CHAPTER IV

NON-MARKET INTERVENTION

The decline in stock index makes the China's authorities worry. This financial market turbulence in China reflect the issue whether China's economy would "head into a hard landing or slowing too sharply" (Walker, 2015). China, a country with the largest economy and export in the world, is considered to have been exporting fear towards the investors, both domestic investors and foreign investors. China's financial market slowdown is feared would have an impact on neighbouring countries particularly that have a direct contact with China as the trading partner.

The explosion of economic bubble which led to the decline on the stock index is exacerbating the economic growth in China and harming the actor of the investment itself. Therefore, the investors and brokerages demanded the China's government to immediately overcome the financial market turbulence. As the regulator in economic activities, the central government of China is responsible to overcome the financial market slowdown through the policies. These policies will be used to correct the slowdown of the capital market in China. In this chapter, the writer would like to explain about the public policies which are fiscal and monetary policy issued by China's government to overcome the crisis.

A. Monetary Policy

General understanding of the monetary policy is how the central banks manage the supply of money called as liquidity, credit and interest rate. Similar with the fiscal policy, the monetary policy also has the important role in an economic term. According to Friedman (2012), monetary policy works around money and credit. The monetary policy is the independent policy that can only be conducted by the central bank. According to Niculae (2013) the monetary policy explains the way in which the central banks adjust the policy as a response towards the economic circumstance. Many economists have interpreted monetary policy in different ways. However, in general, monetary policy is the adjustment of the supply of money in order to direct the economy to the desired condition (Mathai, 2009). Mathai (2009) adds that the monetary policy is generally conducted by the central bank through adjusting the interest rate. The monetary policy is the important policy to achieve inflation and reduce the unemployment as well. When the policymakers are trying to influence the market, they have only two policy instruments whether it is fiscal policy or monetary policy. Monetary policy is one of the main policies as a tool to direct the balance of economy in certain country.

The monetary policy and the fiscal policy are related to each other. Both policies are the important tools for the government to intervene to the market. Therefore, in the practice, the monetary policy often deals with fiscal consequences, and vice versa. According to Šehović (2013, p. 5-27):

> Monetary policy impacts on interest rates and inflation. The level of interest rates reflects its direct impact on fiscal policy through the cost of servicing the public debt that affecting the calculation of its sustainability in the country. On the other hand, the volatility of interest rates may be one of the factors that can affect the fluctuation of surplus that would be sufficient to stabilize the relation between debt and output. Finally, high inflation is another factor that causes many implications on the public finances of economy, starting from an increase in the actual tax burden until creating the pressure on the expenditure side of the budget due to increased transfer of public expenditures, and generally prevents the making of any accurate fiscal projection for the future.

In addition, Šehović (2013, p. 5-27) also explain that the fiscal policy also has impact towards the monetary policy as follows:

> The fiscal policy affects monetary policy through a variety of direct and indirect channels. The most important is certainly the fact that expansionary fiscal policy can result in large fiscal deficits, which may present a challenge for the government to put pressure on the monetary authorities to monetize the deficit, promoting an expansive monetary policy, rising inflation expectations, disrupting the exchange rate, causing a problem with payment balance, and finally with the ability to influence the formation of a currency or financial crisis.

The effectiveness of the monetary policy itself still becomes the debates among the experts. The question whether the monetary policy really works during the recession/crisis or not is still the main debate among the experts. It cannot be denied, in answering this question there are some pros and contras. One group of economists believes that the monetary policy is the absolute answer during the recession, those include Taylor (2009), Mishkin (2009) and many more (Silvia & Iqbal, 2011). Silvia & Iqbal (2011) add that this group believes that the monetary policy is the effective policy for countercyclical stabilization, in addition, they think that the fiscal policy will only create the inflation that will not work during recession. On the other hand, the economist such as Paul Krugman believes that the fiscal policy is still a better policy for the recession (Silvia & Iqbal, 2011). Though the effectiveness of monetary policy and the fiscal policy is still being the debate among the economist, the big country such as the United States, United Kingdom, China and others still use both monetary policy and fiscal policy (Silvia & Iqbal, 2011). Seeing this reality, in can be concluded that the experts will maintain their opinion that they think it is true, no matter what.

The China's stock market crisis influences the sustainability of its economic growth and the investors. Most of the Chinese people are expecting a healthy growth of its country's economy. If China's economy is able to move to the slower growth but also sustainable, it still can increase the standard of living of Chinese people. However, if the slowdown itself is considered as a serious slowdown, it will cause business failure and loss of job. Most of the investors who purchase the shares near the explosion of bubble will experience the severe loss. The stock market crisis makes the China's stock market dropped from its highest rate into the lowest rate. The decline on China's stock market perceived will exacerbate the economic growth in China. That is one of the reasons for the investors to shut down their business due to the fear that it will go worst. The business within the country is supported by the good economic growth, however, if the economic growth itself is going worse, it will influence the business within the country. Seeing the condition that China is now experiencing the slowdown, many parties such as investors and other countries are demanding China to issue the public policies to rescue its slowdown. The central government of China also issued the monetary policy as a response towards its stock market crisis.

The China's financial crisis cannot be separated from the monetary policy in which it is the important tool to stimulate market efficiency. In the context of China, the central government issued monetary policies (called as the patriotic policy) which address the stock market crisis. According to Long (2015), these monetary policies includes: First, the China's Securities Finance (CSF) will lend money to the market amounted US$ 42 billion equivalent to 260 billion Yuan. This stimulus is given to 21 brokerages firms to encourage them to purchase the blue chip stocks. The China's authority believed that this effort will help to lift up the stock indexes in its stock market. The China's Securities Finance (CSF) will also purchase the small and medium shares. The purchase of the shares whether it is small shares or medium shares, will help to increase the stock indexes. Second, the central bank of China has cut the interest rate into the lowest rate. This effort aims to pump the money supply to the system. Third, the China's government devaluate Yuan towards the US dollar. This effort aims to boost the export.

Through the devaluation of Yuan, market has roles in valuing the currency. Now, it sets the Yuan's daily fixing to the United States' dollar based on the currency closing level in the previous day (Curran, 2015). Curran (2015) adds that by keeping the currency, the mechanism can protect China from the financial crisis or market turmoil.

The China's government efforts to respond the decline on the stock market have already been done. The monetary policy, one of the public policies, has been issued by the central government. All the major action taken by the government has been done. However, China's stock market has not been calm yet. After the government issued policies, the China's stock market is still experiencing the uncertainty in which its indexes are going up and down. Sometimes, when it is opened, it will increase highly but when it is closed it will go down (Supriadi, 2015). Such condition still worried the investors to continue the investing activities in China. See the condition in which it still gives the uncertainty after the issuance of the public policies makes the investors do not trust the government action anymore. If the stock market crisis is not handled properly, it will damage many parties, particularly the investors as the actors of the investment.

The efforts done by the central government of China are considered not effective to calm down the stock market crisis in China. It seems that the investors do not trust the China's government because the China's stock market continues to move erratically. After the launching of China's public policies towards the stock market crisis, China is still experiencing the lost. According to Bospoke Investment Group cited by CNN Indonesia (2015), the China's stock market has lost US$ 3.25 trillion which is greater than French's stock market capitalization (Supriadi, 2015). Due to the failure of these policies, people think that the China's government is incompetent in response to the stock market crisis. The monetary policy proposed by the government is not capable and ineffective to overcome the China's stock market crisis.

B. Fiscal Policy

In terms of economy, fiscal policy is one of the important policies besides the monetary policy. "Fiscal policy means the use of the public revenues and expenditures for the realization of the goals of economic policies" (Krasniqi, 2013, p. 465). According to Krasniqi (2013), the fiscal policy has to do with the long-term effect that can accelerate the economic growth. Fiscal policy usually works through incentives (such as tax reduction) and spending (such as government spending) (Silvia & Iqbal, 2011). The public spending is the important tools to boost the economy particularly during the crisis. It can also help to increase the aggregate demand so it can accelerate the economic growth. The fiscal policy is usually conducted by the government. The government influence the economy through taxes and spending.

The crisis has the negative effect towards the economic condition within the country, particularly the financial sector. During the crisis, people are losing their job, the investment stopped, the consumers spending is declining, and finally, the economy is getting worse during the crisis. In this situation, the government have responded through fiscal stimulus which is discretionary spending and tax cuts (Horton & El-Ganainy, 2009). The fiscal policy has the similar policy with the monetary policy which is to direct the economy to the desired condition. What distinguishes both of them is the instrument that they used. If the monetary policy is to control the supply of money, the fiscal policy is to control the public revenues and the spending (Krasniqi, 2013).

The decline on the stock index in China has sparked panic among the investors and also neighbouring countries. The decline which was followed by the economic slowdown will become a threat of the global economic downturn after Greece. In response to this event, the President Xi asks the investors to calm down and imagine this country as large vessel that sometimes may sail with the unstable sailed in the sea (BPF News, 2015). In other word, President Xi asks the investors to calm down in seeing the stock market crisis.

Over the past few decades, China's economy has always shown the extraordinary growth. However, when a problem arise, it will create panic in global economy. As what is happened in the case of stock market crisis. China is now the biggest force in global economy which will directly affect the economic viability in the world. The effect caused by the decline of stock index is felt terrible for the domestic investors. In China, people or institutions that borrowed money to buy shares near to the decline experienced severe loss, particularly those who are engaged in retail business. Now, the investors are looking for the responsibility of the China's authority.

The stock market crisis has become a concern because it is feared that it will become a reflection towards a greater economic slowdown. Not only an economic issue, the decline on the stock index is also reflected the political issue that should be taken seriously by the China's authority. Therefore, the China's government issued a fiscal policy through pouring money which amounted US$ 40 billion to stimulate the economic growth which will be used in the infrastructure project (Long, 2015). China's Finance Ministry said it would issue strict fiscal policies to boost the economic growth and save the stock market in China (Bloomberg News, 2016). The fiscal policy becomes the main method to increase the demand and investment. In addition, it will create productive investment for the long term investment. In China, the infrastructure becomes the driver of its economic growth since it is the profitable investment for China. The adequate infrastructure will support the economic growth. The allocation of fund in infrastructure is expected to help the economic growth better. Moreover it can be the way to save the stock market crisis in China.

According to McKinsey Global Institute, since the global financial crisis, many investments fell in some countries with the large economy including the

United States (Coy, 2016). However, it is different from China that is still able to build infrastructure. Since the beginning of the economic reform until this twenty-first century, the infrastructure in China continues to change in terms of quality. In its development, China's government spends more on infrastructure rather than other countries do. The MGI (McKinsey Global Institute) report shows the China's infrastructure spending that is stronger than the other countries such as United States, Middle East, India, etc (Coy, 2016). However, since the decline on the stock market, many investors shut down the business which led to the decrease of the companies listed in the Shanghai stock exchange composite index and Shenzhen stock exchange composite index. They are approximately over half of the companies which decided to pull their shares (Yan, 2015). In addition, the China's foreign direct investment in 2014 dropped 0.4% compared with a year ago (Wang & Qing, 2014). This is the first time the China's foreign direct investment experienced decline over the past few months. Therefore, the China's authority will issue more strict fiscal policy. It is done through allocating the fund towards the infrastructure project so that it will create the productive investment.

In the chart below, it represents the comparison of the infrastructure development between regions. Coy (2016) adds that the coloured one represents the various investments while the width represents the large of its economy.

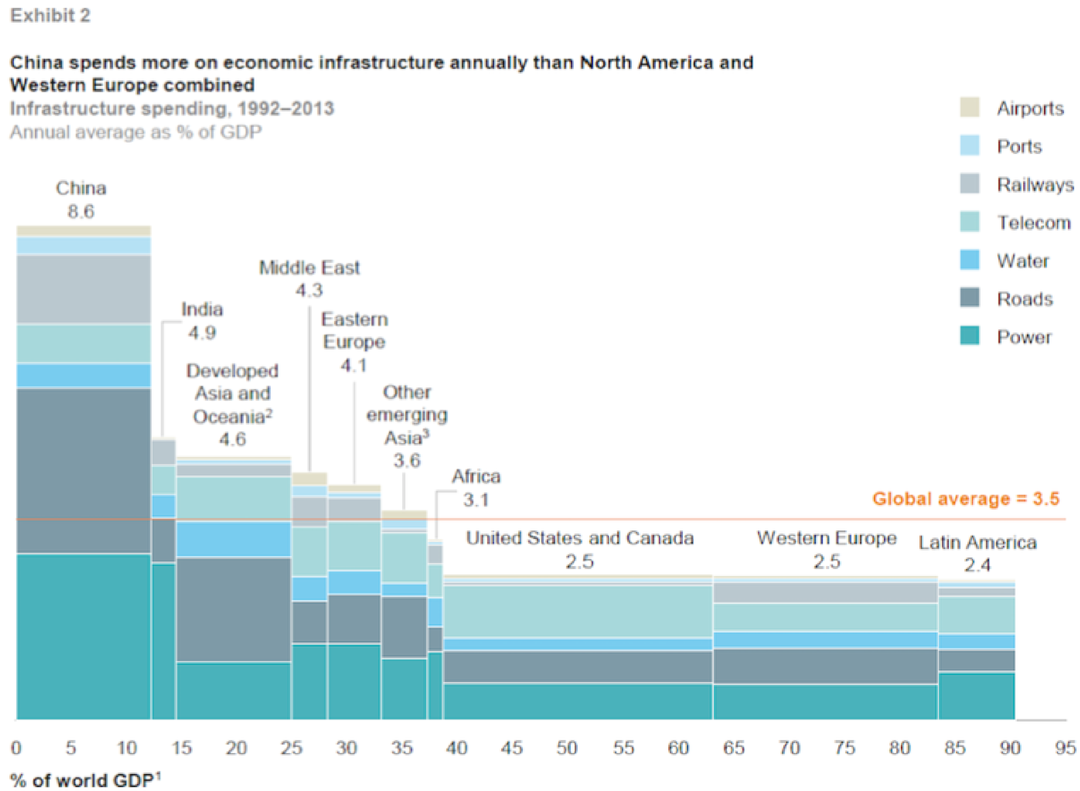

Figure 4.0.1 Infrastructure spending comparison in 1992-2013 (Coy, 2016)

The productive investment is believed to be the reason for the investors to invest in China. The China's government plan to accelerate the spending on infrastructure and granting flexibility access to the private investors to invest in some aspects such as education and medical care (Bloomberg News, 2016). The fiscal policy that emphasizes the infrastructure development is seen as a policy that can rescue the stock market crisis. Moreover, it can also increase the aggregate demand. Unlike the speculative, the infrastructure development is closely linked to long-term investment that can stimulate investors. The long-term investment is considered more secure rather than the short-term investment that is more speculative.

Unlike the monetary policy, the result of the fiscal policy whether it is effective or not is still cannot be decided. The fiscal policy which operates in the government spending and tax needs some times to decide whether or not it is effective. It needs some times to complete the infrastructure project until it can be said effective or not. It also applied in the case of China, the China's fiscal policy that operates in building the infrastructure needs long time to complete it. Therefore, it cannot be said yet whether it is effective or not.