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## Regulation of Petrol and Diesel Prices and their Effects on GDP Growth: Evidence from China

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### Abstract

This paper presents estimates of the effects that government regulation of diesel and petrol prices has on GDP growth. Theory suggests that when supply curves are convex, a decrease in the regulatory price has a larger effect on output than a tantamount increase. Motivated by this theoretical insight, we specify VAR models with asymmetric effects of positive and negative changes in the regulatory prices of diesel and petrol. We estimate the VAR models on quarterly data from China's national accounts during the period Q1 1998 to Q4 2018. Our main findings are that: (i) negative growth rates of regulatory diesel and petrol prices significantly reduce GDP growth; (ii) positive growth rates of regulatory diesel and petrol prices have a positive, but quantitatively small and statistically insignificant effect on GDP growth.

## **Keywords**

GDP growth, energy price regulation

## **JEL Classification**

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# Effects of Government Regulation of Diesel and Petrol Prices on GDP Growth: Evidence from China

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## Abstract

This paper presents estimates of the effects that government regulation of diesel and petrol prices has on GDP growth. Theory suggests that when supply curves are convex, a decrease in the regulatory price has a larger effect on output than a tantamount increase. Motivated by this theoretical insight, we specify VAR models with asymmetric effects of positive and negative changes in the regulatory prices of diesel and petrol. We estimate the VAR models on quarterly data from China's national accounts during the period Q1 1998 to Q4 2018. Our main findings are that: (i) negative growth rates of regulatory diesel and petrol prices significantly reduce GDP growth; (ii) positive growth rates of regulatory diesel and petrol prices have a positive, but quantitatively small and statistically insignificant effect on GDP growth.

Keywords: GDP growth, energy price regulation

## 1. Introduction

In this paper we provide time-series estimates of the effects that regulation of diesel and petrol prices has on China's GDP growth. Regulation of diesel and petrol prices has wide-reaching effects across industries. When a government regulates diesel and petrol prices this affects demand and supply for diesel and petrol (leading to excess demand or supply in the diesel and petrol market); and it also affects production in other industries. This is so because diesel and petrol are important inputs in the production process. In many industries, diesel is used for powering machines: Construction equipment, railroad locomotives, ships, military and emergency vehicles, backup generators – all of these typically run on diesel. The powering of these machines is necessary for the production and delivery of goods and services. On the labor side: many workers commute to their workplace using transportation vehicles, such as buses, trains, or cars. These transportation vehicles are often powered by diesel or petrol. Regulatory diesel prices directly affect production in an industry, such as construction, that uses diesel-powered machines intensively in the production process; and indirectly on other industries because of inter-industry linkages and because diesel and petrol prices affect workers' commuting-to-work costs which in turn affects wages.

Our main contribution to the literature, discussed below, is empirical: we estimate quarterly SVAR models where there are asymmetric effects between positive and negative changes in (the logs of) the regulatory petrol and diesel prices. Our model specification of asymmetric effects is motivated by a recent paper by Boehm and Pandalai-Nayar (2022). These authors provide compelling evidence that industries' supply curves are convex (in logs). When supply curves are convex, and the regulatory price is binding, the percent decrease in output that results from a one percent decrease in the regulatory price exceeds, in absolute value, the percent increase in output that results from a one percent increase in the regulatory price. Hence, one would expect that decreases in the regulatory prices of diesel and petrol have larger effects on output than tantamount increases in these prices.

The first main finding of our empirical analysis is that a decrease in the regulatory diesel price leads to a significant decline in aggregate output. Our baseline VAR model shows that a one standard deviation decrease in the log regulatory diesel price reduces real GDP growth by about 1 percentage point over a period of one year. The cumulative effect on GDP growth over longer horizons, e.g. two or three years, is about as large as the cumulative effect over one year. The contemporaneous effect on GDP growth, i.e. within one quarter, is somewhat smaller – around 0.5 percentage points. The contemporaneous and cumulative effects on GDP growth

over 4 and 8 quarters are significantly different from zero at the 90 percent level. When we look at different sectors we find that the largest effect is in the secondary sector (i.e. manufacturing). We also find large and significant effects for industrial production.

The second main finding from our empirical analysis is that the GDP growth effect of an increase in the log regulatory diesel price is positive but statistically insignificant and quantitatively smaller than the GDP growth effect of a tantamount decrease in the log regulatory diesel price. Over a time horizon of two and three years, the cumulative effects of a one standard deviation increase in the log regulatory diesel price on GDP growth amounts to about 0.2 and 0.5 percentage points, respectively. Cumulative effects on GDP growth are smaller for shorter time horizons, such one quarter or one year.

Results are similar for regulatory petrol and regulatory diesel prices. Decreases in the regulatory petrol price lead to a significant decline in aggregate output: Impulse response functions show that over a period of one year, a one standard deviation decrease in the log regulatory petrol price decreases GDP growth by around 1 percentage point. Increases in the log regulatory petrol price lead to an increase in aggregate output but effects are smaller, in absolute value, than for decreases in the log regulatory petrol price.

China initiated the so-called oil products pricing mechanism in June 1998. Between 1998 to 2018 multiple reforms were introduced to the mechanism, which are summarized in Appendix Table 1. Figure 1 plots the regulatory petrol and diesel prices as well as the international oil price. One can see from Figure 1 that the time-series pattern of the regulatory petrol and diesel prices are related to the time-series pattern of the international oil price, but that these series are not perfectly correlated: The contemporaneous correlation between the quarterly growth rate of the international oil price and the international diesel (petrol) price is 0.516 (0.539).

A necessary condition for our VAR to provide estimates of causal effects of regulatory diesel and petrol price growth on GDP growth is that, contemporaneously, i.e. within a quarter, GDP growth has no systematic direct effects on the growth rate of the regulatory diesel and petrol prices. This condition is likely to be satisfied because of implementation lags – it takes time for government to respond to economic conditions. Our baseline VAR includes the international oil price to ensure that we do not confound the effects of variations in the regulatory prices of petrol and diesel with variations in the international oil prices. Unit root tests show that one cannot reject the null hypothesis that regulatory diesel and petrol prices follow a random walk.

Our paper contributes to two broad literatures in the field of energy economics. First, there is a large strand of literature on effects of international oil price shocks on GDP growth, such as Hamilton (1983), Jimenez-Rodriguez and Sanchez (2005), Berument *et al.* (2010), and Peersman and Van Robays (2012). There are also notable papers exploring the role of international oil price shocks on China's macroeconomic variables, such as Faria *et al.* (2009), Du *et al.* (2010), and Zhao *et al.* (2016); on China's fiscal, monetary, and energy policy, such as Huang and Guo (2007), Kim *et al.* (2017), and Cheng *et al.* (2019); on China's commodity and stock market performance, such as Li *et al.* (2012), Zhang and Qu (2015), Zhu *et al.* (2016), and Zhang *et al.* (2018). Although many scholars emphasize the role international oil prices play in the macroeconomy, there is not much evidence regarding the effects of price regulation on China's GDP growth. A growing line of research attempts to assess the effects of government regulation of coal (e.g., Rong and Victor, 2011; Shen *et al.*, 2012; Xu and Nakjima, 2016), natural gas (e.g., Paltsev and Zhang, 2015; Liu and Lin, 2018; Rioux *et al.*, 2019), and oil (Zhang and Xie, 2016; Deng *et al.*, 2018; Wang *et al.*, 2019). None of these papers distinguish between increases and decreases of regulatory prices. As we will show in the empirical part of our paper, taking this asymmetry into account is important: when the effects of positive and negative changes in the regulatory prices are restricted to be symmetric, the estimated impulse response functions show statistically insignificant effects of regulatory diesel price growth on GDP growth.

The rest of this paper is organized as follows. Section 2 outlines the transmission mechanism of regulatory diesel and petrol prices. We discuss the data and our empirical methodology in Section 3. Section 4 presents impulse response functions for regulatory diesel price growth. Section 5 presents impulse response functions for regulatory petrol price growth. Section 6 shows forecast error variance decompositions. Section 7 concludes.

## **2. The Transmission Mechanism of Regulatory Diesel and Petrol Prices**

In this section we provide a theoretical discussion of how regulatory diesel and petrol prices might affect output. We first discuss effects in the diesel and petrol market (Section 2.1). This is followed by a discussion of the effects on output in other industries (Section 2.2).

### **2.1 The Diesel Market<sup>1</sup>**

Textbook microeconomic theory suggests that if the regulatory price is binding then the sales price is the regulatory price and the traded quantity is the supplied quantity corresponding to

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<sup>1</sup> Results are analogous for the petrol market.

the regulatory price; this means there exists excess demand and a deadweight loss (see e.g. Mas-Colell *et al.*, 1995; Jehle and Reny, 2011). The aggregate Marshallian surplus would increase if the binding price ceiling was lifted. There are at least two reasons why the regulatory prices of petrol and diesel are likely to be binding in China. First, China was a net importer of crude oil during 1996 to 2018, but was always a net exporter of petrol and net exported diesel in many calendar years during this period. Second, there is anecdotal evidence of domestic shortages of petrol and diesel in China.<sup>2</sup>

Panel A Figure 2 shows stylized demand (D) and supply (S) curves for the diesel market. Importantly, the supply curve is assumed to be convex. As in Boehm and Pandalai-Nayar (2022) the supply curve is convex in logarithms. I.e., in this section (Section 2), all the introduced notations for prices and quantities should be thought of as having the natural logarithm in front of them.

$P^{RP}$  is the regulatory diesel price.  $P^*$  is the price where diesel demand equals diesel supply. There are three regulatory prices displayed in Panel A of Figure 2:  $P^{RP1}$  (left-hand-side figure),  $P^{RP2}$  (centre figure),  $P^{RP3}$  (right-hand-side figure) with  $P^* > P^{RP2} > P^{RP1} > P^{RP3}$ . Comparing the left-hand-side figure to the centre figure corresponds to the case of an increase in the regulatory diesel price, i.e.  $\Delta P^{RP} > 0$ . Comparing the left-hand-side figure to the right-hand-side figure corresponds to the case of a decrease in the regulatory diesel price, i.e.  $\Delta P^{RP} < 0$ .

One can see from Panel A of Figure 2 that:

- An increase in the regulatory price  $\Delta P^{RP} > 0$  (from  $P^{RP1}$  to  $P^{RP2}$ ) leads to an expansion in diesel output, i.e.  $\Delta Q > 0$  from  $Q_s^{RP1}$  to  $Q_s^{RP2}$ . Since initially, i.e. at regulatory price  $P^{RP1}$ , there was excess demand for diesel (i.e. a supply shortage), the increase in the regulatory price for diesel leads to a reduction in the excess demand (i.e. leads to a reduction in the supply shortage) for diesel.
- A decrease in the regulatory price  $\Delta P^{RP} < 0$  (from  $P^{RP1}$  to  $P^{RP3}$ ) leads to a decrease in diesel output, i.e.  $\Delta Q < 0$  from  $Q_s^{RP1}$  to  $Q_s^{RP3}$ . Since initially, i.e. at regulatory price  $P^{RP1}$ , there was excess demand for diesel (i.e. a supply shortage), the decrease in the regulatory price for diesel leads to an increase in excess demand (i.e. exacerbates the supply shortage) for diesel.
- The negative effect on diesel output ( $| Q_s^{RP3} - Q_s^{RP1} |$ ) that results from a decrease in the regulatory diesel price ( $\Delta P^{RP} < 0 = -\varepsilon$ ) is larger, in absolute value, than the positive

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<sup>2</sup> See e.g. <https://www.nytimes.com/2005/08/18/business/worldbusiness/fuel-shortages-put-pressure-on-price-controls-in.html>

effect on diesel output ( $Q_S^{RP2} - Q_S^{RP1}$ ) that results from a tantamount increase in the regulatory diesel price ( $\Delta P^{RP} > 0 = \epsilon$ ). This is so because the supply curve for diesel is convex.

## 2.2 Other Industries

Panel B of Figure 2 shows a competitive-market equilibrium for a representative industry  $O$  that uses diesel as an input in production. Industry  $O$  is characterized by a convex supply curve. One should think of representative industry  $O$  as creating demand for diesel in the diesel market (see Panel A of Figure 2). Note that in the market where industry  $O$  operates demand equals supply: There is no regulation, nor any other distortion. These latter assumptions are made so that the analysis is simple and straightforward.

Panel B of Figure 2 shows the supply curves for industry  $O$  for the three different regulatory prices displayed in Panel A of Figure 2. The supply curves depend, among other factors, on the regulatory diesel price and the amount of diesel that is available for purchase.

An increase in the regulatory diesel price from  $P^{RP1}$  to  $P^{RP2}$  shifts industry  $O$ 's supply curve down and to the right, from  $S_1(P^{RP1}, Q_1^{Diesel})$  to  $S_2(P^{RP2}, Q_2^{Diesel})$ . In the competitive market equilibrium shown in Panel B of Figure 2, industry  $O$ 's output increases from  $Q_I^0$  to  $Q_2^0$ . The intuition for this result is as follows. In the diesel market, for the regulatory prices considered, an increase in the regulatory price from  $P^{RP1}$  to  $P^{RP2}$  leads to an increase in the supply of diesel. Because there was initially excess demand for diesel, industry  $O$  readily uses the additional diesel supplied in the diesel market. This is so because the increase in revenues (from additional output generated by industry  $O$  when using the additional diesel) exceeds the increase in costs (diesel purchased at a higher regulatory price). This must be the case since in the diesel market, for the regulatory diesel prices considered, there is excess demand for diesel.

A decrease in the regulatory diesel price from  $P^{RP1}$  to  $P^{RP3}$  shifts industry  $O$ 's supply curve up and to the left, from  $S_1(P^{RP1}, Q_1^{Diesel})$  to  $S_3(P^{RP3}, Q_3^{Diesel})$ . In the competitive market equilibrium shown in Panel B of Figure 2, industry  $O$ 's output decreases from  $Q_I^0$  to  $Q_3^0$ . The intuition for this result is as follows. In the diesel market, for the regulatory prices considered, a decrease in the regulatory price from  $P^{RP1}$  to  $P^{RP3}$  leads to a decrease in the supply of diesel, which further exacerbates the supply shortage of diesel (i.e. increases excess demand for diesel). Industry  $O$  has less diesel that it can use to power the machines necessary for production, which implies that output by industry  $O$  declines. For industry  $O$ , the decrease in revenues (that results from the diesel-shortage-induced output decline) exceeds the reduction in costs (diesel purchased at a lower regulatory diesel price). This must be the case since in the diesel market,



for the regulatory diesel prices considered, there is excess demand for diesel and the reduction in the regulatory price increases this excess demand.

The negative effect on industry  $O$ 's output ( $|Q_3^O - Q_2^O|$ ) that results from a decrease in the regulatory diesel price ( $\Delta P^{RP} < 0 = -\varepsilon$ ) is larger in absolute value than the positive effect on industry  $O$ 's output ( $Q_1^O - Q_2^O$ ) that results from a tantamount increase in the regulatory diesel price ( $\Delta P^{RP} > 0 = \varepsilon$ ). This is so for two reasons: first, because of asymmetric effects on diesel supply (already discussed above for the diesel market); and, second, because the supply curve for industry  $O$  is convex.

### 3. Data and Methodology

#### 3.1 Data description

The sample starts in the third quarter of 1998. The period coincides with when the State Development Planning Commission of China sets the regulatory unleaded petrol (referred to throughout the paper as simply “petrol”) and the regulatory diesel price for the first time. The data ends in the fourth quarter of 2018. There are 82 observations in the sample.

Our main variable of interest is the regulatory price, which is denoted in Section 3 and all tables by  $RP$ . This is either the regulatory price for diesel or the regulatory price for petrol. Following the work of Mork (1989) we create two variables,  $\Delta \ln RP_t^+$  and  $\Delta \ln RP_t^-$ . These variables are defined as follows:

$$\Delta \ln RP_t^+ = \begin{cases} \ln RP_t - \ln RP_{t-1}, & \text{if } RP_{t-1} < RP_t \\ 0, & \text{otherwise} \end{cases}$$

$$\Delta \ln RP_t^- = \begin{cases} \ln RP_t - \ln RP_{t-1}, & \text{if } RP_t < RP_{t-1} \\ 0, & \text{otherwise} \end{cases}.$$

From 1998 to 2018, 179 central government documents recorded each regulatory price adjustment. We first calculate the daily provincial regulatory prices and then compute the quarterly prices by taking a simple average of the daily data in each quarter. The regulatory price in this paper always refers to the maximum regulatory price.<sup>3</sup>

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<sup>3</sup> The maximum regulatory price before 2009 can be computed based on the benchmark regulatory price. We also take the change of tolerance range (e.g., 5% or 8%) into consideration. Therefore, the regulatory price series proposed is comparable before and after all major reforms.

Our benchmark variable for the international oil price is the West Texas Intermediate (WTI); obtained from the Federal Reserve Economic Data provided by the Federal Reserve Bank of St. Louis. The aggregate output variable in our baseline model is GDP (gross domestic product). We also consider particular components of GDP or sectors: PGDP (gross product of the primary sector), SGDP (gross product of the secondary sector), TGDP (gross product of the tertiary sector), EXP (exports), IND (industrial outputs), AGRI (Agricultural outputs).<sup>4</sup> The PGDP refers to the agriculture, forestry, animal husbandry and fishery sectors, and the SGDP represents the manufacturing, mining, and construction sectors. Finally, the TGDP refers to wholesale and retail trades; transport, storage, and post; financial intermediation; real estate; hotel and catering services and other sectors.

Other variables in the VAR model are IR, M2 and CPI. These are, respectively, the interest rate on interbank lending, monetary aggregate M2, and Consumer Price Inflation (CPI). All variables are taken from the National Bureau of Statistics of China. All variables (except regulatory petrol and diesel prices and the interest rate) are seasonally adjusted using the multiplicative Census X-13 method.

### 3.2 Methodology

Consider the following structural VAR model of order  $p$ :

$$B_0 X_t = A_0 + A_1 X_{t-1} + A_2 X_{t-2} + \dots + A_p X_{t-p} + \varepsilon_t \quad (1)$$

where,

$X_t = [\Delta \ln(WTI_t), \Delta \ln(RP_t^+), \Delta \ln(RP_t^-), IR_t, \Delta \ln(GDP_t), \Delta \ln(M2_t), \Delta \ln(CPI_t)]'$ .  $\Delta$  and  $\ln$  are, respectively, the period to t-1 to t change and natural logarithm operators.  $A_0$  is the constant vector,  $B$  and  $A_1, \dots, A_p$  are the coefficient matrices.  $\varepsilon_t = [\varepsilon_t^{WTI}, \varepsilon_t^{RP^+}, \varepsilon_t^{RP^-}, \varepsilon_t^{GDP}, \varepsilon_t^{IR}, \varepsilon_t^{M2}, \varepsilon_t^{CPI}]'$  is the vector of serially and mutually uncorrelated structural innovations; that is,  $E(\varepsilon_t \varepsilon_s') = \mathbf{0}$  and  $E(\varepsilon_t \varepsilon_t') = \mathbf{I}$ .

The contemporaneous matrix  $B_0 X_t$  is:

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<sup>4</sup> According to National Bureau of Statistics, primary sector refers to the broad agricultural sector; secondary sector refers to mining, manufacturing, construction, and utility sector; tertiary sector refers to the broad service sector.

$$B_0 X_t = \begin{bmatrix} 1 & 0 & 0 & 0 & 0 & 0 & 0 \\ b_{10} & 1 & 0 & 0 & 0 & 0 & 0 \\ b_{20} & 0 & 1 & 0 & 0 & 0 & 0 \\ b_{30} & b_{31} & b_{32} & 1 & 0 & 0 & 0 \\ b_{40} & b_{41} & b_{42} & b_{43} & 1 & 0 & 0 \\ b_{50} & b_{51} & b_{52} & b_{53} & b_{54} & 1 & 0 \\ b_{60} & b_{61} & b_{62} & b_{63} & b_{64} & b_{65} & 1 \end{bmatrix} \begin{bmatrix} \Delta \ln (WTI_t) \\ \Delta \ln (RP_t^+) \\ \Delta \ln (RP_t^-) \\ \Delta \ln (GDP_t) \\ IR_t \\ \Delta \ln (M2_t) \\ \Delta \ln (CPI_t) \end{bmatrix} \quad (2)$$

Equation 2 is an otherwise standard Cholesky decomposition, with the exception that there is one additional restriction: ( $b_{21} = 0$ ). This additional restriction says that  $\Delta \ln RP_t^+$  and  $\Delta \ln RP_t^-$  should not impact each other contemporaneously.

According to equation (2), negative and positive regulatory diesel and petrol price growth rates do not respond contemporaneously to any variable in the model, except for the international oil price growth rate. That is, only variations in the international crude oil price have a contemporaneous effect on the growth rate of the regulatory diesel and petrol price. One may be concerned about a contemporaneous effect of China's GDP growth on international crude oil prices (e.g., Beirne *et al.*, 2013; Lin and Li, 2015; Liu *et al.*, 2016); but no consensus has been reached regarding this matter (e.g., Mu and Ye, 2011; Wu and Zhang, 2014; Cross and Nguyen, 2017). Even though a reverse causal effect may exist and a shock to China's GDP growth may be transmitted to the international crude oil price, it is unclear how this would bias estimates of effects that regulatory diesel and petrol prices have on China's GDP growth.

In our baseline VAR the lag structure is set to three as suggested by the Akaike Information Criterion (AIC). We have also estimated VARs with lag structured as suggested by the Bayesian Information Criterion (BIC), which yielded similar results to the ones reported throughout the paper based on AIC.

## 4. Empirical Results for Regulatory Diesel Price Shocks

### 4.1 Response of GDP growth to Regulatory Diesel Price Shocks

We begin by discussing results from a VAR where the effects of positive and negative growth rates in the regulatory diesel price are assumed to be symmetric. That is, we estimate the model presented in equations 1 and 2 but we replace the positive and negative growth rate of regulatory diesel prices with only one variable which includes both positive and negative changes in the log of the diesel price.

Figure 3 shows the symmetric cumulative impulse response. One can see in Figure 3 that the cumulative impulse response of GDP growth to symmetric regulatory diesel price

growth shocks is not significantly different from zero at the 90 percent level for all horizons. Quantitatively, the CIRF in Figure 3 shows a near zero impact effect of regulatory diesel price growth on GDP growth. At peak, which is reached after about 3 quarters, an increase (decrease) in the regulatory diesel price equal to one standard deviation increases (decreases) GDP growth by about 0.4 percentage points.

Figure 4 shows the cumulative impulse response function of GDP growth to positive and negative growth rates of the regulatory diesel price. Figure 4 is based on the estimated VAR model described by equations (1) and (2). In the left column of Figure 4 is displayed the CIRF of GDP growth to a one standard deviation shock to positive regulatory diesel price growth. In the right column of Figure 4 is displayed the CIRF of GDP growth to a one standard deviation shock to negative regulatory diesel price growth.

The right-hand column of Panel A in Figure 4 shows that, over a period of one year, a decrease in the regulatory diesel price equal to one standard deviation of  $\Delta \ln(RP_t^-)$  decreases GDP growth by 1.16 percentage points. On impact, i.e. within the same quarter, a decrease in the regulatory diesel price equal to one standard deviation of  $\Delta \ln(RP_t^-)$  decreases GDP growth by about 0.77 percentage points. The cumulative impulse responses of GDP growth to negative growth of the regulatory diesel price are significantly different from zero on impact and at longer horizons e.g. after two quarters, four quarters, and eight quarters.

The left-hand column of Panel A in Figure 4 shows that the cumulative impulse response of GDP growth to positive growth in the regulatory diesel price is not significantly different from zero at all horizons. Quantitatively, the effects are also small.

#### **4.2 Response of Primary, Secondary and Tertiary GDP Growth to Regulatory Diesel Price Shocks**

In this sub-section, we substitute the variable GDP growth for primary GDP, secondary GDP and tertiary GDP growth and estimate the model described by equations (1) and (2) one at a time for each sub-GDP category. As in previous figures and for the rest of the paper, the left (right) column shows cumulative responses to a one standard deviation shock to the positive (negative) growth rate of the regulatory diesel price.

Panel A and C of Figure 5 show that there are no significant effects regulatory diesel price growth on the growth rates of primary- and tertiary-sector GDP. This is the case for both negative and positive growth rates of the regulatory diesel price.

There is a significant effect of negative diesel price growth on secondary-sector GDP growth. This can be seen in Panel B of Figure 5 Panel B of Figure 5 shows that over the first

four quarters secondary-sector GDP growth significantly decreases following a decrease in the regulatory diesel price. The peak effect is reached in quarter 4. Quantitatively, the CIRF in Panel B of Figure 5 shows that at peak, a decrease in the regulatory diesel price equal to one standard deviation of  $\Delta \ln (RP_t^-)$  decreases secondary-sector GDP growth by about 1.3 percentage points. There are no significant effects of increases in the regulatory diesel price on secondary-sector GDP growth.

### **4.3 Response of Exports, Industrial Output, and Agricultural Output to Regulatory Diesel Price Shocks**

Figures 6, 7 and 8 show the cumulative impulse responses of the growth rates of exports, industrial output, and agricultural output (respectively) to positive and negative growth rates of the regulatory diesel price. To estimate these responses, we substitute in the baseline VAR one-at-a-time the variable GDP growth for the changes in the log of exports (Figure 6), industrial output (Figure 7), and agricultural output (Figure 8).

The right-hand column of Figure 6 shows that a decrease in the regulatory diesel price equal to one standard deviation of  $\Delta \ln (RP_t^-)$  is associated with a statistically significant increase in exports growth of 2.22 percentage points on impact. Thereafter, i.e. at quarters 2 to 12, the cumulative impulse response of export growth to negative growth of the regulatory diesel price is not significantly different from zero.

From the right-hand column of Figure 7 one can see that a decrease in the regulatory diesel price has a significant negative effect on industrial output. The cumulative impulse response function shows a peak after six quarters. After six quarters, industrial output growth is lower by 1.41 percentage points due to decrease in the regulatory diesel price equal to one standard deviation of  $\Delta \ln (RP_t^-)$ .

From the right-hand column of Figure 8 one can see that a decrease in the regulatory diesel price has a significant negative effect on agricultural output. The cumulative impulse response function shows a peak after six quarters. After six quarters, agricultural output growth is lower by 1.43 percentage points due to decrease in the regulatory diesel price equal to one standard deviation of  $\Delta \ln (RP_t^-)$ .

## **5 Empirical Results for Regulatory Petrol Price Shocks**

Effects of regulatory petrol price shocks are similar to the effects discussed in Section 4 for regulatory diesel price shocks. In Figure 9 we present the cumulative impulse response

functions for GDP growth, secondary sector GDP growth, export growth, industrial output growth and agricultural output growth to a shock in the regulatory petrol price growth rate.

The CIRFS in Figure 9 show that a decrease in regulatory diesel prices is related to the following statistically significant responses:

- a decrease in GDP growth of up to 1.12 percentage, which is significantly different from zero in the fifth and sixth quarter (Panel A of Figure 9, right-hand column).
- a decrease in secondary sector GDP growth of up to 1.21 percentage points in the fourth quarter (Panel B of Figure 9, right-hand column).
- a decrease in export growth of 2.23 percentage points on impact (Panel C of Figure 9, right-hand column).
- a decrease in industrial production growth of up to 1.72 percentage points in the fourth quarter (Panel D of Figure 9, right-hand column).
- a decrease in agricultural production growth of up to 1.62 percentage points in the seventh quarter (Panel E of Figure 9, right-hand column).

The effects of increases in the regulatory petrol price -- see the left-hand column of Panels A-E of Figure 9 -- are statistically insignificant, and quantitatively smaller than the effects of decreases in the regulatory petrol price.

## **6. Forecast Error Variance Decompositions**

In this section we discuss forecast error variance decompositions (FEVD) of our SVAR models. In Table 1A we show the FEVD for models with the regulatory diesel price. In Table 1B we show the FEVD for models with the regulatory petrol price. To conserve space, we show only show the FEVD of the first quarter for all output variables. The output growth variables are: the first differences of the logs of GDP, primary sector GDP, secondary sector GDP, tertiary sector GDP, exports, industrial output, and agricultural output.

In Table 1A one can see that the FEV contribution of negative regulatory diesel price growth to GDP growth is 5.73%. For agricultural output growth the contribution is 5.99%; 4.83% for export growth; 3.19% for industrial output growth; and 3.02% for primary and secondary GDP growth. For tertiary GDP growth the contribution of negative regulatory diesel price growth is only about 0.70%. The contribution to aggregate output growth from positive regulatory diesel price growth is smaller than the contribution of negative regulatory diesel price growth. The contribution of positive regulatory diesel price growth to GDP growth is

1.68%, which is about one-third of the contribution that negative regulatory diesel price growth rates have on GDP growth.

From Table 1B one can see that the FEV contribution of negative regulatory petrol price growth to GDP growth is 6.33%. For agricultural output growth the contribution is 5.11%; 4.59% for export growth; 5.03% for industrial output growth; and 3.58% for primary and secondary GDP growth. For tertiary GDP growth the contribution of negative regulatory petrol price growth is only about 1.40%. The contribution to aggregate output growth from positive regulatory petrol price growth is much smaller than the contribution of negative regulatory diesel price growth. The contribution of positive regulatory petrol price growth to GDP growth is only about 0.14%.

Tables 1A and 1B also shows that the FEV contribution from the international oil price is about 18% while the contribution from the interest rate, M2 growth and CPI growth is zero.

## **7. Conclusion**

This paper presented SVAR estimates of the effects that regulatory diesel and petrol prices have on GDP growth in China. The paper's main contribution to the literature was the estimation of SVARs with asymmetric effects of increases and decreases in the log regulatory diesel and petrol prices. Such asymmetric effects arise when industries' supply curves are convex in logs. The paper's SVAR analysis showed that decreases in the regulatory diesel and petrol prices lead to a significant reduction in GDP growth; increases in the regulatory diesel and petrol prices have a positive but statistically insignificant effect on GDP growth. The paper's empirical results are consistent with anecdotal evidence of diesel and petrol shortages in China: Regulatory diesel and petrol prices during 1998-2018 were likely below the market clearing price, which resulted in welfare losses and lower GDP growth.

**Table 1: Forecast Error Variance Decomposition**

## A. Regulatory diesel price

Decompose /Contribution	$\Delta\log(WTI_t)$	$\Delta\log(RP_t^+)$	$\Delta\log(RP_t^-)$	$\Delta\log(OUT_t)$	$IR_t$	$\Delta\log(M2_t)$	$\Delta\log(CPI_t)$
GDP Growth	18.373	1.683	5.730	74.212	0.000	0.000	0.000
Primary Sector GDP Growth	0.350	0.809	3.019	95.820	0.000	0.000	0.000
Secondary Sector GDP Growth	0.350	0.809	3.019	95.820	0.000	0.000	0.000
Tertiary Sector GDP Growth	3.028	2.370	0.697	93.903	0.000	0.000	0.000
Agricultural GDP Growth	0.189	0.001	5.990	93.810	0.000	0.000	0.000
Industrial Output Growth	7.457	0.104	3.190	89.247	0.000	0.000	0.000
Export Growth	3.655	3.211	4.831	88.301	0.000	0.000	0.000

Cholesky Ordering:  $\Delta\log(WTI_t), \Delta\log(RP_t^+), \Delta\log(RP_t^-), \Delta\log(OUT_t), IR_t, \Delta\log(M2_t), \Delta\log(CPI_t)$ 

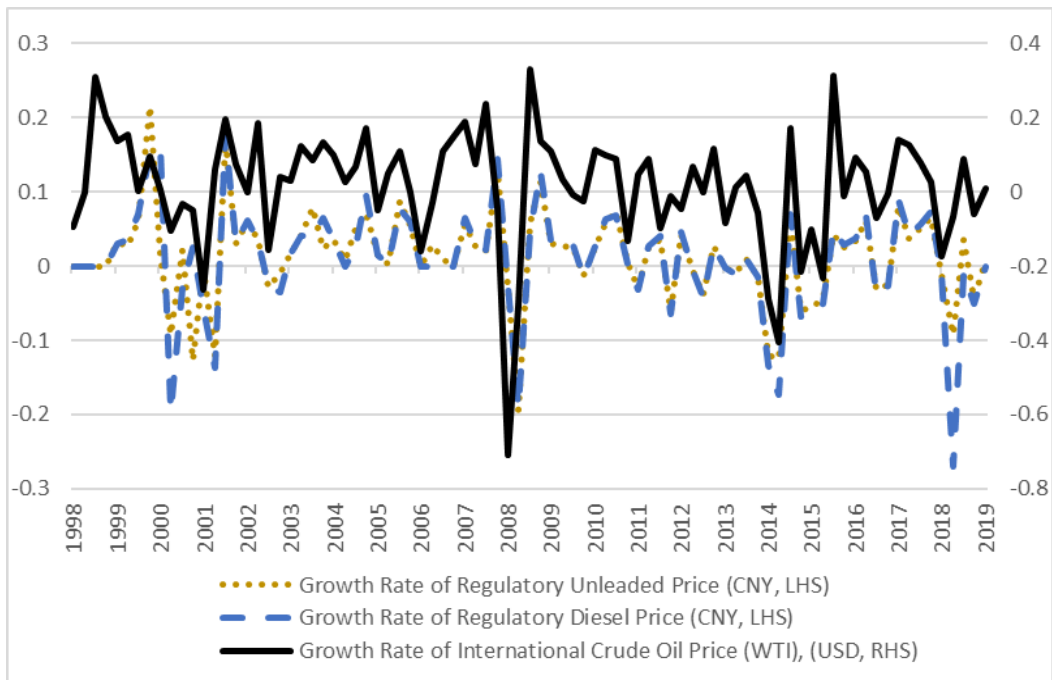
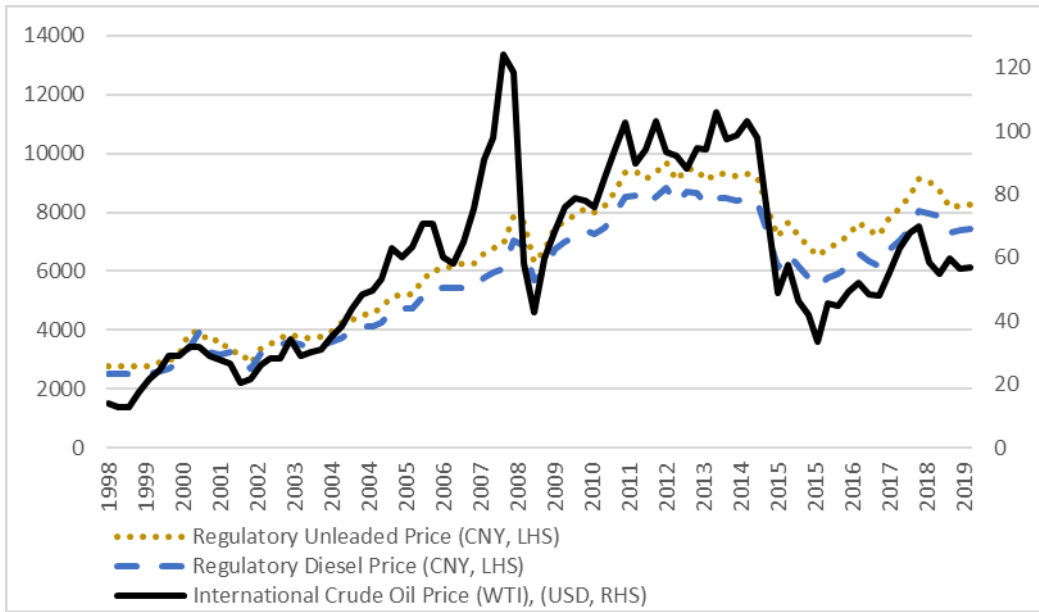
## B. Regulatory petrol price

Decompose /Contribution	$\Delta\log(WTI_t)$	$\Delta\log(RP_t^+)$	$\Delta\log(RP_t^-)$	$\Delta\log(OUT_t)$	$IR_t$	$\Delta\log(M2_t)$	$\Delta\log(CPI_t)$
GDP Growth	16.976	0.136	6.339	76.547	0.000	0.000	0.000
Primary Sector GDP Growth	0.623	3.826	3.575	91.974	0.000	0.000	0.000
Secondary Sector GDP Growth	23.669	0.002	5.576	70.752	0.000	0.000	0.000
Tertiary Sector GDP Growth	2.871	1.242	1.417	94.468	0.000	0.000	0.000
Agricultural GDP Growth	0.062	0.004	5.112	94.820	0.000	0.000	0.000
Industrial Output Growth	4.051	0.103	5.026	90.819	0.000	0.000	0.000
Export Growth	12.516	1.070	4.589	81.823	0.000	0.000	0.000

Cholesky Ordering:  $\Delta\log(WTI_t), \Delta\log(RP_t^+), \Delta\log(RP_t^-), \Delta\log(OUT_t), IR_t, \Delta\log(M2_t), \Delta\log(CPI_t)$



**Figure 1: Regulatory Diesel and Petrol Prices in China**



**Figure 2A: Effects of Diesel Price Regulation on the Diesel Market**

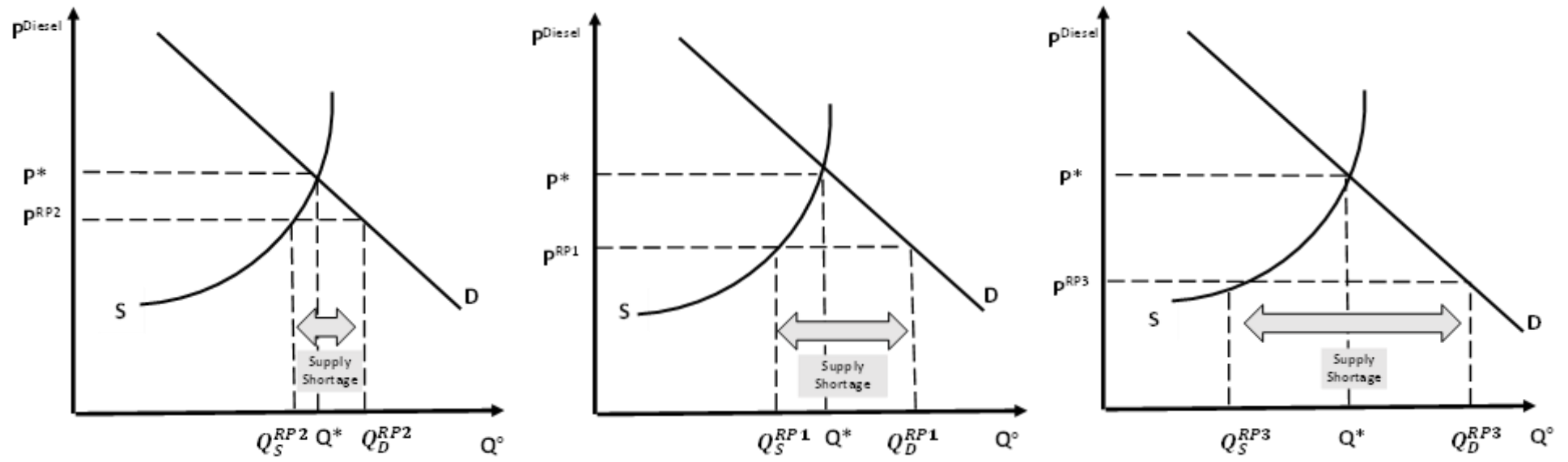
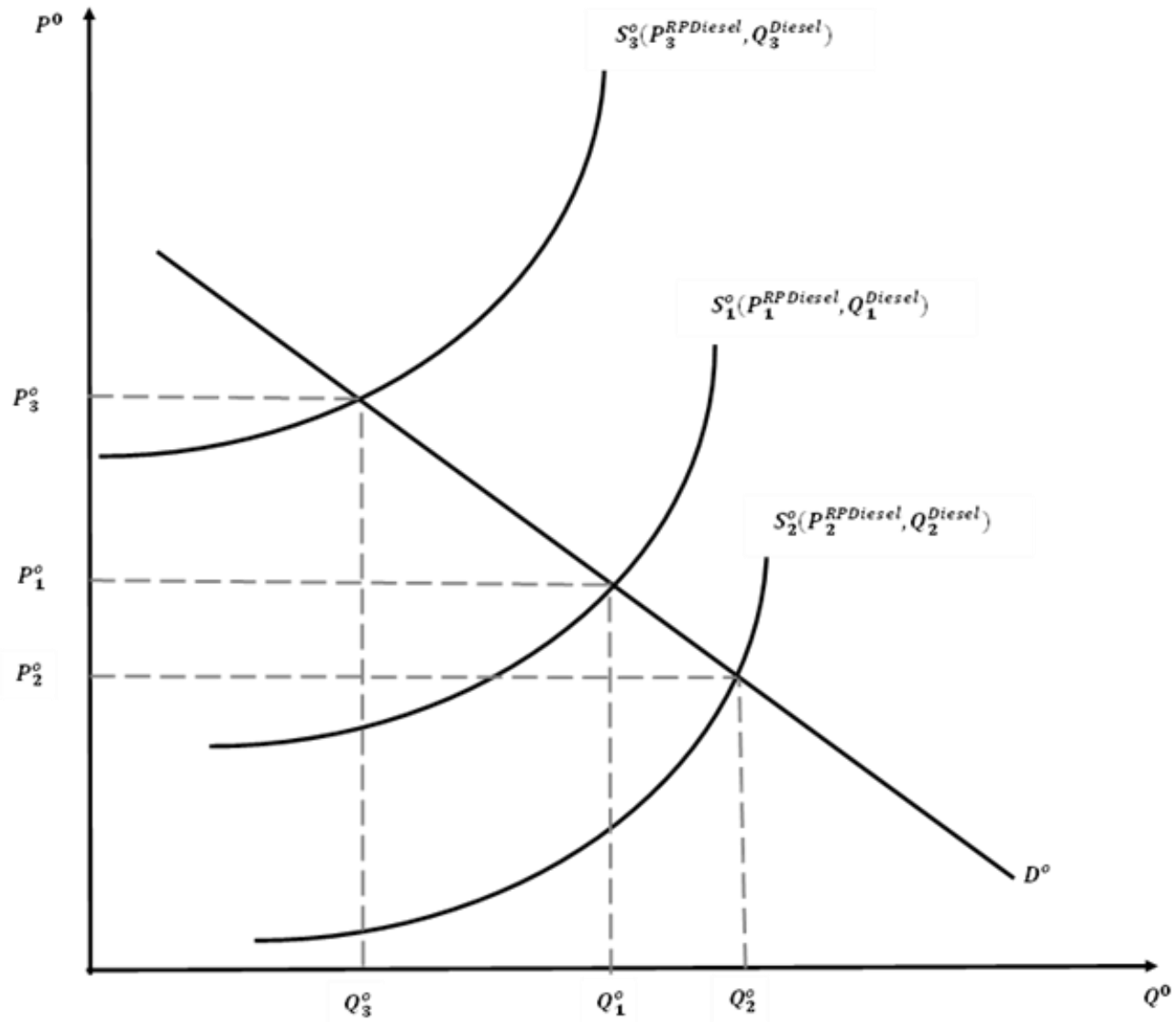
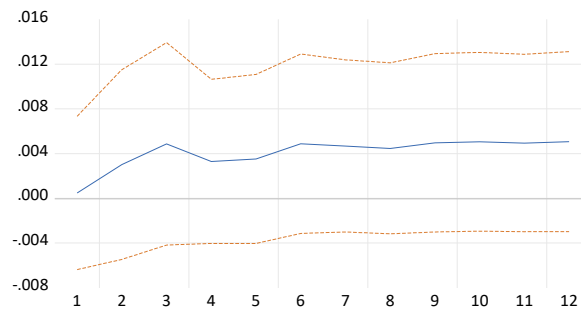


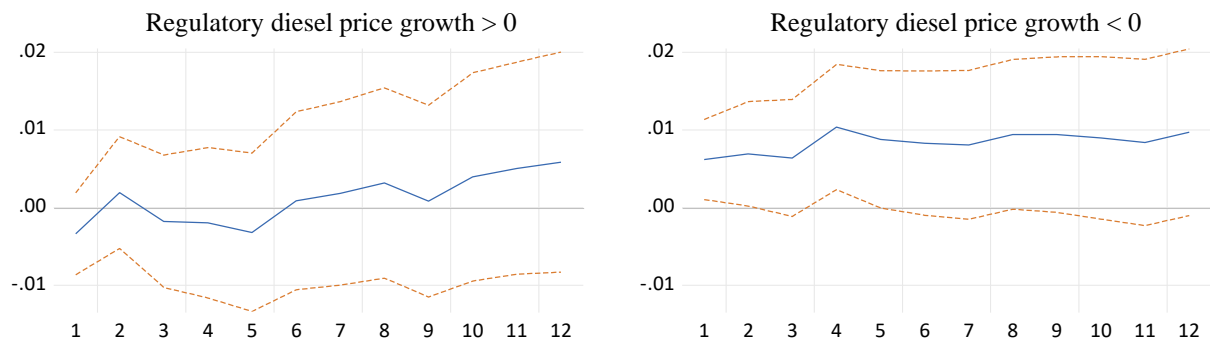
Figure 2B: Effects of Diesel Price Regulation on Other Industries



**Figure 3: Response of GDP Growth to Regulatory Diesel Price Shocks** (Effects of Positive and Negative Growth in the Regulatory Diesel Price are Assumed to be Symmetric)

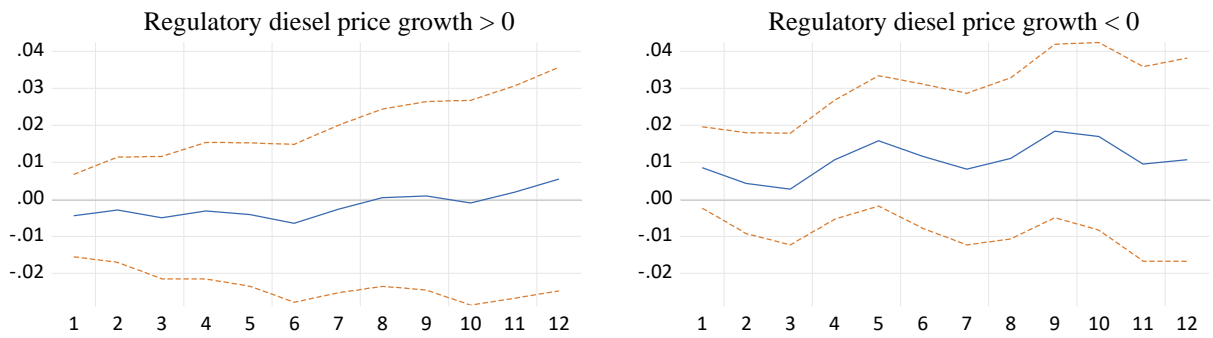


**Figure 4: Response of GDP Growth to Regulatory Diesel Price Shocks** (Effects of Positive and Negative Growth in the Regulatory Diesel Price are Asymmetric)

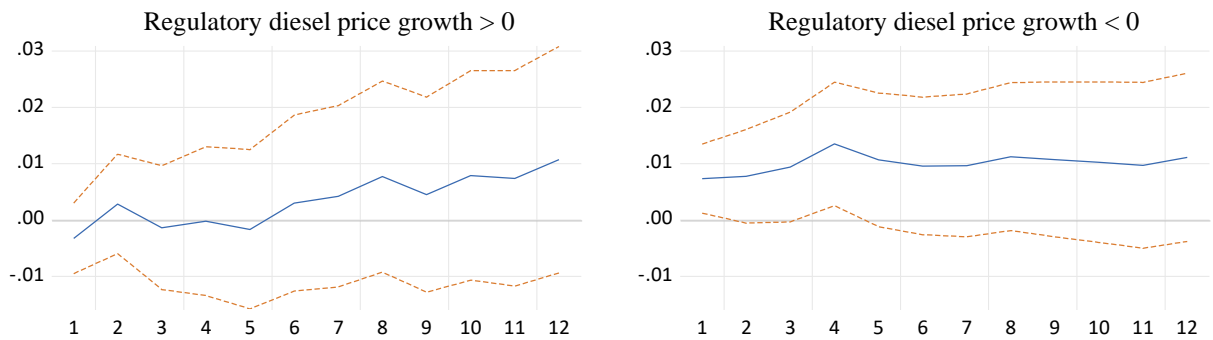


**Figure 5: Response of Primary, Secondary and Tertiary GDP Growth to Regulatory Diesel Price Shocks**

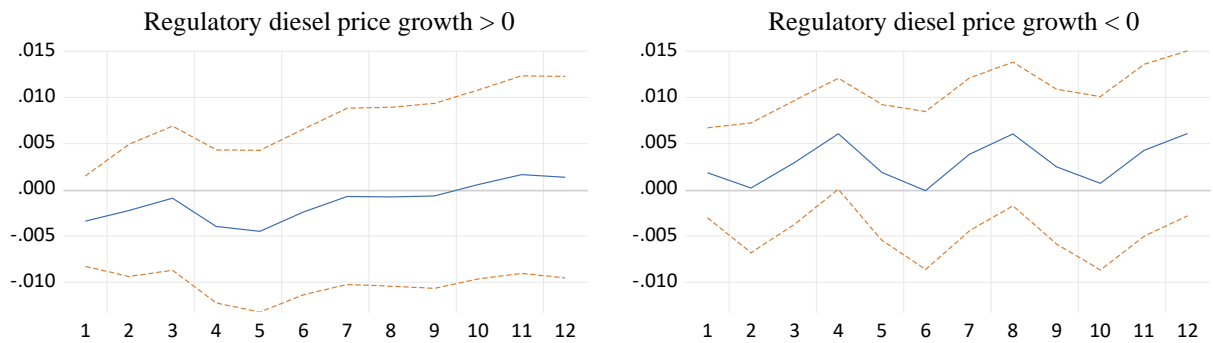
A. Response of primary GDP growth to regulatory diesel price shocks



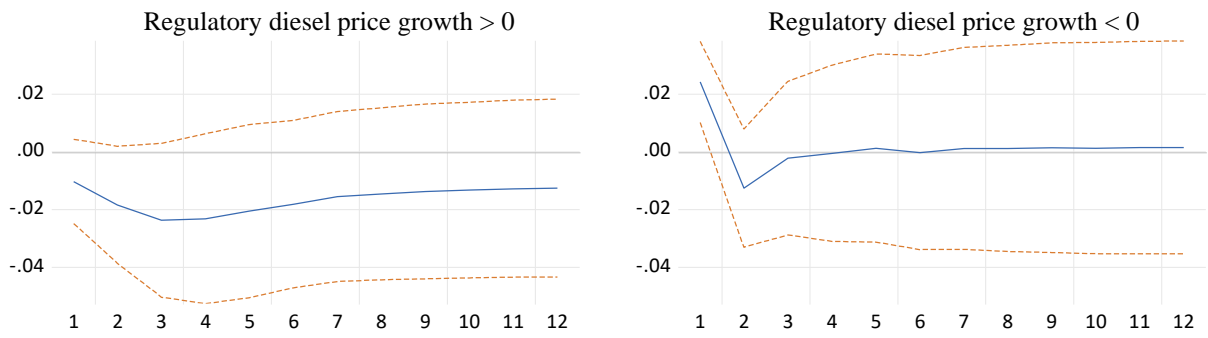
B. Response of secondary GDP growth to regulatory diesel price shocks



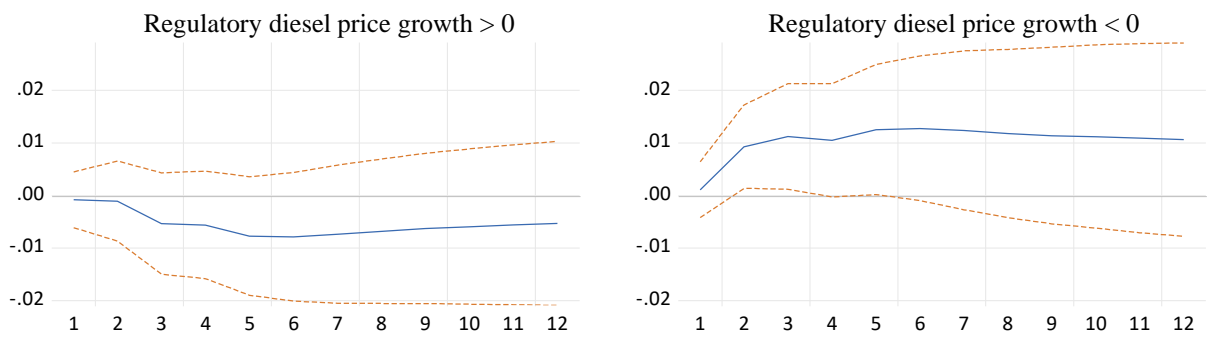
C. Response of tertiary GDP growth to regulatory diesel price shocks



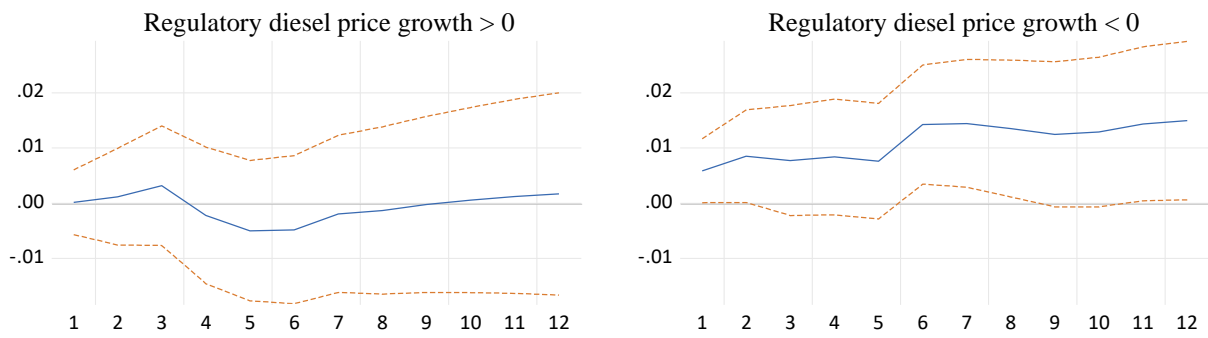
**Figure 6: Response of Exports Growth to Regulatory Diesel Price Shocks**



**Figure 7: Response of Industrial Output Growth to Regulatory Diesel Price Shocks**

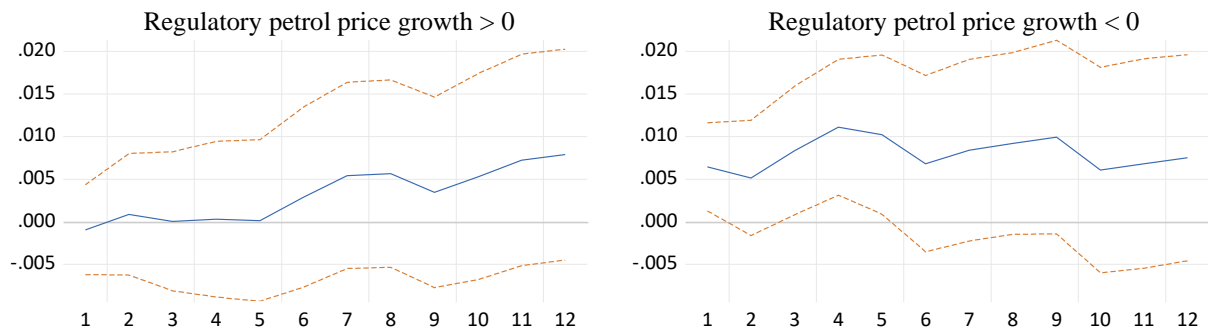


**Figure 8: Response of Agricultural Output Growth to Regulatory Diesel Price Shocks**

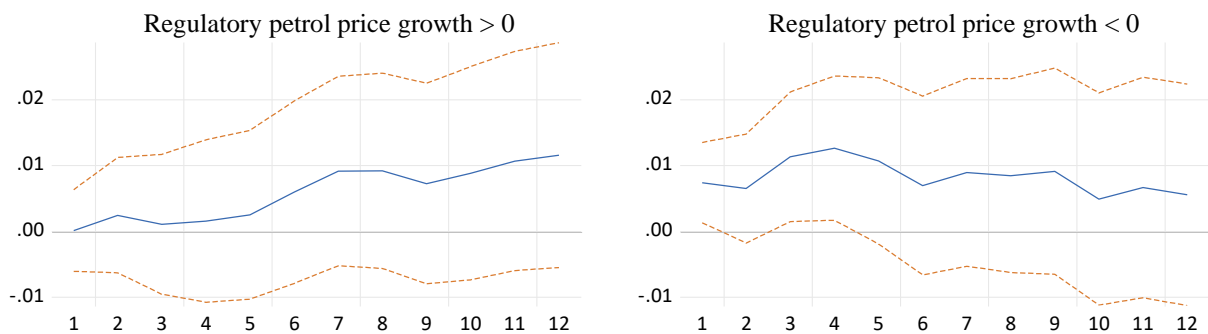


**Figure 9: Asymmetric Cumulative Response of GDP Growth to Regulatory Petrol Price Shocks**

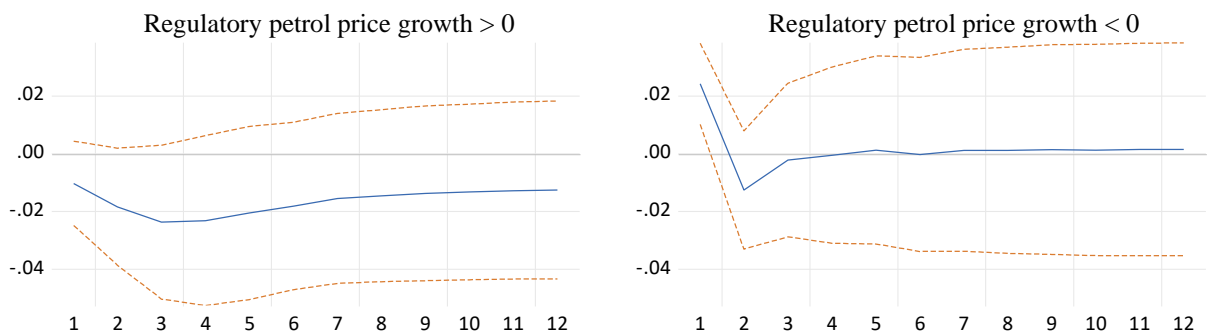
A. Response of GDP growth to regulatory petrol price shocks



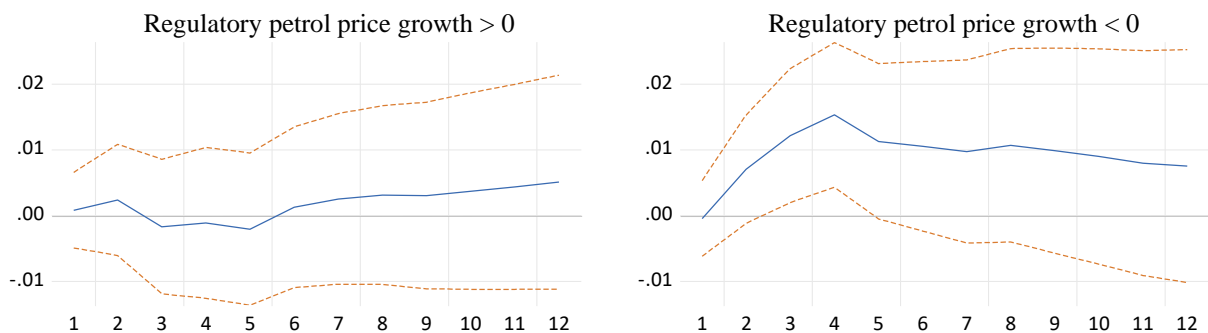
B. Response of secondary GDP growth to regulatory petrol price shocks



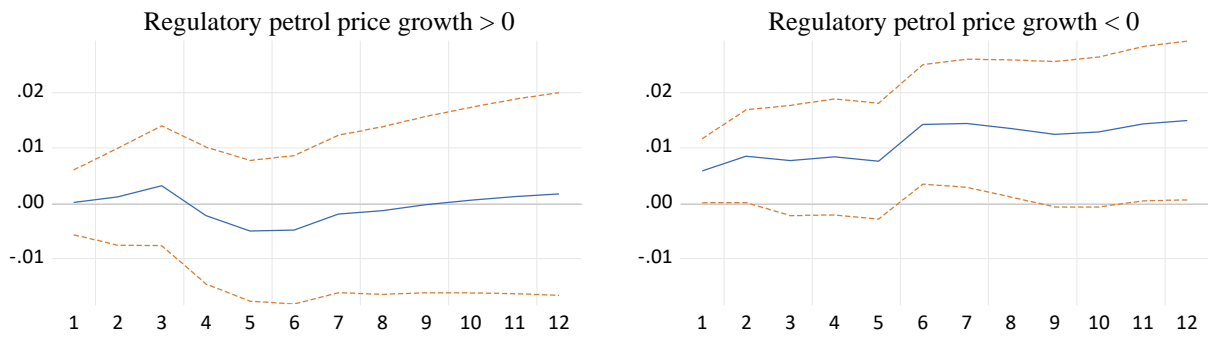
C. Response of exports growth to regulatory petrol price shocks



D. Response of industrial output growth to regulatory petrol price shocks



E. Response of agricultural output growth to regulatory petrol price shocks





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## Appendix A: Major Government Regulations in the Diesel and Unleaded Prices in China

Appendix Table 1. Major reforms of oil products pricing mechanism

Time	Government guidance document	Comment
June 1998	China's Crude Oil and Oil products Price Reform Policy by SDPC (State Development Planning Commission) [1998] No.52	1. SDPC sets the benchmark regulatory price. 2. The retail price is allowed to fluctuate within $\pm 5\%$ tolerance range on the basis of benchmark regulatory price.
June 2000	Notice on Adjusting Oil Products Price by SDPC [2000] No.38	1. The benchmark regulatory price is linked to the FOB price of petrol and diesel in Singapore market. 2. The benchmark regulatory price will be adjusted if the price of Singapore market deviates by more than 5%.
October 2001	Notice on Improving Oil Price Linkage and Adjusting the Oil Products Price by SDPC [2001] No.96	1. The benchmark regulatory price is linked to the weighted average FOB price of petrol and diesel in Singapore, New York and Rotterdam markets. 2. The retail price is allowed to fluctuate within $\pm 8\%$ tolerance range on the basis of benchmark regulatory price.
December 2008	Notice on Implementing the Reform in Oil Products Pricing and Taxing by State Council [2008] No.37	1. The maximum regulatory price is introduced to substitute the benchmark regulatory price. <sup>5</sup> 2. The consumption tax of petrol is raised from 0.2 to 1 Yuan per litre; the consumption tax of diesel is raised from 0.1 to 0.8 Yuan per litre.
May 2009	Principles of Managing the Oil Price by NDRC (National Development and Reform Commission) [2009] No. 1198	1. The maximum regulatory price will be adjusted if the weighted average crude oil price of Brent, Dubai and Cointa deviates by more than 4%. 2. The price adjustment window is 22 consecutive weekdays.
March 2013	Notice on Improving Oil Products Pricing Mechanism by NDRC [2013] No.624	1. The price adjustment window is shortened to 10 consecutive weekdays. 2. The regulatory price will not be adjusted if the change in regulatory price should be less than 50 Yuan per ton. <sup>6</sup>
November 2014	Joint Statement on Raising the Consumption Tax of Oil Products by Ministry of Finance and State Taxation Administration [2014] No.94	The consumption tax of petrol is raised by 0.12 Yuan per litre; the consumption tax of diesel is raised by 0.14 Yuan per litre.
December 2014	Joint Statement on Raising the Consumption Tax of Oil Products by Ministry of Finance and State Taxation Administration [2014] No.106	The consumption tax of petrol is raised by 0.28 Yuan per litre; the consumption tax of diesel is raised by 0.16 Yuan per litre.
January 2015	Joint Statement on Raising the Consumption Tax of Oil Products by Ministry of Finance and State Taxation Administration [2015] No.11	The consumption tax of petrol is raised by 0.12 Yuan per litre; the consumption tax of diesel is raised by 0.1 Yuan per litre.
January 2016	Notice on Improving Oil Products Pricing Mechanism by NDRC [2016] No.64	The regulatory price will be adjusted based on activation conditions if and only if the weighted average crude oil price is greater than 40 and less than 130 USD per barrel.

Note: The State development Planning Commission (SDPC) is the predecessor of current National Development and reform commission (NDRC).

<sup>5</sup> In this paper, unless specified, the regulatory price always refers to the maximum regulatory price.

<sup>6</sup> The exact calculation formula of the regulatory price is undisclosed.