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Household consumption and monetary policy in China

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Abstract

In recent years, the People's Bank of China (PBC) has been relying increasingly on the adjustment of nominal interest rates for stabilization purposes. This paper employs the Euler equation approach to examine the effect of monetary policy, conducted through the interest rate channel, on household consumption. Econometric estimates of six related models suggest a weak substitution effect of the real interest rate. Inflation rates seem to be more relevant to household consumption decisions than do nominal interest rates. The results provide much evidence for the significance of liquidity constraints, but little for that of precautionary savings. © 2002 Published by Elsevier Science Inc.

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1. Introduction

Since the beginning of the 1990s, the Chinese monetary authority—the People's Bank of China (PBC)—has faced new challenges with respect to managing household consumption. At the beginning of the last decade, shortages were eliminated in major consumer goods markets, although supply bottlenecks existed in some sectors such as energy, transportation,

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and raw materials. Slack demand first appeared in the 1989–1991 downturn but was soon relieved by an investment boom triggered by government policy changes.[1] The demand constraint gained renewed attention when economic growth remained slow after the much-acclaimed "soft landing" in 1995. For the PBC, stabilization is no longer simply a question of reigning the expansion of demand, it also involves how to cope with lackluster consumption and investment.

Meanwhile, structural transformation of the economy invalidated the traditional tool for managing consumption—the cash plan. When segmentation between the circulation's of "household money" (cash) and "enterprise money" (bank accounts) broke down, the volume of cash flow was no longer a good indicator of the level of households' liquidity. With mounting financial assets besides cash, households no longer have to confine their consumption to labor income. Theoretically, this expansion of households' financial base introduces the possibility of managing consumption through interest rate changes. This possibility introduces intriguing research questions, however, because neoclassical consumption theory offers no clear-cut prediction about the effect of interest rate changes on the consumption of households that are net savers in the current period. Moreover, households may encounter more constraints in reality than in most general theoretical models; this complication is especially likely to be true for a transitional and less developed economy such as China.

This paper seeks to evaluate the scope for managing household consumption with monetary instruments in China. In particular, it examines the effect of interest rate changes on consumption (from May 1996 to June 1999 there were seven consecutive interest rate cuts). This will be achieved by estimating an array of Euler equation-based models. Two-stage least-squares (2SLS) estimation will be employed with instruments chosen from 14 alternative sets.

The paper is organized as follows. The next section reviews household consumption theory and introduces econometric models for empirical implementation. Data issues are discussed in Section 3. Section 4 presents regression procedures and results. Section 5 discusses policy implications and limitations of the study.

2. Consumption theory and econometric models

2.1. Consumer behavior, uncertainty, and liquidity constraints

The (real) rate of interest bears on household consumption decisions because it is the relative price of present consumption in terms of future consumption. Changes in interest rates will trigger intertemporal resources reallocation through both substitution and wealth effects. Moreover, a rise in the interest rate makes the same amount of savings more

[1] Macroeconomic policy was switched from tightening to expanding right after Deng Xiaoping made a famous speech during his spring tour of southern China in early 1992.