

## The Study on the Causes of Inflation in China

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**Abstract:** Inflation is a continuous rise in the general price level for a certain period of time. In the past decade, while China's economy has developed rapidly, people's income has increased continuously and the price level has continued to rise. The causes of this inflation phenomenon are complex, which is not promoted temporarily, but formed under the background of reform and system transformation recently. Firstly, combined with the domestic and international situation and existing theories, this paper presents an overview of the current concept of inflation; then it analyzes the causes of inflation in China and summarizes three main causes; and the corresponding countermeasures are given for the three main causes, so as to create a good environment for the development of social economy.

### 1. Introduction

#### 1.1 Inflation Characteristics and Related Situation in China in Recent Ten Years

Since the reform and opening up, China's price level has experienced continuous rise; After entering the 21st century, with the continuous enhancement of China's economic strength, serious inflation has withdrawn from the historical stage. By contrast, measured by China's inflation rate, CPI index and PPI index in recent 10 years, China's inflation has been relatively mild in recent years, showing cyclical and comprehensive characteristics, and has had a significant impact on China's macroeconomic field [1]. There are many different explanations about its causes. This paper mainly studies the Demand-pull Causes, Cost-push Causes and Currency Causes [2].

#### 1.2 The Importance of Studying Inflation

Inflation in the past decade has significantly affected China's macro-economy, and the overall rise of price level has had an impact on Residents' consumption level. And inflation will affect the distribution and redistribution of social wealth and income [3]. At the same time, Phillips Curve illustrates the impact of inflation on the relationship between unemployment and employment. Therefore, the problem of inflation needs to be solved urgently, and the importance of introducing policies for adjustment lies in maintaining the stability of China's macroeconomic environment, which is of great significance to the development of politics, economy and society.

### 2. Definition and influence of inflation

#### 2.1 Definition of Inflation

Inflation is a kind of activity that can devalue the national currency, which causes the sustained, widespread and irreversible rise in prices of goods in this country. Inflation can be divided into three

types: Low inflation, Hyperinflation and Galloping inflation. In the equation of exchange,  $MV=PT$ . M means the amount of currency, P is the price level, which is a measure of inflation, and T is the total exchange, which is the total output of the economy. By seeing this equation, people can understand the direct connection between four variables. Inflation have three expressions: demand-pull inflation, cost-push inflation and built-in inflation. Inflation can occur when the amount of currency in the market is more than the total amount of money required in the society and market. The reason of increasing amount of currency can be caused by two main reasons: the monetary policy and nonmonetary policy. Monetary policy: using loose monetary policy and interests rate to regulate market. Nonmonetary policy: the excessive trade surplus, the surplus of foreign exchange reserve and monopoly.

## **2.2 The Influences of inflation**

The decreasing purchase power is the first influence. The quantity of money people stored in the bank is unchanged. But during the inflation, the price of different goods increase, which leads to the power of the money people own decreases. For instance, a tool used to cost 3\$, but now people have to spend 10 \$ to purchase the same tool. People in the past used to buy more than 3 tools, but now they can only buy one. Secondly, more investment can happen in the inflation. According to David Floyd's idea , when money lose its value, it is better to spend it out instead of storing it in bank. Consumers prefer to spend their money on capital goods such as cars, machines and electronic goods[4]. For instance, when people know that if their money in the bands will lose its value, they will be more likely to spend money on something that have good ability to hold its value and increase profits. Under this circumstance, my parents always spend their money on buying residential holdings, jewelry and cars. The reason why they bought these things is that these capital goods always keep their value and help people store their money in stable ways. Thirdly, increasing borrowing cost is caused by inflation. Countries' governments always want to increase the economic development. Some nations give out the fine monetary policy to help people start up their own businesses, borrow some capital goods. The central governments always relies on interest rate to encourage spending. However, when there is too much currency in the market, the banks start to increasing the borrowing cost to reduce the currency on the market. When the borrowing cost keep rising, people will be unwilling to withdraw money from the bank because it is not cost-effective to do this than borrowing from other relatives. Decreasing unemployment rate is the last influence. When the money lose its value in the market, the money needed to employ a people increases. According to the graph drawn by David Floyd, when the unemployment decreases, core CPI increases, which means that managers have to more wage to employees and then the purchasing power of employees increase [5].

## **3. The Causes of Inflation**

### **3.1 Demand-pull Causes**

Demand-pull causes mean that the inflation caused by rising prices due to the excessive demand in the whole economy.

1)One of the causes of inflation can be explained by Phillips curve. This is first created by Keynes, who considered that the unemployment rate and the inflation rate would influence each other, if one of theses increased, the other one would decrease [5]. Under the condition of almost full employment and efficient utilization of resources in China, as the aggregate demand continued to rise, but the total real output could not increase because of the limited resources, more producers would raise the prices of good and services in order to earn more money, then the price level in China would grow up, finally going to be inflation. According to some statistics, China's unemployment rate in the recent ten years were sustained below 4.3%, and the overall trend was downward. People were almost fully employed and had higher living standard, therefore the inflation had been further stoked.

2)The increase on the data of the inward investment in China in recent ten years also promoted some extent of increase on aggregate demand, then promoting the inflation. This kind of investment gives the domestic goods and services more quality and competitiveness, consumers' demand will also

rise with the increase on quality of goods. Firms will raise the price because of the excess demand, therefore rising the price level and causing the inflation. It is shown in the China's data in recent ten years that the overall trend of foreign direct investment kept growing, raising the competitiveness and demand of the domestic products, and finally becoming one of the causes of inflation.

3) The rise of the government spending is also one of the causes of inflation. Since 2010, Chinese government spending figures have been rising since 2010. This is because the government spend more funds on the bridges, high-speed rail and other infrastructure. The AD will increase because government demand is also one of the components of the aggregate demand, finally form the inflation [6].

4) Furthermore, China's inflation also can be caused by the widening gap between import and export. According to the data network in China, the magnitude of the export from China kept rising in recent ten years, the overall gap between export and import also became wider, and China also consistently led the world in foreign trade surplus. In such condition, the domestic products are more and more exported to the foreign countries, and there will be more foreign currency transported into China. To solve the difference in money flow which comes from this condition, the b.o.c would passively increase the circulation of the domestic money, and therefore increasing the price level, becoming one of the causes of the inflation.

### **3.2 Cost-push Causes**

The rise of world oil prices can raise China's inflation rate to a certain extent. China as a major importer of oil, the change of the prices of oil will influence most of the productivity in the country. According to the data, nearly a fifth of China's oil is come from Saudi Arabia. In the recent years, the prices of the oil came from Saudi Arabia increased because of the internal attacks and other reasons, and the money spent by China was also increased. Most of the domestic costs in productivity, such as gasoline, plastics and so on, were increased because of the condition. Producers would rise the price according to the rising costs in order to have more profit, and then became one of the causes of inflation [7].

### **3.3 Currency Cause**

Currency cause occurs when the money supply exceeds the actual demand, and then make the value of the domestic currency decrease. Some products may need more money to buy, and the price level increases due to this condition, then causing the inflation. Although the money supply of China in recent years are going to be stable, there are still some period of time contain a upward trend, and the total exceeded supply amount of money in China [M2] already exceeds the sum of the US and Europe. The main reason of this situation is come from the gap of export and import. This oversupply has led to a decline in the value of China's currency over the past decade, and then cause the inflation.

## **4. Analysis Countermeasures and Causes**

### **4.1 Countermeasures**

#### **1) Implementing *macro-tight monetary policies***

In managing inflation, the government can directly control aggregate social demand by increasing fiscal revenues or reducing fiscal expenditures through austerity fiscal policy to curb the growth of aggregate social demand. The government should compress government expenditures through fiscal surpluses. On the one hand, the government can achieve fiscal surpluses by increasing taxes or by adding new taxes and raising tax rates to control the disposable income of taxpayers. On the other hand, the government can reduce government budget expenditures by compressing expenditures, changing deficit budgets to austerity budgets, and reducing the scale of investment and capital construction spending. This will effectively reduce inflation.

#### **2) Implementing macro-fiscal austerity policies**

In response to inflation, the central bank implements a tight monetary policy that directly reduces the money supply. Specific practices employed include increasing the legal reserve ratio, with the

result that the ability of commercial banks to provide loans and create credit decreases and the money multiplier becomes smaller, leading to a reduction in the money supply and thus weakening the ability of commercial banks to create derivative deposits. As well as increasing the discount rate, the same future money becomes less valuable when converted into today's money, thus affecting the cost of borrowing for commercial banks and leading to a decrease in commercial banks' borrowing from the central bank.

### 3) Implementing an expansionary industrial policy

Industrial policy is the sum of various government policies that intervene in the formation and development of industries in order to achieve certain economic and social goals. Industrial policy can regulate supply, transform industrial structure by promoting or restricting the development of certain industries, adjust the interrelationship between industries so that both the total supply and structure can meet demand, and achieve a balance between the total supply and demand, and the structure. Therefore, industrial policy has a guiding role in adjusting the structure of supply and demand in the market, adjusting the relationship between industries, and helping to achieve a balance between supply and demand in the market. Therefore, the government can exit the industrial policy suitable for each situation to alleviate inflation [8].

## 4.2 Analysis of Causes

### 1) Stability of Employment and Income

In China, the stability of employment rate in foreign-owned enterprises is relatively low, rather than private enterprise and some individual economies are more stable. Labors always prefer those enterprises with stable employment rates —government agencies, public institutions, nation-owned enterprises, etc. Thus, this tendency leads to a one-way flow into the system. The index of the stability of employment rate — term of labor contract — is insufficient. Firstly, The violation of the companies leads to the termination of the labor contract, companies dissolve the contract by mistake, lay off and other reasons result in the real number of years labor devoted in the company is smaller than the years on the contract. There is no labor contract between companies and laborers. Influence factors of super-stable employment. There are many reasons for laborer's preference for super-stable employment, such as psychology, culture, economy and system. Psychological factors: workers are usually risk-averse and give higher weight to certainty returns. Cultural factors: China has a traditional official-oriented culture and the ideology of scholars, agriculture, industry and commerce. It attaches importance to public offices with high employment stability, while despairing industry and commerce with poor employment stability. Economic factors: China's super-stable employment often enjoys high returns from monopoly resources, while the investment and operation environment of private enterprises is deeply affected by the world financial crisis. Institutional factors: The social security system lacks fairness between the private sector and state-owned units, and the allocation of social resources is unbalanced. According to the compensatory wage differential theory, if workers fully understand the information of job characteristics that are very important to them and have high mobility, then under the same conditions, workers' wages will decline with the increase of employment stability. Besides basic salary, the actual income of laborers of over stable employment still includes welfare treatment.

### 2) Influence to the Social Environment

At present, the real income of workers who are employed with excessive stability is higher than the average level of society, and the employment stability index of workers is high, so there is a shortage of job opportunities. The result is an inefficient and corruption-prone economy. The influence of super-stable employment on economic growth. The government, not the market, plays a leading role in determining the wages of the super-stable. If the factors of employment stability are not properly considered, it is possible to distort the allocation of labor resources, which will have a negative impact on economic growth. The countermeasure of the super stable employment problem. The basic principle of dealing with the problem of over-stable employment is to improve the marketization of human resources allocation. Ideally, there should be a free flow of human resources, that is, a two-way flow within and outside the system, rather than the one-way flow "into the system" that prevails in

China. The specific ideas are as follows: to narrow the gap between the stability of workers' employment; In the reform of income distribution, employment stability should be taken into account. Improve the social environment conducive to the free flow of human resources [9].

### 3) Reformation of Currency System

Due to the huge expense during the wars, KMT issued a large amount of legal tender. After the war, the amount of issue increased dramatically in order to pay the military expenditure for the war between the Communist Party in China. Right after the end of the war, the military expenditure was 5.569 trillion yuan, and this number of money increased to 604 trillion yuan, which means it increased 110 times over three years, so the inflation increased more than eleven times than before. KMT understood how serious the economic situation was, Chiang kai shek executed the reformation of currency system, "Gold yuan in place of legal tender"; the legal tender should be replaced by November 20th, and one gold yuan held the same value as 3 million legal tender; prohibit the flow among gold, silver and foreign currency. With this forcible confiscation of gold and silver foreign currency and promote the issue of new gold yuan. However, this plan failed eventually [10].

## 5. Conclusion

To sum up, the causes of inflation in China in recent ten years can be roughly divided into three types: Demand-pull, Cost-push and Monetary. In order to solve the problem of inflation, the government can restrain the growth of total social demand and stabilize employment and income by implementing tight fiscal policy; In terms of Monetary Causes, the central bank can directly reduce the money supply by implementing macro tightening monetary policy. At the same time, in order to achieve the balance of supply and demand in the market, the expanded industrial policy can be implemented; currency system also can be reformed. However, the causes of China's inflation are complex. When analyzing the causes of China's economic development and inflation, we should also consider the characteristics of China's current social development and reformation [11].

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