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Markus Brueckner
Australian National University, Australia

Haidi Hong
Independent Competition and Regulatory Commission, Australia

Joaquin Vespignani
University of Tasmania, Australia

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UNIVERSITY of TASMANIA

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

Markus Brueckner[ac], Haidi Hong[b] and Joaquin Vespignani[cd]

[a]Research School of Economics, Australian National University, Australia
[b]Independent Competition and Regulatory Commission, Australia
[c]Centre for Applied Macroeconomic Analysis, Australian National University, Australia
[d]Tasmanian School of Business and Economics, University of Tasmania, Australia

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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 in the regulatory price. 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 statistics 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.[1] 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 unleaded 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 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. When supply curves are convex, and the regulatory price is binding, the decrease in output that results from a one-unit decrease in the regulatory price exceeds, in absolute value, the increase in output that results from a one-unit increase in the regulatory price. Hence, one would expect that a decrease in the regulatory prices of diesel and petrol has larger effects on output than a tantamount increase in these regulatory 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 growth rate of the 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

[1] Note that in this paper, we will refer to petrol and unleaded are used interchangeably.

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 particular 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. There are no significant effects of decreases in the regulatory diesel price growth rate on the interest rate, money growth, or the CPI inflation rate.

The second main finding from our empirical analysis is that the GDP growth effect of an increase in the growth rate of the regulatory diesel price is statistically insignificant; and quantitatively smaller than the GDP growth effect of a tantamount decrease in the regulatory diesel price growth rate. Over a time horizon of two and three years, the cumulative effects of a one standard deviation increase in the growth rate of the 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 growth rate of the regulatory petrol price increases GDP growth by around 1 percentage point. Increases in the regulatory petrol price lead to an increase in aggregate output but effects are smaller than for decreases in the 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 WTI in US dollars and the regulatory unleaded and diesel prices measured in Chinese Yuan (CNY). This figure shows that regulatory unleaded and diesel prices follow WTI prices but move much more smoothly. This is particularly noted in the period 2007 to 2008 (global financial crisis) and in the unexpected decline of oil prices observed in 2014 (see Baumeister and Kilian (2016)).

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 directs effects on the growth rate of the regulatory diesel and petrol prices. This condition is likely to be satisfied: there are implementation lags associated with government policies – it takes time for government to respond to economic conditions. With regard to the oil product pricing mechanism, there are complex activation conditions on regulatory price adjustments. Our baseline VAR includes as a control variable 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 testing the effect of international crude oil price on GDP, 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 indicators, 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 crude 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 key: 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 unleaded 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. Robustness checks are presented in Section 7. Section 8 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

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 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.[2]

Graphical Analysis

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. 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 Qs^{RP1} to Qs^{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 Qs^{RP1} to Qs^{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.

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

- The negative effect on diesel output (│ Qs^{RP3} - Qs^{RP1} │) that results from a decrease in the regulatory diesel price (ΔP^{RP} <0=-ε) is larger in absolute value than the positive effect on diesel output (Qs^{RP2} - Qs^{RP1}) that results from a tantamount increase in the regulatory diesel price (ΔP^{RP} >0=ε). 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. The latter assumption is made of course for simplicity only.

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_1^0 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 *s*'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_1^0 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 benchmark regulatory unleaded petrol (unleaded) and 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, *RP*. This is either the regulatory price for diesel or the regulatory price for unleaded petrol. Following the work of Mork (1989) we create two variables, RP_t^+ and RP_t^-. These variables are defined as follows:

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

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

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.[3]

[3] 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 prices 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 benchmark 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).[4] 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*:

$$\mathrm{B}_0 X_t = A_0 + A_1 X_{t-1} + A_2 X_{t-2} + \cdots + A_p X_{t-p} + \varepsilon_t \tag{1}$$

where,

$X_t = \left[\Delta\log(WTI_t), \Delta\log\left(RP_t{}^{+}\right), \Delta\log(RP_t{}^{-}), \mathrm{IR}_t, \Delta\log(GDP_t)\ \Delta\log(M2_t), \Delta\log(CPI_t)\right]'$.

Δ and log are, respectively, the period to t-1 to t change and natural logarithm operators. A_0 is the constant vector, B and A_1 , …, A_p are the coefficient matrices. $\varepsilon_t = \left[\varepsilon_t^{WTI}, \varepsilon_t^{RP^+}, \varepsilon_t^{RP^-}, \varepsilon_t^{GDP}, \varepsilon_t^{IR}, \varepsilon_t^{M2}, \varepsilon_t^{CPI}\right]'$ 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:

[4] 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.

$$B_0X_t = \begin{bmatrix} 1 & 0 & 0 & 0 & 0 & 0 & 0 \\ b_{10} & 1 & 0 & 0 & 0 & 0 & 0 \\ b_{20} & 0 & 1 & 0 & 0 & 0 & 0 \\ b_{30} & b_{31} & b_{32} & 1 & 0 & 0 & 0 \\ b_{40} & b_{41} & b_{42} & b_{43} & 1 & 0 & 0 \\ b_{50} & b_{51} & b_{52} & b_{53} & b_{54} & 1 & 0 \\ b_{60} & b_{61} & b_{62} & b_{63} & b_{64} & b_{65} & 1 \end{bmatrix} \begin{bmatrix} \Delta\log(WTI_t) \\ \Delta\log({RP_t}^{+}) \\ \Delta\log({RP_t}^{-}) \\ \Delta\log(GDP_t) \\ IR_t \\ \Delta\log(M2_t) \\ \Delta\log(CPI_t) \end{bmatrix} \qquad (2)$$

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 ${RP_t}^{+}$ *and* ${RP_t}^{-}$ should not impact each other contemporaneously.

According to Equation (2), negative and positive regulatory diesel and unleaded 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 unleaded 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). In robustness analysis, use two lags as suggested by the Bayesian Information Criterion (BIC)

4. Empirical Results for Regulatory Diesel Price Shocks

This section presents cumulative impulse response functions (CIRFs) of our SVAR model described in equations 1 to 3. The Section 4.1 shows results of CIRF of GDP growth to the growth rate of regulatory diesel prices. In section 4.2 we show the results of asymmetric CIRFs of the growth rate of regulatory diesel price shocks on key macroeconomic variables. In Section 4.3, we show asymmetric CIRFs of the growth rate of regulatory diesel price shocks to primary, secondary, and tertiary GDP growth. In Section 4.4, we present asymmetric CIRFs of the growth rate regulatory diesel price shocks on exports, industrial and agricultural output growth.

4.1 Cumulative Response of GDP growth to Regulatory Diesel Shocks

In Figure 3, we estimate the model presented in equation 1 to 3 but we replace the positive and negative growth rate of regulatory diesel prices for only one variable which capture both positive and negative changes in the growth rate of diesel price. One can see from Figure 3 that the impulse response of GDP growth to regulatory diesel price growth shocks is not significantly different from zero at the 90 percent level for all horizons.

4.2 Asymmetric Cumulative Response of Macroeconomic Variables to Regulatory Diesel Shocks

Figure 4 shows the CIRF for the model estimated in Equations 1 to 3. In the left (right) column, we show responses to macroeconomic variables to a positive (negative) one standard deviation increases in the growth rate of regulatory diesel prices.

Panel A of Figure 4 shows that, over a period of one year, one standard deviation (3.48 percentage points) decrease in the growth rate of the regulatory price for diesel decreases GDP growth by about 1.16 percentage points. On impact, i.e. within the same quarter, a one standard deviation decrease in the growth rate of the regulatory price for diesel decreases GDP growth by about 0.77 percentage points. The cumulative effects of decreases in the growth rate of the regulatory price on the growth rate of GDP are significantly different from zero on the firth, the second and the fourth quarters. In contrast, the cumulative effects of increases in the growth rate of the regulatory price are not significantly different from zero at the 10 percent significance level.

In panel B, one standard deviation decrease in the growth of regulatory diesel prices is connected to a statistically insignificant response of interest rate. Panel C shows that a one standard deviation decrease in the growth rate of the regulatory price for diesel increases M2 growth up to 1.3 percentage points. M2 growth responses are statistically significant different from zero from the third to the eight quarter. Finally, in panel D, the cumulative effects of an increase in the growth rate of the regulatory price are in significant in both cases.

4.3 Asymmetric Cumulative 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 in Equation 1-3 one at a time for each sub-GDP category. As in previous figures and for the rest of the paper, on the left (right) column we present results of cumulative responses to increase (decrease) of the growth rate of regulatory diesel prices.

Figures 5, panel A and C show that primary and tertiary GDP growth responses to the growth rate of regulatory diesel price shocks are statistically insignificant at conventional levels. However, Figure 5, panel B, indicates that a one standard deviation decrease in the growth rate of regulatory diesel prices is linked with a statistically significant decline in the growth rate of secondary GDP. This figure shows a persistent decrease in secondary GDP growth for fourth quarters; the maximum is 1.3 percentage point in the fourth quarter.

4.4 Asymmetric Cumulative Response of Exports, Industrial Output, and Agricultural Output Growth to Regulatory Diesel Price Shocks

Figures 6, 7 and 8 show the cumulative responses of exports, industrial output, and agricultural output growth (respectively) to one standard deviation increase (decrease) of the growth of regulatory diesel price shock. To estimate these responses, we substitute the variables GDP for the other output variables; exports growth, industrial output and agricultural output growth and estimate the benchmark model one at a time for each output-variable.

The right-hand of Figure 6 indicates that a one standard deviation decrease in the growth rate of regulatory diesel prices is associated with a statistically significant increase in exports growth of 2.22 percentage points at impact. The right column of Figure 7 shows that a one standard deviation increase in growth rate of regulatory diesel prices leads to an maximum increase in industrial output of 1.41 percentage points in the sixth quarter. Finally, in Figure 8, agricultural output growth responses to an increase of the growth rate of regulatory diesel price shock is statistically significant at impact and from quarters sixth to nineth. The maximum response 1.43 percentage points in the sixth quarter

5 Empirical Results for Regulatory Petrol Price Shocks

In Figure 9, we present the cumulative response of the output variables; GDP, secondary GDP, exports, industrial and agricultural output growth to one standard deviation increase (decrease) in the growth rate of regulatory unleaded prices (rather than diesel prices).

The main result of these estimations is that the cumulative responses to a decrease in the growth of regulatory diesel prices (3.51 percentage points) is related to the following statistically significant responses:

- In Panel A, to a decrease on GDP growth of up to 1.12 percentage and are significantly different from zero at the fifth and sixth quarters.
- In Panel B, to a decrease on secondary GDP growth of up to 1.21 percentage points in the fourth quarter.
- In Panel C, a decrease on exports growth of up to 2.23 percentage points at impact

- In Panel D, a decrease on industrial production growth of up to 1.72 percentage points at the fourth quarter.
- In panel E, a decrease on agricultural production growth of up to 1.62 percentage points in the seventh quarter

6. Forecast Error Variance Decompositions

In this section, we discuss forecast error variance decomposition (FEVD) of our SVAR models. In Table 1A we show the FEVD for the models in which regulatory price is diesel and in Table 1B the regulatory price used is unleaded. To conserve space, we show only show the FEVD of the first quarter for all output variables. The output variables are GDP; primary, secondary and tertiary GDP; exports; industrial output; and agricultural output growth.

Tables 1A and 1B show that between 74 and 96 percentage points of the variation of output variables in both tables can be explained by its own lagged structured. The contribution to output variables by interest rate, M2 growth and CPI growth are very small.

In Table 1A, the negative regulatory diesel price contribution to GDP growth is 5.73 percentage points, following in magnitude (percentage points) by agricultural output growth (5.11), export growth (4.83), industrial output growth (3.19) and primary and secondary GDP growth (3.02). The contribution of negative regulatory diesel price is only 0.70 percentage points.

The output variables contribution to output from positive regulatory prices is relatively small. In Table 1B, the contribution to primary sector GDP growth to positive regulatory unleaded price is 3.8 percentage points, while the contributions of other variables of either diesel or unleaded regulatory price are much smaller for all other output-variables.

In Table 1B, the negative regulatory diesel price contribution to GDP growth is 6.33 percentage points, following in magnitude (percentage points) by secondary GDP sector growth (5.58), agricultural output growth (5.11), industrial output growth (3.19), export growth (4.59) and primary GDP sector growth (5.58). The contribution of negative regulatory diesel price is 1.42 percentage points.

7. Robustness Checks

In the first robustness check, we use the WTI in domestic currency rather than in US dollars. Figure 10, show the results of this estimation. A one standard deviation increase in the growthy rate of regulatory diesel is connected to a decrease of the GDP growth of around 1.01 percentage points consistently with the results observed in our benchmark model.

In Figure 11, we estimate the benchmark model (Equations 1-3) using the Bayesian Information Criterium (BIC) to select the lag structure. The BIC selected two lags (rather than three lags selected by the BIC). Figure 11 to Figure 4 shows very similar characteristics. The main difference is that the maximum response of GDP growth occurs after the fourth quarter rather than after the second quarter (observed in the benchmark model).

8. 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 regulatory diesel and petrol prices. Such asymmetric effects arise when industries' supply curves are convex. The paper's SVAR analysis showed that decreases in the regulatory diesel price lead to a significant reduction in GDP growth; increases in the regulatory diesel price 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.

Table 1: Forecast Error Variance Decomposition

A. Variance decomposition of all output-variable (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	0.062	0.004	5.112	94.820	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. Variance decomposition of all output-variable (regulatory unleaded 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 Regulatory Petrol Prices in China During 1998Q4-2018Q4

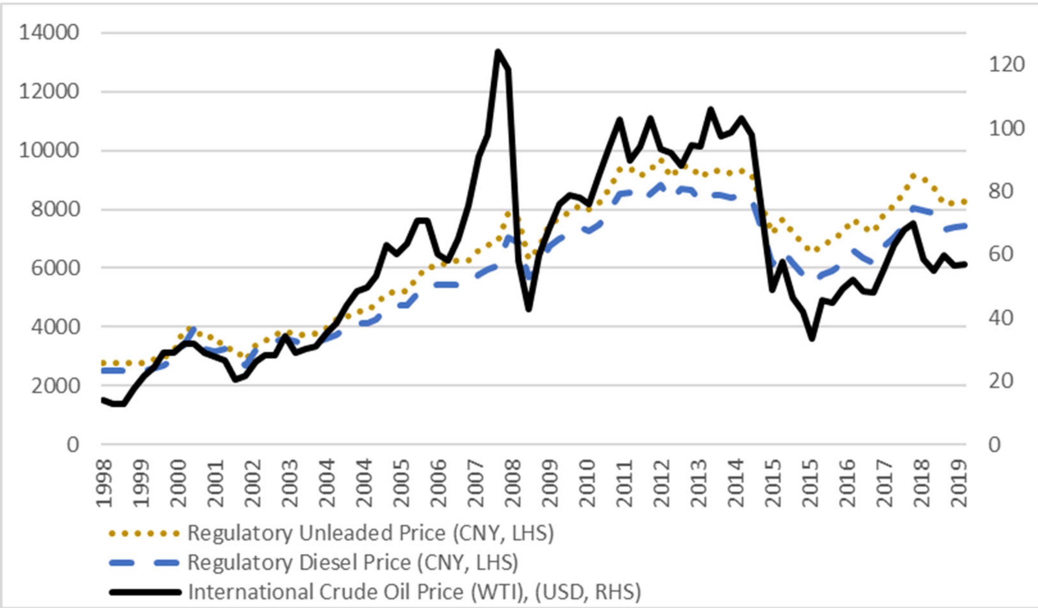


Figure 2A: Effects of Diesel Price Regulation on the Diesel Market

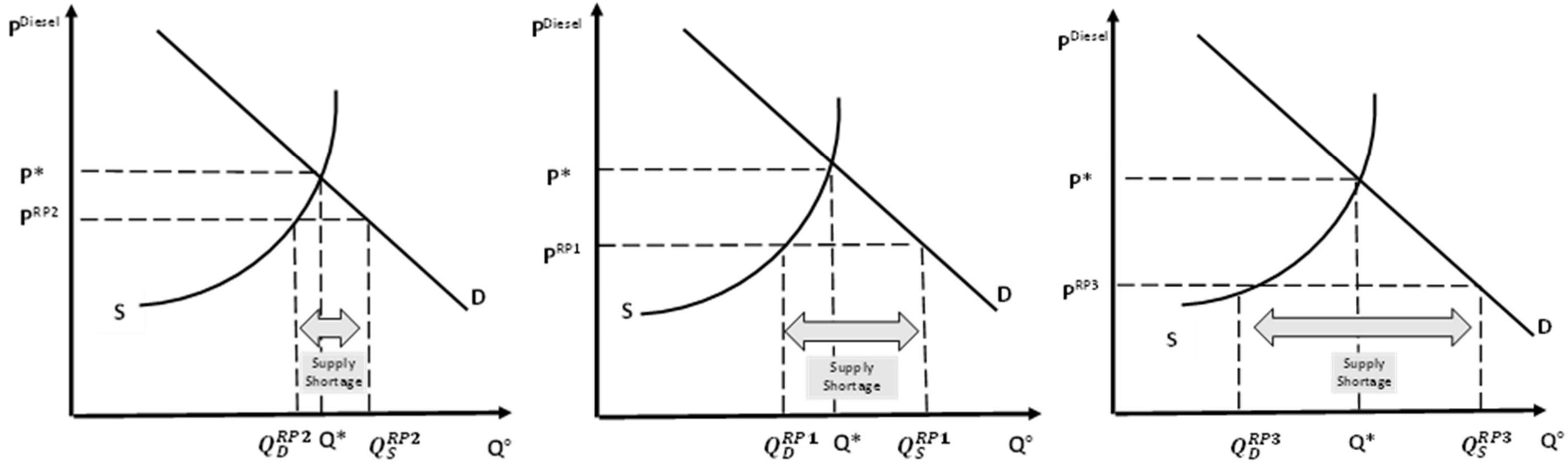


Figure 2B: Effects of Diesel Price Regulation on Other Industries

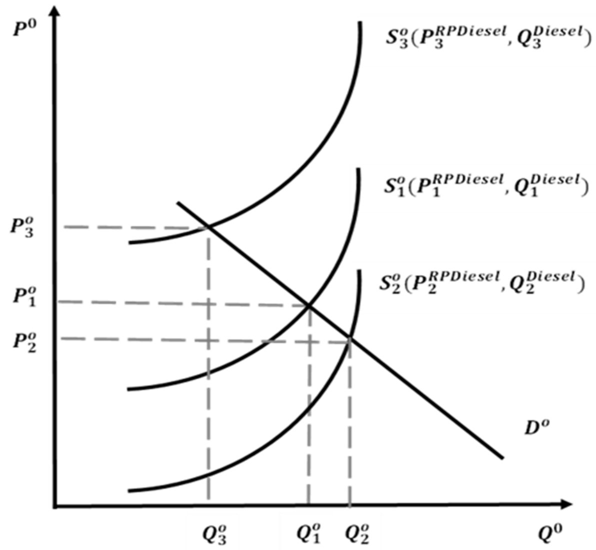


Figure 3: Cumulative Response of GDP Growth to Regulatory Diesel Price Shocks: The Symmetric Case

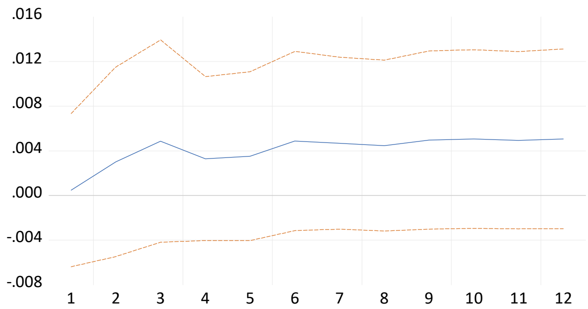


Figure 4A: Cumulative Response of GDP Growth to Regulatory Diesel Price Shocks: The Asymmetric Case

A. Response of GDP growth to a one standard deviation increase in the growth rate of regulatory diesel price.

Regulatory price growth > 0 Regulatory price growth < 0

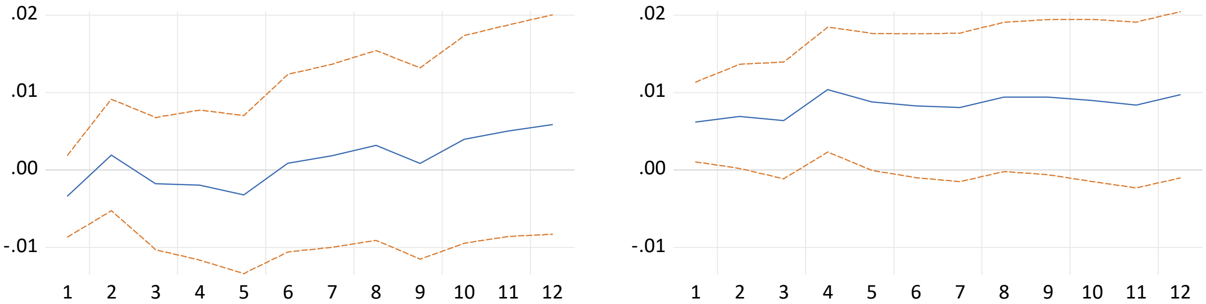
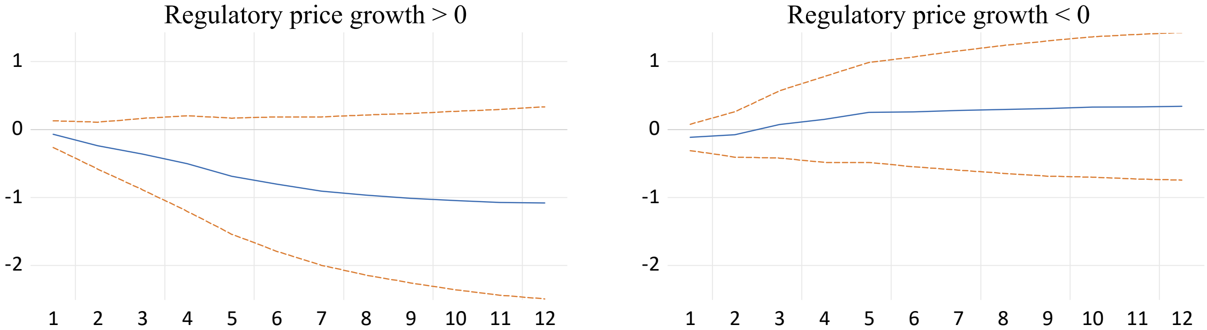


Figure 4B: Cumulative Response of Other Variables in the VAR to Regulatory Diesel Price Shocks: The Asymmetric Case

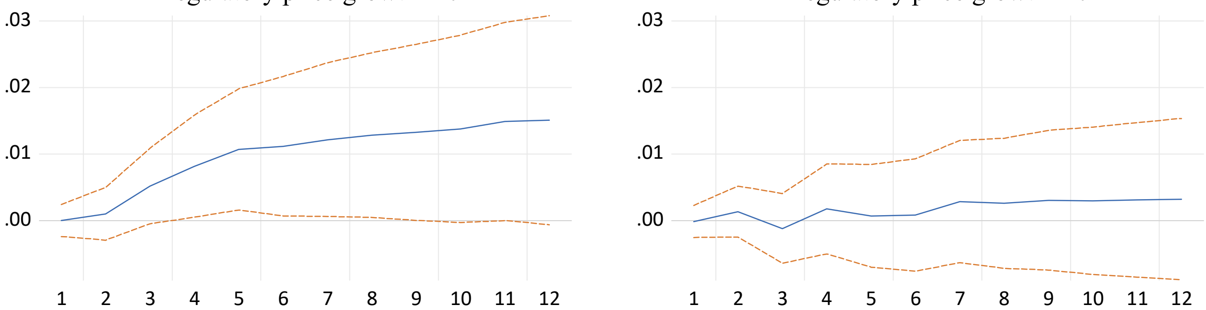
B. Response of interest rate to a one standard deviation increase in the growth rate of the regulatory diesel price.

Regulatory price growth > 0 Regulatory price growth < 0



C. Response of M2 growth to a one standard deviation increase in the growth rate of the regulatory diesel price.

Regulatory price growth > 0 Regulatory price growth < 0



D. Response of CPI growth to a one standard deviation increase in the growth rate of the regulatory diesel price.

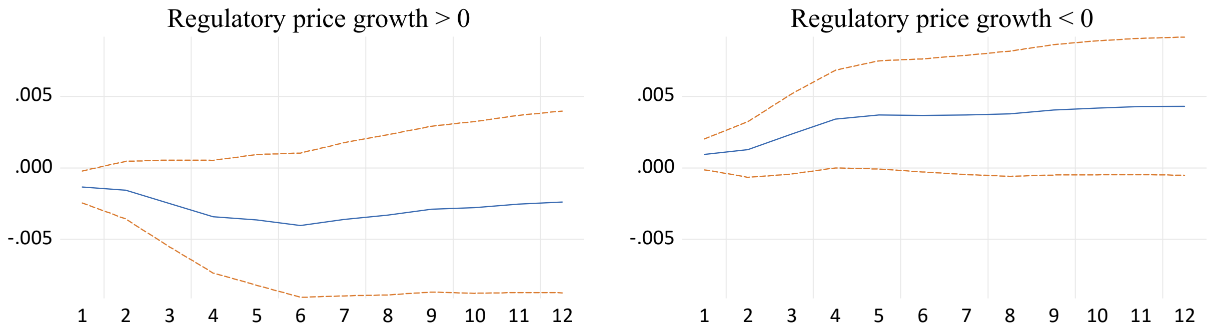
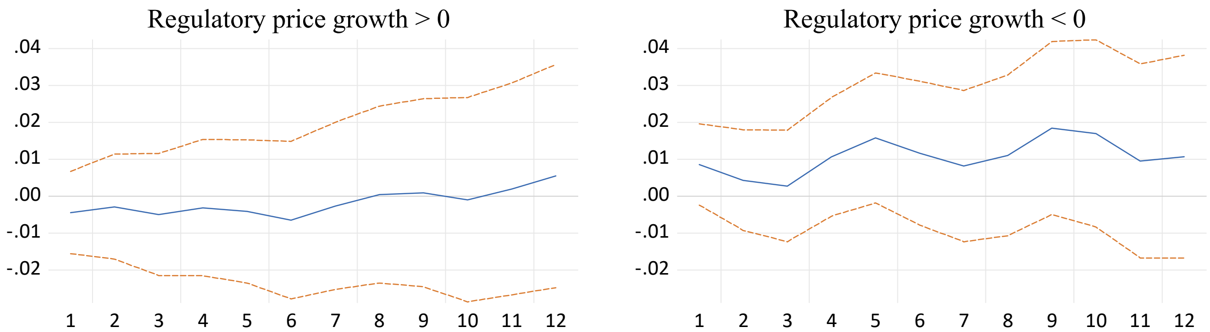
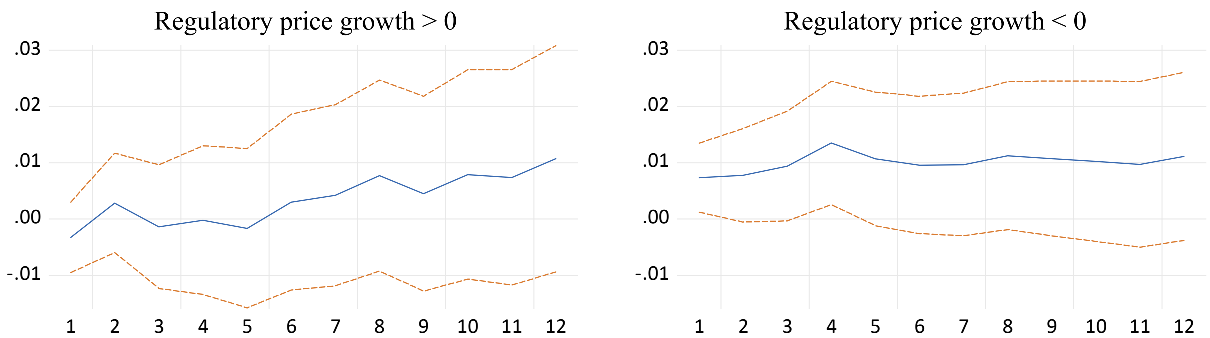


Figure 5: Cumulative Response of Primary, Secondary and Tertiary GDP Growth to Regulatory Diesel Price Shocks

A. Response of primary GDP growth to a one standard deviation increase in the growth rate of the regulatory diesel price.



B. Response of secondary GDP growth to a one standard deviation increase in the growth rate of the regulatory diesel price.



C. Response of tertiary GDP growth to a one standard deviation increase in the growth rate of the regulatory diesel price.

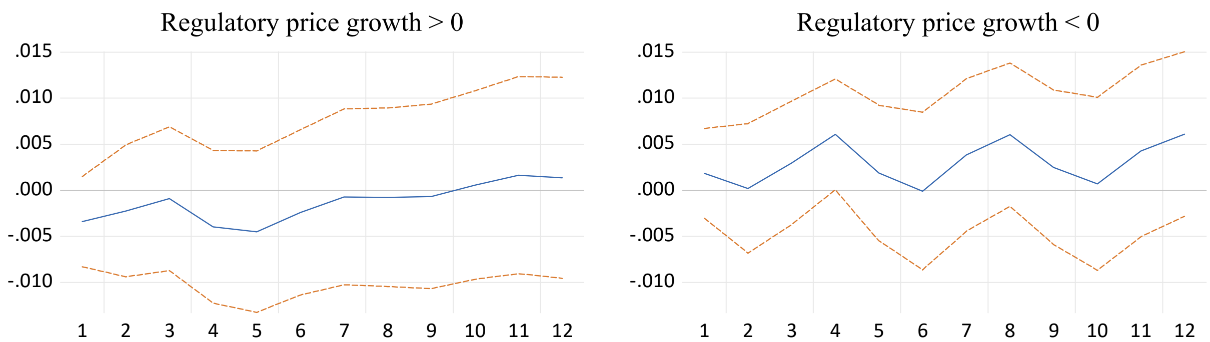


Figure 6: Cumulative Response of Exports Growth to Regulatory Diesel Price Shocks

Response of exports growth to a one standard deviation increase in the growth rate of the regulatory diesel price.

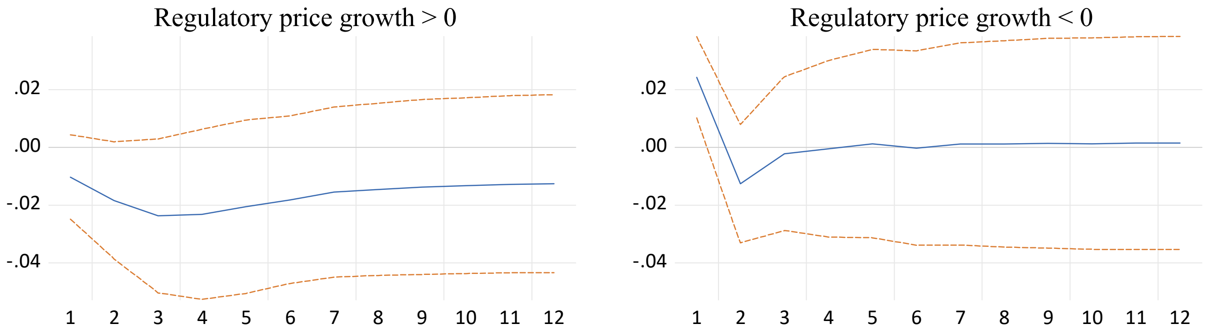


Figure 7: Cumulative Response of Industrial Output Growth to Regulatory Diesel Price Shocks

Response of industrial output growth to a one standard deviation increase in the growth rate of regulatory diesel price.

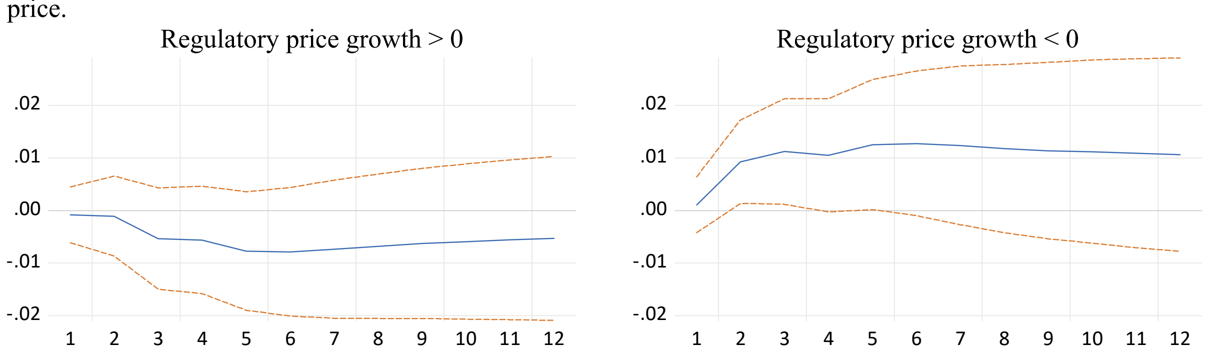


Figure 8: Cumulative Response of Agricultural Output Growth to Regulatory Diesel Price Shocks

Response of agricultural output growth to a one standard deviation increase in the growth rate of regulatory diesel price.

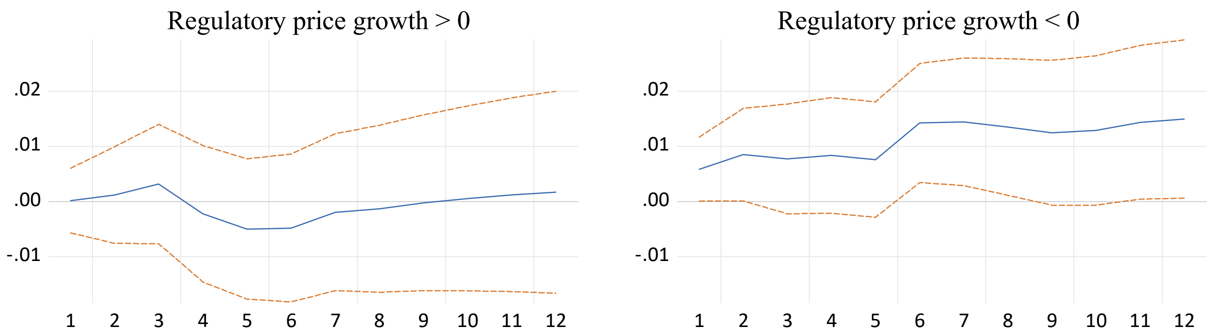
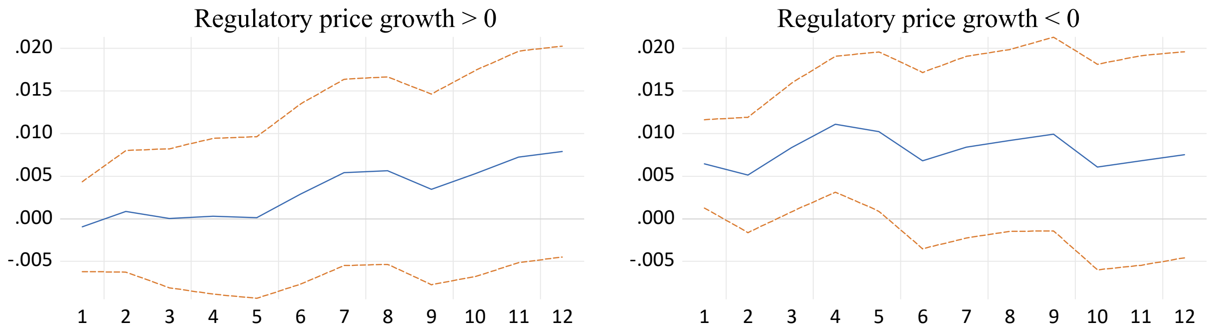
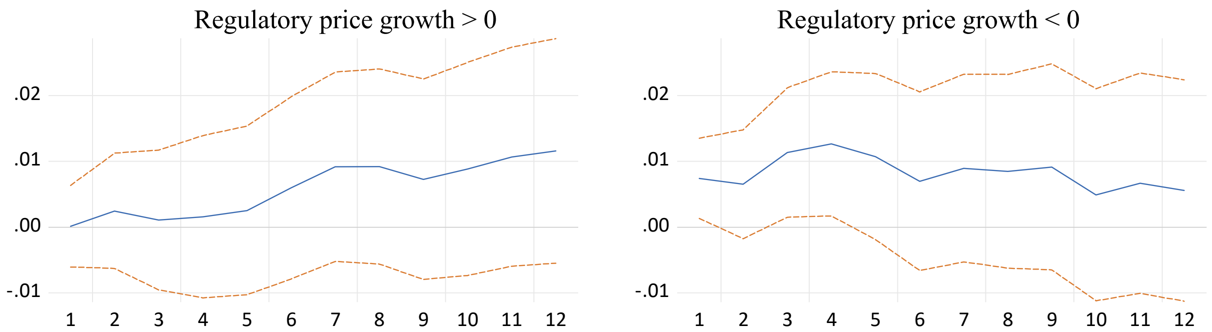


Figure 9: Macroeconomic Effects of Regulatory Petrol Price Shocks

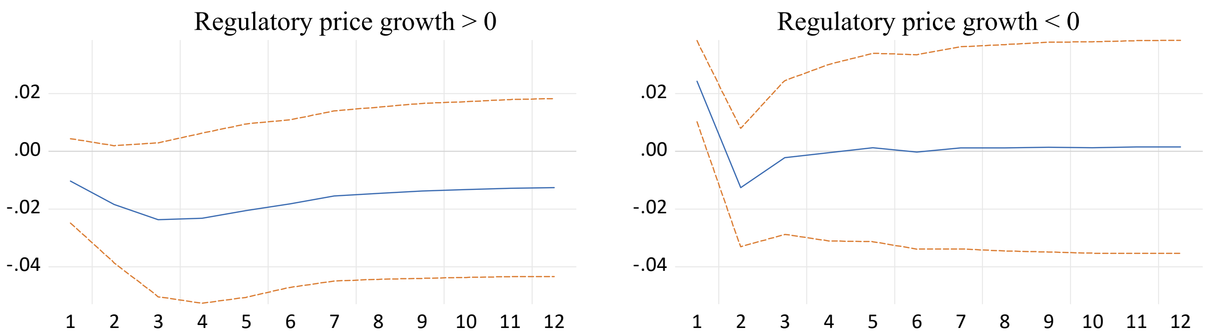
A. Response of GDP growth to a one standard deviation increase in the growth rate of the regulatory unleaded price.



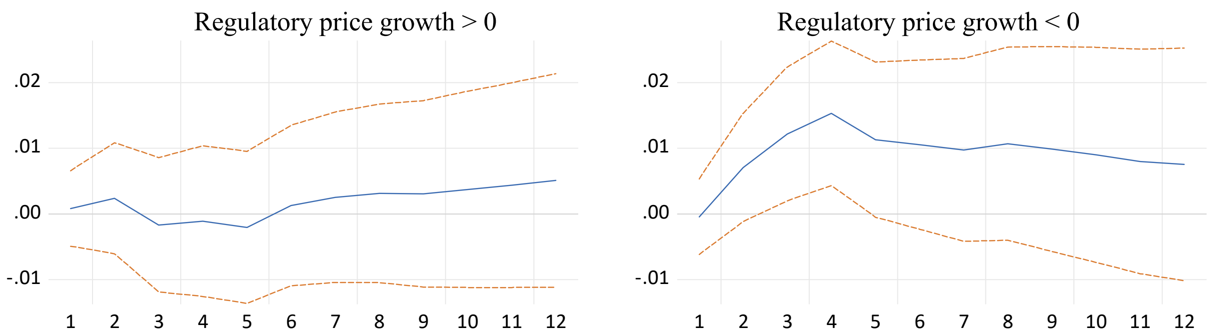
B. Response of secondary GDP growth to a one standard deviation increase in the growth rate of the regulatory unleaded price.



C. Response of exports growth to a one standard deviation increase in the growth rate of the regulatory unleaded price.



D. Response of industrial output growth to a one standard deviation increase in the growth rate of regulatory unleaded price.



E. Response of agricultural output growth to a one standard deviation increase in the growth rate of regulatory unleaded price.

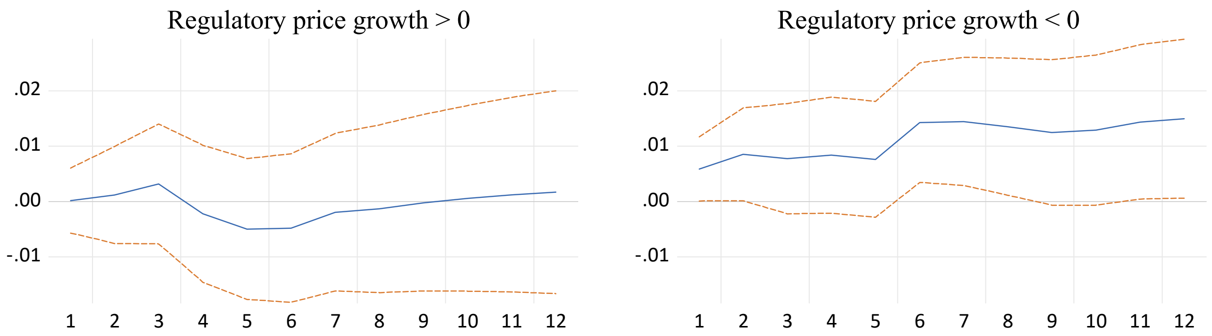
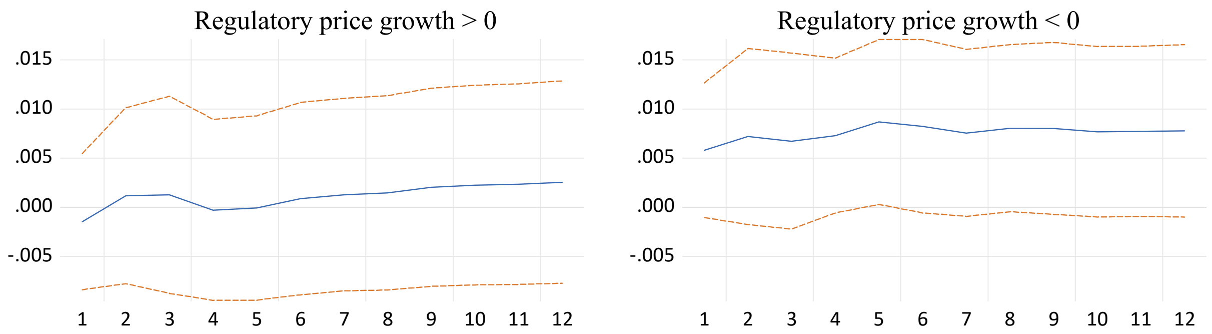


Figure 11: Robustness SVAR with 2 Lags (BIC Selection)

Response of GDP growth to a one standard deviation increase in the growth rate of regulatory diesel price.



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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 ±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 ±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.[5] 2. The consumption tax of unleaded 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 Cinta 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.[6]
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).

[5] In this paper, unless specified, the regulatory price always refers to the maximum regulatory price.

[6] The exact calculation formula of the regulatory price is undisclosed.