Summary

Growth has been a hallmark of Chinese economic development. In recent years, however, China's GDP growth has slowed down considerably while countercyclical government policy has taken center stage. This is especially the case following the 2008 financial crisis, when the government injected 4 trillion RMBs into investment to combat a sharp fall of output growth. Issues related to both trend and cycle are now on the minds of policymakers and economists.

The goal of this paper is to identify the driving force behind rapid growth and cyclical fluctuations in China. We find that growth and cyclical swings are deeply rooted in China's institutional arrangements. We argue that preferential credit policy to promote heavy industries accounts for the unusual cyclical patterns as well as the post-1990s economic
transition characterised by a rising investment rate, a declining labor income share, and a growing foreign surplus. Our research suggests that such preferential policies distort business finance and have positive as well as negative consequences.

Negative consequences include the rise in indebtedness of large firms which has become an issue of some concern for policymakers, and the increasing difficulty of obtaining investment loans by small businesses (see, for example, recent articles in Financial Times and Wall Street Journal). The spectacular growth rates in recent years have been fueled by preferential credits to unproductive large firms at the cost of loans allocated to more productive small firms. Going forward, we argue that effective policy should be aimed at reducing the preferential credit access given to large firms especially those in the heavy sector. This adjustment is necessary to alleviate the growing pain of low consumption and income growth experienced in China.

Our theoretical framework offers a constructive framework to study these issues as well as other related macroeconomic issues. In addition, the paper documents several striking facts of trend and cycle that characterize China’s macroeconomy. We provide a core of quarterly macroeconomic time series data for systematic research on China. Moreover, our theoretical model's mechanism and assumptions are corroborated by institutional details, disaggregated data, and banking time series data, with distinct Chinese characteristics.

The Eighteenth National People's Congress in 2012, when discussing various policy goals, explicitly expressed concern about low consumption growth and the labor share in China. We argue that financial reforms geared at eliminating the distortions in business finance highlighted in this paper would go a long way toward making short-term and long-term loans
more efficiently thereby putting the economy on a more balanced path. It is our hope that this paper will stimulate further research on China's macroeconomy.