Chapter 4
Policy Implication and Recommendations

How to carry out macroeconomic policies in the next 2 years has attracted a lot of attention because the uncertain external economic outlook: to maintain a high growth rate, by continuing the traditional development pattern and go all out or to achieving steady growth by implementing a mild strength expansionary control policy, gradually shifting policy and then focusing on deepening reform and structural adjustments?

The simulated results of the three different scenarios with different policies are reported in Table 4.1:

Table 4.1 indicates that:

First, the lowest growth rate of GDP would be 7.5 %, in the worst case that the euro area's economic turmoil turns into a recession in 2013. It means that the trend of "stability in slowing down" has being established in China's economic growth. Although the impact of recession in the euro area will put downside pressure on China's economic growth in the short term, a modest macro-control expansionary policy could prevent China's economy from further declining. Otherwise, even carrying out the "2 trillion Yuan" massive investment stimulus policy to improve growth, the economic growth could only be moved up to the level of 8.25 % and 8.86 % 2012 and 2013 respectively, Therefore the stimulus package has neglectable positive impact.

Secondly, on the other way, the cost of such a stimulus policy is very expensive. It includes: newly increased 2 trillion Yuan investment, and thus increasing burden of local governments' debt in the next 2 years; 3.05 %–4.29 % of inflation rate (CPI); a further rise in the share of fixed asset investment in GDP, a further decline in the share of residential consumption in GDP, and in addition to further distortion in the national economy structure; further rise in the proportion of resources that controlled by local governments and central government, and then the more governmental interference to the market economy; the delay of the process of transforming economic development mode once again, and so on.

Thirdly, China has maintained a high growth rate of over 10 % since 2001. The cost to achieve this high growth is also high. At least in its later period, the negative

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Table 4.1 Prediction and simulation of different trends of China's economic growth in 2012–2013

Scenario assumption	Year	Gross domestic product (GDP)	Total domestic consumption Comparable price	Gross fixed capital formation Comparable price	Export US dollar (current price)	Import US dollar (current price)	Consumer price index (CPI)	Fixed assets investment price index (P_I)	GDP deflator index (P_GDP)
Base prediction	2012	8.01	8.27	8.97	10.82	5.76	2.9	1.98	1.85
	2013	8.3	7.18	9.05	15.93	10.87	3.27	4.42	4.31
Euro area economy further deteriorated	2012	7.71	8.26	9.1	6.42	3.94	2.69	1.76	1.72
	Gap with the basis prediction	**–0.31**	**–0.01**	**0.13**	**–4.39**	**–1.82**	**–0.21**	**–0.22**	**–0.13**
	2013	7.5	7.17	10.24	1.43	5.81	1.84	2.86	3.17
	Gap with the basis prediction	**–0.79**	**–0.01**	**1.19**	**–14.5**	**–5.07**	**–1.43**	**–1.57**	**–1.14**
"2 trillion yuan" massive fiscal spending plan	2012	8.25	8.28	9.58	10.69	5.86	3.05	2.14	1.94
	Gap with the basis prediction	**0.24**	**0.01**	**0.61**	**–0.13**	**0.1**	**0.15**	**0.16**	**0.09**
	2013	8.86	7.19	10.67	14.98	11.03	4.29	5.55	5.13
	Gap with the basis prediction	**0.56**	**0.01**	**1.62**	**–0.95**	**0.16**	**1.02**	**1.13**	**0.82**

Sources: Calculation of the Center for Macroeconomic Research (CMR-XMU) respects include: resource preserving, environment protecting and income share of working class. And the cumulative of these negative effects leaded to the urgency of transforming economic development mode. Transforming development pattern means the requirement of reducing the high economic growth rate appropriately to exchange for effective, resource, environmental protection, for technical progress, industrial restructuring, and for the adjustment of national income and residential income distribution structure, to achieve inclusive growth.

Fourth, the economic growth rate about 8 % should be considered as a normal or potential growth rate after China entered a new development stage with second highest growth rate. In general, when an economy entered into a new development stage that it's economic growth mainly depend on domestic demand, it was very difficult to maintain a growth rate over 10 % for a long period. However, under the current circumstance that external economy continues to deteriorate, China economy is able to hold the economic growth rate of about 7.5 % or above. This indicates that even in so bad external surroundings, China also can generally maintain an economic growth rate of about 8 % primarily relying on domestic consumption and investment demand

By assuming that 8 % is the normal or potential growth rate after China entered a new development stage with the second highest growth rate, we conclude:

In current macroeconomic situation, China should not launch a new massive fiscal spending stimulus plan. Because the previous stimulus plan, launched in 2009, had raised series of issues to be solved, though it supported the economic growth. These issues are: further strengthening the capacity of the government controlling resources and crowding out the share of resources controlled by market economy, exacerbating the imbalance of national economic structure, improving governmental debt burden, boosting inflation, and so on. Among these problems, what we must pay special attention is the soaring debt of local governments.

Up to the end of 2010, governmental debt balance was approximately 17.47 trillion Yuan, among which central government debt balance was 6.75 trillion Yuan, an increase of 1.43 trillion Yuan, 26.88 % compared to the end of 2008; and local government debt balance even reached to 10.72 trillion Yuan, which was 5.15 trillion Yuan higher than the end of 2008.[1] Affected by this, the debt balance ratio of local governments to central government had jumped from 1.04 in 2008 to 1.59 in 2010.

The rapid increase of governmental debt will lead to many adverse effects.

First, large scale debt will offset the effect of macroeconomic policies. In 2010, the proportion of governmental debt to GDP is about 43.5 %, which was low compared with developed economies such as Euro area, the United States and Japan.[2] Comparison 34.7 % in 2 years ago, the proportion had rapidly increased 8.8 percentage points. Meanwhile, from debt-service payment perspective, central government should pay about 1.35 trillion Yuan in 2011, which accounted for more

[1]Quote from No. 35 announcement that published by the National Audit Office of P.R.C in 2011 and CEIC database.

[2]The proportion of public debt to GDP is about 62.2 % in U.S. in 2010; Euro area is nearly 85 % averagely, in which Greece, Italy and Belgium are more than 100 %; Japan is more than 200 %.

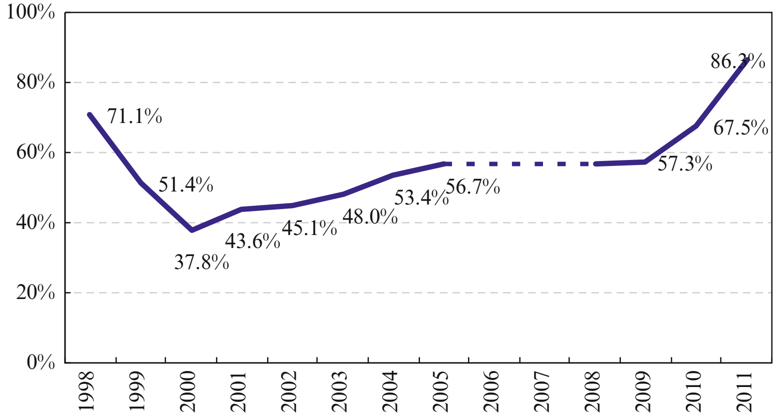

Fig. 4.1 Trend change of the ratio of debt-service payment to the income from issuing bonds (The data of 2006–2008 is missing. We show them with *dotted line*. Sources: CEIC)

than 10 % of total fiscal expenditure, only next to the expenditure scale of education, agriculture, forestry and water conservancy as well as social security; and the ratio of debt-service payment to the income from issuing bonds was up to a new high record of 86.3 % (Fig. 4.1). This means only 13.7 % of the income could be spent on other expenditures. Therefore, the increase of debt-service payment will partially offset funds obtained through debt financing, which will greatly compress the operating space of future macroeconomic policies.

Secondly, the rapid rise of debt will significantly increase fiscal burden of local government, and increase short-term debt payment risk. In 2011, the debt at maturity of local government is up to 2.62 trillion Yuan, which comprises about half of local fiscal income. The scale of maturity debt will be slightly less in 2012 and 2013, but still more than one trillion Yuan, which are 1.84 and 1.22 trillion Yuan respectively. In the context of a significant slowdown in fiscal revenue growth in the next 2 years, it will bring great financial pressures to local government. According to No. 35 announcement that published by the National Audit Office of P.R.C in 2011, by the end of 2010, a total of 78 municipal and 99 county governments bear a high repayment obligation debt ratio over 100 %, which accounted for 19.9 and 3.56 % of the total numbers of the two level governments. Due to insolvency, some local governments had to borrow new debts to roll over old debts, or even had overdue payment.

Thirdly, in addition to micro risks of short-term debt payment pressure, the rapid increase of government debt will also cause macro risks. First of all, residents are the ultimate bearer of government debt. Therefore, the augment of the size of the debt will promote future tax level, reduce the actual income of residents, decrease the willing of consumption, and then further distort the aggregate demand structure, which will neutralize the effect of the expansionary policies in turn; Second, when the normal tax growth cannot afford the scheduled debt service payment, land finance has become the most important and dependable source of revenue to local governments. Therefore, the high scale of the debt will not be conducive to the adjustment of fiscal system, and it also can be difficult to curb the inner impulse of local government to relax house purchase quota policies.

In the context of large size of government debt, shrinking space to issue more bonds, high overdue risks of debt service payment, and related macro risks, the re-start of massive fiscal spending stimulus plan will undoubtedly increase government debt burden, and will not be conducive to the structural adjustment of aggregate demand, the reform of fiscal system and the implementation of real estate market regulation and control policies. Especially, when external economic environment have no significant change, the pull effect to marginal economic growth of such a high policy cost of re-start massive fiscal spending stimulus plan is very limited. It is unprofitable and harmful, either from policy possibility, or from necessity.

Therefore, the current macroeconomic policies should be located at: a fine-tuning of moderately expansionary policy, which aims to stabilize the growth rate around 8 %, and at the same time, gradually veering the policy priorities to deepen institutional reform and structural adjustment. While maintaining a appropriate growth rate around 8 %, China has to gradually remove the significant structural imbalance and institutional barriers, which hinder and constraint the development of our long-term potential growth, and accelerate the transformation of economic development mode during the "Twelfth Five-Year Plan" by further reform and structural adjustment.

China must focus on improving the efficiency of resource use and economic growth; on changing the structure of income distribution; on restricting governments' power; on reducing tax burden and regulating the proportion of governmental revenue in GDP; on the better using of fiscal revenue to social welfare spending; on eliminating monopoly and narrowing residential income gap, to create the conditions for entering to a new development stage that mainly depend on domestic demand. The research team believes that an healthy economy, should improve social and economic structure, should be efficient and inclusive. In one word, China should pay more efforts on improvement of wellbeing of people with social progress, even growth rate is slightly lower than previous years.