

# *Research on the Relationship Between China's Monetary Policy and Inflation*

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**Abstract:** Inflation is the phenomenon of a significant and sustained increase in the overall level of monetary prices of goods and services. If inflation gets out of control, it will undermine the credit foundation of society and cause adverse effects on the economy. How to effectively control inflation while maintaining economic growth is an important challenge faced by monetary policy makers. Central banks often adopt contractionary monetary policies to control excessive inflation. China has taken measures such as tightening monetary policy and controlling credit in response to previous inflation incidents. However, in the face of new situation in the world economy, especially against the backdrop of China's relatively low inflation rate in recent years, it need for a more flexible and forward-looking monetary policy. This article suggests that Chinese monetary policy makers pay attention to the balance between controlling inflation and maintaining economic growth, flexibly use various monetary policy tools for fine-tuning, and strengthen the coordination and cooperation between monetary policy and other macroeconomic policies.

**Keywords:** China, monetary policy, inflation.

## 1. Introduction

Inflation is an economic phenomenon. From a historical perspective, since the emergence of undervalued currency, inflation has accompanied the development of human society, sometimes severe and sometimes mild. In the past century or so, inflation has become a global problem. Since 2019, influenced by multiple factors such as loose monetary policies of major economies, geopolitical conflicts, global supply chain turbulence, and market expectations, the global inflation rate has set a record high since the 21st century, far exceeding the 2% target commonly set by central banks around the world. From a practical perspective, whether the fight against high inflation in 2024 can be successful and what kind of monetary policy will the Federal Reserve and central banks of various countries adopt are key topics that the market continues to pay attention to.

People have conducted extensive research on inflation and reached some consensus, but there are still many differences, even regarding the definition of inflation, which is the most fundamental issue, the academic community does not have a completely consistent understanding. Overall, inflation manifests as an increase in the overall price level and a decrease in the value of money.

If inflation is not so severe or within expectations, it may not necessarily be a bad thing, or even a good thing. However, when the degree of inflation exceeds expectations, it can undermine the credit foundation of society, cause wealth transfer, and make people lose patience for the future. The

economy can have adverse consequences due to inflation, including currency depreciation, reduced savings value, and undermining consumer and business confidence.

In the complex and ever-changing global economic environment, The impact of monetary policy on inflation has always been of particular concern to governments and economists around the world. It is generally believed that inflation is caused by the money supply exceeding the necessary amount, and to curb excessive inflation, a tight monetary policy is needed. Monetary policy, as an important means of macroeconomic regulation, has a direct impact on inflation. This is of great significance for macroeconomic policy-making and economic management.

The research objective of this article is to analyze the specific relationship between China's monetary policy and inflation based on the basic theoretical framework of inflation and monetary policy and provide targeted recommendations. Firstly, the introduction in the first part introduces the research background and objectives of this article. Then in the second part, the theoretical framework of monetary policy and inflation is elaborated, and the importance of monetary policy in controlling inflation is analyzed. The third part discusses the characteristics and challenges of China's monetary policy and proposes strategic recommendations for China's monetary policy to address inflation. The fourth part of the conclusion summarizes the main points, conclusions, recommendations, and prospects for the future of this article.

## **2. Theoretical Basis**

### **2.1. Concept, Objectives, and Tools of Monetary Policy**

Monetary policy usually refers to the measures taken by the central bank to influence investment and the overall economy by adjusting the money supply and interest rates in order to achieve specific economic objectives [1]. The country will adopt "tight", "loose" or "moderate" policies on the money supply according to different stages of economic development. Central banks regulate the money supply through the use of a variety of tools to adjust market interest rates, which in turn affect capital investment, thereby regulating overall macroeconomic demand. The four main monetary policy tools include the reserve requirement ratio, open market operations, discount policy and benchmark interest rate. Among them, Items 1 to 3 belong to quantitative monetary policy tools, which focus on regulating economic operations by directly adjusting the money supply. The fourth item belongs to price based monetary policy tools, which indirectly regulate market expectations and economic behavior through changes in asset prices.

### **2.2. Definition, Types, and Causes of Inflation**

In the Western economic community, there are generally two approaches to defining inflation. One viewpoint is to define inflation as the sustained increase in the overall price level. Samuelson is one of the representatives of this viewpoint, who believes that inflation means an overall increase in price levels, with prices of goods and services generally rising [2]. There is a view that inflation is only true when the excessive growth of the money supply causes prices to rise. The famous economist Milton Friedman was a major proponent of this theory. He argues that inflation is always a money-induced phenomenon, which occurs when the growth of the money supply far exceeds the growth of the output of goods and services. If the amount of money circulating in the market increases more than the available goods and services, then the price level will rise, leading to inflation [3].

At present, the definition of inflation mostly starts from the phenomena it manifests. Inflation is generally defined as the phenomenon of a significant and sustained increase in the overall level of monetary prices of goods and services [4]. In theory, inflation can be divided into four types: "cost push" inflation caused by rising prices of raw materials such as commodities, "currency devaluation" inflation caused by excessive circulation of currency in the market, "demand push" inflation caused

by excessive demand leading to supply shortages, and "expectation poor" inflation driven by market entities' predictions of future price increases [5].

The causes of inflation can be mainly attributed to two categories: one is spontaneous inflation caused by loose monetary policies and rising labor costs in the country; The second is input inflation caused by factors such as loose monetary policy, global supply chain restructuring, and wars. The OECD has found that the input characteristics of this round of inflation since 2019 are quite obvious [6].

### **2.3. The Importance of Monetary Policy in Adjusting Inflation**

The monetary policy framework of the United States is based on the "dual mission" given to the Federal Reserve by Congress, namely "promoting maximum employment" and "maintaining price stability" (usually reflected by controlling inflation rates). These two goals are contradictory. In order to promote employment, it is necessary to implement a loose monetary policy, which may induce inflation. Controlling inflation requires adopting a tight monetary policy. Therefore, the Federal Reserve must strike a balance between promoting employment and stabilizing prices, both of which are equally important.

Generally speaking, inflation is caused by the money supply exceeding the necessary amount, resulting in total social demand exceeding total supply. Measures to suppress total demand should be taken, such as tightening consumer spending, investment spending, and government spending, to promote total demand to approach total supply and stabilize prices. There are two main policies to suppress aggregate demand: tight monetary policy and tight fiscal policy.

In terms of tight monetary policy, specific measures include: (1) selling securities during open market operations to reduce the money supply in circulation, such as selling government bonds, which is the most important and frequently used policy tool. (2) Increase the rediscount rate. (3) Increase the statutory reserve requirement ratio. (4) Directly raising interest rates and tightening credit scale in countries with interest rate controls. Whether indirectly increasing interest rates by contracting the money supply or directly raising interest rate levels, an increase in interest rates will reduce people's consumption demand and increase savings; The increase in interest rates also means an increase in investment costs, which will have a restraining effect on investment demand.

If people delve into the root causes of inflation, people can further discuss monetary policy. Murray Rothbard proposed that inflation is not only due to the increase in the quantity of money, but also involves the depreciation of the value of money. He believes that government intervention in the money supply is the main cause of inflation, which reduces the purchasing power of money and thus triggers price increases. By analyzing historical cases and economic theory, Rothbard delves into the complex relationships between central banking, fixed exchange rates, and inflation, and reveals that inflation tends to benefit only a few people. He pointed out that when the government manipulates or influences the flow of money in the market, it directly reduces its real value, making ordinary consumers pay higher prices for the same goods and services. This process not only harms the public interests, but also aggravates the unequal distribution of wealth in society. Rothbard warned that if the international monetary system cannot be reformed at the basic institutional level, the inflation rate of all mankind will become increasingly fast in the future, and even impossible to deal with [7].

## **3. Characteristics and Challenges of China's Monetary Policy**

### **3.1. China's Monetary Policy and Inflation**

China's monetary policy is an important tool for macro-control and has a direct impact on the level of inflation. When the inflation rate is high, the central bank usually implements a contractionary monetary policy to reduce aggregate demand by reducing the money supply in the market and raising

interest rates, so as to curb inflation. In this case, the central bank may take a variety of measures. For example, it can sell government bonds through open market operations to soak up liquidity. In addition, raising the reserve requirement ratio is also a common method, which forces commercial banks to keep more money in reserves, thus reducing the money available for lending. Together, these strategies can effectively slow down the overheated consumption and investment activities in the economy and help to keep price increases within a reasonable range.

China's monetary policy has multiple objectives. Article 3 of the Law of the People's Bank of China states that monetary policy is aimed at keeping the value of money stable to promote economic growth. Monetary value stability here involves price stability and control of inflation, while promoting economic growth includes job creation. Broadly speaking, China's monetary policy framework seeks to strike a balance between "maintaining the stability of the value of the currency, including containing inflation," and "promoting economic development, including increasing employment."

China's monetary policy covers the ultimate target, policy tools, operational indicators and intermediate targets. The ultimate goal is usually to balance economic growth with price stability. The main operational tools include credit programs, central bank loans, interest rate policies and deposit reserve ratio. In the process of operation, the deposits and base money of the specialized banks of the central bank are key indicators. On the intermediate target, it focuses on a series of indicators, such as the amount of cash in circulation, narrow money (M1), broad money (M2), and the scale of national bank loans.

Since China's reform and opening up, the economy has experienced seven major economic fluctuations, five of which were inflation. These five instances of inflation occurred in 1980, 1985, 1987-1989, 1993-1995, and 2007-2008. Inflation has had varying degrees of negative impact on China's economy and society. These inflationary pressures are all related to excessive investment leading to currency issuance or loosening of previous tightening policies. China's monetary policy mainly focuses on tightening monetary policy and controlling credit, adopting measures such as interest rate hikes and increasing reserve requirement ratios, effectively controlling the spread of inflation.

China has long regarded quantitative monetary policy as its main regulatory tool. Compared to the United States, which mainly adopted price based monetary policy tools since the 1990s, China only began to transition to price based monetary policy in 2013. However, due to the problem of poor transmission channels of interest rates in China, quantity based monetary policy still plays a buffering role during the transition period of monetary policy [8].

Excessive inflation is harmful to economic and social development, while low inflation rates or deflation are also detrimental to economic and social development. Compared with the high global inflation, the situation in China is different. Inflation, at about 2 per cent, is still low. In the face of downward pressure on the economy, the direction of China's monetary policy is crucial to promoting economic growth. In the global inflation wave, the inflation of China and the United States showed a significant negative correlation. Thus, unlike the United States, which has adopted high interest rates and tight monetary policy, China is currently pursuing a supportive monetary policy to provide fiscal support for continued recovery and improvement.

### **3.2. Strategic Suggestions for China's Monetary Policy to Address Inflation**

Firstly, monetary policy should be flexibly adjusted using various monetary policy tools based on the international and domestic economic situation. Monetary policy makers need to closely monitor the status of world affairs, keenly perceive changes in the situation, timely assess inflation risks, scientifically formulate and adjust monetary policies in a timely manner, continuously innovate and

improve monetary policy tools, effectively control inflation while maintaining economic growth, and better respond to various challenges and risks.

Secondly, monetary policy needs to strengthen coordination and cooperation with other macroeconomic policies. Monetary policy should be coordinated and coordinated with fiscal policy, industrial policy, etc. In the current situation of slowing economic growth, monetary policy should be closely coordinated with proactive fiscal policy and industrial support policies to form a policy synergy, jointly promoting stable economic growth and basic stability of price levels.

Thirdly, the central bank should appropriately utilize price based monetary policy tools. While continuing to use quantitative monetary policy tools such as the statutory reserve ratio, open market operations, and discounting, people will further open up channels for interest rate transmission and actively leverage price based monetary policy tools such as interest rates and exchange rates.

#### 4. Conclusion

The above analysis indicates that monetary policy makers need to maintain a balance between controlling inflation and promoting economic growth. The formulation of monetary policy is not achieved overnight, but an art that requires careful planning and flexible adjustment. Loose monetary policy can stimulate economic growth, but it may also exacerbate inflationary pressures. Once excessive inflation occurs, it is necessary to adopt a tight monetary policy to curb inflation. On the other hand, a tight monetary policy can curb inflation, but an excessively tight monetary policy may also suppress economic growth, lead to rising unemployment rates, and even trigger economic recession. In this case, a loose monetary policy stance should be adopted instead. Especially when the inflation rate is low and the economy is facing downward pressure, a tight monetary policy cannot be adopted. The art of balancing inflation and monetary policy is an important issue in macroeconomic management and a core task for monetary policy makers.

Based on the current international and domestic economic situation, China should adopt a moderately active supportive monetary policy. Given that China's domestic inflation situation is different from that of the United States and Europe, facing not the risk of high inflation, but the risk of sustained low inflation, efforts should be made to avoid the risk of deflation. Therefore, China needs to adopt a moderately active supportive monetary policy. In terms of the combination of monetary tools, while adopting quantitative monetary policy tools, people should further open up the transmission channels of interest rates and make better use of price based monetary policy tools. People should Strengthen policy coordination closely coordinate monetary policy with active fiscal policy and supportive industrial policy, ensure a certain economic development speed, and vigorously promote economic and social development.

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