading GDP growth rates by one to two quarters. These observations conform to the theoretical causality of expectations to subsequent realizations.

On the whole, the Chinese government has successfully delivered strong signals to the public with the Five-Year Plans so far. By virtue of decent credibility, the Plans have led economic development without worrying about the effects of policy announcements on expectations. However, I detect a sign of de-anchoring of expectations around the twelfth Plan announce-

¹ Argentina experienced hyperinflation peak in 1989, at almost 5000 percent of inflation. The inflation rate between 1980 and 1988 averaged 750 percent. Like other chronic hyperinflation episodes, Argentina also suffered recurrent hyperinflations after the implementation of stabilization policies.

ment. The consumer expectation index swung back and forth, detached from the announcement and the link between the GDP growth rate and consumer expectation index weakened. This goes in line with the increasing number of news that have been casting doubts on the Chinese government's credibility and the recent stock market plunge. Retrieval of policy credibility will be an essential prerequisite for the success of China's New Normal era. The experiences of central banks across the world suggest that communication and transparency are of great importance when it comes to credibility. **KIEP**