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Center for Macroeconomic Research of Xiamen University

China's Macroeconomic Outlook

Quarterly Forecast and Analysis Report, February 2014

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Preface

This report is a partial result of the "China Quarterly Macroeconomic Model (CQMM)," a project of the Center for Macroeconomic Research (CMR) at Xiamen University. The CMR is one of the Key Research Institutes of Humanities and Social Sciences of the Ministry of Education of China. The research is funded by the National Social Science Foundation of China (13&ZD029), the Youth Project of the National Social Science Foundation of China (13CJL017, 11CJY073), the Key Research Institutes of Humanities and Social Sciences of the Ministry of Education of China (13JJD790026, 13JJD790025, 12JJD790001, 2009JJD790038), and the National Nature Science Foundation of China (71073130).

Since the launch of CQMM 8 years ago, 14 forecast reports with policy simulations and 8 essay collection books on China's macroeconomic analysis have been published. This is the 16th forecast report, which is a summary of forecast results released at the "China Macroeconomic Advanced Forum (Spring 2014), CQMM Press Conference for Economic Projections for 2014–2015." The forum was jointly organized by the Center for Macroeconomic Research, Xiamen University and the Economic Information Daily, Xinhua News Agency in Beijing on February 20, 2014.

We are grateful to all the experts for their valuable comments at the press conference. We also appreciate the support extended by the Economic Information Daily, Xinhua News Agency. We thank the media for reporting the conference. Of course, we are fully responsible for any mistakes that remain in this report.

Xiamen, China

Center for Macroeconomic Research
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Chapter 1
Introduction

The real growth rate of China's gross domestic product (GDP) was 7.7 % in 2013. The corresponding consumer price index (CPI) rose by 2.6 %, and the producer price index (PPI) fell by 1.9 %. Growth of investment in manufacturing as well as the growth of industrial added value slowed down, although economic growth kept pace with its 2012 counterpart. As a result, growth of government revenue and expenditure continued to decrease sharply; notably, the real growth rate of government revenue fell below the real growth rate of GDP for the first time since 1997. Moreover, the growth of foreign trade in China was weak because of slow economic recovery in Europe and the United States, the continually appreciating RMB, and rising domestic wages. Since the growth of real income of residents evidently dropped, and the government restricted its public consumption expenditure, the contribution rate of final consumption to GDP growth decreased further. Once economic growth faced downward pressure, the launch of government-led investment in order to stabilize the economy seemed an inevitable choice, as the economic structure had not improved and no new growth mechanisms had been formed. Since the outbreak of the global financial crisis, the economic growth rate has continued to fall despite the rapid expansion in social financing; thus, each percent of growth needs more social funds, and potential growth has continued to drop under the current economic system.

Although the external market is expected to recover in 2014, the problem of excess domestic production capacity and the pressure of debt repayment on local governments would suppress the expansion of government investment in the real economy. Meanwhile, the implementation of a comprehensive plan for deepening reforms, which would lead to a new economic system, should affect the stability of economic growth to some extent. The forecast of the China Quarterly Macroeconomic Model (CQMM) shows that **China's GDP growth rate will decrease to 7.62 %, 0.08 percentage points lower compared with the last year, followed by an increase to 7.79 % in 2015**. Notably, for 2014, the annual GDP growth would fall to 7.46 % in the first quarter, thanks to the rebound in export growth, and the effects

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of the stabilization policy would cause it to rise to 7.76 % in the second quarter, the highest point of the whole year. Then, it is expected to slowly fall to 7.70 % in the fourth quarter.

China's inflation level is expected to remain stable in 2014. Its CPI in 2014 would be 2.82 %, 0.2 percentage points higher compared with the last year. In 2015, the CPI would attain a moderate level of 2.92 %. Moreover, the PPI would remain negative for the next 2 years, although it would increase gradually. Notably, it is estimated that the PPI would be −0.88 % in 2014 and −0.55 % in 2015.

Total exports at current price (valued in USD) are expected to grow to 9.66 % in 2014, showing an increase of 1.57 percentage points compared with the last year. However, total imports are expected to grow at 8.28 %, an increase of 1.06 percentage points over 2013. As a net effect, the trade surplus would narrow further. Assuming that the debt risk of local governments will be controlled, the growth rate of urban fixed assets investment at current prices is forecasted to be 18.42 %, 1.30 percentage points lower than that in 2013. The total retail sales of consumption goods at current prices would increase by 13.56 %, about 0.4 percentage points higher than last year.

The rapid increase of government-led investment has substituted investments in manufacturing and real estate and can guarantee the stable growth of the total fixed asset investment. However, the growing size of local government debts has increased the risk of debt defaults and threatens the safety of the financial system.

Firstly, the scale of local government debts has expanded too fast. The audit announcement released by the National Audit Department on December 30, 2013 showed that the debt balance of local governments, which was only 1.81 trillion CNY in 1997, increased to 17.88 trillion CNY at the end of June 2013. The average annual growth rate of the debt balance of local governments was 15.92 %. From 2010 to June 2013, the debt balance local governments (including provinces, cities, and counties) were obligated to repay grew at an annual rate of 19.97 %. Notably, the average annual growth rate of the debt balance of provinces, cities, and counties was 14.41 %, 17.36 %, and 26.59 % respectively, far exceeding the relevant GDP growth as well as the corresponding growth in local government revenue.

Secondly, platform companies with local government backgrounds as well as state-owned or state-controlled enterprises are not independent players in the market. Under the current government administration and soft budget constraints, the risk preferences of such enterprises would inevitably become distorted, and their inappropriate financing behaviors would enhance unfair competition in the fund market. This distorted financing behavior would definitely push up the borrowing interest rates in the market and raise the cost of funds.

Thirdly, the rapid expansion of local government debts squeezes the majority of bank loans. Assuming that the total funds remain constant in the market, the excessive financing provided to the local governments by banks would certainly substitute the loan ratio of independent market entities, especially the small or micro non-state-owned enterprises, which would increase their financing costs as well. If the total borrowing funds available to independent market entities remain constant, nonstandard and large-scale financing by the local government would inevitably

force the banks to increase the scale of total borrowing funds, which would perhaps become the source of inflation in the future. Otherwise, both financing costs and social financing would increase concurrently under this condition.

Therefore, the ability of the government to control the scale of local government debt, optimize the finance structure, and lower the risk of local governments defaulting on their debts, would effectively become the key to comprehensive plans for deepening reforms, especially those necessary for the taking the current finance system to the next stage.

The report "China's Macroeconomic Outlook, Quarterly Forecast and Analysis Report, September 2, 2012" acknowledged that the rapid expanding scale of local government debts could impact the stable growth of the Chinese economy in the long term. Accordingly, the research team compiling this report emphasized that "efforts to stabilize economic growth should not entail excessive investment" and "China should not launch any plans for large-scale investment should the GDP growth fall below 8 %, following the downward trend of 2012." Thereafter, in the spring and fall versions of the series report "China's Macroeconomic Outlook" for 2013, the research term discussed scenarios of changes in government revenue should the economy enter a phase with a moderately high (7–8 %) GDP growth. The research team pointed out that the growth in government revenue could not be maintained above GDP growth as the potential for growth had already fallen; however, the share of GDP dominated by the Chinese government was too high, since the growth in government revenue had evidently exceeded growth in GDP over the past 15 years. Too rapid a growth in government revenue would not favor the healthy growth of the socialist market economy. The government would not only need to clearly define the boundary between the market and itself but it would also have to control the share of government revenue in the GDP. Therefore, the government would need to control the size of government budget and establish a thrifty fiscal system in the long term. This policy would favor adjustments to the economic structure as well as enhance economic vitality and resource allocation efficiency. The research team underscored the importance of these ideas in this report, namely that policy simulation concerns should be directed at the impact of the rise in the ratio of local government debts on the macroeconomy.

The policy simulation focuses on regulating the finance channel and finance structure of local government debts by controlling them. It contains two scenarios. The first scenario assumes a rise in the ratio of government bonds to debt in order to optimize the macroeconomic effects of the financing structure of local governments, assuming that the growth of money supply as well as the total local government debt remains constant. The second scenario is based on the first scenario, but it introduces new policy variables to analyze the macroeconomic impact arising from the proper control of total local government debts and the rise in the share of bond financing in total government finance.

The research team believes that given the situation of the debt risk of local governments, the government should first control the scale of total debts and then adjust the debt structure. Eventually, it should establish relevant laws pertaining to local government bond financing. According to the term structure of current local

government debts, these debts would enter a peak period of maturity. Therefore, the local government should raise the share of bond financing[1] by debt exchange, lower the ratio of bank loans and build-transfer (BT) and trust financing, and restrict non-regulated behaviors in the process of debt financing. Thus, the government should control the scale of local government debt financing and eliminate any opportunistic behaviors, like pursuing better economic performance at the expense of overdrawing future financial resources.

The policy simulation shows that it would be favorable to stabilize GDP growth, promote private investment, and encourage public consumption, provided local governments could properly specify ways to finance debt and raise the bond financing ratio. This could also improve the balance of supply and demand in the fund market and restrain increases in the finance cost. Besides, such measures would help expand exports and narrow the trade surplus to some extent. Thus, the macroeconomic effect would be more pronounced if the local government could compress the debt scale based on the abovementioned measures.

If regulating local government debt finance is the first step to eliminate the debt risk, then the government should further restrict the scale of debts and limit any arbitrary expansion of the resource allocation ratio at the national level. However, this problem cannot be solved by relying on the approval authority of the central government alone. There is the added need to establish an intertemporal mechanism for budget balancing, an accountability system for comprehensive government finance reporting, systems for standard and reasonable debt management, and a risk warning mechanism at both the central and local government levels. Moreover, according to the requirements of "The Decision on Major Issues Concerning Comprehensively Deepening Reforms by the Central Committee of Communist Party of China," it is important to build a legal and service-oriented government and to correct the overemphasis on the GDP growth, which has been traditionally used to assess an officer's achievements. Moreover, it is necessary to establish a constraint system and finance guarantee mechanism so that the local government can implement public service, market supervision, social management, and environmental protection as its main duties.

Based on the above analysis, the research team makes the following policy suggestions:

1. The key to establish a system that guarantees stable economic development in the future is to correct distortions of the production factor price. These distortions form the micro basis for extensive growth mode under a government-led market. Establishing such a system could make the market the true decisive factor in resource allocation and correct the factor price that was formed many years ago and continues to exist at the present time.

[1] In particular, this includes bonds and city investment bonds that local governments entrust the Ministry of Finance to issue indirectly, as well as the municipal bonds issued directly by local governments under strict audition.

2. The power of government should be controlled and weakened appropriately in order to correct the distortion in the factor price and let the market be the main force in resource allocation. Only drastic decreases in the amount of resources allocated directly by the government can promote resource allocation according to market rules, prices, and competitions, and thus help realize efficiency optimization.
3. Policies regulating the debt size and debt finance channels of local governments serve as measures for preventing debt risk as well as determining the boundary between the market and government. This helps decrease direct resource allocation by the government and makes the market the key player in resource allocation. A market economy cannot exist if restrictions are not imposed on the ratio of government revenue in GDP, government access to resources, and expenditure of government revenue.
4. Market-oriented interest rate reform is the most significant measure to correct the factor price distortion. It should fulfill the requirement for the market to determine interest rates for deposits and loans as quickly as possible. Nevertheless, restrictions on arbitrary debt financing by the government would be necessary for market-oriented reform of interest rates, efficiency of funds, and decreasing finance costs.
5. The structure of finance market must be more rational. The market-oriented reform of interest rates can restrict the nonstandard and arbitrary government debt financing only if a competitive finance market exists. The opening up of the finance market and the formation of a competitive market structure should come about simultaneously. This would break the monopoly, promote effective competition, realize effective financial resource allocation, raise fund utilization efficiency, lower the finance cost, and improve the public revenues.
6. The government should introduce tax system reforms as soon as possible, so as to complete the local tax system and gradually raise the ratio of direct taxes. For servicing different levels of government administration, the authorities should undertake tax reforms immediately, complete the local tax system, and gradually raise the share of direct taxes. The government should base local taxes mainly on the estate tax, consumption tax, and personal income taxes, in order to set up new sources for financing the needs of local governments and promote changes in their behavior.
7. The government should clearly specify all "dos and don'ts" in the management of the "negative list." It should delineate which particular activities and actions must not be implemented, so as to leave no doubts and discourage individuals from implementing the activities prohibited by the "negative list." In the event of excess production capacity in the manufacturing sector, the government should administrate according to the "negative list," so as to promote private investment by opening up more sectors to investment, thus formulating new avenues for economic development.
8. The government should break its administrative control and monopoly in order to develop the service industry. The service industry, which promises more opportunities for private investment, should be a key field in the management of

the “negative list.” To speed up management system reforms in the service industry and to garner much-needed private investment, it is important to accelerate these developments so as to bring about positive changes in people’s lives. These changes would also stimulate residents’ consumption and provide new development opportunities. Lastly, but not least, such measures are significant for guaranteeing stable progress in the next stage of planned growth for China.

Chapter 2
A Review of China's Economy in 2013

2.1 Economic Growth Stabilized, and the Economic Growth Structure Adjusted Slowly

In 2013, China's real GDP grew by 7.7 %, the same as in 2012. Since 2010, the economic growth rate has declined for four consecutive years (Fig. 2.1). Quite similar to the macroeconomic trends and policy control mode adopted in 2012, from mid-2013, the central government launched a series of fine-tuning measures to stabilize the economic growth rate after experiencing sustained downward growth during the first half of 2013. These measures inhibited the declining economic trend in the third and fourth quarters and ensured that the annual economic growth rate for the entire year matched that of the previous year. However, the real annual growth rate of industrial value added was only 9.7 %, a decrease of 0.3 percentage points from 2012, and the lowest since 2009. A constant drop in the growth rate of industrial value added reflects a slowdown in the real economy.

The growth rate of real income slowed down and the contribution rate of consumption to economic growth declined further. In 2013, the per capita disposable income of urban residents grew by 7.0 %, a decrease of 2.6 percentage points from the previous year and 0.7 percentage points lower than the economic growth rate. The per capita net income of rural residents grew by 9.3 %, 1.6 percentage points higher than the economic growth rate, but 1.4 percentage points less than last year. Influenced by the declining growth rates of real incomes of urban and rural residents and restrictions on the "three public expenditures" and other anti-corruption measures, total retail sales of consumption goods grew by 11.5 %, a decrease of 0.6 percentage points from the previous year. The cumulative contribution rate of final consumption to GDP growth dropped sharply to 50.0 %, a decrease of 5 percentage points from the previous year. The cumulative contribution of net exports to economic growth continued to decline, from −2.1 % in 2012 to −4.4 % in 2013. The

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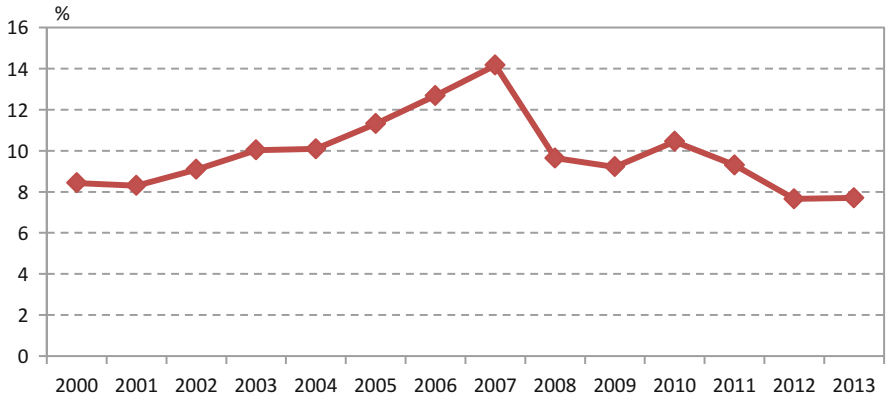

Fig. 2.1 Changes in the real GDP growth rate (Data source: CEIC)

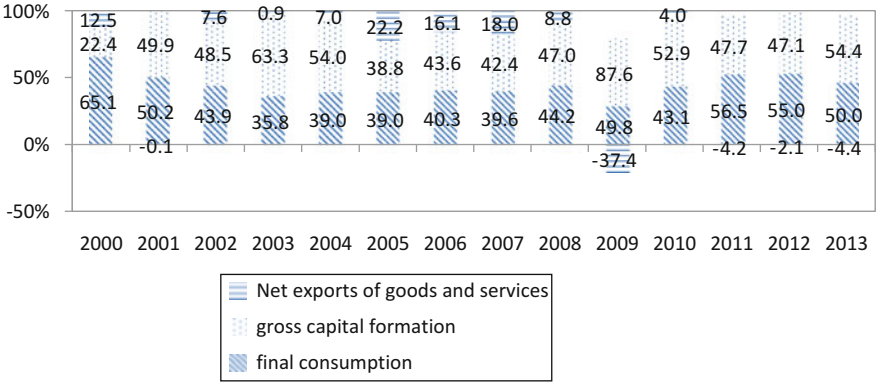

Fig. 2.2 Changes in the contribution rate of GDP growth based on the expenditure accounting approach (Data source: CEIC)

cumulative contribution of gross capital formation to GDP growth thus rose to 54.4 %, an increase of 7.3 percentage points over the previous year (Fig. 2.2).

Although GDP growth in 2013 was roughly the same as that in 2012, the economy has gradually stabilized during the process of continuous decline since 2008. This seems to presage the formation of a new economic growth platform. However, the economic developments of the past 2 years show that this new growth platform does not have a solid foundation yet. The continuous decline in the growth rate in the first halves of 2012 and 2013, its steady rise after the implementation of mid-year policy measures, and the re-emergence of the downward trend at the beginning of the next year indicated that China's economic growth is still not self-sustaining. Under the existing institutional framework, the drive of economic growth has continued to decline, economic vitality has decreased gradually, and efficiency has continued to drop. To achieve economic growth, the country has had to rely on an

external driving force, namely, expansion in government investment. The new central government intensified anti-corruption efforts and encouraged austerity to inhibit extravagant government spending over a period of time. On the surface, all these measures led to a further decline in final consumption. However, basically, the decline in final consumption reflected that the existing economic growth mode had not been fundamentally reversed, the growth rate of household income slowed down, and household consumption remained sluggish. As the economic structure has not been adjusted effectively and a new mechanism for economic growth is not yet to form, once economic growth encounters greater downward pressure, government-led investment expansion will become the final option to stabilize economic growth. The growth rates of real incomes of urban and rural residents declined further in 2013, exacerbating structural distortions.

2.2 Manufacturing Investment Growth Fell Sharply

In 2013, fixed asset investment (excluding rural households) grew by 19.6 %, a decrease of 1 percentage point from the previous year. Among them, the growth rates of investments in the manufacturing and real estate sectors decreased significantly, while those of investment in transportation, storage, and postal services increased. The shrinking real economy directly inhibited investment in manufacturing. Annual manufacturing investment grew by 18.5 %, a decrease of 2.8 percentage points from the previous year, the lowest level since 2000. Real estate investment grew by 20.3 %, a decrease of 2.1 percentage points from the previous year. Transportation, storage, and postal services investment grew by 17.2 %, an increase of 6.0 percentage points over the previous year (Fig. 2.3). Manufacturing investment made up 33.76 % of total fixed asset investment, a decrease of 0.33 percentage points from the previous year. Transportation, storage, and postal services investment accounted for 8.29 % of total fixed asset investment, a decrease of 0.17

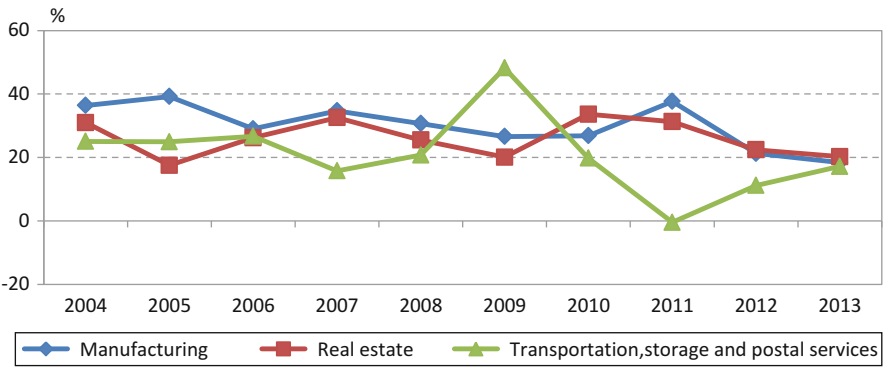

Fig. 2.3 Changes in the growth rate of investment in fixed assets by industry (Data source: CEIC)

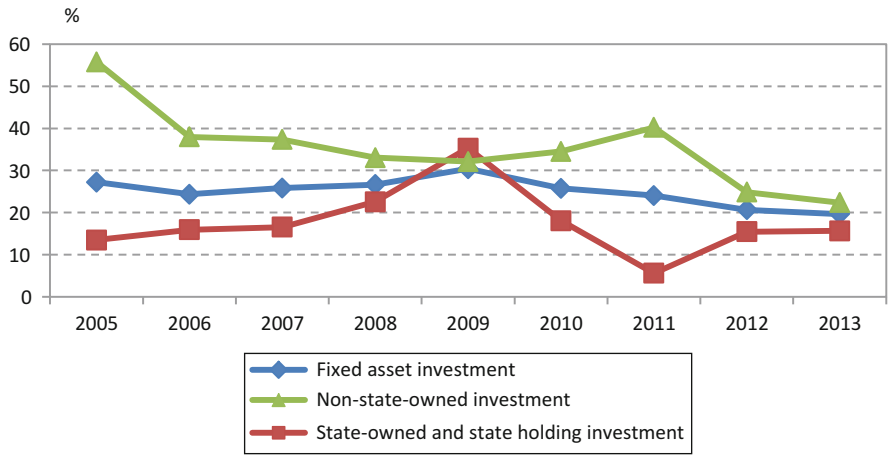

Fig. 2.4 Changes in the investment growth rate in fixed assets by ownership type (Data source: CEIC)

percentage points from the previous year. Real estate investment accounted for 25.53 % of total fixed asset investment, an increase of 0.14 percentage points over the previous year.

In terms of investor type, the growth rate of investment from non-state-owned enterprises continued to decline, while investment in state-owned enterprises increased month-by-month. In 2013, investment from state-owned and state-controlled enterprises grew by 15.6 %, an increase of 0.2 percentage points over the previous year, and investment from non-state-owned enterprises grew by 22.4 %, a decrease of 2.4 percentage points from the last year (Fig. 2.4).[1] Investment from enterprises located in Hong Kong, Macao, and Taiwan grew by 7.0 %, a decrease of 1.9 percentage points from the previous year, while investment from foreign business grew by 4.5 %, a significant decrease of 9.1 percentage points from the previous year. The shrinking of the real economy led to a significant decline in non-state-owned enterprise and manufacturing investment growth. At the same time, although "The Decision on Major Issues Concerning Comprehensively Deepening Reforms" was adopted at the Third Plenary Session of the 18th Communist Party of China (CPC) Central Committee (which proposed a series ideas to develop the socialist market economy), namely the need to refine the relationship between the government and the market and the promotion of decisive mechanisms in resource allocation, more time is needed for their implementation and for the resolutions to take effect. Improper institutional restrictions on non-state economic sector investment and the investment "glass door" can, to a certain extent, inhibit probable investment growth that may have been fueled by independent market entities.

[1] Fixed assets investment from non-state enterprises = investment from domestic enterprises – investment from state-owned and state holding enterprises.

2.3 The Growth of Imports and Exports Was Weak, and the Trade Surplus Continued to Expand

While the United States and Europe accelerated the process of economic recovery in 2013, the continued appreciation of the RMB and the increase in domestic wages weakened the growth of China's imports and exports. Total exports in USD grew by 7.9 % only, the same as last year, while imports grew by 7.3 %, an increase of 3.0 percentage points over the previous year (Fig. 2.5). The annual trade surplus reached 259.75 billion USD, an increase of 29.4 billion USD over the previous year. Total utilized foreign direct investment reached 117.586 billion USD, a decrease of 3.487 billion USD from the previous year. Foreign exchange reserves continued to increase, reaching 3.82 trillion USD.

Trade structure improved, and the share of general trade increased. In 2013, China's general trade exports (in USD) grew by 10.1 %, an increase of 2.4 percentage points over the previous year. The growth rate of general trade imports was 8.5 %, an increase of 7 percentage points over the previous year. The trade deficit of annual general trade narrowed slightly to 22.1 billion USD. On the other hand, the growth rate of processing trade exports continued to decline to −0.2 %, a decrease of 3.5 percentage points from the previous year and that of imports in processing trade grew by 3.3 %, an increase of 0.8 percentage points over the previous year. The trade surplus of annual processing trade rose to 363.6 billion USD. The share of general trade exports rose to 49.2 % of total exports, an increase of 0.9 percentage points over the previous year, while processing trade exports accounted for 30.9 %, a decrease of 3.1 percentage points from last year. General trade imports accounted for 56.8 % of total imports, an increase of 0.7 percentage points over the previous year. Processing trade imports accounted for 25.5 %, a decrease of 1 percentage point from the previous year (Fig. 2.6). The increasing share of general trade reflected the improvement in China's trade structure.

The share of China's exports to Asia continued to increase, and imports from Europe and the United States rebounded rapidly. In 2013, the growth rate of China's

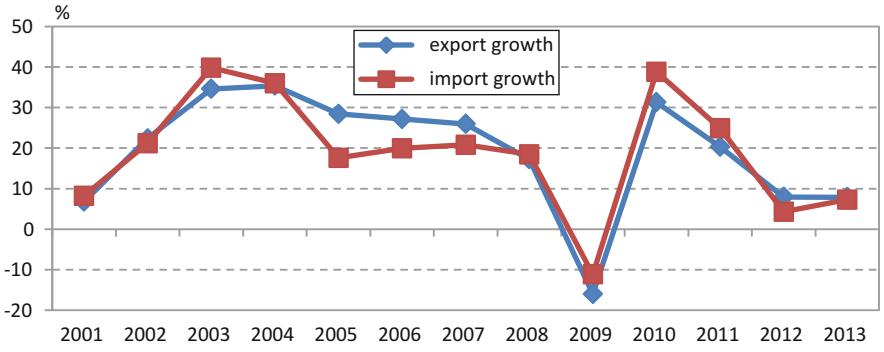

Fig. 2.5 Changes in the growth rates of total exports and total imports (USD) (Data source: CEIC)

Fig. 2.6 Changes in the composition of exports and imports by trade type. (**a**) Export composition. (**b**) Import composition (Data source: CEIC)

exports to Asian countries was 12.7 %, a decrease of 0.7 percentage points from the previous year, while the growth rate of exports to the United States was 4.7 %, a decrease of 3.8 percentage points from last year. The growth rate of exports to Europe reached 1.2 %, shifting from negative growth in 2012 to positive growth, an increase of 7.4 percentage points over the previous year. Compared with 2012, the share of China's exports to the EU and the United States in total exports was 15.3 % and 16.7 %, respectively, a decrease of 1 and 0.5 percentage points. The share of exports to Asia continued to rise, reaching 51.3 %, an increase of 2.2 percentage points. On the import side, the growth rate of China's imports from the United States increased greatly, reaching 14.8 %, an increase of 6 percentage points over the previous year. The growth rate of imports from Asia and the EU was 5.0 % and 3.5 %, respectively, an increase of 1.6 and 2.9 percentage points, respectively. The share of China's imports from Asia and the EU in total imports was 56.0 % and 11.3 %, respectively, amounting to a decrease of 1.3 and 0.4 percentage points, respectively. The share of imports from the United States was 7.8 %, an increase of 0.5 percentage points (Figs. 2.7 and 2.8).

2.4 The PPI and CPI Trends Show an Expanding "Scissor" Shape

PPI continued to decline, whereas the CPI was relatively stable. In the first half of 2013, year-on-year PPI declined faster, dropping from −1.64 % at the beginning of the year to −2.69 % in June. In the first half of 2013, the year-on-year growth rate of the CPI was below 3 % for all months except February. In the second half of 2013,

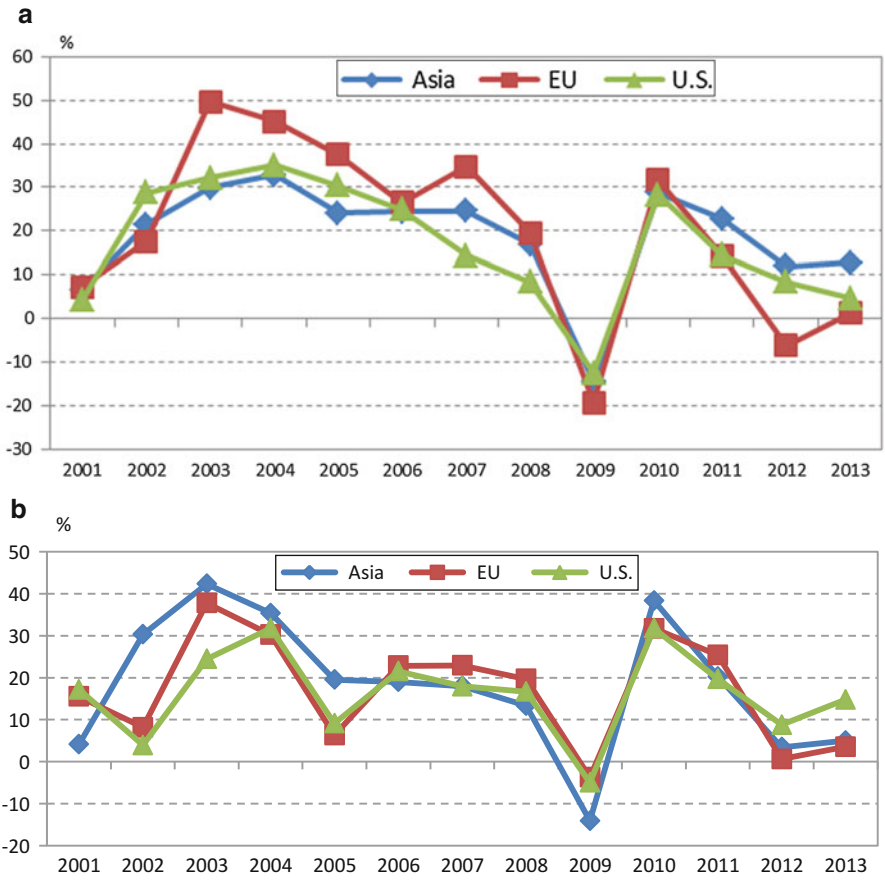

Fig. 2.7 (**a**) Changes in the growth rate of China's exports to major regions. (**b**) Changes in the growth rate of China's imports from major regions (Data source: CEIC)

influenced by the policy signals promoting "steady progress" and the clarification of the economic growth limit by the central government, both PPI and CPI began to recover. The annual PPI decreased 1.9 % compared with last year, while the CPI increased 2.6 % over the previous year (Fig. 2.9). In all categories of the CPI, the CPI excluding food and energy and year-on-year non-food CPI in 2013 remained steady within the 1–2 % range. From the eight CPI categories, CPI for food, housing, and clothing increased by 4.7 %, 2.8 %, and 2.3 %, respectively. It can be seen that the rising prices of food and other commodities with less price elasticity of demand were the major causative factors of inflation in 2013; the changes in the remaining CPI categories were relatively small.

After 2011, the CPI and PPI have continued following opposing trends, emphasizing the downward trend of the real economy and the serious excess production capacity in the industrial sector. From the third quarter of 2011, the month-to-month

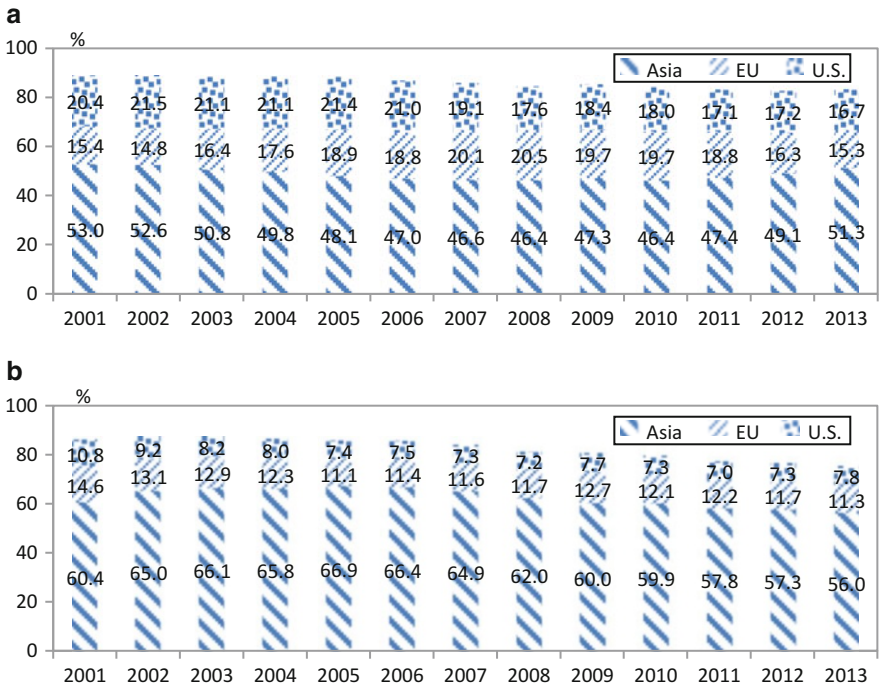

Fig. 2.8 (**a**) Changes in the composition of China's exports by region. (**b**) Changes in the composition of China's imports by region (Data source: CEIC)

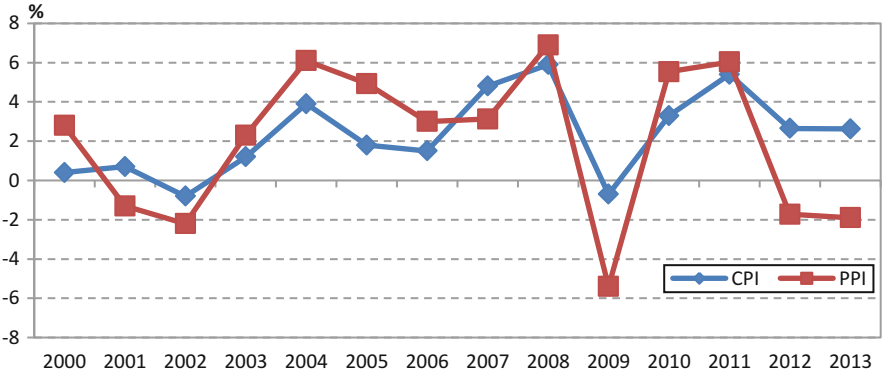

Fig. 2.9 Year-on-year changes between CPI and PPI (Data source: CEIC)

growth of the CPI exceeded that of the PPI by nearly a percentage point or more in nine consecutive quarters; the trends of the CPI and PPI showed a very clear "scissor" movement in the last 2 years. A look at the year-on-year growth since the first quarter of 2012 shows that the CPI and PPI have always maintained a gap of more

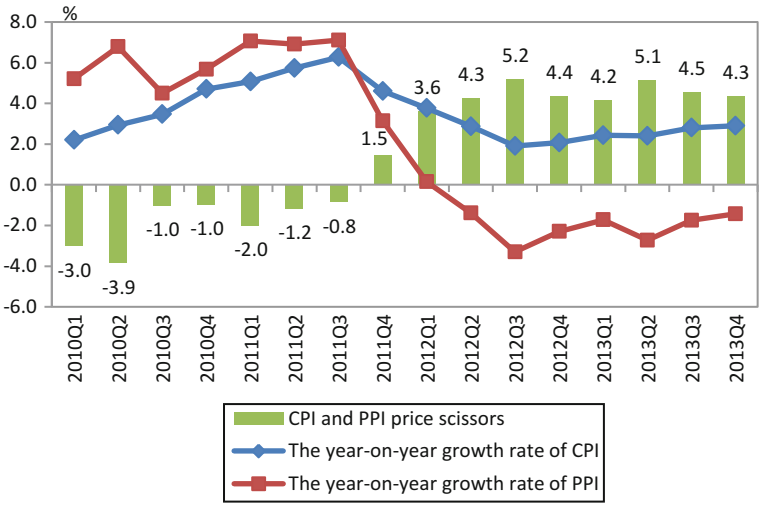

Fig. 2.10 The "scissors" trend of the year-on-year growth rates of the CPI and PPI (Data source: CEIC)

than four percentage points (Fig. 2.10). Apparently, this fact cannot be simply explained by price transmission mechanism disorders. Provided the growth rate of money supply (M2) maintained a high long-term level, the deviation between the CPI and PPI reflected the continuous downturn in the real economy, serious excess production capacity in the industrial sector, lack of liquidity in the real economy, some capitals in unproductive circulation, and so on. On the one hand, the conflicting trends of the CPI and PPI indirectly increased the capital cost of the actual production sector; on the other hand, due to the decline in expected profit, they inhibited the level of investment in the actual production sectors.

2.5 The Monetary Policy Maintained Prudent, and Financing Costs Continued to Rise

In 2013, the central bank continued to implement a prudent monetary policy, and money supply slowed down. The annual broad money (M2) amounted to 110.65 trillion CNY, an increase of 13.6 % compared with last year, while the growth rate dropped by 0.2 percentage points. Narrow money (M1) grew by 9.3 %, an increase of 2.8 percentage points over the previous year. Currency in circulation (M0) grew by 7.1 %, a decrease of 0.6 percentage points from the previous year.

Nevertheless, the economy still faced the pressure of rising financial cost. In June 2013, the "money shortage" incident became a turning point for capital markets throughout the year. After a modest adjustment in the monthly weighted average

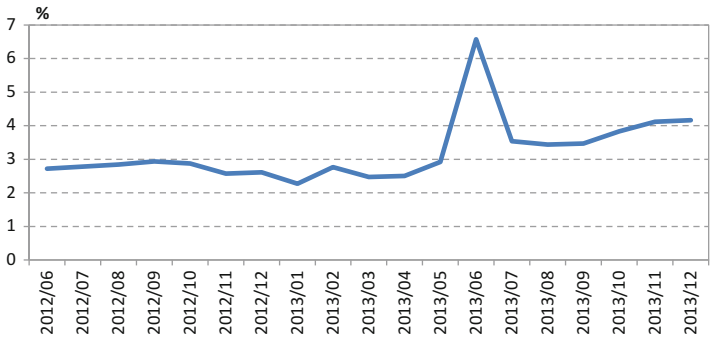

Fig. 2.11 Changes in the weighted average interbank interest rate (Data source: CEIC)

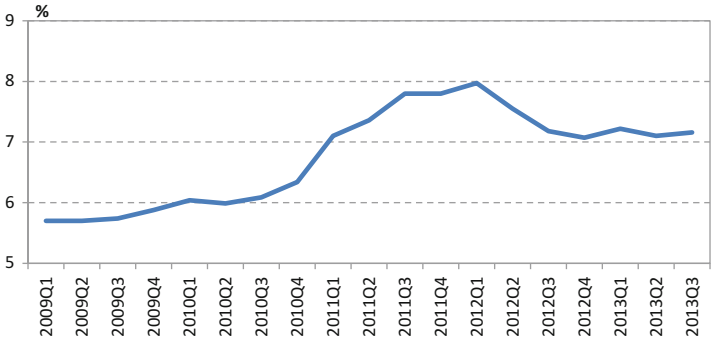

Fig. 2.12 Changes in the general weighted average lending rate (Data source: CEIC)

interbank interest rate in the first 5 months of the year, it suddenly jumped to a record high of 6.58 % in June. In the second half of the year, the capital market maintained a tight supply of state funds, and the interbank rate rose steadily during the remaining months, except August. It rose to 4.16 % until December, the second highest rate after June (Fig. 2.11). Money market tensions pushed financial institutions to improve lending rates to nonfinancial institutions and other departments: the general weighted average lending rate in RMB in the third quarter climbed to 7.16 % (Fig. 2.12). In addition, the share of loans with interest rates exceeding bench interest rates began to decline significantly after June.

On the other hand, the effectiveness of funds continued to decline. In 2013, the total amount of social financing reached 17.29 trillion CNY, an increase of 1.53 trillion CNY over last year. Among them, the new RMB loans amounted to 8.89 trillion CNY, an increase of 8.4 percent over the previous year. Corporate bond financing amounted to 1.8 trillion CNY, a decrease of 20.2 percent compared with last year. Trusts and entrusted loans amounted to 4.39 trillion CNY, an increase of 70.9 percent over the previous year. Promoted by trust and entrusted loans financing, the total amount of social financing reached 6.17 trillion CNY in the first quarter of

2013, an increase of 2.28 trillion CNY (58.54 %) over the previous year. However, the huge sums of money invested did not accelerate economic growth effectively; it continued to decline until the second quarter. In fact, since the outbreak of the financial crisis, despite the rapid expansion in social financing, economic growth continued to decline in most years. In fact, the scale of social financing required for each percentage point of economic growth continuing to expand, thus reflecting that the potential growth of economic system and economic development were in constant decline.

2.6 Both Growth Rate of Fiscal Revenue and Expenditure Declined, and Local Debt Continued to Increase

Until November 2013, the accumulated government revenue grew by 9.87 % to reach 11.97 trillion CNY, a decrease of 2.04 percentage points compared with the previous year. The tax revenue accounted for 85.98 % of this amount, a slight increase of 0.08 percentage points over the same period last year. Excluding price changes, real revenue growth was lower than the economic growth rate over the same period, ending the 15 consecutive year history of the annual revenue growth being significantly higher than real economic growth rate in the same period from 1997 to 2012.[2] Due to the decline in revenue growth, expenditure growth slowed down significantly. By November, expenditure had grown by 9.34 % to reach 11.47 trillion CNY, a decrease of 8.58 percentage points compared with the previous year.

Local government debt grew rapidly. According to the announcement released by the National Audit Department on December 30, 2013, until June 2013, the local government debt balance (broad caliber) reached 17.89 trillion CNY, an increase of 12.62 % over the end of 2012. Of this amount, the debt borne by the provincial, city, and county governments reached 10.58 trillion CNY, an increase of 3.87 trillion CNY over the end of 2010. The average annual outstanding debt grew by 19.97 %. Between 2008 and 2012, the growth rate of both the narrow government revenue and the broad government revenue[3] was always lower than the growth rate of local government debt balance (Fig. 2.13). Thus, the continuous rise in local government debt levels and possible debt will pose significant risks to China's economy in the coming years.

In conclusion, although the Third Plenary Session of the 18th CPC Central Committee clarified the future direction of comprehensively deepening reforms and

[2] From 1997 to 2012, on average, the real growth rate of revenue exceeded economic growth by 5.5 percentage points over the same period. In 2012, the growth rate of fiscal revenue exceeded economic growth by 2.2 percentage points. Source: CQMM Research Group, Center for Macroeconomic Research, Xiamen University: *"China's Macroeconomic Forecast and Analysis - 2013 Fall Report" (August 2013).*

[3] Narrow government revenue refers to government public revenue, while broad government revenue refers to the sum of government public finance income and income from government funds.

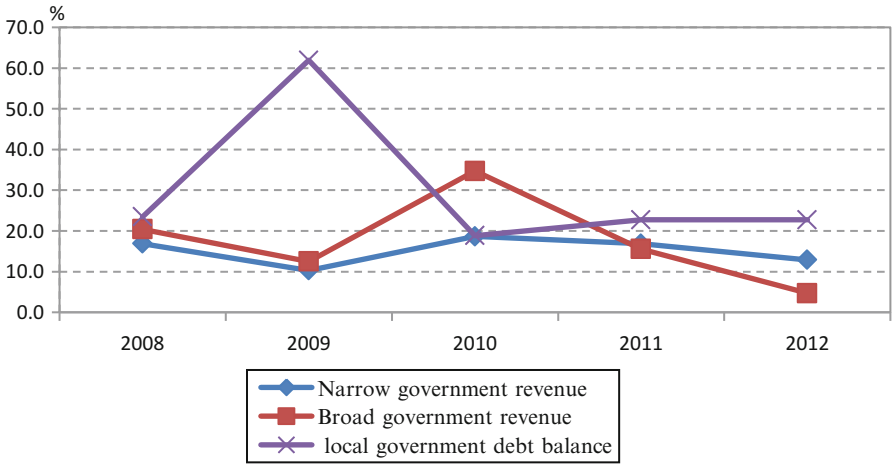

Fig. 2.13 Comparison between growth rates of government revenue and debt balance (Data source: CEIC)

outlined a series of major reform strategies, its effects will become evident only after some time. The deepening reform of China's economic system, the adjustment of its economic structure, and the transformation of economic development still have a long way to go. The declining growth rates of urban and rural household incomes and the renewed anti-corruption movement caused the contribution rate of final consumption to GDP growth rate to decline significantly. The economy of the United States continued to accelerate its recovery process, and the haze of the European sovereign debt crisis gradually dispersed; however, export growth continued to remain weak, private investment willingness remained low, and thus, public investment appears to be the major driving force for stabilizing economic growth at present. This shows that domestic causes will determine whether China's economy can maintain stable development in the future.

In 2013, the rapid rise in public investment offset the decline in manufacturing and real estate investment growth to some extent, ensuring investment in fixed assets and the steady growth of the economy. However, a rapid expansion in the scale of local government debt has increased the government's default risk. The rigid demands of local government financing platforms and real estate investment funds induced the financial sector to expand the scale of its balance sheet operations, and the central bank's cautious attitude toward liquidity further exacerbated the level of tension in the capital market. The ability to effectively control the size of local government debt, optimize its financing structure, and reduce local government default risk, has become key for comprehensively deepening reforms, especially the fiscal and financial reforms planned in the next stage.

Chapter 3
Forecast of China's Economy for 2014–2015

3.1 Assumptions on Exogenous Variables

3.1.1 Economic Growth Rates of the United States and the Euro Area

In 2013, the recovery of the housing market and increasing household wealth helped private demand expand at a steady pace in the United States. The unemployment rate decreased. It is reasonable to assume that the economy of the United States grew. The updated outlook from the International Monetary Fund (IMF) in January 2014 suggests that the economic growth rate will be 2.8 % in 2014, increasing to 3.0 % in 2015. On the other hand, the debt crisis risk will be lower, but the improvement of the peripheral economies may be curtailed by the credit bottleneck. The IMF assumes that the eurozone is gradually stepping out of recession, and its economic growth rate will be 1.0 % in 2014, increasing to 1.4 % in 2015 (Fig. 3.1).

3.1.2 Main Exchange Rates

Since the new round of exchange rate system reform, the exchange rate of the RMB against the USD has appreciated to 36.7 %. In addition to the influence of the international financial crisis of 2009, which led to a modest appreciation, the other years showed a faster appreciation trend. In 2013, the spot exchange rate of the RMB against the USD appreciated by 2.91 % for the whole year, an obvious acceleration compared to the corresponding value of 1 % in 2012.[1] In 2014, the Federal Reserve

[1] At the end of 2013, the central parity of RMB against the USD was 6.0969 CNY, an appreciation of 3.09 % over the previous year.

CMR of Xiamen University, *China's Macroeconomic Outlook*,
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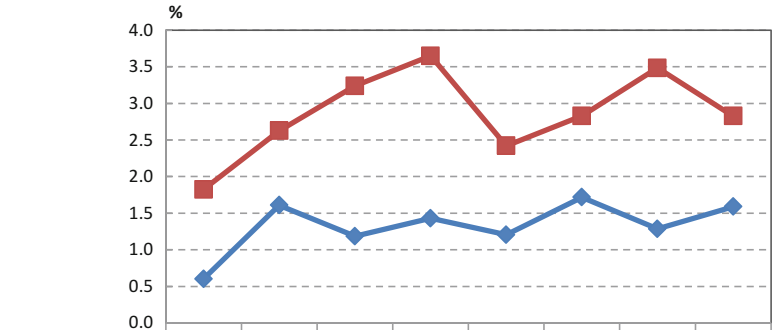


	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4
EU17GDP_C	0.60	1.61	1.19	1.43	1.21	1.72	1.29	1.59
USGDP_C	1.82	2.63	3.24	3.65	2.42	2.83	3.48	2.83

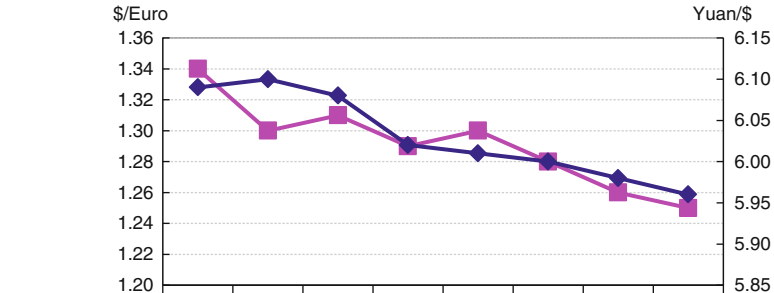
Fig. 3.1 Assumptions of growth in the United States and the Euro Area (Note: "EU17GDP_C" denotes growth rate of the eurozone, while "USGDP_C" denotes that of the United States)

is expected to gradually withdraw from quantitative easing (QE III). Emerging countries face capital outflows, which will reduce the pressure on the appreciation of the RMB. China will continue to promote reforms of the RMB exchange rate in 2014. Simultaneously, China's economic growth will be relatively stable, and the spread arbitrage and trade surplus will continue to promote the appreciation of the RMB. We estimate that the exchange rate of the RMB against the USD will rise by about 2 % in 2014. There might be a short reversal followed by continued appreciation due to the withdrawal of QE III in the second quarter. The exchange rate of the USD against the RMB will be about 1:6.02 at the end of 2014. The exchange rate of the USD against the RMB may be lower than 6 until the third quarter of 2015, and if annual appreciation is maintained at 1 %, the exchange rate of the USD against the RMB will be about 1:5.96.

In 2014, the eurozone will start to recover. However, recovery will not be strong, and therefore, the rate of inflation will remain low. The European Central Bank will maintain low interest rates. The EUR will plunge against the USD, and we estimate that the exchange rate of the EUR against the USD at the end of 2014 will be 1:1.29, changing to 1:1.25 in 2015 (Fig. 3.2).

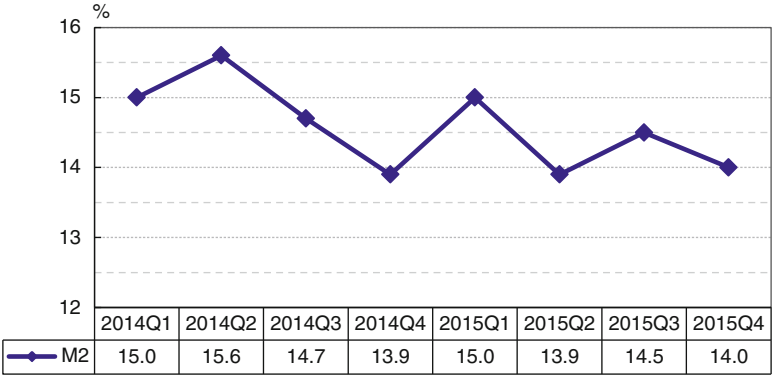
3.1.3 Growth Rate of Broad Money Supply (M2)

Because the shadow banks and local government debt scale continues to expand, the pressure of guarding against financial risk would be larger. The pressure of macroeconomic policy will tighten in 2014, and we expect the central bank's monetary policy will maintain a tight balance. In addition, due to the large export growth base in the first quarter of 2013, export growth in the first quarter of 2014 will likely fall more than expected, leading to a larger decline in first-quarter economic growth. In



	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4
USDEURO	1.34	1.30	1.31	1.29	1.30	1.28	1.26	1.25
ER_W	6.09	6.10	6.08	6.02	6.01	6.00	5.98	5.96

Fig. 3.2 Assumptions of major exchange rates (Note: "ER_W" denotes the exchange rate of the RMB against the USD, and "USDEURO" denotes that of the USD against the EUR)



	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4
M2	15.0	15.6	14.7	13.9	15.0	13.9	14.5	14.0

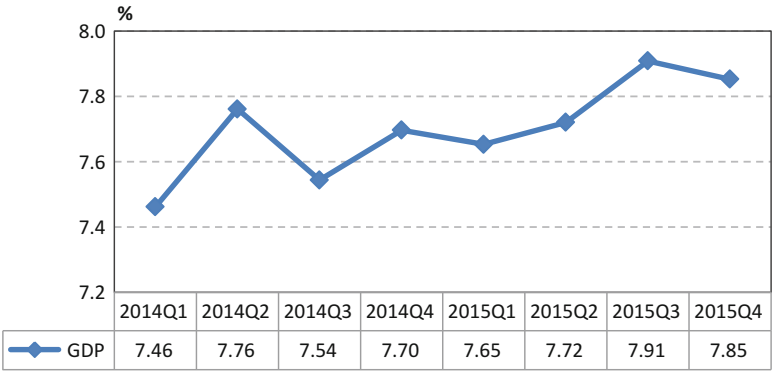
Fig. 3.3 Assumptions of the growth rate of M2

order to reduce economic fluctuations, the central bank will implement a relatively loose monetary policy in the second quarter, and the year-on-year growth of M2 is likely to be 15.6 %. After the economy recovers in the second quarter, the central bank will tighten the monetary policy in the second half of the year. The year-on-year growth of M2 is expected to be 13.9 %. Recent years have seen rising calls to accelerate the pace of market-oriented interest rate. The central bank cancelled the floating lower limit of the loan interest rate in 2013, and recently, under the competition pressure posed by financial innovation tools such as the balance of the treasury account, bank deposit interest rates began to float. If interest rate marketization is implemented in 2015 alongside the United States gradually withdrawing from QE III, we are likely to see certain lagged effects. We expect that the year-on-year growth of M2 may be about 0.1 % higher than 14 % for all of 2014, in response to the economic downward pressure. On the other hand, the benchmark lending rate will be maintained at the current level of 6 % until the end of 2015 (Fig. 3.3).

3.2 Forecasts of China's Major Macroeconomic Indicators for 2014–2015

3.2.1 Growth Rate of the GDP

Using the abovementioned assumptions of exogenous variables, the prediction results of the CQMM show that in 2014, China's GDP growth will continue to fall slightly to 7.62 %, 0.08 % lower than that in 2013. The GDP growth rate will rise to 7.79 % by 2015. The growth rate trend will remain suppressed over the next 2 years, the main reasons being (a) the gradual decrease and increase of the negative and positive effects, respectively, of the comprehensively deepening reforms, and (b) the challenges in the external economic environment. Analyzing the quarterly year-on-year growth rate (Fig. 3.4) shows that the large export base in the first quarter of last year led to a sharp decline in year-on-year growth of exports (at times, it was even negative). The tight monetary policy and the unimproved real economic environment also limit the possible expansion of investment growth in the first quarter. In addition, government measures such as the "eight rules" and "six bans" directly inhibit government spending in the short term and indirectly inhibit enterprise and residents' consumption; these measures will suppress the growth rate in the first quarter, particularly since it relies on final consumption. In the first quarter of 2014, China's economic growth rate is expected to drop to 7.46 %. After the second quarter, with the rebound in export growth and the pro-growth policy shift, economic growth is likely to jump to 7.76 %, the highest rate throughout the year. Then, due to the restriction imposed by inflationary pressure, tighter currency controls will cause economic growth to dip slowly to 7.70 % in the fourth quarter.



	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4
GDP	7.46	7.76	7.54	7.70	7.65	7.72	7.91	7.85

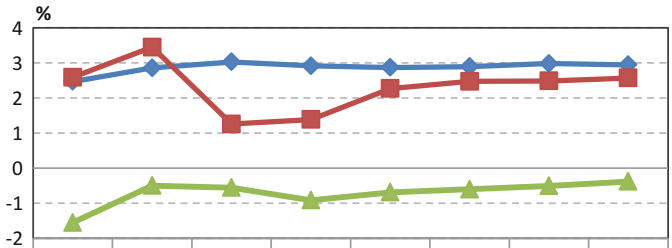
Fig. 3.4 Forecast of GDP growth rate (year-on-year basis)

3.2.2 *Forecasts of Major Price Indices*

The Model predicts that the CPI will rise by 2.82 % in 2014, 0.20 % higher than the previous year. By 2015, the CPI is expected to rise to 2.92 %. By quarter (Fig. 3.5), the CPI may rise to 2.85 % in the second quarter of 2014 and reach a peak of 3.03 % in the third quarter. Then, it would fall slightly to 2.91 %. The rebounded economy in 2015 will cause the CPI to keep rising until it reaches 2.98 % in the third quarter, falling slightly to 2.94 % in the fourth quarter. The PPI in the next 2 years will continue to maintain negative, but the degree of decline is expected narrow gradually. The PPI is expected to be −0.88 % in 2014, further narrowing to −0.55 %. By quarter (Fig. 3.5), the PPI may fall to −1.55 % in the first quarter of 2014. Thereafter, it will rise to −0.50 % in the second quarter, followed by falls in the latter two quarters. It is predicted to stand at −0.92 % in the fourth quarter. In 2015, the PPI is expected to rebound and may recover to −0.38 % in the fourth quarter.

In 2014, the GDP deflator (P_GDP) could rise to 2.16 % and improve to 2.45 % in 2015. By quarter, P_GDP will rise to 2.59 % in the first quarter of 2014 and will continue to rise to its annual peak of 3.45 % in the second quarter. It will fall through the third quarter and stand at 1.38 % in the fourth quarter. In 2015, the index will maintain a rising trend, increasing to 2.57 % in the fourth quarter (Fig. 3.5).

Overall, China's economy will continue to maintain steady and rapid growth in 2014, with economic growth predicted to be stable at a new level of around 7.5 %. The full-year GDP growth is expected to be 7.62 %. Annual inflation is expected to remain moderate, and the CPI is expected to rise by 2.82 %. Our research team believes that due to the gradual effects of the comprehensively deepening reforms and worldwide economic recovery, China's GDP growth rate will recover in 2015, and the CPI growth will also increase.



	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4
CPI	2.47	2.85	3.03	2.91	2.87	2.89	2.98	2.94
P_GDP	2.59	3.45	1.25	1.38	2.27	2.47	2.48	2.57
PPI	-1.55	-0.50	-0.56	-0.92	-0.69	-0.61	-0.51	-0.38

Fig. 3.5 Forecasts of major price indices (year-on-year basis) (Note: CPI, "P_I", "P_GDP", and PPI denote consumer price index, price index of investment in fixed assets, GDP deflator, and producer price index, respectively)

3.2.3 *Forecasts of Growth Rates of Other Major Macroeconomic Indicators*

3.2.3.1 Export, Import, and Reserve Growth

The Model predicts that in 2014, the accelerating recovery of the American economy and the alleviation of the eurozone economic crisis will restore China's import and export growth. Total exports, which are currently calculated in USD, are expected to grow by 9.66 % in 2014, 1.57 % higher than the previous year. Total import growth is likely to rise to 8.28 %, 1.06 % higher than the previous year (Table 3.1). By quarter, the year-on-year growth of exports in the first quarter of 2014 will edge up by 0.71 % only because of the base effect, reaching 14.77 % in the third quarter, and it will reach 12.07 % in the fourth quarter. The year-on-year growth of imports in the second quarter of 2014 could reach the annual peak of 10.54 % and then fall back every quarter, finally reaching 8.07 % in the fourth quarter. Because of the improved export growth, foreign exchange reserves are expected to grow by 10.81 % in 2014. With comprehensive recovery in the external market demand in 2015, China's import and export growth will continue to rise. Export growth and import growth is expected to reach 14.69 % and 12.55 %, respectively, according to current prices in USD. Foreign exchange reserves will probably grow by 10.08 % in 2015 (Table 3.1, Fig. 3.6).

Table 3.1 Forecast of the growth rates of exports and imports in 2014–2015 (%)

	Exports				Imports				Foreign exchange reserves
Time	At constant price	At current price	General trade at current price	Processing trade at current price	At constant price	At current price	General trade at current price	Processing trade at current price	Current price
2014	9.36	9.66	12.96	11.18	6.37	8.28	11.91	8.89	10.81
Q1	1.55	0.71	9.65	3.15	6.03	6.01	16.29	1.22	15.18
Q2	11.65	11.62	13.50	13.38	7.86	10.54	14.31	13.31	15.55
Q3	13.65	14.77	16.02	16.02	6.34	8.53	8.61	12.24	13.25
Q4	10.97	12.07	12.68	12.56	5.30	8.07	9.01	9.25	10.81
2015	13.57	14.69	16.97	11.12	10.87	12.55	16.62	6.84	10.08
Q1	12.48	13.65	15.10	11.63	7.73	9.59	10.06	8.29	10.72
Q2	13.28	14.40	16.54	11.08	9.07	10.69	13.81	6.16	10.52
Q3	14.00	15.14	17.75	10.96	11.56	13.37	18.71	6.13	10.33
Q4	14.43	15.46	18.31	10.82	14.99	16.39	23.62	6.85	10.08

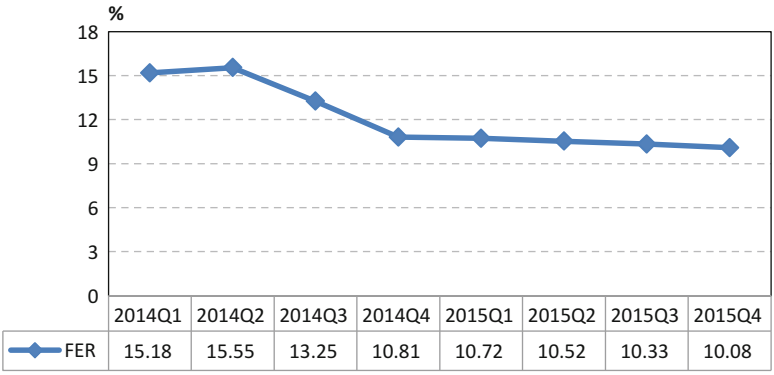


Fig. 3.6 Growth rate of reserves (year-on-year basis)

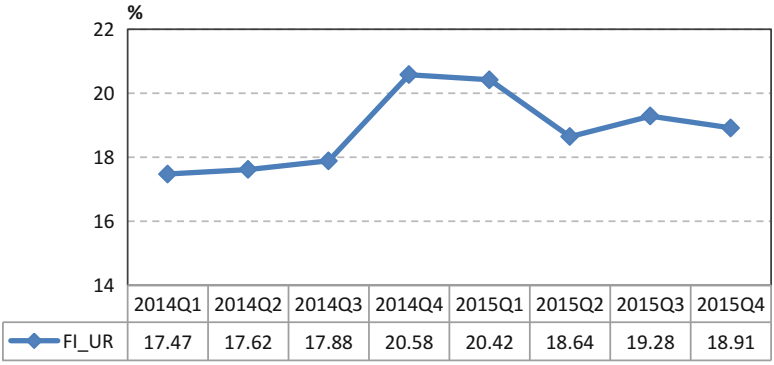


Fig. 3.7 Growth rate of total fixed capital formation (year-on-year basis) (Note: "FI_UR" denotes the growth rate of fixed capital formation in urban areas at current price)

3.2.3.2 Growth Rate of Total Fixed Capital

The Model predicts that in 2014, due to the risk control of local government debt and excess production capacity, urban fixed assets investment growth will be 18.42 % (according to the current price), down by 1.30 % compared to the previous year (Fig. 3.7). Affected by a new round of urbanization in 2015, urban investment demand will further increase, making urban fixed assets investment growth reach 19.29 %. By quarter, urban fixed assets investment growth (by the present price) will fall slightly to 17.47 % in the first quarter of 2014 and then rise to 20.58 % in the fourth quarter. Except for the first quarter, all quarters of 2015 are expected to be controlled within 20 %.

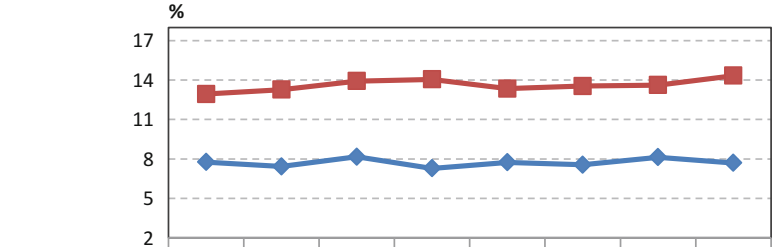
3.2.3.3 Growth Rate of Consumption

The Model predicts that in 2014, total residents' consumption will grow by 7.65 % (according to the constant price), slightly (0.30 %) higher than the previous year. It will increase slightly to 7.78 % in 2015 and become stable thereafter. In 2014, total retail sales of social consumer goods will grow by 13.56 % (according to the present price), 0.40 % higher than the previous year, rising slightly (to 13.72 %) in 2015.

By quarter, the growth in total residents' consumption (by constant price) will reach its peak of 8.17 % in the third quarter of 2014, falling to 7.28 % in the fourth quarter. It will remain flat in 2015, reaching its annual peak of 8.13 % in the third quarter and falling to 7.69 % in the fourth quarter. The growth in total retail sales of social consumer goods (by present price) will increase quarter-by-quarter in 2014. In 2015, it will rise relatively steadily quarter-by-quarter until it reaches 14.33 % in the fourth quarter (Fig. 3.8).

Above all, the Model predicts the following:

1. In 2014, despite the continued recovery of the peripheral market, China's domestic overcapacity will continue to curb investment growth of the entity economy. Local government debt expansion will also restrain the expansion of government investment. At the same time, the transformation of the old and new mechanisms, caused by the promotion of various reform measures, will also create a certain degree of uncertainty for economic growth. In 2014, China's economic growth is expected to be 7.62 %, slightly (0.08 %) lower than that in 2013. The CPI is expected to rise by 2.82 %. The stability of the economic growth rate will create conditions favorable to China's government, allowing it to speed up the implementation of the comprehensively deepening reforms.
2. Comprehensively deepening reforms in politics, society, and the economy will drive the markets to fully play their role in the allocation of resources in 2015. The breaking of the government's monopoly, implementation of the government's



	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4
CON_D_C	7.77	7.43	8.17	7.28	7.74	7.56	8.13	7.69
RETAIL	12.93	13.27	13.92	14.05	13.35	13.55	13.62	14.33

Fig. 3.8 Growth rate of consumption (year-on-year basis) (Note: "CON_D_C" denotes the growth rate of residents' consumption and "Retail" denotes the growth rate of retail sales of consumer goods at current price)

"negative list" management, and opening up to private investment will further enhance the vitality of the economy and resource utilization efficiency. This will gradually enlarge the residents' income and consumption and promote the transformation of China's economic growth pattern. As the effects of the comprehensively deepening reform measures become gradually evident, GDP growth in 2015 is expected to rise, becoming about 0.17 % higher than that in 2014.

3. The gradual recovery of the eurozone economy and the solid recovery of the American economy will steadily increase China's imports and exports in 2014. Total exports are expected to grow by 9.66 % according to the present price, 1.57 % higher than the previous year. Growth in total imports is likely to rise to 8.28 %, 1.06 % higher than the previous year. The trade surplus is expected to narrow further.
4. Although controlling local government debt risk can reduce investment growth, new urbanization will steadily promote investments in fixed assets. Urban fixed assets investment growth is expected to be 18.42 % according to the present price in 2014, down 1.30 % from the previous year. At the same time, comprehensively deepening reforms will also open up new fields to investment of private capital, which will help in stabilizing investments and economic growth.

High local government debt, excess capacity, environmental depletion and deterioration, the disappearance of the demographic dividend show that China's economy must advance structural adjustments. Despite the slow recovery of the peripheral market environment, the domestic economy has stabilized since the third quarter of 2013, and policies intended to adjust the structure of the national economy must be adhered to. China must break its dependence on stimulus packages during economic slowdowns and resist pressures exerted by economic growth through the implementation of the comprehensively deepening reform measures, correction of the distorted relative prices, improvements in investment and financing systems, and expansion of long-term sustainable economic development.

Chapter 4
Policy Simulation

4.1 Controlling the Size of Local Government Debt and Optimizing the Structure of Local Government Financing

After the reforms and opening up of the economy, some local governments in China have begun raising construction funds via debt. Since 1979, local governments have borne the responsibility of repaying debt. The period of 1981–1985 witnessed intensive borrowing by the provincial government, while the city and county governments resorted to intensive debt from 1986 to 1996. Under the pressure of GDP growth, fiscal revenue maximization, and competition between areas, local governments always advanced future fiscal resources through debt in pursuit of achievements for the current term, namely the maximization of political and economic interests. This eventually became the consistent tacit behavior of local governments. By the end of 1996, all the country's provincial governments, 353 of the total of 392 city governments (accounting for 90.05 % of the total), and 2405 of the total 2779 county governments (accounting for 86.54 % of the total) had borrowed debts. By the end of 2010, only 54 county governments across the entire country did not borrow government debt.[1] According to audit announcement No. 32 of the National Audit Office in 2013, by the end of June 2013, the three levels of government (province, city, and county) were obligated to repay a combined debt of 10.89 trillion CNY over and above 2.67 trillion CNY guaranteed by the government, the exception being that the governments might bear the rescue responsibility for 4.34 trillion CNY of debt. From 1997 to the end of June 2013, local government debt balance (generalized statistical caliber) increased from 1.81 to 17.88 trillion CNY (by 15.92 % per year). From 2010 to the end of June 2013, the balance of debt the

[1] Announcement no. 35 of the National Audit Office, 2011: "National Audit Result of Local Government Debt," June 27, 2011.

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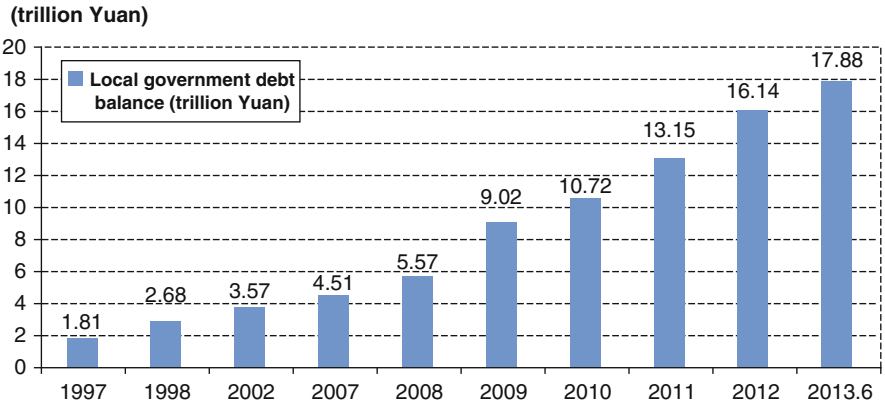


Fig. 4.1 Change in the generalized debt balance of the local government (Data source: Announcement No. 32 of the National Audit Office, 2013)

abovementioned three levels of government were obligated to repay increased by 19.97 % per year, while the average annual growth rate of province, city, and county level government was 14.41 %, 17.36 %, 26.59 %, respectively; in each case, the balance of debt far exceeded the rate of economic growth over the same period and local government revenue growth at the same level.[2] The growth rates of the debt balances of the three levels of government showed that the lower the level of government, the faster its debt growth (Fig. 4.1).

The drastic expansion of the local government debt scale stemmed from a new round of anti-crisis management. After the 2008 global financial crisis, under the onslaught of a significant hit in exports and the grim situation of domestic economic growth, the central government launched the 4 trillion CNY economic stimulus program. The local governments responded enthusiastically and reported a large number of infrastructure projects. However, the central government's actual investment funds amounted to 1.18 trillion CNY only, and local governments needed to meet the shortfall themselves. Given the practical constraints of their limited financial resources, local governments were forced to rely on land sales and debt to raise investment capital. Because the "Budget Law" clearly stipulates that local governments should not borrow debt by themselves, apart from the bonds issued by the Ministry of Finance issues bonds on the behalf of local governments,[3] local governments were encouraged by the central government to set up a large number of the financing platform companies. Through the transfer of assets such as land, equity, fees, bonds, and other assets, companies that reached the standard of financing in

[2] Announcement No. 32 of the National Audit Office, 2013: "National Government Debt Audit Announcement," December 30, 2013.

[3] The Ministry of Finance has issued bonds on behalf of local governments since 2009.

assets and cash flow were quickly established by local governments. Local governments also supplemented with guarantees and promises to participate in the activities of the companies' credit financing, in order to undertake various projects (bank loans, urban construction investment bonds, trust, financial leasing, insurance, etc.) and raise money for them. Urban construction investment companies, urban construction companies, urban construction development companies, and other asset management companies belong to local government financing platform.

Thus, local government financing platforms sprang up as the circulation of urban construction investment bonds encouraged by governments increased significantly. But bank loans grew more rapidly and became the main funding source for local government debt. According to the data, in early 2008, the national debt scale of local government financing platforms at all levels was about 1 trillion CNY. The corresponding number was 9.76 trillion CNY by the end of 2009 and included the balance of loans of financial institutions amounting to about 7.38 trillion CNY, which accounted for 75.61 % of the total amount of government debt financing platforms. This translates into a year-on-year growth of 70.4 %, higher than the average loan balance growth of 36.5 % in the same period.

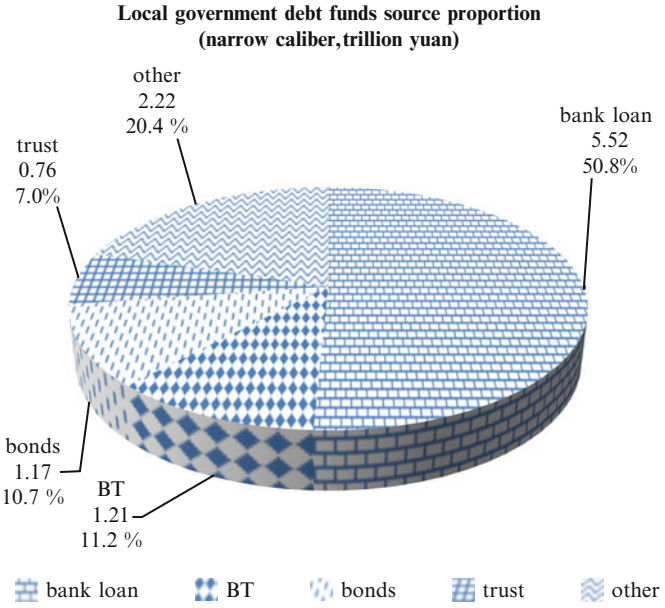
As the number and scale of local government financing platforms soared, the underlying fiscal and financial risks attracted widespread attention and concern. After 2010, because of the strict control of financing platform debts by regulators, the local governments' financing channels changed. Platform loans accounting for the balance of government debt declined slightly, but shadow banking (including urban construction investment bonds, trust, financial leasing, insurance, etc.) quickly became the channel for local governments to refinance old debt, thus further expanding the scale of investment financing (Fig. 4.2).

Obviously, the current nonstandardized and overscale debt financing of local governments in China has caused negative economic effects that cannot be ignored.

Firstly,[4] as the non-independent market entities mainly consist of platform companies backed by local governments and state-owned or state-controlled enterprises, the administrated operational goals and soft budget constraints will inevitably lead to imbalances in risk preferences. The distortion in financing behavior will raise the interest rate and distort the cost of capital, thus aggravating unfair competition in the capital market.[5]

[4] According to Announcement No. 32 of the National Audit Office on December 30, 2013, the ratio of the debt balance of local government platform companies and state-owned or state-controlled enterprises to the debt the government is obligated to repay is 48 %.

[5] The narrow debt of local governments through BT financing accounts for 11.2 % of total debt and 8.3 % by the generalized statistical caliber. The annual interest rate of this part of the funds is usually about 15 % and may even rise to 20 %. The narrow debt of local governments through trust financing accounts for 7.0 %, and general debt, 8.0 %. The cost of capital is roughly between 9 and 11 %.



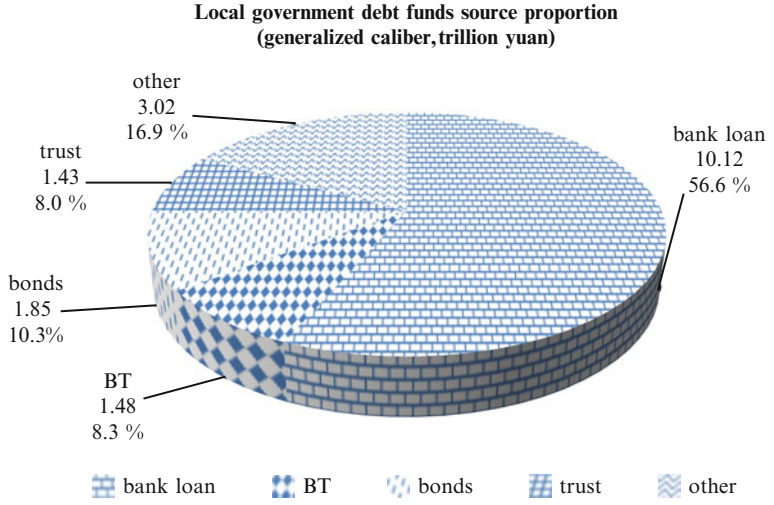


Fig. 4.2 The structure of local government debt (by fund source) (up to June 2013) (Note: 1. "Narrow caliber" indicates the debt that the government is obligated to repay, while "generalized caliber" denotes the debt that the government is obligated to repay and that which is guaranteed by the government (i.e., the government might bear rescue responsibility for this debt). 2. "Other types" includes account payable, other units and individual loans, construction underwritten, deferred payment, securities, insurance and other financial institution financing, fiscal lending (national debt and foreign debt), financial leasing, and financing. Data source: Announcement No. 32 of the National Audit Office, 2013 and calculations by the research team)

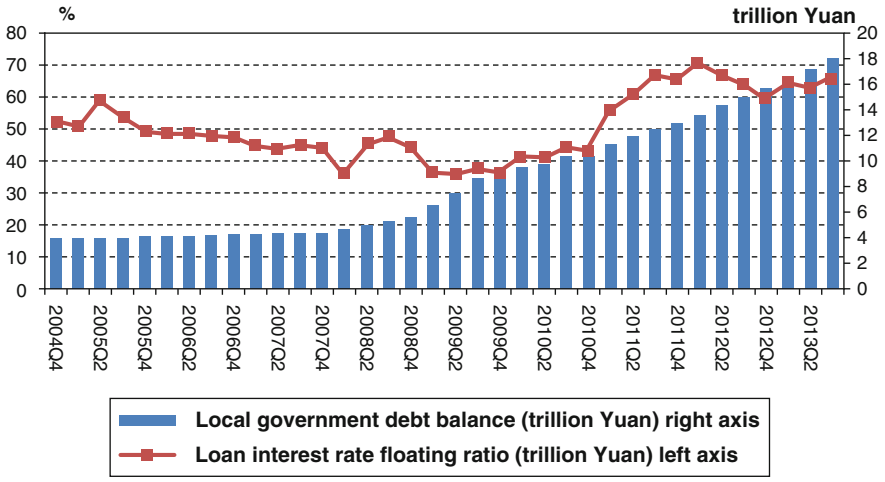


Fig. 4.3 Local government debt balance and loan interest rate floating ratio (Data source: Announcement of the National Audit Office and "Monetary Policy Report")

Secondly, the rapid expansion of local government debt financing squeezes a large amount of bank loan funds.[6] As the amount of whole loan funds is fixed, the large number of bank loans financed by local governments is bound to squeeze the amount of bank loans of the independent market entities, especially the non-state-owned micro enterprises, as well as improve their financing cost. As the amount of whole loan funds that can be obtained by independent market entities remains unchanged, the nonstandardized and overscale debt financing of local governments is bound to force the bank financial system to increase the scale of social loan funds, thus creating inflation pressures.

In fact, since 2009, the local government debt balance grew rapidly; meanwhile, loan interest rate floating range ratio of financial institutions, which reflected a shortage of market funds, rose sharply (Fig. 4.3).[7] At the same time, the market demand for funds maintained strong growth momentum. In 2013, total social financing reached 17.29 trillion CNY, an increase of 24.3 % compared to 2009.

Thirdly, the growth rate of local government debt was much higher than that of its assets. During 2000–2012, the average annual growth rate of local government debt was 26.2 %, while assets grew at an annual rate of 16.1 %. The expansion rate

[6] By the end of June 2013, the narrow debt financing of local governments through bank loans accounted for 50.8 % of the total debt, and generalized debt financing, 56.6 %. The former accounted for 8.1 % of the total financial institutions' RMB loan balance during this period; the latter accounted for about 1/7th (14.8 %) of the RMB loan balance during the same period. Data source of financing costs: http://www.yinhang.com/ Taking the 1-year yield as the benchmark, extracting the 1-year yield of trust from the web site, and taking the normal yields of intermediary institutions into consideration, the actual financing costs will increase by about 1–2 %.

[7] From 2009 to 2012, the average ratio of the loan interest rate floating range for financial institutions was 38.1 %, 41.6 %, 61.0 %, 66.4 %, respectively.

of debt was significantly higher than that of assets, and the asset-liability ratio rose sharply by 25.5 %, which aggravated the debt burden of local governments and heightened debt risks.

In "China's Macroeconomic Forecast and Analysis Report – Fall 2012," the research team had noticed the influence of the sharp explosion in local government debt on economic growth, especially in the long term. Due to concerns about local government debt risks, when the economic growth rate in the first half of 2012 "broke eight" and continued to slide, the research team emphasized that preventing excessive investment stimulation was one of the necessary conditions to achieve steady economic growth, and the massive stimulus program should not be launched again. Thereafter, in the section concerning "policy stimulation and policy suggestions," in the spring and fall reports of 2012, the research team discussed the change in fiscal revenue after the economy entered a lower growth stage of 7–8 % and stressed that it would be difficult for fiscal revenue to grow faster than the economy, because economic growth would fall to a new level. Given that the fiscal revenue had grown faster than the economy for a period as long as 15 years, the ratio of resource flow under the actual control of the Chinese government to the GDP was already high. Taking into account the annual increase in government debt balance in recent years, the financial resource that can be controlled by the Chinese government will be much higher as a share of the GDP (Table 4.1).

The ratio of resources under actual government control to GDP is one of the key indexes. The share taken by the government from the national income and the manner in which the government obtains and uses resources reflects the relationship among government, society, and market in a particular economy. Therefore, regulating the behavior of local government debt financing and controlling the scale of local government debt are not only important policy measures to guard against, so

Table 4.1 Resource flows under actual control of the government (2008–2012)

	2008	2009	2010	2011	2012
Nominal GDP (trillion Yuan)	31.40	34.09	40.15	47.31	51.89
Government revenue/GDP (%)	29.99	31.40	35.69	36.31	35.64
General government revenue/GDP (%)	34.24	35.98	40.64	41.07	39.87
Government actual dominant resources /GDP (%) (1)	37.61	**46.10**	**44.88**	**46.22**	**45.63**
Government actual dominant resources /GDP (%) (2)	39.0	**49.5**	**43.1**	**50.7**	**50.9**

Data source: Calculations by the research team

Note (The research team did not deduct public finance subsidies from social insurance funds. According to Gao (2004), excluding subsidies, the ratio of government revenue to GDP was about 35.33 %, slightly less than the value presented in this report): Government revenue = Public finance income + governmental fund income + income of state-owned capital management budget + social insurance fund income. General government revenue = Government revenue + state-owned enterprises' profits. Resources under government control/GDP (1) = (Generalized government revenue + balance of local government debt increment)/GDP. Resources under government control/GDP (2) = (Generalized government revenue + balance of national government debt increment)/GDP

as to dissolve the risks of local government debt, but they also pose significant concerns that dictate the boundary between the government and the market, the decisive role of market mechanisms in resource allocation, and every aspect in a macroeconomy. With these thoughts in mind, the research team believes it is prudent to focus on controlling the total size of local government debt and improve the proportion of bond financing. Accordingly, these macroeconomic effects of the proposed measures are studied via policy simulations in the following section.

4.2 Results of Policy Simulations

This simulation focuses on standardizing the debt financing pattern of local governments and improving their bond financing proportions. This policy simulation presents two scenarios:

Scenario 1 Assuming constant money supply growth and a constant overall scale of local government debt, we analyze the macroeconomic effects of optimizing local government financing structure by increasing the percentage of government bond financing.

Scenario 2 On the basis of scenario 1, we analyze the macroeconomic effects of moderately controlling the overall scale of local government debt, while increasing the percentage of bond financing by including new policy variables.

Currently, the research team believes that firstly, the debt risk of local government must be controlled, and then it should be defused gradually on the basis of this control. At the same time, we should establish sound laws and regulations for the management of local government debt financing and normalize the debt financing behavior of local government. According to the existing local government debt maturity structure, the local governments of China will reach a peak in debt payment in 2014–2016. Given the uneven levels of the financial situation among different regions, the provinces, cities, and counties of the midwest, which have weaker financial resources, will face greater pressure of debt payment.

Therefore, currently, the bond financing proportion of local governments must be improved (specifically for bonds, quasi-municipal bonds issued for local governments by entrusting the Finance Ministry, and municipal bonds allowed by autonomous issue of local governments on the basis of strict scrutiny). Moreover, there is a need to decrease the percentage of bank loan financing, BT, and trust financing of local government debt, and restrain the non-normative local government debt financing by debt replacement. These measures would help control the scale of local government debt financing, putting an end to deficit spending and the opportunistic behavior of pursuit for achievements and benefits during their tenure, at the cost of overdrawing future financial resources.

Our thoughts regarding the policy simulation are shown as Fig. 4.4.

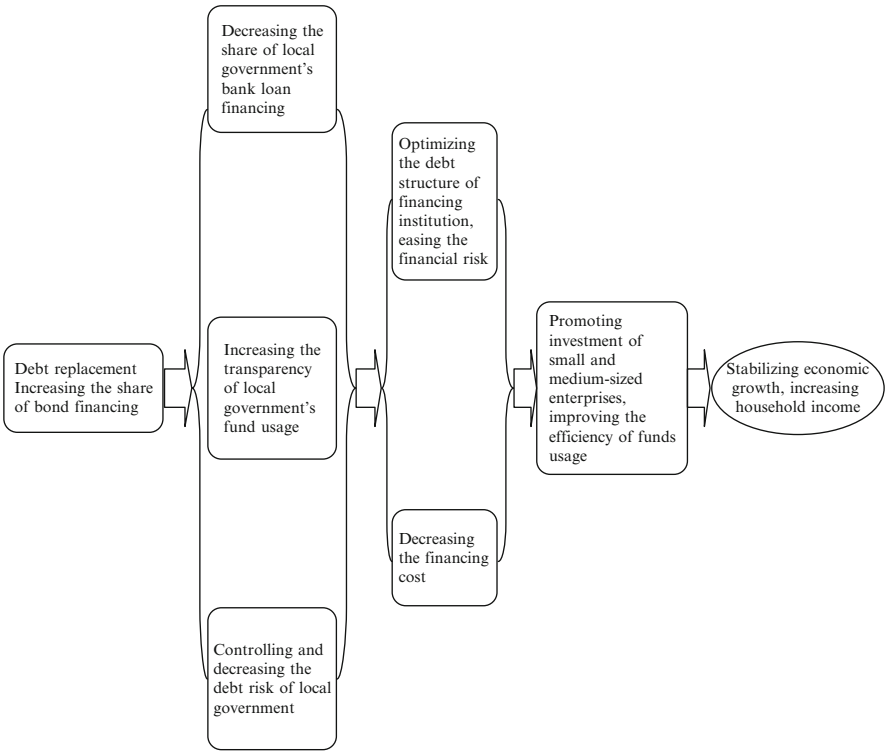


Fig. 4.4 Macroeconomic effects of optimizing local government financing structure

Scenario 1: Assuming constant money supply growth and a constant overall scale of local government debt, we analyze the macroeconomic effects of optimizing local government financing structure by increasing the percentage of government bond financing.

Assuming constant money supply growth and a constant overall scale of local government debt, since the share of local government bank loan financing has been controlled, more credit funds are released for independent market entities in the credit market. Moreover, as the balance of power for money supply and demand changed in the credit market from 2010 to 2012, the floating upward ratio of average loan interval per year returns to the average levels observed from 2007 to 2009 (41.54 %), while the corresponding floating upward interest rate each year drops to 0.90 %, 21.01 %, and 23.78 %, respectively. We can calculate the new quarterly floating upward ratio for the 3 years from 2010 to 2012 (Fig. 4.5), assuming that the quarterly value decreases equally. Further, according to the weighted loan ratio in the original interval, we estimate the new weighted loan interest using the new quarterly floating upward ratio. It can be observed that the difference between the new interval's weighted loan interest and benchmark interest rates basically remains stable and no longer indicates a rising trend (Fig. 4.6).

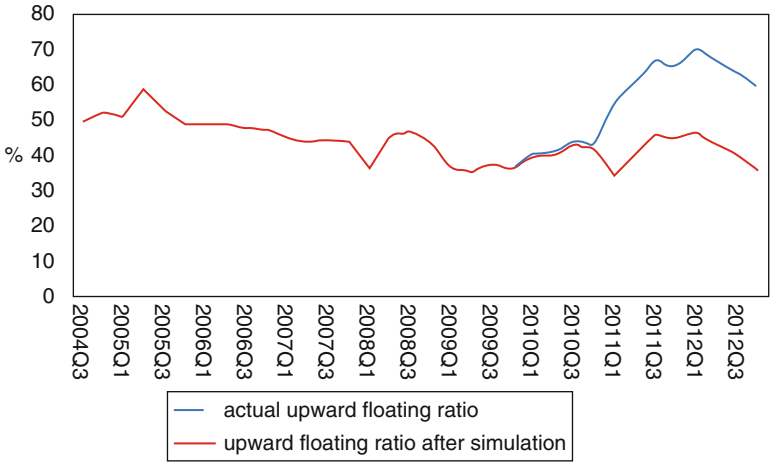


Fig. 4.5 Controlling the share of local government bank financing debt and lowering the upward floating ratio of RMB loan interest rates (one of the assumptions of Scenario 1) (Data source: Estimated by the research team)

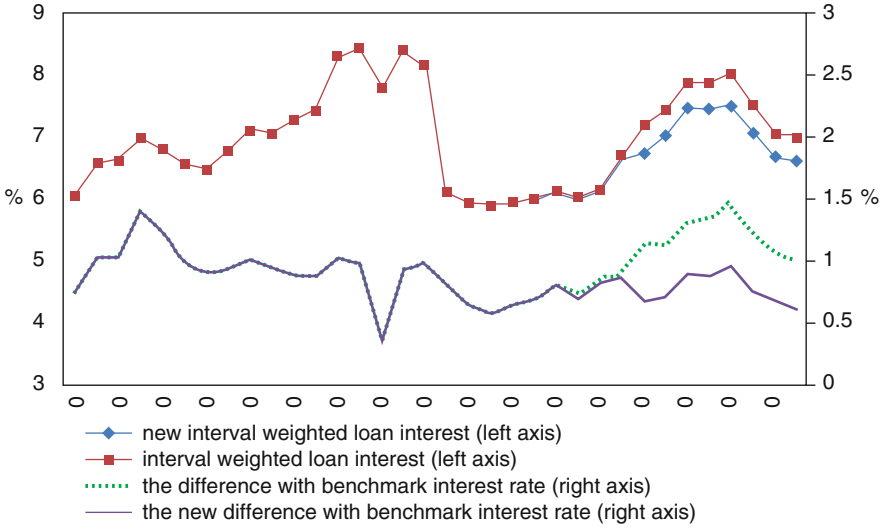


Fig. 4.6 A comparison of the actual and simulated series of interval weighted loan interest (one of the assumptions of Scenario 1) (Note: The quarterly data for the simulation series for 2010–2012 are the actual upward floating ratios of every quarter minus the fragments of the average floating ratios per year over which in 2007–2009; that is, equal amounts were decreased every quarter to maintain the seasonal change. Data source: Calculated by the research team)

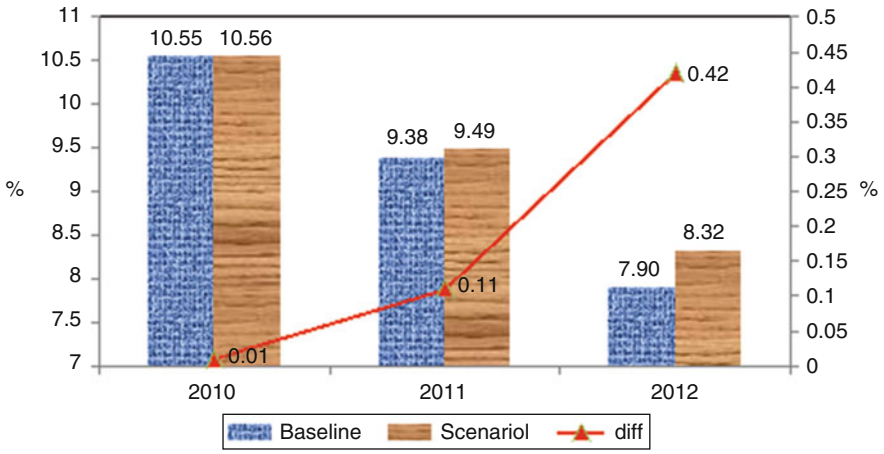


Fig. 4.7 Changes in GDP growth rate (Note: "Baseline" denotes the basic simulation condition. "Scenario 1" denotes the simulation condition of Scenario 1. "diff" denotes the difference of simulation value of Scenario 1 and the basic simulation value (right-hand side axis). Data source: Calculated by the research team)

The results of the policy simulation are as follows. Firstly, the GDP will grow marginally. Assuming constant money supply, controlling the proportion of local government bank financing debt and inhibiting the rising cost of financing is conducive to the stable growth of the GDP. Meanwhile, private investment is promoted by decreasing financing costs, thus accelerating the growth of the economy. Compared to the result of the baseline model, the policy simulation using data from 2010 to 2012 shows that the GDP growth rate can be increased by 0.01 %, 0.11 %, and 0.42 % respectively (Fig. 4.7), and growth in urban fixed assets investment can be increased by 0.02 %, 0.31 %, and 0.97 % respectively (Fig. 4.8).

Secondly, the share of non-state enterprise investment in fixed assets investment is increased, and it can be improved by 0.01 %, 0.18 %, and 0.56 %, respectively, compared to the base values (Fig. 4.9).

Thirdly, household consumption will also grow. The growth rates of household consumption from 2010 to 2012, calculated at comparable prices, increased by 0.01 %, 0.13 %, and 0.58 %, respectively, compared to the corresponding base values (Fig. 4.10). However, there is no obvious change in the share of household consumption in GDP from the view of aggregate demand structure. From 2010 to 2012, the proportion of household consumption increases only slightly by 0.004 %, 0.01 %, and 0.07 %, respectively, compared to the original base values (Fig. 4.10), while the percentage of gross fixed assets investment remains almost constant (Fig. 4.11).

Fourthly, imports increase, the growth rate of net export decreases, and trade surplus is somewhat narrowed. From 2010 to 2012, the growth speed of import calculated at current USD increases by 0.01 %, 0.10 %, and 0.39 %, respectively, compared with the corresponding base values, and the growth rate of export remains more or less constant. Accordingly, the growth rate of merchandise trade net export

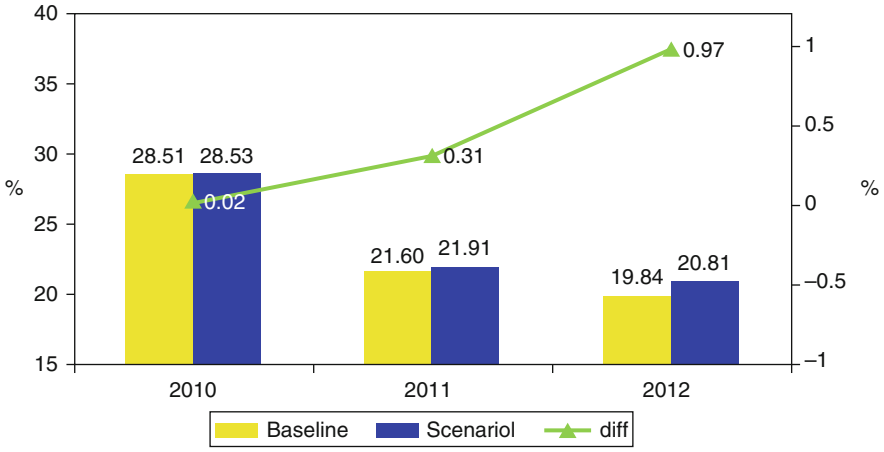


Fig. 4.8 "Baseline" denotes the basic simulation condition (Notes: "Scenario 1" denotes the simulation condition of Scenario 1. "diff" denotes the difference of the simulation value of Scenario 1 and the basic simulation value (right-hand side axis). Data source: Calculated by the research team)

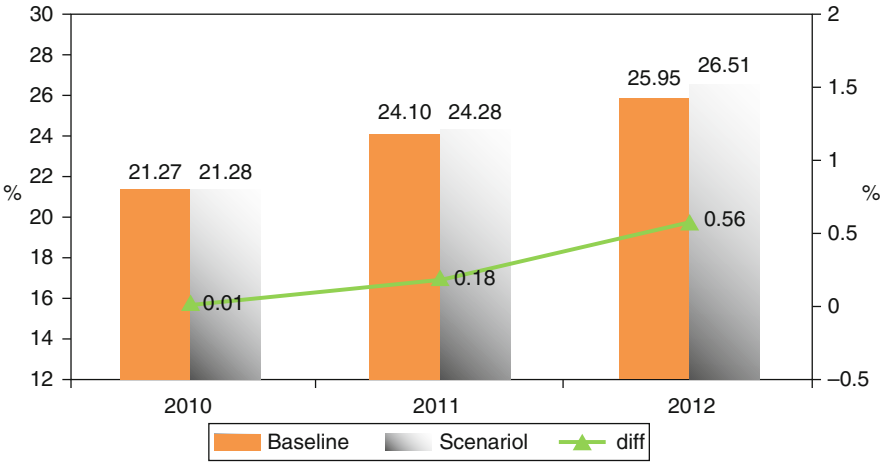


Fig. 4.9 Changes in the percentage of private investment in non-state investment (Note: "Baseline" denotes the basic simulation condition. "Scenario 1" denotes the simulation condition of Scenario 1. "diff" denotes the difference of the simulation value of Scenario 1 and the basic simulation value (right-hand side axis). Data source: Calculated by the research team)

decreases by 0.01 %, 0.25 %, and 1.14 %, respectively, compared with the corresponding base values, and the proportion of net export in GDP also slightly drops by 0.001 %, 0.01 %, and 0.05 % percent, respectively.

On the whole, if we increase the share of debt financing of local governments, improve the balance of the power of supply and demand in the capital market, and

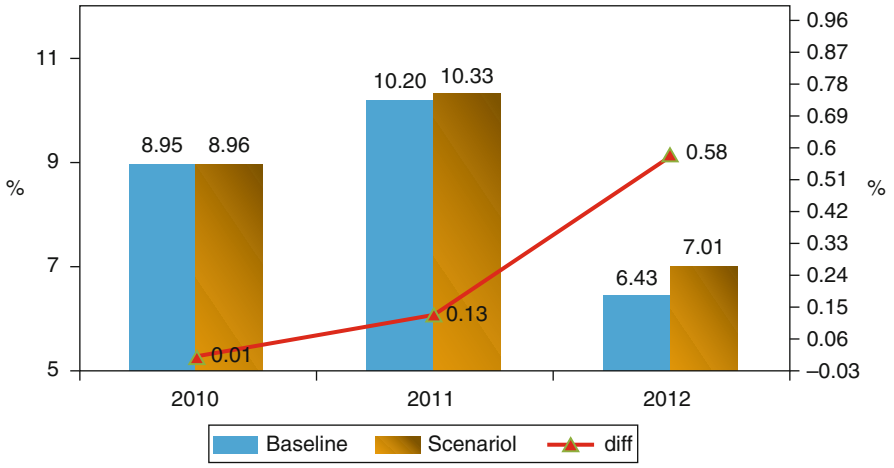


Fig. 4.10 Change in household consumption growth rate (Note: "Baseline" denotes the basic simulation condition. "Scenario 1" denotes the simulation condition of Scenario 1. "diff" denotes the difference of the simulation value of Scenario 1 and the basic simulation value (right-hand side axis). Data source: Calculated by the research team)

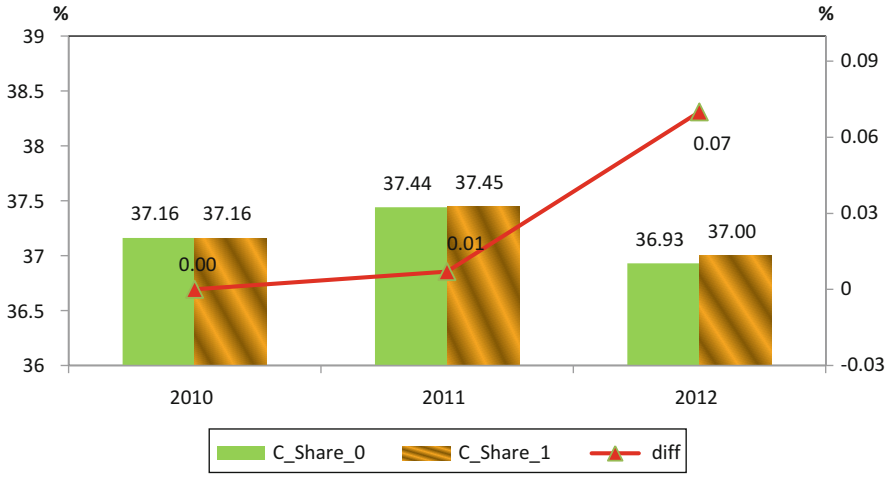


Fig. 4.11 Change in the share of household consumption in the GDP (Note: "C_Share_0" denotes the basic simulation condition. "C_Share_1" denotes the simulation condition of Scenario 1. "diff" denotes the difference between the simulation value of Scenario 1 and the basic simulation value (right-hand side axis). Data source: Calculated by the research team)

inhibit the rising of financing costs, GDP growth can be stabilized. Simultaneously, these measures will also promote increased private investment, expand household consumption, and play a positive role in increasing imports and narrowing the trade surplus.

Scenario 2: On the basis of scenario 1, we analyze the macroeconomic effects of moderately controlling the overall scale of local government debt, while increasing the percentage of bond financing by including new policy variables.

Scenario 1 presents the simulation analysis for improving the proportion of debt financing, assuming that the whole scale of government debt remains constant. Here, we consider the possible macroeconomic effects of simultaneously exercising moderate control over the whole scale of local government debt and enhancing the share of local government debt financing.

The simulation result of Scenario 1 shows that assuming constant growth rate of money supply (M2), the decrease in capital usage cost will hasten GDP growth. If we relax the assumption of constant money supply further, assuming that money supply decreases for the implementation of the debt replacement plan while maintaining the presumed interval weighted loan interest in Scenario 1, what will be the combined effects?

We need, firstly, to assume a descending growth rate for M2, so as to achieve the abovementioned simulation situation. The data from 2003 show that M2 maintains a high growth rate; it was as high as 28.4 % in 2009. From 2010 to 2012, in spite of the drop in the growth rate, it continued to remain quite high, recording 18.9 %, 17.3 %, and 14.4 %, respectively.[8] The gross scale of M2 reached 110.7 trillion CNY in 2013.

Suppose we were to increase the share of local government debt financing in 2010 while controlling the growth in local government outstanding debt, and should the annual growth rate fall to half the original/actual growth rate, then accumulated outstanding local government debts would drop by 0.86, 2.17, and 3.91 trillion CNY, respectively for 2010–2012. Suppose that the decrease in local government debt can equally reduce the supply of M2, then M2 would drop to 0.86, 1.31, and 0.74 trillion CNY, respectively from 2010 to 2012.

The results of the policy simulation indicate the following. Firstly, there appears to be an obvious decrease in the price level as household consumption accelerates. This decrease is significant because of the drop in money supply. The CPI would drop by 0.12, 0.34, and 0.19 %, respectively, compared to the base values from 2010 to 2012. Consequently, household consumption growth would speed up. From 2010 to 2012, the growth rate of household consumption would increase by 0.02 %, 0.28 %, and 0.79 %, respectively, compared to the base values; these growth rates are higher than those of the simulation result of Scenario 1 (Fig. 4.12).

Secondly, both urban fixed assets investment and GDP increase after decreasing at first. The growth rate of urban fixed assets investment drops by 0.14 % and 0.44 %, respectively compared with the base values in 2010 and 2011, with 2012 showing an increase by 0.03 % (Fig. 4.13). The GDP growth rate presents almost the same variation trend; compared with the base values, it drops by 0.02 % in 2010, and it increases by 0.03 % and 0.34 %, respectively in 2011 and 2012 (Fig. 4.14).

[8] The central bank changed the statistical caliber of M2 in October 2011.

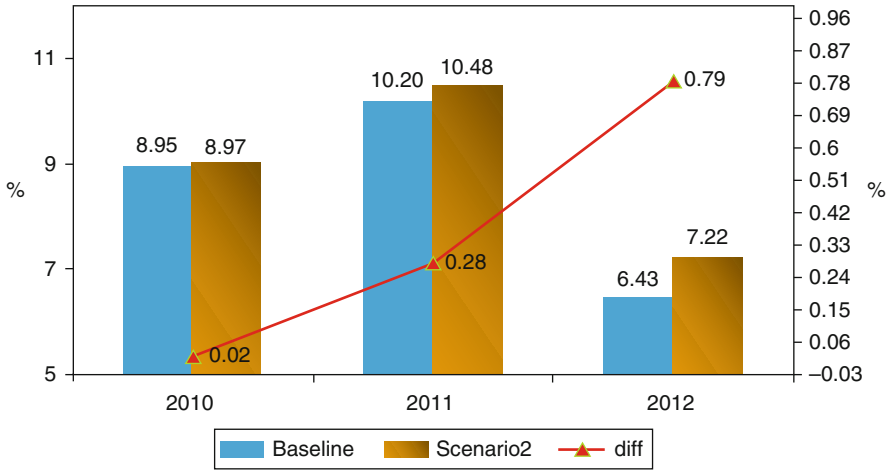


Fig. 4.12 Change in the growth rate of household consumption (calculated at comparable prices) (Note: "Baseline" denotes the basic simulation condition. "Scenario 2" denotes the simulation condition of Scenario 2. "diff" denotes the difference between the simulation value of Scenario 2 and the basic simulation value (right-hand side axis). Data source: Calculated by the research team)

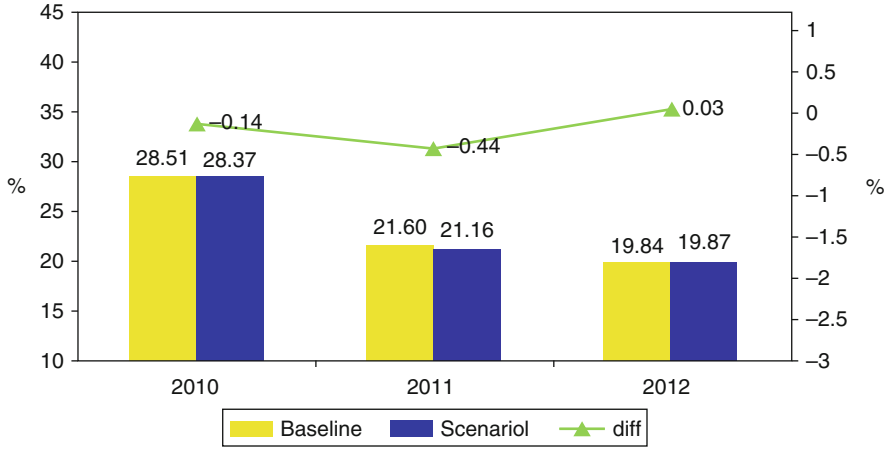


Fig. 4.13 Change in the growth rate of urban fixed assets investment (Note: "Baseline" denotes the basic simulation condition. "Scenario 2" denotes the simulation condition of Scenario 2. "diff" denotes the difference between the simulation value of Scenario 2 and the basic simulation value (right-hand side axis). Data source: Calculated by the research team)

This suggests that although decreasing financing cost will lessen the money supply and cause a drop in economic growth in the short term, in the long run, it will be more conducive to economic growth due to the recovery of non-state economy investment and accelerated household consumption growth.

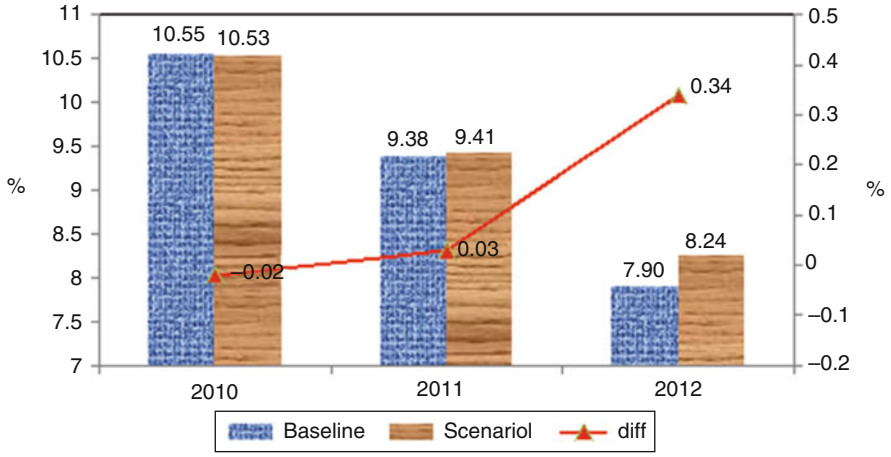


Fig. 4.14 Change in GDP growth rate (Note: "Baseline" denotes the basic simulation condition. "Scenario 2" denotes the simulation condition of Scenario 2. "diff" denotes the difference between the simulation value of Scenario 2 and the basic simulation value (right-hand side axis). Data source: Calculated by the research team)

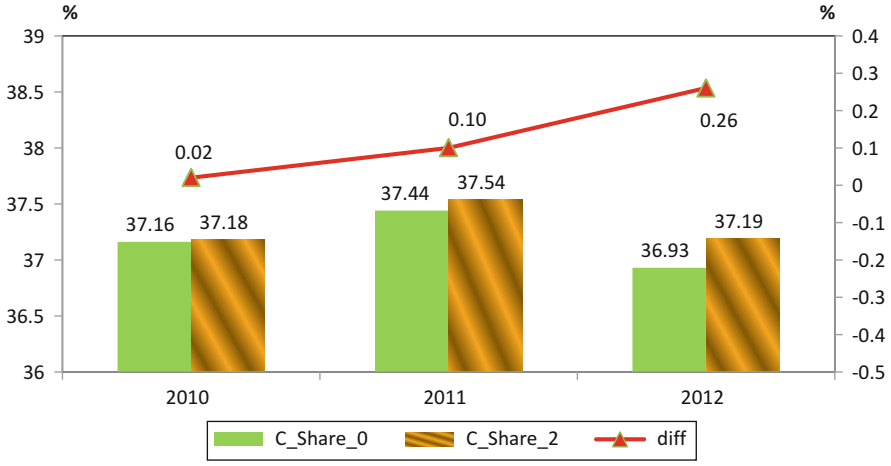


Fig. 4.15 Change in the share of household consumption in GDP (Note: "C_Share_0" denotes the basic simulation condition. "C_Share_2" denotes the simulation condition of Scenario 2. "diff" denotes the difference between the simulation value of Scenario 2 and the basic simulation value (right-hand side axis). Data source: Calculated by the research team)

Finally, in terms of aggregate demand structure, the share of household consumption appears to be increasing. The rising trend gradually enlarges from 2010 to 2012, increasing by 0.02 %, 0.10 %, and 0.26 %, respectively, in 2010, 2011, and 2012 compared with base values (Fig. 4.15). The share of gross fixed capital formulation calculated at comparable prices declines year-by-year, dropping by 0.02 %,

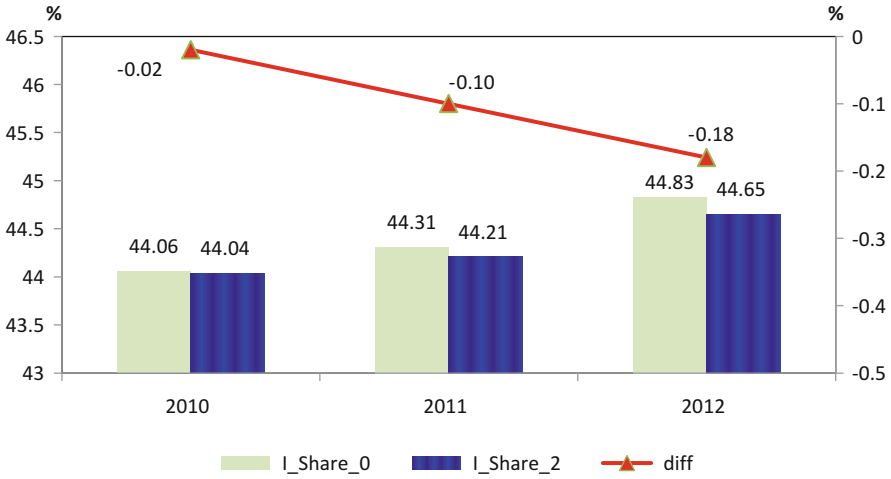


Fig. 4.16 Change in the share of total fixed assets formulation in GDP (Note: "I_Share_0" denotes the basic simulation condition. "I_Share_2" denotes the simulation condition of Scenario 2. "diff" denotes the difference in the simulation value between Scenario 2 and the basic simulation value (right-hand side axis). Data source: Calculated by the research team)

0.10 %, and 0.18 %, respectively, compared with base values in the 3 years (Fig. 4.16). The share of net export remains constant in 2010 and 2011, showing a slight (0.03 %) drop in 2012. As a whole, the aggregate demand structure shows an obvious improvement, and there is also a certain degree of improvement in the economic structure imbalance situation.

Under the premise of Scenario 2, that is, assuming that the whole scale of local government debt is moderately controlled while the share of bond financing is increased, we find that it is conducive to improve capital allocation efficiency and implement a tight monetary policy. Doing the latter will not only maintain the GDP growth rate, but it will also control inflation effectively, increase household consumption, and help improve the aggregate demand structure.

In conclusion, the result of Scenario 1 of the policy simulation of the CQMM shows that assuming constant growth rate of the money supply (M2), increasing the share of local government debt financing, balancing the power of supply and demand in the capital market, and inhibiting rising financing cost is conducive to maintaining stable GDP growth, increasing private investment, and expanding household consumption. Simultaneously, it also plays a positive role in increasing imports and narrowing the trade surplus.

The result of Scenario 2 of the policy simulation of the CQMM shows that based on the assumptions of Scenario 1, if we further loosen the assumption of constant money supply and suppose that money supply decreases for the implementation of the debt replacement plan, while maintaining our presumption of the interval weighted loan interest in Scenario 1, the combined effects of the two situations are as below.

1. There is an obvious decrease in the price level, and household consumption grows faster. The CPI drops by 0.12 %, 0.34 %, and 0.19 %, respectively, compared to the base values from 2010 to 2012. From 2010 to 2012, the growth rate of household consumption increases by 0.02 %, 0.28 %, and 0.79 % respectively compared to the base values, all of which exceed the simulation result of Scenario 1.
2. Both urban fixed assets investment and GDP show an increase after decreasing at first. The growth rate of urban fixed assets investment drops by 0.14 % and 0.44 %, respectively, compared with the base values in 2010 and 2011, and in 2012, it increases by 0.03 %. The GDP growth rate shows almost the same variation trend; compared with the base values, it drops by 0.02 % in 2010 and increases by 0.03 % and 0.34 % in 2011 and 2012, respectively. This suggests that should the financing cost decrease, although it will lessen the money supply and decrease economic growth in the short term, it will be more conducive to economic growth in the long run, due to the recovery of non-state economy investment and faster household consumption growth.
3. In terms of the aggregate demand structure, the share of household consumption rises, and this rising trend gradually enlarges, increasing by 0.02, 0.10, and 0.26 % compared with the respective base values from 2010 to 2012. The share of gross fixed capital formulation calculated at comparable prices declines year-by-year, dropping by 0.02 %, 0.10 %, and 0.18 %, respectively, compared with the respective base values in the 3 years. The share of net export remained constant in 2010 and 2011, and thereafter, dropped slightly (by 0.03 %) in 2012. As a whole, the aggregate demand structure appears to have improved significantly, accompanied by a certain degree of improvement in the economic structure imbalance situation.

Chapter 5
Policy Implications and Recommendations

The "Decision on Major Issues Concerning Comprehensively Deepening Reforms" (henceforth, the "Decision") was approved at the 3rd Plenum of the 18th CPC Central Committee in November 2013. The "Decision" contains the guidelines and details for China's reforms in the coming decade. The year 2014 promises to play a vital role in the historical process of the socialist market economy development.

Not only will this year promote China's all-round deepening reforms and have a profound impact on the future development of China's socialist market economy, it will also be a critical period for China, as it firmly establishes a new growth rate platform and achieves its goal of doubling the national income once again by 2020; given that the country aims for the national per capita GDP to exceed the USD 5,000 mark, China would soon attain the status of an upper-middle income country.

Despite past efforts, China's economic growth rate has declined each year since 2008 (after the global financial crisis), with the current growth rate gradually stabilizing to a new annual growth rate platform of around 7.5 %. However, as mentioned above, the foundation of the new platform is still unstable: it is basically the product of the combination of constant decay in the potential growth rate, drawbacks of the existing system, and the stimulation provided by government-led discretionary investment. Therefore, in order to realize a doubling of income, the government must establish the mechanism and institutional foundation needed to achieve stable economic development in the next stage.

On the basis of the above analyses, our research team proposes the following policy recommendations.

1. The key to establish mechanisms to achieve stable economic development in the future is to correct the distortion of relative prices of factors, which is the microfoundation for extending the pattern of economic development to a government-led market economy. If we are to correct the distortion of relative prices of factors, which has accumulated dangerously over the years, we must pay due

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heed to market mechanisms, which will play a decisive role in resource allocation.

2. We must prioritize government control appropriately in order to correct distortions of relative prices and establish market mechanisms as the decisive driver in resource allocation. Only substantially reducing the government's direct allocation of resources can promote the allocation of resources based on market rules, market prices, and market competition and achieve maximum benefit and efficiency optimization.
3. Controlling the size of local government debt and regulating the borrowing behavior of local governments are not only important measures to prevent the risk of local government debt, but they are also the necessary premises defining the boundary between the government and the market. It is necessary to reduce the direct allocation of resources by the government and instead let the market play a decisive role in the resource allocation. The proportion of government revenue in GDP is one of the key ratios to strike a balance between the roles of the government and the market under an economy market. The government uses a variety of methods, including taxes, nontax revenue, and debt financing, to obtain a share of the national income. Government access to these resources and the manner of their use reflect the relationship between the government and society, and also the market, in particular economies. Therefore, we must control the proportion of government revenue in GDP, standardize government access to resources, and review and supervise the use of the government revenue. It is not possible to have a market economy if these restrictions and measures are ignored.
4. Interest rate liberalization is one of the most important initiatives to correct the distortion of relative prices of factors, which in turn is the micro-foundation for extending the pattern of economic development to a government-led market economy. However, in recent years, various changes in the labor, land, resources, and capital markets illustrate one problem: the distortion of relative prices of factors has been difficult to control. Deposit and loan interest rate liberalization must be implemented as soon as possible. However, interest rate liberalization should be on the premise that the debt financing behavior of the government has been effectively controlled. If the government as well as the government-backed non-independent market entities compete unrestrictedly with the independent market entities in the rights of fund use, the results of interest rate liberalization will be decided by non-market interest rates, leading to further distortions in resource prices, mismatch of resources as well as increase in financing costs. Only by dividing the boundary between the government and the market and by limiting the government's arbitrary debt financing, can we create the necessary precondition for interest rate liberalization, improve capital utilization efficiency, and reduce financing costs.
5. Rationalizing the market structure of the financial markets is also crucial. In order to realize interest rate liberalization, not only must we control the government's nonstandard ultra-scale debt financing behavior as a precondition, but we must also rely on a competitive financial market structure. The opening up of the financial market and the restructuring of the competitive market should be imple-

mented simultaneously to break the monopoly, promote effective competition, achieve efficient allocation of financial resources, improve capital utilization efficiency, reduce financing costs, and increase residents' incomes.

6. China must accelerate tax system reforms, improve the local tax system, and gradually increase the proportion of direct taxes. The "Decision" points out that the responsibility of the central government is to macro-control, and the primary responsibilities of local governments include the provision of public services, market supervision, social management, environmental protection, etc. However, local government functioning has been unsatisfactory since quite some time. This is closely associated with both misunderstanding the core of China's economic construction and the tax system. So far, governments at all levels in China take production tax as the main source of revenue, and therefore, without exception, governments at all levels consider economic growth as their top priority. In order to meet the needs of different government management, policies accelerating tax system reforms, improving the local tax system, and gradually increasing the proportion of direct taxes should be implemented as soon as possible. Efforts are also needed to transform local government behavior through the establishment of a local tax system, mainly including the proportional share of real estate tax, consumption tax, and personal income tax, and of a new local government financial guarantee mechanism. These tax reforms will also help rational distribution and coordinated development among cities.
7. China must implement "negative list" management and open up more fields to investment. Currently, the country is facing over-capacity in the manufacturing sectors. The government must implement "negative list" management and open up more investment areas to promote private investment and form a new foundation for economic growth.
8. It is vital to break the administrative control and state-owned monopoly and develop the service industry. The service industry promises to be one of the important areas in the implementation of "negative list" management and the opening up of additional investment areas. Currently, China's service industry is seriously lagging behind; in 2011, it accounted for only 43.35 % of all industries in China, while the corresponding figure for countries in the same per capita income group and low-income group countries was 55.63 % and 49.82 %, respectively, over the same period. In contrast with the severe over-capacity in China's manufacturing industry, there is a serious supply shortage in China's service industry, especially shortages relating to the basic needs of people's livelihoods. These problems are caused by the slow process of service industry marketization. In general, private investment in the Chinese service industry and public utilities accounted for less than 50 %. The state-owned enterprises enjoy a monopoly. The transportation, healthcare, education, entertainment, telecommunications, finance, utilities, and other industries accounted for more than two-thirds of the investment in state-owned enterprises. From the view of employment, in 2012, manufacturing employment in the non-state sector accounted for 94.42 % of the total, while the corresponding number for the service industry was 74.07 % (the public management, social security, and social organization

departments are basically state-employed, and thus, they are not taken into account). The proportion of service industry employment in state-owned enterprises is much higher than the other sectors of the national economy. Besides state-owned monopoly, many industries are still the object of government regulation, and non-state-owned capital is debarred. International experience shows that the service industries of countries that have just transformed themselves into middle-income economies grow fairly rapidly. The transition experiences of Japan and South Korea indicate that after undergoing a rapid growth period, their economies underwent a period marked slower (medium speed) growth, and during this time, all the new job opportunities arose from the service industry. Accelerating reforms in service industry management and opening up the industry to investment will promote private investment and help develop the industry. Doing so will help fulfill basic needs, such as providing people with their livelihood and expanding consumption, thus giving rise to a new economic growth point. It is of great significance that China achieves steady growth in the sub-high economic growth phase.

Chapter 6
Comments and Discussion

On February 20, 2014, Xiamen University and the Economic Information Daily, Beijing, jointly held a "High Level Symposium on China's Economy and Press Conference of China's Quarterly Macroeconomic Model (CQMM) Forecast." The participating experts and scholars expressed their views on the current economic situation and its prospects and proposed relevant policy recommendations. These views are presented below.

6.1 Zhang Zhuoyuan, Researcher and Former Director of the Institute of Economics, Chinese Academy of Social Sciences: Root of the Difficulties Experienced by China's Economy and Ways to Deepen Reforms

I am honored to have participated for the first time in this press conference covering macroeconomic forecasts. I have read the conference material quite a few times, and I believe your predictions and analyses have had a relatively large impact on society. The amount of information presented therein is also relatively large. It seems that the macroeconomic analysis, forecasting, and research do not necessarily need to be done in Beijing; I think Xiamen University serves the purpose well. The quality and scale of this report are commendable. The policy recommendations are feasible, and personally, I generally agree with them all.

The report concluded that the rapid expansion in the size of local government debt not only pushed up the interest rates but also crowded out bank loan quotas and improved financing costs for small- and medium-sized enterprises. Solving this problem is considered the key for the next stage of fiscal and financial reforms. I am in favor of this analysis, which is persuasive.

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Regarding China's economic situation, I think it is moving toward stability, but the downward trend has not been completely curbed as yet. This process still faces many obstacles. However, do not be too pessimistic; we will not head for an economic "hard landing," like some people abroad estimate. Because, after all, China is still experiencing the industrialization and urbanization process, and the process of industrial transformation and upgrading is ongoing. Notably, the potential for developing the tertiary industry, that is the service industry, is still relatively large, and a growth rate of about 7 % can be maintained for some time. Meanwhile, the national balance sheet is still relatively good. According to the estimates of the Academy of Social Sciences, our sovereignty net assets amount to more than 20 trillion and our foreign exchange reserves are abundant, and so, a sovereign debt crisis is unlikely.

Currently, the major difficulty faced by the Chinese economy is the slow process of transformation and structural adjustment, the pace of which has increased over nearly 20 years. As the report points out, the soft budget constraints of local government debt enhanced unbalanced, uncoordinated, and unsustainable debt issues. I think that the report has identified the problem correctly, and it is appropriate to flag this issue as the theme of this year's macroeconomic analysis.

In order to let the market play a decisive role in allocating resources, it is crucial to deepen government reforms. If this does not happen, economic restructuring will be difficult to achieve, thus making it hard for the market to play the decisive role. The government itself can hardly play its role effectively. After the Third Plenum of 18th CPC Central Committee, the Central Committee established the Central Leading Group for comprehensively deepening reforms and set up the Central Reform Office to implement them. In terms of reforms, the year 2014 promises to be noteworthy; if we can implement the reforms as intended by the Third Plenum decision, China's economy will gradually advance in a healthy fashion.

6.2 Li Shantong, Researcher and Former Minister of the Development Strategy and Regional Economic Research Department, Development Research Center of the State Council: Factors Characterizing China's Economic Stages and Analysis of the Structural Changes

China's economy has undergone periodic changes. First, consider economic growth. The GDP growth rate reached 14.2 % in 2007 and then fell to 7–8 %, and it is unlikely to return to 14.2 %. Second, the proportion of secondary industry in GDP also peaked in 2006 and 2007, following which it also declined. Third, in the first decade of the 21st century, the contributions of exports and net exports to economic growth were very large, but after the international financial crisis, this contribution in the past 20 years may have overshot the peak. Fourth, currently, the supply of the

working-age population is growing slowly. It will reach its peak in 2016–2017 and then decrease gradually.

According to data released by the Bureau of Statistics in January, the growth rate of the tertiary industry in 2013 exceeded that of the secondary industry; this has rarely been recorded before and deserves attention. The impacts of the manufacturing industry are worth noting in the context of the following four factors. First, rising labor costs leads to a declining proportion of labor-intensive exports. Second, regarding the financing costs, the capital is divorced from the substantial economy and flows to real estate. Rising land costs makes up the third factor, and increasing environmental costs, the fourth.

Overall, there are several issues of concern in 2014. The first issue concerns ways to enhance the competitiveness of the manufacturing sector, because China is still undergoing industrialization. This enhancement is very important for economic growth, employment, and long-term stability. The second issue is the price trend; prices of industrial products keep falling and those of consumer goods other than food are low. Thus, inflation does not pose a risk this year. Another issue is the prevention of fiscal and financial risks, as raised in Xiamen University's report. Although local government debt risk is still manageable, we should pay attention to this problem.

6.3 Wang Tongsan, Researcher and Former Director of the Research Institute of Quantitative and Technical Economics, Chinese Academy of Social Sciences: Analysis of the Lessons from Three International Economic Crises

Xiamen University is famous for its economic forecasting. I have also been involved in economic modeling and forecasting. It now appears that Xiamen University has considerably more prowess than we do in this field; they have predicted the results to two decimal places, emphasize scientific integrity, and strive for excellence, all of which are commendable. They have exerted considerable efforts to locate the inflection point in the forecast period, which is very important in academic research. They have stressed the importance of the combination of model predictions and empirical research, rather than treating the modeling process as a purely technical problem. More importantly, analyzing combinations of predicted values, bearing in mind the various technical and practical problems in economic operations, is significant for economic forecasting. In this respect, Xiamen University process is very innovative.

Today, I want to analyze the influences of the three previous international economic crises or financial crises on China, and list the experiences and lessons we can draw upon for our national macro-control measures.

First, let us consider the Asian financial crisis. Our main strategy to tackle the Asian financial crisis was not to devalue the RMB, which plays an important role not only for China's steady economic growth but also supports Hong Kong's economy. The "do not devalue" policy was appreciated by the world, but China itself has suffered some losses. The first loss is the emergence of deflation, and the second is slow economic recovery.

Second, we consider the U.S. financial crisis. Amid the measures to deal with the American financial crisis, there is a typical term called the "4 Trillion Stimulus Plan" which played an important role in maintaining rapid and stable economic growth. However, it also caused some negative impacts and losses, mainly in the following four aspects: first, inflation; second, the industrial structure has not been adjusted; third, overcapacity; and fourth, local debt.

Third, consider the European sovereign debt crisis. The fundamental policy guideline in response to this crisis was to consider both the current and long-term scenarios, stabilize macroeconomic policies, firmly promote reforms and opening up of the economy, stimulate market activity, focus on economic transformation and upgrading, and optimize the structural adjustment. Given its specific conditions, the so-called range of 7.5–3.5, such a policy is absolutely necessary. However, there will be other macroeconomic situations, and the resulting changes to the macro-control policy in response to these situations still requires research.

6.4 Li Daokui, Professor and Director of the World Chinese Economic Research Center, Tsinghua University: Implement Financial Reforms to Resolve Macro Risks

This is the third time I have had the privilege to participate in commenting on Xiamen University's economic forecasting report. They have made very impressive progress within a few years. The popularity of such conferences is rising, as many experts and scholars participate in the discussion. I think the participation of the Economic Information Daily has contributed much to the forecasts over the past 2 years, and the school attaches great importance to it. Today, the team is led by the University President, which is commendable. Moreover, the enthusiasm of the young people who worked on this report is characteristic of Xiamen University. This is a highly successful undertaking, given that so much care and attention have gone into analyzing such a huge amount of data for this report.

Today, I will mainly address macroeconomic risks. In my opinion, the greatest risk is local government debt, which is entirely consistent with the results of Xiamen University's reports. The assumptions of the audit administration in the estimation of local government debt and guaranteed debt are based on historical data. Theirs is a simple derivation, which is questionable. If local government debt is not restrained, it will affect the Chinese economy through the financial system, through two specific channels. The first is the bank; if some local governments are unable to repay

their debts in the short term in breach of the contract, we will see a direct impact on the quality of commercial bank loans. The second concerns the trust. Awareness of the trust rigid payment itself is impractical; once the rigid payment breaks down, the risk will spread. Therefore, not only is a significant risk to the trust rigid payment opaque, but people's lack of knowledge about the risk to the trust is also worrisome.

Fundamentally, the local government must find a new way of financing. Constructions relating to people's needs, such as subways, buses, air and water transport infrastructure, and the ability to cope with the natural disasters will be a new point of growth for China's economy. Local governments can privatize a part of public infrastructure construction and transform some projects that hardly have commercial returns into more financially promising projects. For example, regarding subway construction, we can learn from Hong Kong, where the subway company took over the top floors of the station. We can compensate for original losses or meager profits of subway traffic with returns on a variety of commercial investments on the top floors of the subway station and the underground.

How do we guard against financial risks? First, we must clean up trust products and gradually let the market know that they are risky. Second, we should promote banking reforms and enhance the robustness of the financial system, proceeding with asset securitization.

In short, we must make financial reforms take effect, while making efforts to finance local government infrastructure. If these two things can be done, then the macro risk can certainly be controlled. Then, after a couple of years of effort, I believe China's economic growth rate will increase.

6.5 Professor Gao Peiyong, President of Strategic Finance Academy, Chinese Academy of Social Sciences: Lock All Government Revenue into an "Unified" System Cage

In accordance with today's conference theme, my title for today's discussion is "lock all government revenue into an 'unified' cage," the key word being "unified."

People are likely to think: why does the local government borrow, borrow so much, and even resort to any means to achieve borrowing? This is because local governments are short of money. Why are the local governments short of money? This is because the current financial system is unreasonable, and the finances between the central and local arms are imbalanced. People often say that the share of the finance between the central and local governments is 50:50 and that local governments undertake over 80 % of the functions. However, our concern is about the first level of government revenue. If the finance includes the net income of social insurance funds and the operating income of state-owned capital, then the share of fund allocation, on the whole, will be 70:30. Xiamen University's report points out that the ratio of government revenue to GDP reached 35.64 %, and our calculation

result is 35.33 %. This difference may be attributed to whether we deduct from financial subsidies or social insurance. But it also shows that no matter what viewpoint we take, the entire macro tax burden has already been quiet high.

In such conditions, easing local debt risk requires us to mobilize all government revenue, which is an important starting point, rather than just staring at public revenue. The problem now is we seemed have nominally considered all government revenues in the budget, but in fact, there are different management standards and management specifications for different types of government revenues. Currently, only the public finance budget can be examined, approved, and planned. In contrast, the government fund budget, social insurance fund budget, and state-owned capital operation budget can only be examined rather than granted. I think that considering revenues with "case-dough" properties that are in a state of division into public projects is not only one aspect of the next fiscal reforms, but also the priority to guard against fiscal, financial, and local debt risks. Whether we should reduce local government debt or settle local debt regards careful consideration.

In the late 1990s, the proportion of non-public revenue and public revenue was about 60:40. After years of reforms, this proportion changed and is now probably 65:35; namely, public revenue probably accounts for all government revenue (65 %), and the remaining three budget categories account for about 35 %. Despite great improvements, the problem has not been solved fundamentally. Therefore, in order to guard against risks of local government debt and eradicate this risk completely from the mechanism, we must make up our mind to implement overall budget management. We should not only consider all government revenues within the budget, but we should also add the word "unified," in the sense that we must consider all government revenues into a unified budget, when we jointly consider the current national realities.

6.6 Professor Zhang Yansheng, Secretary-General of the Academic Committee, National Development and Reform Commission: Some Proposals to Prevent Current Fiscal and Financial Risks

I want to talk about three issues. First, judging from the forecast of Xiamen University, there should be some guarantees to solve the short-term macroeconomic stability problem. Public finance real income declines are related to whether the government should cut tax to nurture sources of revenue, or expand the tax base, or impose tax? As revenue and rigidity of expenditure decline, can government public spending and quasi-public goods be taxed by way of PPP and privatization? Therefore, the financial risk is not only a short-term financing problem, but also

poses issues regarding the structural and institutional factors behind short-term growth.

Second, this year's report shows good progress. But I think some data changes may be needed; is this a short-term phenomenon or the beginning of a new long-term trend? Generally, double-digit growth in export trade indicates the negative growth of the processing export trade. Is this a short-term phenomenon or the start of a long-term trend? Does it denote a change in the division of labor pattern of a product category? From 2013 to 2014, traditional export growth rate significantly exceeded the growth rate of high-tech exports and products exports. Are these accidental factors or long-term structural changes? If they are long-term structural changes, we need to explain them under the conditions of rising labor costs, rising in all costs, shrinking demand, and increasing friction; can the export growth rates for textiles, clothing, and footwear record double digits for these 2 years? Will the figure exceed that for the high-tech and electromechanical sectors? By ownership, foreign and state-owned enterprise growth is negative or very low (less than 2 %), while the growth rate of private enterprises is close to 20 %. Under mixed ownership, the past situation of foreign-invested enterprises accounting for half the enterprises has changed. Is there any relationship between the RMB exchange rate appreciation since 2005, rising labor costs since 2005 (which we called the "Lewis turning point"), the new "Labor Contract Law" of 2007, the significant increase in various costs in 2009, and the strong growth this year? Textiles, clothing, and footwear appeared to have garnered good development momentum, but will this be sustainable in 2013 and 2014? We look at the data in 2012 and believe that they mark the end of an old trend. Do the data from 2013 to 2014 signal the beginning of a new trend?

Third, after comparing the Asian financial crisis with the U.S. subprime crisis, we found that the Asian financial crisis is our crisis, a crisis of Asian production networks. So, economies and companies that rely/relied highly on the Asian production network lost a lot. The economies relying on the American global production network were generally immune to the crisis. For example, the Asian crisis had little impact on Taiwan. But in the case of the American subprime crisis, the influence reversed; the American subprime crisis made no difference to all the economies relying heavily on Asian production networks. In contrast, all the economies relying heavily on the American global production network were hit hard by the American crisis.

I think that the structural adjustment and system reform were not in an important position during the last decade; in fact, it was the return of the old system. To solve local government debt issues in the next stage requires solving institutional factors and the behavioral distortions of local governments that have occurred in the past 10 years.

6.7 Yu Bin, Researcher and Director, Department of Macroeconomic Research, Development Research Center of State Council: Promote Reform in Areas with Significant Growth Effect Priority, and Mitigate Economic and Financial Risks in an Orderly Manner

First, we should not have too many expectations for this year's economic growth. To analyze matters from the demand aspect, we must first realize that a prominent feature of economic growth from last year, export growth, is no longer stable. The main reason is that traditional export competitiveness began to weaken. Specifically, the shares of labor-intensive products in the international market in 2012 and 2013 declined, and moreover, both the share of industrial Chinese-manufactured goods in global manufactured goods and import shares of the U.S. and Europe also fell. It is difficult to conclude that this year's export growth is significantly higher than last year's, even if the external environment improves in 2014.

Second, the manufacturing sector has actually suffered a significant decline in investment growth for two consecutive years. Factors such as overcapacity, excessive competition, and vicious competition led to an apparent plunging in manufacturing growth. The real estate market pattern is expected to become divided this year; there will be a significant downward trend in real estate investment growth, with overall investment growth likely to fall to around 18 %. Finally, consumption is not so good this year. The plunge in manufacturing has created aftereffects: Income growth is declining and spending power is falling, and it is expected that this year's spending will, at most, be the same as last year's.

Third, it is important to give priority to reforms in areas with significant growth effects. Currently, macro-control and the government's steady growth policies to guarantee the stability of economic development in China are becoming increasingly less effective, and on many levels, the loss outweighs the gain. Conversely, deepening reforms by implementing them in areas that would reap obvious benefits will create a sustainable driving force for economic development. Examples of such measures include introducing price competition in basic industries, allowing access to non-monopoly sectors, and improving efficiency through competition so as to ensure survival of the fittest and reduce costs..

Fourth, we must lessen the accumulated risk in an orderly manner. The serious risks posed by local government debt call for extreme measures. For example, if the local government cannot pay the debt, then local officials should not be promoted and should not receive their salaries, and local infrastructure projects should be stopped. The reforms call for proactive adjustments, so as to release the accumulated risk in an orderly fashion, by deepening reforms in a number of related areas.

Fifth, fiscal and financial risks deserve serious attention. We should transform public decision making into a more scientific and meticulous process, adjust the structure of expenditures, and improve the efficiency of public spending. Meanwhile, the welfare system cannot be constructed blindly; it should match or adapt to present situation and financial resources, rather than being overdesigned.

6.8 Doctor Zhang Monan, Vice Researcher at the Economic Forecast Department of the State Information Center: Use Innovative Ideas to Improve the Leverage Ratio

The Chinese economy needs to not only manage the leverage ratio but also the risks of deleverage. The global debt crisis and the financial crisis, in fact, ultimately reflect crises in the national balance sheet. In the face of such crises, deleveraging and debt elimination are inevitable rebalancing processes for a national economy. Therefore, controlling deleveraging is more important, as it acts as a lever for the country itself.

Now, the largest risk from local government debt in China does not concern the paying ability, but it arises from liquidity due to the mismatch between short-term assets and liabilities. The digestion of the U.S. debt can be achieved basically by transferring the lever and balance sheet, rather than operating the lever directly. China can learn from the experience of the U.S.; namely, it is not necessary to hold back on the lever directly, but transferring the lever or reducing hold on it by debt digestion will suffice. Therefore, we must adjust the structure of the balance sheet. On the one hand, on the asset side, we can exchange part of the debt for equity, namely, we can transform debts into assets. For example, we can replace debt through the property rights exchange market by building infrastructure for such a market. If there is a risk, we can also eliminate it via debt restructuring or debt default and the bond market. On the other hand, we should promote the transformation of indirect financing to direct financing and revitalize banks' assets and a large number of household savings, which are currently parked in commercial banks.

In the future, we may consider further revitalization of state-owned assets by injecting a number of operating assets and business capital, so as to attract in currency incomes and liquidity earnings onto the local financing platform. We can also set up a special public account to completely revitalize public assets in the special account. Moreover, we should allow the gainful part of the assets and commercial assets to subsidize this special account.

6.9 Professor Wang Luolin, Ad Hoc Consultant and Former Executive Vice President of the Chinese Academy of Social Sciences: Face the Reality to Accelerate the Pace of Reform and Adjustment

Given the current economic situation, the economic situation in 2014 will be little more difficult than that of 2013. There is more or less a consensus on this point. Although the IMF has gradually improved its forecast for the world economy for next year, it has lowered the forecast for the Chinese economy. This does not appear to be strange to our researchers, but I think it puts great pressure on our decision makers. We should carefully guide our cadres at all levels to face this reality. We do

not discuss how we may reform the economy to help it grow quickly, and I think this is unlikely. I think we are in the throes of period of system transformation. The economic downward pressure is relatively large at this stage, which is unavoidable. The promoting roles of structural adjustment and reforms are difficult to gauge in the short term. In this period, we engage in analysis and forecasting, and we must guide the cadres to face this reality and not resort to whitewash. Only by facing reality can we build a solid foundation to further accelerate reforms and adjustments.

The entire economic system is in need of reform, including our analyses and methods of making predictions. In recent years, Xiamen University has conducted many studies on this issue. I suggest that when you explore these issues, apart from analyzing some fundamental, long-term structural and institutional factors, you should also analyze short-term factors. For instance, what factors will affect economic growth this year? On the employment issue, I do not agree with their assessment that this year's employment issue does not pose a big problem, but I am more interested in this issue, because the effects of downward economic growth will show up in employment a few months later. The economy was down last year, and I estimate that this downward pressure will be relatively larger this year. Consider the food issue as another example. I asked someone who engages in agriculture as to why economic conferences allot such significance to food-related issues. Over the years, a large number of migrant workers have swarmed to cities, thus leading to large-scale land abandonment in rural areas, and the migrants have sold a lot of their productive suburban land to real estate businessmen in exchange for some bad deals. While it appears that there is no reduction in the total amount of land, in fact, good quality farmland is rapidly reducing. Thus, it is important to consider such issues when we conduct economic analyses. The current belief dictates that reform is difficult and that we should stimulate and boost reform by opening up the economy widely. If this is allowed, what will be the effects of such a practice on the economy this year? You should also study these issues. It is said that in addition to the Shanghai Free Trade Zone, more than 20 cities have applied to create Free Trade Zones. The Centre is inclined towards prioritizing Free Trade Zones in Tianjin and Guangdong, while other cities are also hoping for the same benefits. The reasons for their optimism are understandable; they hope that creating Free Trade Zones will help their economies. But what will be the true effect of such Free Trade Zones on our economy? It is important to observe these issues and conduct research on them.

Chapter 7
A Survey of China's Macroeconomic Performance in 2014

To keep abreast of the macroeconomic situation and policy trend, an annual questionnaire survey of China's macroeconomic situation and policy started in January 2014 for the second time, hold by the Economic Information Daily, Xinhua News Agency and the Center for Macroeconomic Research, Xiamen University (one of the Key Research Institutes of Humanities and Social Sciences of the Ministry of Education of China). There were 18 questions directly about China's macroeconomic situation and policy trend in the questionnaire, and we invited some domestic economists in relevant area for this survey by email in the early of January, and finally got responses from 57 of them. This survey offered the latest understandings and judgments of experts concerning challenges in China's recent macro-economy, recent China's local government debt risk problems, macroeconomic situation of Europe and U.S.A., trends of some major indicators about China's macro-economy and trends of China's macroeconomic policies in 2014. The results of this survey are presented as follows:

7.1 The Greatest Challenge in China's Economic Development

What is the greatest challenge for China in economic development? 63 % of the experts answered with the high risk of local governments' debts, 46 % with some systematic risks in financial institutions, 44 % with the increasing uncertainty of real estate market, 44 % with the slowdown of China's substantial economic growth, and 40 % with the worsening problem of excess production capacity. The results above showed that more than 60 % of the experts claimed that the greatest challenge of China's economic development was the high risk of local governments' debts. In addition, more than 40 % of the experts maintained that some systematic risks in financial institutions, the increasing uncertainty of the real estate market, the

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slowdown of China's substantial economic growth, and the worsening problem of excess production capacity would be the greatest challenges, which were the crucial or important factors that would affect the healthy development of China's future economy.

What's more, 13 % of the experts had different opinions on the greatest challenge including the short-run adjustment of the real estate market in the first-tier and second-tier cities, the rapidly increasing factor costs, the fact that there was not an effective institution based on market regulation for development of enterprises' technology and optimization of industrial structure, the fact that economic growth depended overmuch on the pull of exports and investments (especially investments on real estate), the underlying great stagflation risk problem which needed to be solved, and the unclear relationship between government and market.

7.2 The Recent China's Local Government Debt Risk Problems

According to the audit results about the debts of local governments which were published by the state auditing administration in December 30th of 2013, the scale of local governments' debts increased from 10.7 trillion yuan in the end of 2013 to 17.9 trillion yuan in the end of June 2014, which equaled to 33 % of the GDP. What are the opinions of experts on the degree of recent China's local government debt risk? The survey showed that 56 % of the experts claimed the degree of local government debt risk was high, 30 % thought it was really quite high and 14 % maintained that it was still safe. In sum, most of experts thought that the debt risk of China's local governments was still controllable.

What kinds of measures will be taken to solve the debt risk problem of China's local governments? The results showed that 61 % of the experts thought that these debts should be categorized by full-covered budget management. 56 % claimed that local debt market should be established, which was market-oriented and could be openly operated. 53 % maintained that China should change the recent evaluation mode based on GDP only. 16 % considered that China should optimize the planning of local governments. In general, most of the experts believed that the effective measures to control the debt risk of China's local governments are "categorizing debts by full-covered budget management", "establishing local debt market which was market-oriented and could be openly operated" and "changing the recent evaluation mode based on GDP only". In addition, 9 % of the experts offered other policy advices including "speeding up the reform of fiscal and taxation system to make financial power match authority of office in central and local government", "establishing a cross-year budget balance mechanism", "keeping consummating graded financial control system and formally starting the local debts", "transforming functions of local governments and making them take part in microeconomic activities

less directly", "adjusting the fiscal relationship between central and local government, and making local governments' authority of office match their disposable assets", "reforming the investing and financing system, and broadening the market access for cities' infrastructure" and "reforming the financial system, and weakening the administrative propensity of financial resource allocation".

Facing the fact that the debt problem of local governments becomes more and more severely, the central government of China started to strengthen monitoring of local governments' financing platform. What kind of effects will it have on social fund demand situation? The survey showed that 39 % of the experts answered with "no effects on social fund demand situation", 28 % with "making the fund demand decrease slowly", 25 % with "making the fund demand increase slowly", 5 % with "making the fund demand decrease rapidly" and only 3 % with "making the fund demand increase rapidly". In sum, the experts have relatively different opinions on this question, which explained that the effect of strengthening monitoring of local governments' financing platform on social fund demand situation is relatively complex.

7.3 The Macroeconomic Situation of Europe and U.S.A. in 2014

Global economy was in the slow process of economic recovery, but growing sluggishly. In accordance with the latest economic forecast of the Federal Reserve, the economic growth rate of USA was between 2.2 % and 2.3 % in 2013. Comparing with its performance in 2013, what kind of trend will American economy have in 2014? The survey reflected that 81 % of the experts claimed that the economic growth rate of USA would increase slowly. 10 % of them thought that it would increase rapidly. 7 % said that it would be equal roughly to the level in 2013. Only 2 % maintained that it would decrease slowly and no one considered that it would decrease rapidly. Overall, overwhelming majority of the experts believed that the American economy would be in recovery, and the growth rate would increase in people's prediction, which situation would be relatively optimistic.

The economy of Euro zone which was shocked by the debt crisis and still in recession was expected to grow in the rate of −0.4 %. Comparing with the situation in 2013, what kind of trend will the economy of Euro zone have in 2014? In the 56 effective questionnaires to answer this question, the results showed that 70 % of the experts answered that the economic growth rate of Euro zone would increase slowly. 28 % claimed that it would be equal roughly to the level in 2013. Only 2 % of the experts thought that it would decrease slowly and no one said that it would increase or decrease rapidly. In sum, overwhelming majority of the experts believed that the economy of Euro zone would be also in recovery and the growth rate would be higher than the one in 2013, which situation would be relatively optimistic.

7.4 The Forecast of Some Major Indicators of China's Macro-economy in 2014

With respect to the growth rate of China's GDP in 2014, the survey showed that 54 % of the experts thought that it would be "between 7.5 % and 7.9 %", 37 % expected that it would be "between 7.1 % and 7.4 %", 7 % claimed that it would be "8 % or more" and only 2 % maintained that it would be "7 % or less". In sum, 61 % of the experts considered that the growth rate in 2014 would be higher than 7.5 %. 39 % of the experts expected the growth rate would be less than 7.5 % and the economic growth of China would slow down continually considering the growth rate of 7.7 % in 2013.

Concerning the variation of China's CPI in 2013, the survey showed that 65 % of the experts expected it to be "between 2.6 % and 3.0 %", 28 % thought that it might be "between 3.1 % and 3.5 %", 7 % chose "between 2.1 % and 2.5 %", and that no one claimed that it would be "2.0 % or less" or "3.6 % or more". In sum, all experts considered that the variation of CPI would be less than 3.5 % in 2014. In other words, most experts claimed that the price level would still stay steady and the inflationary pressure would continue to be lessened considering the fact that the CPI increased by 2.6 % in 2013.

In regard to the growth of China's total retail sales of consumer goods in 2014, the survey showed that 47 % of the experts expected the total retail sales of consumer goods would increase year on year at the rate "between 12.6 % and 13.0 %", 35 % considered that it would increase at the rate "more than 13.0 %", 14 % chose "between 12.1 % and 12.5 %", and only 4 % claimed that it would be "12.0 % or less". Considering the fact that the total retail sales of consumer goods grew by 11.5 % year on year in 2013, the results reflected that most experts maintained that the growth of the total retail sales of consumer goods would be higher in 2014 than one in 2013.

Regarding to the growth of China's fixed investments in 2014, the survey showed that 46 % of the experts expected the total fixed investments would increase year on year at the rate "between 19.1 % and 20.0 %", 23 % considered that it would increase at the rate "between 20.1 % and 21 %", 17 % chose "19.0 % or less", 9 % thought that the growth rate would be "between 21.1 % and 22.0 %", and only 5 % claimed that it would be "more than 22.0 %". Considering the fact that the total fixed investments grew by 19.2 % year on year in 2013, it was clear that most experts maintained a relatively steady growth of China's fixed investments in 2014.

Comparing with the slowdown of the economy and investment growth, the growth rate of the investments in real estate market in 2013 was higher than one in 2012. So what would the trend of the housing price and sales volume be in 2014? In the 55 effective questionnaires to answer this question, the survey showed that 56 % of the experts expected a trend of "increasing housing price and increasing sales volume", 26 % considered "increasing housing price and decreasing sales volume", 13 % chose "decreasing housing price and decreasing sales volume", and 5 % thought that there would be "decreasing housing price and increasing sales volume".

In brief, more than a half of experts forecasted a continuous uptrend in China's real estate market in 2014 comparing with the situation in 2013.

With respect to the situation of exports in 2014, 49 % of the experts expected the total exports would increase year on year at the rate "between 8.1 % and 9.0 %", 32 % considered that they would increase at the rate "between 7.1 % and 8.0 %", 17 % chose "more than 9.0 %", only 2 % claimed that they would be "between 6.1 % and 7.0 %" and no one forecasted that they would be "6.0 % or less". Considering the fact that the total exports grew by 7.9 % year on year in 2013, the results reflected that more than 60 % of the experts maintained that the growth of the total exports would increase to a certain degree in 2014, which would probably be benefited from the uptrend of American and European economies.

Concerning the growth of China's broad monetary supply (M2) in 2014, 56 % of the experts had the expectation that M2 would grow at the rate "between 14.1 % and 15 %". 31 % considered "between 15.1 % and 16 %".11 % chose "14.0 % or less". Only 2 % thought that it would be "more than 17.0 %" and no one maintained the views that the growth rate would be "between 16.1 % and 17.0 %". M2 grew at the rate of 13.6 % in 2013, so the survey reflected that nearly 80 % of the experts claimed that the growth of M2 would be higher in 2014 than one in 2013.

In regard to the USD to CNY (RMB) exchange rate in 2014, 56 % of the experts expected it would be "between 6.0 and 6.1". 35 % considered that it would be "less than 6.0". 7 % chose "between 6.1 and 6.2". Only 2 % claimed that it would be "between 6.2 and 6.3" and no one expected that it would be "more than 6.3". Hence, most of the experts forecasted a continuous trend of RMB revaluation against USD.

Will the current policies taken by China's government to carry out the process of urbanization actively and steadily contribute to a higher growth rate of resident consumption in future? The survey showed that 77 % of the experts expected that the urbanization would have a certain positive effect on the higher growth of resident consumption in future. 11 % of them considered a significantly positive effect. 10 % thought there would be no obvious relation between them and only 2 % forecasted a certain negative effect of urbanization on the growth of consumption in the short run. No one thought there would be an obviously negative effect. In short, most of the experts considered that the urbanization would promote the demand expansion of consumption.

7.5 Three of the Most Anticipated Economic Work in 2014

In December of 2013, the central economic working conference deployed six key tasks of economic work in 2014. In economists' opinions, which are the most anticipated? The results showed that 75 % of the experts answered with "focusing on controlling the debt risk", 68 % with "focusing on ensuring and improving people's wellbeing", 67 % with "adjusting the industrial structure industriously", 32 % with "keeping improving the level of opening up", 23 % with "ensuring the national food security", and 16 % with "promoting the coordinated development of regions

actively". In brief, more than two-thirds of the experts claimed that "focusing on controlling the debt risk", "focusing on ensuring and improving people's wellbeing" and "adjusting the industrial structure industriously" would be three of the most anticipated economic work in 2014.

7.6 The Trends of China's Macroeconomic Policies in 2014

Regarding to the trend of China's fiscal policies in 2014, 74 % of the experts considered that the central government would maintain the steady and robust fiscal policies. 24 % held that expansionary fiscal policies would be implemented and only 2 % claimed that it would carry forward contractionary fiscal policy.

With respect to the trend of China's monetary policies in 2014, 88 % of the experts considered that the central government would maintain the steady and robust monetary policies to keep neutral. 9 % held that loose monetary policies would be implemented, and that only 3 % claimed that it would carry forward restrictive monetary policy.

According to the Chinese Pinyin order of their names, the experts who joined this questionnaire survey were:

Chang Xin, Chen Gong, Chen Guifu, Chen Shoudong, Chen Yanbin, Chen Yongjun, Fan Conglai, Fan Ziying, Gao Bo, Gong Min, Guo Xibao, Jian Xinhua, Jin Tao, Lai Desheng, Li Jianwei, Li Jing, Li Xuesong, Liu Shucheng, Liu Xiahui, Liu Yu, Liu Yunzhong, Liu Zhibiao, Lu Shengrong, Pang Jinju, Qiu Chongming, Qiu Dong, Shen Kunrong, Shi Jinchuan, Tang Jijun, Tong Jinzhi, Tu Xinquan, Wang Changyun, Wang tongsan, Wang Cheng, Wang Haijie, Wang Jiping, Wang Yanwu, Wang Yuesheng, Wen Chuanhao, Xiao Xingzhi, Xu Jianguo, Xu Yifan, Xu Wenbin, Xu Xianchun, Yang Zhiyong, Yin Xingmin, Yu Bin, Yu Changlin, Yuan Fuhua, Zeng Jinli, Zhang Long, Zhang Yanqun, Zhang Zhuoyuan, Zheng Chaoyu, Zhong Chunping, Zhu Jianping, Zhuang Zongming.

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