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.