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Examining China's Local Government Fiscal Dynamics: With a Special Emphasis on Local Investment Companies (LICs)[2]

China's buoyant economy has long riveted the attention of the world. A closer look at China's economic dynamism would lead to an awareness of a greater role played not by the central government but by local governments. Local governments have recently proliferated their own investment companies (LICs) (Róngzī Píngtái/融资平台) to finance their urban development projects. In the meantime the burgeoning of the assets and liabilities of these LICs has cast a dark cloud of doubt over their financial health.[3] This short essay tries to examine recent developments, the origin and financial health of LICs. In addition, the essay discusses the question of an ends-and-means disagreement, i.e., a policy dissonance between local governments' fiscal efforts including LICs and the achievement of China's national goal, i.e., a "Harmonious Society (Héxié Shèhuì/和谐社会)," or precisely speaking, a "Building a Well-off Society in an All-round Way (Quánmiàn Jiànshè Xiǎokāng Shèhuì/全面建设小康社会)."[4]

1. LIC: Splendid Financial Innovation or A Necessary Evil?

1-1. A Mushrooming Number of LICs in 2009

When the world economy was plunged into a tumultuous and uncertain situation in the wake of the collapse of the Lehman Brothers in September 15, 2008, the Chinese government announced a sizable RMB 4-trillion stimulus package on November 9, 2008 (see Table 1-1).[5] The announcement was made just prior to President Hu Jintao's attendance at the G20 summit in Washington, D.C., signaling China's strong will to overcome the 2008 financial crisis.[6] In addition, the Chinese government adopted a loose monetary policy to give local governments and the private sector wider latitude to promote infrastructure investment. According to a survey conducted by Japan's Mizuho Research

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[2] LIC's alternative English translations include Local Government Financing Vehicle, Municipal Development and Investment Company, and Urban Development Investment Corporations (UDICs). UDICs are the translation by the World Bank regarding Chéngshì Jiànshè Tóuzī Kāifā Gōngsī (城市建设投资开发公司).

[3] See, for example, the blog of Victor Shih, dated on April 4, 2010, http://chinesepolitics.blogspot.com/2010/04/reply-to-my-critics-on-local-debt.html; See also Arthur Kroeber, managing director of GaveKal Dragonomics, "Popping China's Debt Myth," *Wall Street Journal*, June 29, 2010, http://online.wsj.com/article/ SB10001424052748703964104575335962410004720.html.

[4] *Xiǎokāng* (小康) is an abstract concept and literally means "Small Well-Being." The term has a long history. In *Shijing* (《詩經/the *Book of Songs*》), a collection of ancient songs that is believed to come into being 2,000 years ago, *Xiǎokāng* was first mentioned as a social state in which people led a fairly comfortable life. *Liji* (《禮記/the *Book of Rites*》), another ancient classic, contains a more systematic description of *Xiǎokāng*. When Deng Xiaoping met with Japan's prime minister Masayoshi Ohira (大平正芳) on December 6, 1979, he used *Xiǎokāng* for the first time in public to describe Chinese-style modernization. See, for example, http://www.china.org.cn/english/features/48531.htm.

[5] As for a detailed analysis of the stimulus package, see, for example, Barry Naughton, 2009, "Understanding the Chinese Stimulus Package," *China Leadership Monitor*, No. 28 (Spring), Palo Alto, CA: Hoover Institution, Stanford University, May.

[6] Some experts calculate that without the RMB 4-trillion package China's growth rate for 2009 could have been plummeted to 2.9%. As for the detail, see, for example, Xinshen Diao, Yumei Zhang and Kevin Z. Chen, 2010, "Country-level Impact of Global Recession and China's Stimulus Package," Discussion Paper No. 979, Washington, D.C.: International Food Policy Research Institute (IFPRI), May.

Institute, almost all local governments unveiled their ambitious infrastructure investment plans to sustain economic growth as well as to improve the welfare level of its local population (see Table 1-2).[7] The total amount of these local government investment plans reached sizable RMB 30 trillion.

Table 1-1. China's Stimulus Package and Accompanying Policy Measures

RMB 4 Trillion Package: Major Policy Measures (Billions of RMB)	Initial Plan Nov., 2008	Revised Plan Mar., 2009
Affordable Housing for Low and Medium Income Brackets	280	400
Rural Area Infrastructure	370	370
Large-scale Infrastructure (Railroads, Roads, Airports, and Power Plants)	1,800	1,500
Health, Cultural Facilities and Education	40	150
Ecological and Environmental Investment	350	210
Technological Innovation and Structural Adjustment	160	370
Reconstruction of the Area hit by Sichuan Earthquake	1,000	1,000
Increasing Income Standard in both Urban and Rural Areas	280	400
Total	4,000	4,000
Accompanying Policy Measures		
Value-Added Tax reduction by RMB 120 billion		
Financial Support for Economic Growth (Lifting of Control over Bank Loans)		
Long-range Plan for Adjustment and Rejuvenation in Major 10 Industries[8]		

Source: The authors' compilation based on various sources including materials of the Council Standing Committee.

Table 1-2. Major Investment Proposals Unveiled by Provincial Governments

Province	Investment Proposals
Jilin	Ha'erbin-Dalian High-Speed Rail, Changchun-Jilin Intercity Rail, and Expansion of Airport
Shanghai	Inner-city Transportation, Regional Highway, and EXPO Projects
Jiangsu	Shanghai-Nanjing Intercity Rail, Taizhou Bridge, and Lianyunggan Port
Fujian	Punan Highway and Reconstruction of the Fuqing Nuclear Power Plant
Guangdong	Zhujiang Delta Inner-city Transportation and Wuhan-Guangzhou High-speed Rail
Shaanxi	Railway, Highway, Reconstruction of Electricity Grid in Urban and Rural Areas
Anhui	Railways, Road, and Bridges
Hubei	Large-scale Infrastructure
Hunan	36 Highways, Waste Water Treatment Plant on Xiang River and Lake Dongting
Guangxi	Railways, Highways, and Airports
Shaanxi	Xiping Railways, Subway in Xi'an, and Expansion of Xianyang Airport
Sichuan	Reconstruction of the Areas hit by Sichuan Earthquake
Yunnan	China-Burma Natural Gas Pipeline, Chemical Plants, and Yunnan Guilin Rail
Hainan	Agriculture, Development of Recreational Properties

Source: The authors' compilation based on the material presented in Takamoto Suzuki (鈴木貴元), 2009, "Chugoku 'Yon-cho-gen' no Keizai Taisaku no Kosatsu (中国「4 兆元」の経済効果の考察/A Study of Economic Effects of China's 'RMB 4-Trillion' Stimulus Package)," Tokyo: Mizuho Research Institute, January 5.

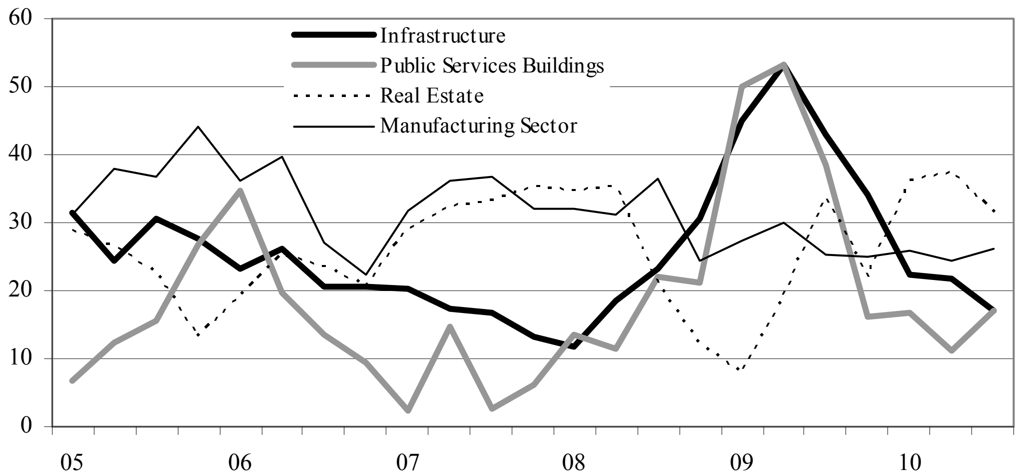
Thus, the year 2009 witnessed intrepid behavior of China's government sector to stave off a domestic recession. Figure 1-1 shows the recent developments of China's fixed asset investment by major categories. The figure makes us understand that throughout the year of 2009, two major categories—(1) infrastructure including roads and bridges, and

[7] During the course of elaborating the stimulus package, strong voices came from coastal regions that are highly dependent on exports (e.g., Jiāngsū (江苏), Guǎngdōng (广东), and Shànghǎi (上海))and inland regions whose people work as migrant workers in the coaster regions (e.g., Sìchuān (四川), Yúnnán (云南), Shǎnxī (Shaanxi) (陕西), Húběi (湖北), and Chóngqìng (重庆)). As for more detailed information, see, for example, Takamoto Suzuki (鈴木貴元), 2009, "Chugoku 'Yon-cho-gen' no Keizai Taisaku no Kosatsu (中国「4 兆元」の経済効果の考察/A Study of Economic Effects of China's 'RMB 4-Trillion' Stimulus Package)," Tokyo: Mizuho Research Institute, January 5.

[8] Shídà Chǎnyè Zhènxīng Guīhuà (十大产业振兴规画).

(2) public services buildings including hospitals and schools—experienced an amazing increase. In principle, these types of investment projects are, as explained briefly above and will be examined in more detail later, planned and executed not by the central government but by local governments.

Figure 1-1. Types of Fixed Asset Investment, Y-o-Y (%)



Note: Public Services Buildings include schools, hospitals, community centers, etc.
Source: China Data Online.

These stimulus measures executed by local governments triggered a mushrooming number of LICs. In 2007, when the World Bank conducted a survey on LICs, the estimated number of LICs was 360.[9] At the end of 2009, the number of LICs reached 8,221 among which those established by provinces and prefectures were 3,314 while those by counties were 4,907.[10] As a matter of fact, prior to the stimulus package, the number of LICs had already increased dramatically in 2009, reaching 3,800 as of May, 2009.[11] Some experts ascribe such increase to a statement made by the People's Bank of China (PBoC), China's central Bank, and China Banking Regulatory Commission (CBRC) on March 2009.[12] The statement indicated that both of the PBoC and the CBRC support the efforts of local governments among which satisfy appropriate conditions to diversify investment financing channels including the establishment of LICs and the issuance of bonds through LICs.[13] This announcement was greeted and deliberately interpreted suitable for various local governments and led to a burgeoning number of LICs. Wei Jianing, Deputy Head of Macroeconomic Research Department, Development Research Center of the State Council (DRC), says that in the past LICs were established by provincial and prefectural governments. Recently, however, the lion's share of newly established LICs

[9] World Bank, 2009, "The Urban Development Investment Corporation (UDICs) in Chongqing, China," Technical Assistance Report, Washington, D.C. It should be noted that the World Bank report does not specifically refer to its definition of UDICs.

[10] See, for example, "重估融资平台风险," March 12, http://finance.cnfinancer.com/finance/2010-03-12/863768.html.

[11] See "范剑平：地方融资债务增速惊人 县级平台几无盈利," November 5, 2009, http://news.xinhuanet.com/fortune/2009-11/05/content_12393874.htm.

[12] See "中国人民银行、中国银行业监督管理委员会关于进一步加强信贷结构调整促进国民经济平稳较快发展的指导意见," March 18, http://www.fdi.gov.cn/pub/FDI/zcfg/yh/P020090324329201876312.pdf.

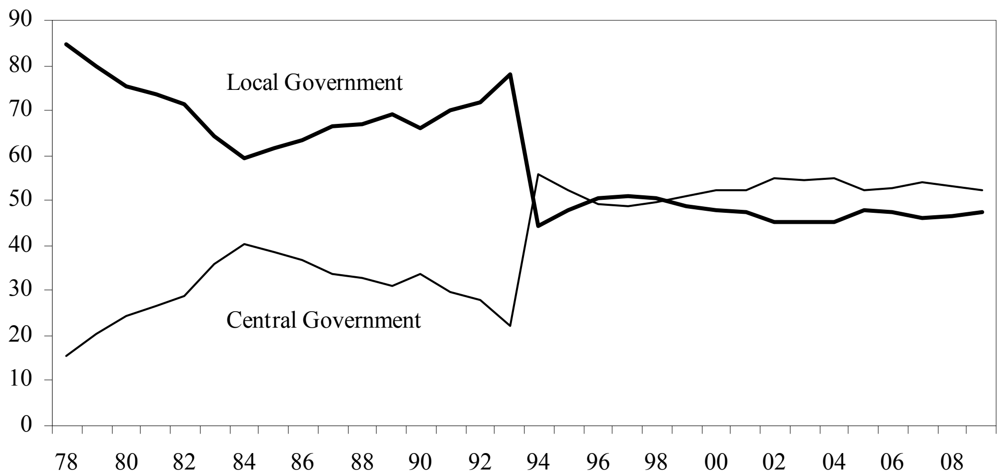
[13] *Ibid*.

consists of those established by county-level governments.[14]

1-2. The Genesis of LICs—Big Projects and Chronic Fiscal Austerity Were the Mother of LICs

The creation of LICs is an innovative product for financing huge infrastructure investment projects in large cities and dates back to the early 1990s.[15] The central government endorsed the LICs as one of first steps for the introduction of market principles in China's financial markets ("marketization (shìchǎnghuà/市场化)" because large-scale LIC-related projects are what the central government had wanted to execute. In addition to the central government's endorsement, the establishment of LICs was also developed because of fiscal austerity that local governments suffered in the mid-1990s. The 1994 Tax-Sharing reform (fēnshuìzhì/分税制) brought about a stricter budget constraint for local governments (see Figure 1-1).[16]

Figure 1-1. Revenue Share of Central and Local Governments, (%)



Source: China Data Online.

While local governments' tax revenues were reduced substantially, expenditures of local governments were on the rise because of additional welfare costs for growing "new vulnerable populations" resulting from reforms of the State-Owned Enterprises (SOEs) and a massive migration of farmers.[17]

[14] See, Wei Jianing (魏加宁), 2010, "Difang Zhengfu Tourongzi Pingtai de Fengxian Hezai (地方政府投融资平台的风险何在/How Could the LICs of Local Governments Evaluated?), " *Zhongguo Jinrong* (《中国金融/China Finance》), No. 16.

[15] As for a brief history of LICs, see, for example, World Bank, *op. cit*., p. 92.

[16] See, for example, Wu Jinglian (吴敬琏), 1999, *Dangdai Zhongguo Jingji Gaige: Zhanlüe yu Shishi* (《当代中国经济改革 战略与实施/Present Economic Reform in China: Strategies and Implementation》), Shanghai Yuandong Chubanshe (上海远东出版社), pp. 314-317; See also Lou, Jiwei, 2008, "The Reform of Intergovernmental Fiscal Relations in China: Lessons Learnt," in *Public Finance in China: Reform and Growth for a Harmonious Society*, edited by Jiwei Lou and Shuilin Wang, Washington, D.C., World Bank. pp. 156-169.

[17] Local governments were allowed to spend their financial resources discretionally in 1988 when an overhaul of the fiscal contracting system (cáizhèng bāogānzhì/财政包干制). But, the system invited an unbridled local fiscal autonomy which the central government could not neglect. As for more detailed analyses, see, for example, Susan H. Whiting, 2007, "Central-Local Fiscal Relations in China," China Policy Series No. 22, New York, NY: National Committee on United States-China Relations and Jiro Naito (内藤二郎), 2010, "Fiscal System and Policy in China—Transition and Tasks of Thirty-year Reform and Opening Policy," *Public Policy Review*, Vol. 6, No. 3 (March), Tokyo: Policy Research Institute, Ministry of Finance. As for the "new vulnerable populations," see, Tony Saich, 20008, "The Changing Role of Urban Government," in *China Urbanizes: Consequences, Strategies, and Policies* by Shahid Yusuf and Tony Saich, Washington, D.C.: World Bank. In the meantime, an opinion to readjust the revenue distribution between the central and local

Local governments cannot obtain financial sources directly from the markets; they are not allowed to (1) have fiscal deficits nor issue bonds by Article 28 of the Budget Law (Yùsuànfǎ/预算法), (2) enter into a loan process by Article 17 of the Lending General Provisions (Dàikuǎn Tōngzé/贷款通则), and (3) offer anything as collateral by Article 8 of the Guaranty Law (Dānbǎofǎ/担保法). For these reasons, local governments, in order to finance urbanization infrastructure, have tried to develop and transform their lands to lease at higher prices, develop a build-operate-transfer (BOT) scheme,[18] and establish LICs.[19] Legally, an LIC is completely different entity from a local government devoid of legal status to endure fiscal deficits, make bank loans, and offer loan collaterals. By establishing LICs as off-budget entities of local governments, local governments have their LICs raise funds for big infrastructure projects. LICs can obtain financial resources through various means including bank loans, bonds (the so-called "chéngtóuzhài (城投债)", i.e., enterprise bonds or mid-term notes (MTNs)), and the so-called "yínxìnzhèng (银信政) " i.e., investment from investment trust companies. LICs can also be classified into two types—(1) enterprise-style LICs (jīngyíngxìng róngzī píngtái (经营性融资平台)) established to manage infrastructure depending on revenues, and (2) finance-style LICs (róngzīxìng róngzī píngtái (融资性融资平台)) established to specialize in financing for investment projects.[20]

Among the earliest and most notable LICs was Shànghǎishì Chéngshì Jiànshè Tóuzī Kāifā Zǒnggōngsī (上海市城市建設投資开发总公司), established in July 1992 by the Shanghai municipal government.[21] It developed Shanghai's infrastructure as a "big-push"-style investment project, especially bridges connecting the Pǔxī (浦西) and Pǔdōng (浦东) Districts.[22] The breathtaking success in Shanghai invigorated other local governments in the costal regions and made them follow suit. Consequently, major cities in Western China, under the banner of "Western Development (Xībù Dàkāifā/西部大开发)," established a slew of LICs. In 2002, the Chongqing municipal government established 8 LICs, calling the attention of the World Bank and leading to the publication of its 2009 survey noted

governments is raised as a "disagreement between administrative and fiscal authorities (Shìquán yǔ Cáiquán bùxiāng Pǐpèi /事权与财权不相匹配)," at the time of proposing the Twelfth Five Year Plan (12-FYP).

18 BOT is a form of public-private partnership (PPP) for project financing; a private company receives a concession contract from the public sector to finance, construct, and operate a facility. In 1994, the Shanghai municipal government and a Hong Kong private company agreed on a BOT contract to build East Yan An Road Tunnel (Yán'ān Dōnglù Suìdào/延安东路隧道). See, for example, Ke, Y.J. *et al.*, 2009, "Public-Private Partnerships in China's Infrastructure Development: Lessons Learnt, prepared for the International Conference on Changing Roles: New Roles and New Challenges, October 5-9, 2009. There are various types of PPP. As for a more comprehensive review, see, for example, Chen Jiagui (陈佳贵) and Wang Tongsan (汪同三) eds., 2008, *Zhongguo Touzi Tizhi Gaige 30-nian Yanjiu* (《中国投资体制改革 30 年研究/A Study of China's Investment System Reforms in the Past 30 Years》), Zhongguo Shehui Kexueyuan Wenke (中国社会科学院文库), Beijing: Jingji Guanli Chubanshe (经济管理出版社).

19 As for recent studies on land development by local governments, see, for example, Tao, Ran, 2010, "Land Leasing and Local Public Finance in China's Regional Development: Evidence from Prefecture-level Cities," *Urban Studies*, Vol. 47, No. 10 (September), pp. 2217-2236; As for the recent condition of BOT in China, see, for example, Weng Tat Chan *et al*, 2005, "Interface Management for China's Build–Operate–Transfer Projects," *Journal of Construction Engineering & Management*, Vol. 131, No. 6 (June), pp. 645-655; In addition to land lease, BOT and LICs, Ānhuī (安徽) Province invented in 2002 financial schemes named "yínzhèng hézuò (银政合作)" or "dǎkǔn dàikuǎn (打捆贷款)" to finance plural projects. These schemes, however, were banned in 2006 by the central government. In 2003, although the city government of Ānshān (鞍山) established a listed company (Ānshān Xìntuō (鞍山信託)) in Shanghai stock market to finance infrastructure projects, this type of financial scheme, however, is not widely accepted because of stricter and more transparent regulations. See, for example, Shi Hongxiu (时红秀), 2010, "Difang Zhengfu Zhaiwu Guimo Jiujing You Duoda/地方政府债务规模究竟有多大?/How Large Is Local Governments' Debt?" *Zhongguo Jingjibao* (《中国经济报/China Economic Times》), July 5, http://finance.jrj.com.cn/opinion/2010/07/0503407709557.shtml.

20 See, for example, "中国银行董事长肖钢：地方融资平台贷款应有保有压," November 2, 2009, http://www.zgjrw.com/News/2009112/index/256684085500.shtml.

21 See, for example, Wei Jianing, *op. cit*.; See also the website of Shanghai Chengshi Jianshe Touzi Kafa Zonggongsi: http://web.chengtou.com/English/index.aspx.

22 As for the concept of "big push," see Shahid Yusuf, 2008, "Optimizing Urban Development," in Yusuf and Saich, *op. cit*.

above.[23]

A brief history of LICs tells that imperative huge infrastructure in large cities and chronic financial austerity of local governments gave birth to LICs as an "ideal off-budget platform of local governments."[24] Since the early 1990s, infrastructure investment in agglomerated urban areas has long been desperately needed and consequently proved to sufficiently efficient. For this reason, LICs at the early stages can be called splendid financial innovation. However, the year 2009 witnessed a thriving time for LICs. Some local governments not only established LICs anew but also consolidated and expanded their existing LICs. The city government of Xiangtan (湘谭) in Hunan (湖南) Province, for example, consolidated their 5 LICs into 3 LICs, and injected additionally its government assets into the 3 LICs.[25] Other local governments tried to establish local financial conglomerates by making their LICs absorb the stocks of banks, securities houses, and leasing companies in their regions.[26]

2. The Financial Health of LICs

The burgeoning number of LICs has led to a lingering fear held by economic analysts and practitioners both at home and abroad. A rapid rise in LICs-related investment might involve, if unintentionally, significant amount of ineffective and inefficient use of money. It would be undeniable that such inefficient investment might trigger a systemic financial risk for the Chinese economy, and led to a worldwide tumultuous situation. This section examines the financial health of LICs.

2.1. A Sphinx Nature of LICs

Based on a survey of LICs in Chongqing, the World Bank report points out a lack of transparency and the difficulty of data compilation regarding financial operations of LICs. The report also tells us that "it is not clear if local governments themselves are fully aware of the status of the financial position" of their LICs.[27] First, in practice, LICs have close ties with local governments, though LICs are legally independent from local governments. Given an apparent lack of well-functioning financial markets in China, commercial banks have no way but to provide LICs with

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[23] Huang Qifan (黄奇帆), the person in charge of Pudong District's development in Shanghai during the mid-1990s, moved to Chongqing as Vice Mayor in 2001. Since then Mr. Huang has worked extensively on the establishment of 8 LICs—(1) Chóngqìngshì Chéngshì Jiànshè Tóuzī Gōngsī (重庆市城市建设投资公司) specializing in infrastructure investment, (2) Chóngqìngshì Kāifā Tóuzī Yǒuxiàn Gōngsī (重庆市开发投资有限公司), financial services , (3) Chóngqìngshì Dìchǎn Jítuán (重庆市地产集团), real estate development, (4) Chóngqìngshì Shuǐwù Kònggǔ Jítuán (重庆市水务控股集团), water supply and sewerage services, (5) Chóngqìngshì Gāosùgōnglù Fāzhǎn Yǒuxiàn Gōngsī (重庆市高速公路发展有限公司), highways, (6) Chóngqìngshì Jiāotōng Lǚyóu Jítuán (重庆市交通旅游集团), tourist facilities, (7) Chóngqìngshì Shuǐlì Tóuzī Jítuán (重庆市水利投资集团), hydroelectric power generation, and (8) Chóngqìngshì Néngyuán Tóuzī Jítuán (重庆市能源投资集团), energy supply. For a detailed description, see, for example, Deng Quanlun (邓全伦), 2010, "Chongqing Rongzi Mijue: 'Badatou' Rongzi Moshi Shou Shihang Kending/重庆融资秘诀: '八大投'融资模式受世行肯定/Secret of the Chongqin LICs: The Model of the 'Eight Large LICs' Approved by the World Bank," June 10, http://news.hexun.com/2010-06-10/123946190.html.

[24] World Bank, *op. cit*., p. 93.

[25] Zhongguo Renmin Yinhang Xiangtanshi Zhongxinzhihang Ketizu (中国人民银行湘潭市中心支行课题组), 2010, "Xinxing Difang Zhengfu Tourongzi Pingtai de Yunzuo yu Xiaoying/新型地方政府投融资平台的运作与效应/Operations and Effects of Local Governments' New Investment Companies," *Zhongguo Jinrong* (《中国金融/China Finance》), No. 7.

[26] See, for example, "Difang Rongzi Pingtai Jianguan Yijian 'Nanchan'/地方融资平台监管意见'难产'/Control over LICs: 'Hard to Find' Recommendations," *Zhongguo Jingji Zhoukan* (《中国经济周刊/China Economic Weekly》), 2010, No. 13.

[27] *Ibid*., p. 85.

loans based on their judgment on trustworthiness not of LICs but of local governments.[28] Second, some LICs have secured a loan for plural investment projects. This type of loan makes it difficult to identify individual project risks.[29] Third, other LICs tend to develop infrastructure investment plans by expecting higher prices for land lease, which could make their financial assessment look unrealistically rosier and unfathomably riskier. Finally, some local governments tacitly guarantee when their LICs receive loans from banks. In this case, it is very difficult to identify a legal basis to decide which side—either governments or banks—will shoulder a loss at the time of project failure.[30] Accordingly, the World Bank suggests three things. First, LICs should improve their financial transparency. Second, they concentrate on projects that will secure sufficient cash flow. Third, they try to finance themselves in the marketplace and become less dependent on government subsidies.[31]

Given this nebulous nature of LIC performance, the LIC financial risk can only be calibrated by examining the nature of projects and the size of local governments. First, transportation infrastructure (e.g., highways) and utility infrastructure (e.g., gas pipelines and electric power transmission lines) are classified as projects that can collect user fees. Second, construction of convention centers and sports stadiums are also regarded as projects that can expect sufficient revenues from commercial tenants and advertisements. Third, the larger the population of a local government is, the rosier the prospect for financial viability of these infrastructure and commercial investment becomes. In large population areas, LICs can be established based on an idea that "big push" infrastructure investment is financially viable on the grounds that "build first, demand comes." Finally but most importantly, the higher status a local government has in the administrative hierarchy, the more financially successful the government's LICs are. Accordingly LICs at the provincial or prefectural level can be financially viable. However, LICs at a remote and uninhabited county level, it would be very difficult to secure sufficient cash flow. Based on similar inference, China International Capital Corporation Ltd. (CICC), China's first joint venture investment bank, estimates 20-to-30% of the entire-LIC loans are LICs at the county level.[32] Mr. Fan Jianping, Director of Economic Forecasting of the State Information Center (SIC), said that LICs at the county level barely record profits.[33]

2.2. The Financial Health of LICs: From the Creditor Perspective

Because of LICs' sphinx characteristics, there are some experts who estimated the amount of LICs'

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[28] Xiao Gang, President of Bank of China, made remarks that assessing the risk of LICs is totally different from that of private companies. The assessment is dependent on the future prospects for the revenue of the local government, land price, development of industrial parks and real estate. See Xiao Gang (肖钢), 2009, "Difang Rongzi Pingtai Daikuan Ying Youbao Youya/地方融资平台贷款应有保有压/Offering Loan for LICs Should Have Flexible Approaches," November 2, http://www.boc.cn/bocinfo/bi1/200911/t20091102_878075.html.

[29] Some LICs find it convenient to flexibly transfer profits from lucrative projects to loss-producing projects. See, for example, Guo Lihong (郭励弘), 2009, "Shishi Zhaiquanren Rongzi Pingtai de Xinyong Pingji/实施债权人融资平台的信用评级/LIC Credit Rating," *Zhongguo Jinrong* (《中国金融/China Finance》), No. 20.

[30] See, for example, Gao Ziqiang (高自强), 2010, "Guanyu Difang Rongzi Pingtai Daikuan Fengxian de Renshi yu Sikao/关于地方融资平台贷款风险的认识与思考/Reviewing Risk regarding LICs," *Zhongguo Jinrong* (《中国金融/China Finance》), No. 16.

[31] World Bank, *op. cit*., pp. 85-91.

[32] Mao Junhua (毛军华) and Luo Jing (罗景), 2010, "Zai Fazhanzhong Dongtai Jiejue Wenti/在発展中动态解决问题/Dynamic Solving Problem in the Middle of Development," http://www.doc88.com/ p-59759156812.html.

[33] See "范剑平：地方融资债务增速惊人 县级平台几无盈利," November 5, 2009, http://news.xinhuanet.com/fortune/2009-11/05/content_12393874.htm.

non-performing loans (NPLs) based on their own hypotheses. Liu Mingkang, Chairman of CBRC, reportedly said that the loans for LICs reached RMB 7.38 trillion at the end of 2009, a substantial RMB 3.05 trillion increase throughout the year.[34] He also reportedly said that the amount as of June 2010 was RMB 7.66 trillion and that 26% of the loans might be difficult to settle. If this ratio is not wide off the mark, albeit completely accurate, NPLs might be RMB2.0 trillion.[35] By an alternative approach, Shen Minggao, Head of China Research, Citigroup on Asia, estimates the outstanding LIC loans. He calculates the loans for LICs were about RMB 7 trillion at the end of 2009. He also forecasts the loans will reach RMB 12 trillion at the end of 2011.[36] Out of these loans, he concludes that NPLs at the end of 2011 would be RMB 2.4 trillion, 20% of the entire LIC-related loans. Victor Shih, an associate professor of Northwestern University, estimates RMB 11.4 trillion at the end of 2009 by adopting a systematic approach with which he aggregates each banks' credit line for LICs. His estimate of NPLs associated with LICs is RMB 2.3 trillion, 20.2% of the entire LIC-related loans.[37]

2.3. The Impacts of LIC NPLs on the Chinese Economy

Amidst growing concerns about LIC-related NPLs, banks and local governments have begun restructuring ill-managed LICs.[38] Accordingly all banks have already been vigilant against loans for LICs. In the meantime, out of the total loans of the China Development Bank (CDB) the LIC-related loans accounts for 48% (see Table 2-1).

Table 2-1. LIC-related Loans of Major Banks in China (End of June 2010)

Categories	Name of Bank	(A) Loans for LICs (billions of RMB)	(B) Total Loans (billions of RMB)	(A)/(B) (%)	NPL Ratio (%)
Former Policy Bank	China Development Bank (End of 2009)	1,780	3,708	48.0	0.99
State-owned Commercial Banks	4 State-owned Commercial Banks	2,228	21,460	10.4	0.20
	Industrial and Commercial Bank of China	700	6,354	11.0	0.02
	China Construction Bank	578	5,216	11.1	0.11
	Agricultural Bank of China (End of Sept., 2009)	530	4,620	11.5	0.58
	Bank of China	420	5,270	8.0	0.17
Joint-stock Commercial Banks	7 Joint-stock Commercial Banks	1,005	5,866	17.1	n.a.
	China Everbright Bank (End of Sept., 2009)	204	736	27.7	n.a.
	China Minsheng Banking Corp.	200	955	20.9	n.a.
	China CITIC Bank	168	1,193	14.1	n.a.
	Industrial Bank	159	793	20.1	n.a.
	China Merchants Bank	140	1,331	10.5	0.09
	Huaxia Bank	76	489	15.5	n.a.
	Shenzhen Development Bank	58	369	15.7	n.a.

Source: The authors' calculation by collecting statistics from various sources.

34 The chairman's remarks at the second economic and financial briefing on April 20, 2010 (reported by *Nanfang Dushibao* (《南方都市报/Nanfang Daily》), April 27, 2010) and his remarks at the third economic and financial briefing on July 20, 2010 (reported by *Jinrong Shibao* (《金融时报/Financial News》), July 27, 2010).

35 *Zhongguo Zhengquanbao* (《中国证券报/China Securities Journal》), October 14, 2010.

36 Shen Minggao (沈明高) and Peng Cheng (彭程), 2010, "Difeng Rongzi Pingtaide Yuanlü yu Jinlü (地方融资平台的远虑与近虑/Short- and Long-term Consideration on Local Investment Companies), *Zhongguo Gaige* (《中国改革/China Reform》) No. 5.

37 Shih, Victor C., 2010, "Local Government Debt: Big Rock-candy Mountain," *China Economic Quarterly*, June, pp. 26-32.

38 On June 10, 2010, the State Council made a statement that local governments and commercial banks should take firm actions toward LICs with bleak prospects; governments should inject public funds into such LICs; commercial banks should ask collateral for loans. See "国务院关于加强地方政府融资平台公司管理有关问题的通知," http://www.gov.cn/zwgk/2010-06/13/content_1627195.htm.

Despite the paucity of accurate statistics, the authors tried boldly to get a rough estimate of LIC loans as of 2010 in the following way. The average ratio of LIC-related loans to the total loans held by the seven joint-stock commercial banks is 17.1% (see Table 2-1). The total loans held by the thirteen joint-stock commercial banks including other 6 banks such as Jiaotong Bank and Guangdong Development Bank is RMB 9.62 trillion.[39] Accordingly, an estimated figure for LIC-related loans held by the thirteen joint-stock commercial banks can be RMB 1.65 trillion (RMB 9.62 trillion multiplied by 17.1%), though it is tantamount to guess work. Thus, a rough estimate of the four state-owned and thirteen joint-stock commercial banks (RMB 2.23 added to RMB 1.65) is RMB 3.88 trillion (see Table 2-2).

Table 2-2. A Risk Assessment of LIC-related Loans (Trillions of RMB, 2010)

	Total	Provincial	Counties
All Financial Institutions	7.7	5.7	2.0
China Development Bank (CBC)	1.8	1.1	0.7
Four State-owned Commercial Banks and Thirteen Joint-stock Commercial Banks	3.9	3.3	0.6
Regional Banks	2.0	1.3	0.7

Note: The figures for total loans of Agricultural Bank of China and China Everbright Bank are those at the end of September 2010.
Source: The authors' calculation by collecting statistics from various sources.

As explained earlier, the extremely opaque and riskier nature of LIC-related loans is observed in general among those loans at level of county governments. Based on the remarks made by CBRC Chairman Liu Mingkang, the authors assume that the LIC-related loans at the county level (which are regarded as NPLs) may be RMB 2.0 trillion. The author also assume that 15% of the LIC-related loans held by major commercial banks is at the county level, the total amount for county-level LICs is RMB 0.6 trillion (RMB 3.9 trillion multiplied hypothetically by 15%). The remainder of the loans for the county-level LICs is RMB 1.4 trillion (RMB 2.0 trillion minus RMB 0.6 trillion). If this amount is split in half by the CBC and other regional banks, each of them has RMB 0.7 trillion as NPLs (see Table 2-2).

Finally, the authors try to elaborate on a discussion over financial impacts of these NPLs. If all the county level loans—about RMB 2.0 trillion—were to be identified as NPLs, and the losses incurred may be split in half by banks and local governments. The CDB would suffer a loss of RMB 0.35 trillion, major commercial banks, RMB 0.3 trillion, and smaller regional banks, RMB 0.35 trillion. As for the government side, they would also suffer RMB 1.0 trillion.

First, out of the total amount of LIC-related loans held by the CDB (RMB 1.8 trillion), about RMB 0.7 trillion is those at the county level (see Table 2-2). Hypothetically even if the CDB should shoulder the loss of the half of its total NPLs, the size of the losses related to the NPLs (RMB 0.35 trillion) reaches at 9.4% of the CDB's entire loans. When the four state-owned commercial banks had their NPL problems in the late 1990, their NPL ratios exceeded 25%.[40] Based on this historical experience, the authors assume the CDB's financial health might not be endangered because its

39 Other banks are Shanghai Pudong Development Bank, Evergrowing Bank, China Zheshang Bank, and Bohai Bank.

40 In 1997, the NPL ratios of the four state-owned commercial banks were above 25%. In 2002, the Agricultural Bank of China had a 36.6% NPL ratio, the Industrial and Commercial Bank of China, 25.4%, the Bank of China, 23.4%, China Construction Bank, 15.2%, See, for example, Kumiko Okazaki, 2007, "Banking System Reform in China: The Challenges of Moving toward a Market-oriented Economy," Santa Monica, RAND Corporation.

current NPL ratio is extremely low (0.99%).[41] Second, major commercial banks, both state-owned and joint-stock, have entered aggressively the LIC loan markets in recent years. The four state-owned commercial banks and major joint-stock commercial banks have RMB 3.9 trillion of LIC-related loans as estimated above. However these banks have much safer LIC-related loans because they are those at the provincial and prefectural level. In other words, judging from the size of local government, their LIC-related loans are calibrated as safe. Furthermore, these LIC-related loans are those guaranteed by cash flows generated by investment projects. For example, when the authors checked the LIC-related loans held by the Bank of China, 90% of its LIC-related loans are at the level of provincial and municipal governments, and only 10% of the loans are those at the county level. At the same time 50% of the Bank of China's LIC-related loans are those covered by a 100% level of the future cash flow; 12% of the loans are those covered by a 30-to-70% level of the future cash flow. Out of the remaining 38% of the bank's LIC-related loans, 90% of its loans are those guaranteed either by local governments or secured by collaterals.[42] In this way, the authors conclude that the LIC-related loans held by major commercial banks would not lead to financial debacles of these banks. Third, failures of smaller banks, if any, might not require audacious rescue efforts made by the PBoC or the CBRC. The reason is that those smaller regional banks whose financial operation is geographically limited would not cause a systemic risk in entire China. Instead, failures of ill-managed and smaller institutions might be a window of opportunity to consolidate China's financial institutions, at least on a regional base, and enhance industry efficiency that will bring about a greater contribution to higher economic growth in China. At the same time, these failures could accelerate the establishment of China's financial regulatory framework regarding deposit insurance and financial institution bankruptcy.

The authors' calculation of the loss of local governments—around RMB 1.0 trillion—is one thirds of the current revenue size of whole local governments in China (RMB 3.3 trillion in 2009). When local governments are forced to write off its LIC-related NPLs, financially feeble county governments might face a sovereign debt crisis. In this case, the central government could eventually take the lead to rescue debt-ridden county governments by transferring funds. Even in our worst scenario where the local governments' entire loss of RMB 1.0 trillion was covered by the central government, the loss itself is about 2.5% of GDP in 2011.[43] This 2.5% level is less serious compared with the case when China faced a serious NPL problem to rescue the four state-owned commercial banks and the CDB with enormous amount of fund—16.4% of GDP in 1999 and 15.8% in 2003. Given the size of the total assets held by banks and the revenue of local governments, the above amount of NPLs—around RMB 2.0 trillion—is less likely to cause a systemic risk in China's financial world, albeit sporadic failures of smaller regional financial institutions. At the same time, since foreign banks have not been engaged with any LICs, no international repercussion is expected unlike the case of the 1999 ITIC debacle.[44]

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41 The CDB has long been specialized in development financing and gained expertise over years in deft management of LICs. See, for example, Wei Jianing, *op. cit*., and Zhang Yanhua (张艶花), 2010, "Difang Zhengfu Rongzi Pingtai Fengxian: Huajie yu Fansi/地方政府融资平台风险：化解与反思/LIC Risk: Resolution and Reflection," *Zhongguo Jinrong* (《中国金融/China Finance》), No. 16.

42 See, for example, "中国銀行行長、李礼辉「百年新跨越」," November 3, 2010, http://www.boc.cn/bocinfo/bi1/201011/t20101103 _1187730.html.

43 GDP for the year 2011 is based on the authors' forecast.

44 As for the 1999 ITIC debacle, see, for example, Charles Adams *et al*., 1999, *International Capital Markets: Developments, Prospects, and Key Policy Issues*, Washington, D.C., International Monetary Fund.

The first two sections of this essay have examined recent developments of LICs, the origin and financial health of LICs. LICs are, as we have argued, a convenient policy tool for local governments to dole out financial resources from private financial institutions to plan infrastructure investment under the central government's mantra of "marketization." Thus, LIC is a financial innovation to supplement government financial shortages along with land lease and BOT. Accordingly we can safely call an LIC a wonderful financial innovation at least on a regional base and in short terms. However, we still suspect an LIC as a necessary evil to boost a local economy in a short-term period; at the same time, an LIC is counterproductive for China's national goal: a "Harmonious Society (Héxié Shèhuì/和谐社会)." Accordingly, the remainder of the essay tries to investigate the role played by LICs in the establishment of a "Harmonious Society."

3. The Role of LICs in the Chinese Economy—A Wrong Choice of Ways to Reach the National Goal?

3.1. Local Government Fiscal Dynamics: A Sea Change in China's National Policy Planning

An impressive increase in the number of LICs was a reflection of insatiable demand for China's infrastructure. The essay has found LICs are less likely lead to a systemic risk in the previous sections; instead, they might nurture slow-but-steady progress in China's financial structure. At the same time, the burgeoning LICs have proved to be a wake-up call that China's excessively investment-biased growth path might be a pernicious impact on China's national goal—"Building a Well-off Society in an All-round Way (Quánmiàn Jiànshè Xiǎokāng Shèhuì/全面建设小康社会)."

Ironically, with the benefit of hindsight, the current type of LICs could have been the most effective means to develop areas targeted selectively within China. At the early stage of development, China adopted Deng Xiaoping's development ideologies—(1) "Principle of Letting the Minority Be Prosperous First (Xiānfùlùn/先富论)" in 1978 and (2) "Consideration for the Two Situations (Liǎngge Dàjú/两个大局)" in 1988. In the latter, he stressed "To speed up the opening up coastal areas to make this a two- billion people, the majority of areas to be developed quickly, thus boosting the development of the Mainland and better." When the scopes of the central and local governments were perfectly dovetailed, there was little uncertainty and elevated prospects for successes in the "state-selected" coastal areas. For this reason, despite the lack of "market," LICs were an effective weapon to quickly achieve the economic ends.

In the Post-Deng Era, the economic ends have widely changed as later discussed. Therefore, given an imperfect process of "marketization," a growing cloud of doubt over the appropriateness of LICs as an economic means has emerged because they inevitably invite ineffective and inefficient investment. In other words, LICs are, unless well-designed in a well-functioning financial market, counterproductive to achieve an end. Given underdeveloped financial markets in China, LICs have worked effectively and efficiently in narrowly focused investment projects under the strong leadership of the central government. In Post-Deng China, however, the focus of investment projects has been expanded in a geographical and sectoral sense. During the Jiang Zeming presidency which adopted the Tenth Five Year Plan (10-FYP, 2000-2005), local governments have long put special emphasis on infrastructure investment under the banner of "Western Development (Xībù Dàkāifā/西部大开发)," "Revitalizing Northeast China (Dōngběi Zhènxīng/东北振兴)," and "China Central Section's Development (Zhōngbù Juéqǐ/中部崛起)." In 2002, President Jiang Zeming announced the achievement, albeit partially, of a "Well-off Society (Xiǎokāng/小康)," and redirected China's goal toward "Building a Well-off Society in an All-round Way."[45] During the current Hu Jintao presidency, the focus of LICs is further expanded both in geographical and in sectoral terms. The Eleventh Five Year Plan (11-FYP, 2006-2010) ("Shíyìwǔ/十一五") is now trying to achieve a "Harmonious Society," "New Socialist Countryside (Shèhuìzhǔyì Xīnnóngcūn/社会主义新农村)," and "Recycling Economy (Xúnhuán Jīngjì/循环经济)," based on a new idea of "Scientific Concept of Development (Kēxué Fāzhǎn Guān/科学发展观)."[46] The 11-FYP has brought about a broader and more blurred scope of investment projects especially in the area of large scale nation-wide investment. For this reason, the risk of ill-managed LICs is unstoppably rising, which was soon detected and controlled by the central government as we discussed in earlier sections. Table 3-1 shows a transition of China's investment policy in association with major changes between the Deng Era and the Post-Deng Era.

Table 3-1. Transition in China's Investment Policy Scheme

	Deng Xiaoping Era (1978~1997)	Post-Deng Xiaoping Era (1997~)
National Goals	"Well-off Society (Xiǎokāng/小康) (in a limited part of China)"	"Well-off Society in an All-round Way (Quánmiàn Xiǎokāng Shèhuì/全面小康社会)"
Economic Principles	"Principle of Letting the Minority Be Prosperous First (Xiānfùlùn/先富论)" "Consideration for the Two Situations (Liǎngge Dàjú/两个大局)"	"Scientific Concept of Development (Kēxué Fāzhǎn Guān/科学发展观)" "Harmonious Society (Héxié Shèhuì/和谐社会)"
Target Areas	Coastal Area	Western China, Central China, Northeast China, "New Socialist Countryside (Shèhuìzhǔyì Xīnnóngcūn/社会主义新农村)"
Target Industries	Foreign Direct Investment (FDI) Export-oriented Industries	High Value-added Industries including IT and "Recycling Economy (Xúnhuán Jīngjì/循环经济)"
Fiscal Policy Conditions	After the 1994 Tax Reform, Local Governments Suffer Chronic Fiscal Austerity	
Investment Governance	Transfer of Investment Planning Authority to Local Government: Partially in 2001, and Wholesale in Principle in 2004	

Source: The authors.

The authors have examined carefully the texts of the 10-FYP and 11-FYP by comparing with their predecessors, i.e., the 8-FYP and 9-FYP and found geographical and sectoral broadness of the 10-FYP and 11-FYP (see Table 3-2). Ironically, in the 10-FYP and 11-FYP, the Chinese leadership clearly recognizes the seriousness of unbalanced development in geographical and sectoral terms. At the outset of this essay, the authors looked to the important role played by local governments. Given the central government's targets being broadened and blurred, local governments have, through their policy measures including land lease, BOT, and LICs, aggressively but unconsciously exacerbated the imbalance between investment and consumption over the past years. In this way, these policy measures have

45 On November 8, 2002, at the 16th National Congress of the Communist Party of China (CPC) (中国共产党第十六次全国代表大会), President Jiang Zemin reported that the national goal of a "Well-off Society (Xiǎokāng/小康)" had been achieved, but the "Xiaokang" is still "at a low level, not in an all-round way, and unbalanced in development (低水平的、不全面的、发展很不平衡的)." See, http://news.xinhuanet.com/newscenter/2002-11/17/content_632260.htm.

46 "Scientific concept of development" is the current ideological guideline of China, reinforced by President Hu Jintao at the 17th National Congress of Communist Party of China on October 17, 2007. It consists of five pillars—sustainable development, social welfare, a person-centered society, increased democracy, and, ultimately, the establishment of a "Harmonious Society." See "胡锦涛在中国共产党第十七次全国代表大会上的报告(3)," http://cpc.people.com.cn/GB/64093/67507/6429844.html. See also, Joseph Fewsmith, 2004, "Promoting the Scientific Development Concept," China Leadership Monitor, No. 11 (July), Palo Alto, CA: Hoover Institution, Stanford University.

produced an ironical and inconsistent result—worsening imbalance between investment and consumption. This imbalance is now being pointed out, but not yet corrected.

Table 3-2. Key Issues in the Five Year Plan (FYP) Since the 1990

	Eighth FYP (1991~1995) "Bāwǔ/八五"	Ninth FYP (1996~2000) "Jiǔwǔ/九五"	Tenth FYP (2001~2005) "Shíwǔ/十五"	Eleventh FYP (2006~2010) "Shíyìwǔ/十一五"
Economic Grand Strategies[47]	(Promotion of "Moderate" Economic Growth/促进经济的"适度"增长)	(Maintaining of "Swift" Growth of National Economy/国民经济持续"快速"增长)	(Maintaining of "Rapid" Development of National Economy/国民经济保持"较快"发展速度)	(Maintaining of "Steady" and Rapid Economic Development/保持经济"平稳"较快发展)
Economic Development	(Development of Major Economic Sectors/主要经济部门发展) (III)	(Pillar Industries/支柱产业) (IV-3) (Tertiary Industry/第三产业) (IV-4)	(Economic Structure/经济结构) (Part II)	(Optimization and Upgrading of Industrial Structure/工业结构优化升级) (Part III) (Services Industries/服务业) (Part IV)
Regional Development	(Regional Economic Development/地区经济发展) (IV)	(Balanced Regional Economic Development/区域经济协调发展) (VI)	(Western Development Strategy/西部大开发展战略，Balanced Regional Development/ 地区协调发展) (Ch. 8)	(Balanced Regional Development/区域协调发展) (Part V)
Urbanization	(Economic Development in the Coastal Region/沿海地区的经济发展) (IV-1)	(Urban Construction/城乡建设) (IX-3)	(Urbanization Strategy/城镇化战略) (Ch. 9)	(Urbanization and Healthful Development/城镇化健康发展) (Ch. 21)
Rural Development	(Rural Economy/农村经济) (III-1)	(Rural Economy/农村经济) (IV-1)	(All-round Development of Rural Economy/农村经济全面发展) (Ch. 3)	(New Socialist Countryside/社会主义新农村) (Part II)
Science and Technology	(Science and Technology, Education/科学技术、教育发展) (V)	(Strategies for Promoting Science and Education/科教兴国战略) (V)	(Science and Technology, Education and Human Resource Development/科技，教育和人才) (Part III)	(Strategies for Promoting Education and Strategy to Invigorate China through Human Resource Development/教兴国战略和人才强国战略) (Part VII)
International Transaction	(Foreign Trade and Economic and Technological Exchange/外贸易和经济技术交流) (VI)	(Opening-up/对外开放) (VIII)	(Reform and Opening-up/改革开放) (Part V)	(Mutually Beneficial and Opening-up Strategy/互利共赢的开放战略) (Part IX)
Environment	(Environment Protection/环境保护) (IV-7)	(Environment and Ecological Protection/环境和生态保护) (IX-2)	(Resources and Environment/资源和环境) (Part IV)	(Resource-saving and Environment-friendly Society/资源节约型、环境友好型社会) (Part VI) (Recycling Economy/循环经济) (Ch. 22)
Welfare of the People	(Social Security/社会保障) (VII-8)	(Redistribution Mechanism/再分配机制) (VII-5) (Reform of Social Security System/社会保障制度改革) (VII-6)	(People's Live/人民生活) (Part VI)	(Harmonious Society/和谐社会) (Part X)

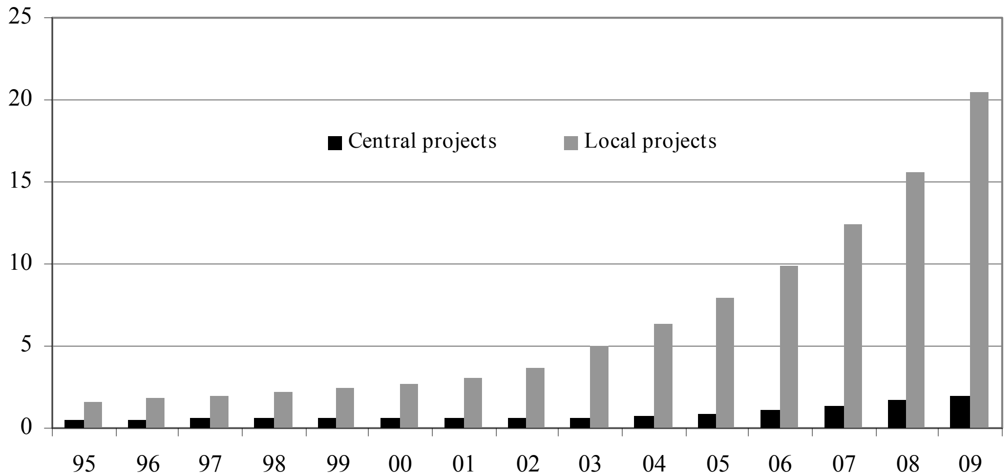
Source: The authors compilation based on materials issued by the Chinese Government.

Under these circumstances, investment in local areas—through (1) local governments' own planning, and (2) their *indicative planning*—has burgeoned at a stunning pace when it is compared with central government-initiated

47 Regarding "Economic Grand Strategies," double quotation marks denotes the key elements that the authors tried to emphasize in each FYP.

investment.[48] Figure 3-1 shows a comparison in amount between central government-initiated investment and investment in local areas. It leads to an understanding that local governments have a larger role in investment behavior in China.

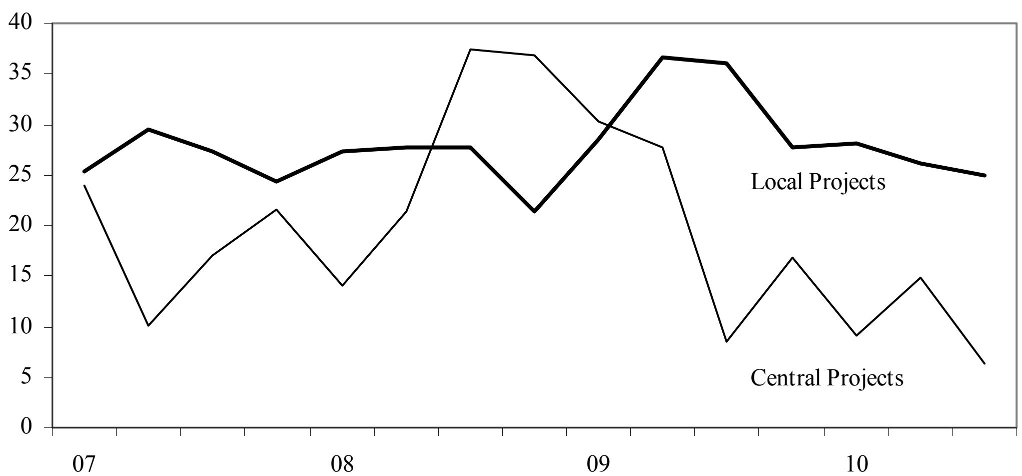
Figure 3-1. Investment initiated by the Central Government and Investment in Local Areas, (RMB Trillions)



Source: China Data Online.

Figure 3-2 also tells that investment that is not initiated by the central government has expanded very fast.

Figure 3-2. Growth Rates of Investment: Central Government-initiated vs. Local Area, Y-oY (%)



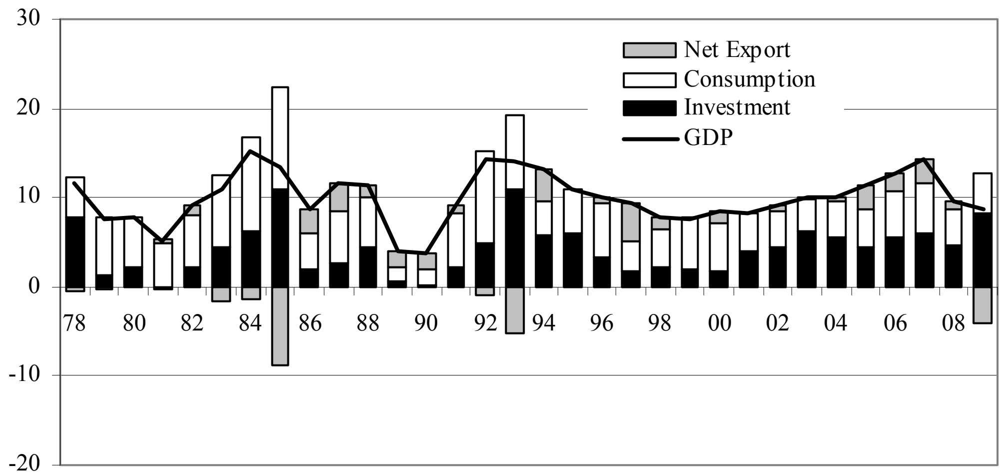
Source: China Data Online.

48 As one characteristic trait of China's investment governance, Sebastian Heilmann finds a "plethora of less binding forms of *indicative planning* (italics in the original)" that is based on government forecasting (e.g., statements that attest growth potential to certain industries), signaling (e.g., announcement about preferential policies), and indirect incentives (e.g., improved access to bank credits) to stimulate market activities and resource mobilization in sectors that are identified by the government as having development potential. See, in more detail, Sebastian Heilmann, 2010, "Economic Governance: Authoritarian Upgrading and Innovative Potential," in *China Today, China Tomorrow: Domestic Politics, Economy, and Society*, edited by Joseph Fewsmith, Plymouth: Rowman & Littlefield.

3.2. China's Engine of Growth: Fixed Asset Investment

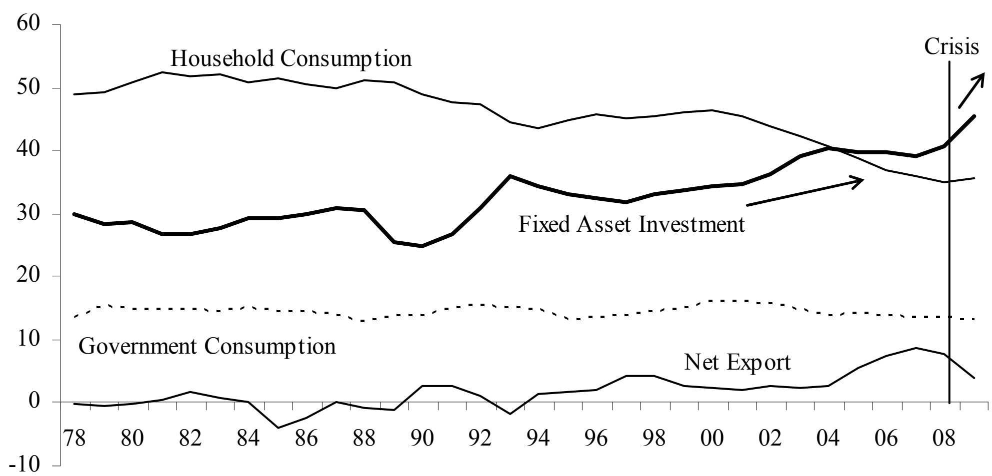
The major consequence of the 10-FYP and 11-FYP is, as disused above, broadening of target areas for infrastructure investment from China's coastal regions to its peripheral and inner regions. Another consequence is further worsening of investment-consumption imbalance. Under these circumstances, the world economic crisis and China's policy responses accelerated the pace of this imbalance. China's fixed asset investment in 2009 recorded 22.5 trillion Yuan and grew at an amazing 30% for the first time since China experienced such a rapid rise in investment in 1994. Accordingly, the contribution of investment to entire economic growth was 8.2% out of 8.7% (see Figure 3-3).

Figure 3-3. Major Components' GDP Growth Contributions, YoY (%)



Source: China Data Online.

Figure 3-4. Major Components' Share of GDP, (%)



Source: China Data Online.

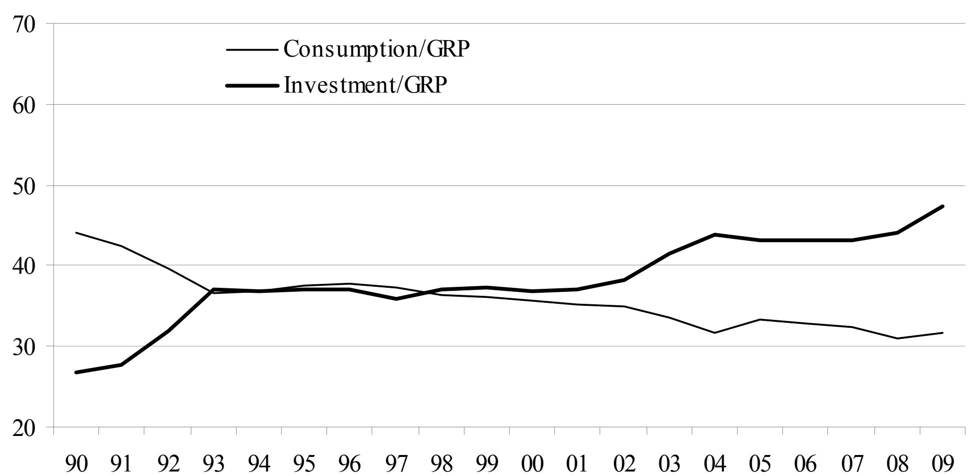
At the same time, the central government adopted a looser monetary policy with a view to facilitating investment projects designed by local governments. For this reason, since 2009, fixed asset investment has increased dramatically. Historically, among emerging economies, China's fixed asset investment has been extremely high for many years. In 2004, fixed asset investment exceeded household consumption. The stimulus package expanded further the gap between household consumption and fixed asset investment (see Figure 3-4).

4. Investment-oriented Growth and the Future of China's Economy

4.1. When Will Consumption Replace Investment as A Strong and Stable Engine of Growth for China?

China's rapid economic growth has transformed its landscape dramatically. However, everybody has not yet reached a conclusion that China has successfully transformed its economy to a matured one where all people can enjoy their consumption, especially in rural areas. Figures 4-1, 2, and 3 show the shares of gross regional product (GRP) regarding fixed asset investment share and the household consumption in the regions of Coastal, Central, and Western China.[49] First, as the earliest and most developed region, Coastal China experienced first among the three regions a time when investment exceeded consumption in 1998. Since then, however, Coastal China has not yet seen a balanced economic development where the consumption share of GRP is slowly but steadily declining while the investment share of GRP is gradually rising although infrastructure stock has become accumulated.

Figure 4-1. Coastal China's Consumption and Investment, Percentage of GRP (%)



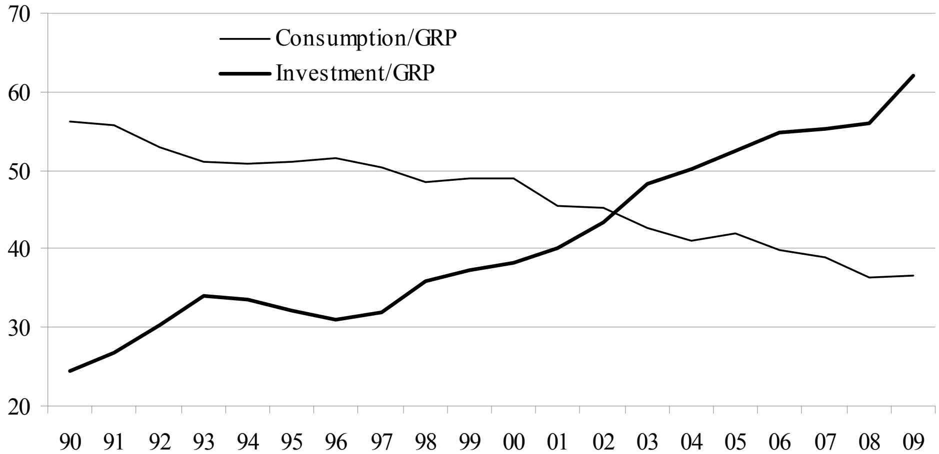
Source: China Data Online.

In January 2000, President Jiang Zeming established a Leadership Group for Western China Development (Xībùdìqū Kāifā Lǐngdǎo Xiǎozǔ/西部地区开发领导小组) within the State Council. The group leader was Zhu Rongji (Prime Minister) and deputy leader was Wen Jiabao (Vice-Premier). Since then the "Western Development" has

[49] Coastal China covers Yangtze River Delta (Shanghai, Jiangsu, Zhejiang), Pearl River Delta (Guangdong), Jing Jin Tang Area (Beijing, Tianjin, Hebei) and others (Liaoning, Shandong, Fujian, Hainan); Western China, 6 Provinces (Gansu, Guizhou, Qinghai, Shaanxi, Sichuan, and Yunnan), 5 autonomous egions (Guangxi, Inner Mongolia, Ningxia, Tibet, and Xinjiang), and one Municipality (Chongqing); Central China, 8 Provinces (Shanxi, Henan, Hubei, Hunan, Anhui, and Jiangxi, Jilin, Heilongjiang).

induced massive infrastructure investment both by the central and local governments.[50] Led by these investments projects, in 2003 Western China investment share of GRP exceeded that of consumption (see Figure 4-2).

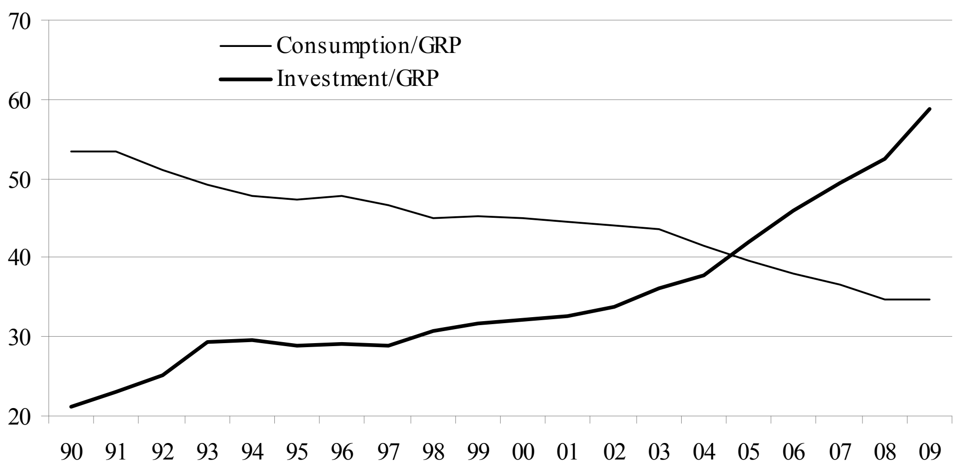
Figure 4-2. Western China's Consumption and Investment, Percentage of GRP (%)



Source: China Data Online.

In March 2004 at the Central Economic Work Conference, Premier Wen Jiabao referred for the first time to an idea of "China Central Section's Development (Zhōngbù Juéqǐ/中部崛起)." In response to the statement, local governments in the region have machinated a deluge of investment projects. In 2005, Central China saw the investment share of GRP exceeded that of consumption through huge infrastructure investment like Western China's case.

Figure 4-3. Central China's Consumption and Investment, Percentage of GRP (%)



Source: China Data Online.

50 Huge projects led by the central government are , for example, "Electricity Transmission from West to East in China (Xīdiàn Dōngsòng/西电东送)," "South-to-North Water Diversion (Nánshuǐ Běidiào/南水北调)," "West-East Natural Gas Transmission (Xīqì Dōngshū/西气东输)," and "Qinghai-Tibet Railway (Qīng-Zàng Tiělù/青藏铁路). As for a detailed description, see, for example, the official website, http://www.chinawest.gov.cn/web/index.asp.

It should be noted that huge infrastructure investment itself does not deserves blame at all. The problem is that huge infrastructure investment does not, in China's case, improve the welfare of the population at large. Accordingly, the household sector's income and consumption cannot rise as investment does. Furthermore, an economy that is heavily dependent on investment might be unstable because consumption whose movement is more stable cannot play a larger part, and might lead to ineffective and inefficient overinvestment. Nicholas Lardy, a Senior Fellow of the Peterson Institute for International Economy, makes a comparison in the investment share of GDP among China, Japan, Korea, and Taiwan during individual countries' highest level of the investment share and concludes that China's investment share of GDP is extremely high.[51] According to the comparison, Japan's investment share did not exceed 40% even in its high growth period, Korea's reached 40% just once, and Taiwan's never approached 40%.

At the same time, some observers have already pointed out that geographically diffused investment projects are developed in a simultaneous way without any market-based arbitrage mechanism under the banner of "Building a Well-off Society in an All-round Way." For this reason, China's green energy policy invited excessive investment in wind power generators and polycrystalline silicon production facilities for solar cells.[52] In addition, ineffective and excessively opulent investment projects have been criticized in urban development.[53] Despite the high level of China's investment share of GDP, however, capital stock per capita is still quite low. In other words, China still needs huge investment not in an inefficient way, but in an extremely efficient way.[54]

4.2. Counterproductive for a Harmonious Society

In the second half of this essay, the authors have raised the question of an ends-and-means disagreement, i.e., a policy dissonance between local governments' fiscal efforts and the achievement of China's national goal, i.e., a "Harmonious Society," or precisely speaking, a "Building a Well-off Society in an All-round Way."[55] Local governments have proliferated policy measures (including LICs) to act along with the central government's targets through the development of huge infrastructure investment projects. Ironically, these investment projects, however, have not inadvertently brought about enhanced welfare of the populace but merely exacerbated income disparities and

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51 Nicholas R. Lardy, 2007, "China: Rebalancing Economic Growth," a paper prepared for Conference "The China Balance Sheet in 2007 and Beyond," held jointly by the Peterson Institute and the Center for Strategic and International Studies, May. See also Louis Kuijs, 2006, "How Will China's Saving-Investment Balance Evolve?" Policy Research Working Paper No. 3958, Washington, D.C.: World Bank.

52 As for the wind power industry and polycrystalline silicon production facilities, see, for example, State Council (国务院), 2009, "国务院批转发展改革委等部门关于抑制部分行业产能过剩和重复建设引导产业健康发展若干意见的通知," September 26, http://www.gov.cn/zwgk/2009-09/29/content_1430087.htm. As for future prospects for China's wind power industry, see, for example, Jiang Qian (姜谦), 2010, *2010-2015nian Zhongguo Fengli Fadian Hangye Touzi Fenxi ji Qianjing Baogao* (《2010-2015 年中国风力发电行业投资分析及前景预测报告/Investment Analysis and Forecast for China's Wind Power Industry, 2010-2015》), Shenzhen: Zhongtou Guwen (中投顾问).

53 The city of Ordos, or È'ěrduōsī (鄂尔多斯), attracted the Western media in 2010 as "ghost city" or "empty city," see, for example, *Time*, 2010, "Ordos, China: A Modern Ghost City," April 5, http://www.time.com/time/photogallery/0,29307,1975397,00.html, and *Wall Street Journal*, 2010, "Revisiting China's 'Empty City' of Ordos," May 12, http://blogs.wsj.com/chinarealtime/2010/05/12/revisiting-chinas-empty-city-of-ordos/. See also Guo Jianming (郭剑鸣), 2006, *Difang Gonggong Zhengce Yanjiu* (《地方公共政策研究/Local Government Public Policy Research》),Beijing: Zhongguo Shehui Kexue Chubanshe (中国社会科学出版社).

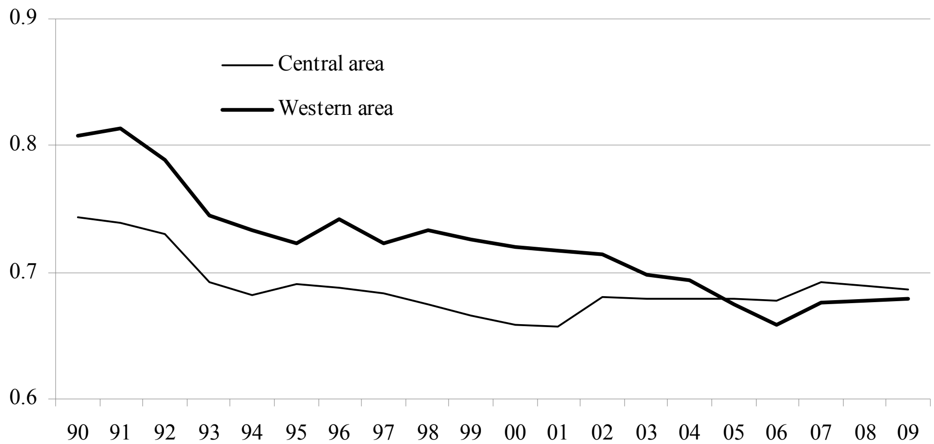
54 China's capital stock per capita is $6,200 in constant 2005 prices and exchange rates, while South Korea's is $55,000, the United States's, $94,000, and Japan's, $136,000. For a detailed description, see McKinsey Global Institute, 2010, "Farewell to Cheap Capital?: The Implications of Long-term Shifts in Global Investment and Saving," p. 36.

55 As for the disagreement between President Hu Jintao's goals and his means, the 11-FYP, see, for example, Yuji Miura (三浦有史), 2010, "Ko Kinto Seiken no Riso to Genjitsu (胡錦濤政権の理想と現実/Hu Jintao's Dilemma: Ideal versus Reality)," *Kan-Taiheiyo Bijinesu Joho* (『環太平洋ビジネス情報/Pan-Pacific Business Information』), Vol. 10, No. 37 (April), Tokyo: Japan Research Institute, pp. 46-83.

an inefficient use of China's savings—vital sources for future consumption.

Figure 4-4 shows the income levels of Central and Western China compared Costal China. It clearly tells us efforts of the Chinese leadership to mitigate income disparities during the 10-FYP and 11-FYP have a mixed result. The Chinese leadership has successfully slowed down the pace of widening disparities among regions. However, the central government has not successfully set a trend to correct regional disparities. Given the low level of capital stock per capita, infrastructure investment by local government should and will continue to play a larger part in regional development with its sphinx and nontransparent nature.[56] For this reason, the authors look to opinions voiced from within China that further "marketization" should be advanced.[57] In order to lay a firm foundation for "marketization," however, China should be careful in designing its institutional framework; especially it should avoid market failure by reducing the risks of information asymmetry.[58]

Figure 4-4.Income Disparities: Central and Western China vs Coastal China, (Costal China=1.0)



Source: China Data Online.

[56] As for nontransparent financial behavior of local governments in China, see, for example, Lili Liu, 2008, "Creating a Regulatory Framework for Managing Subnational Borrowing," in *Public Finance in China: Reform and Growth for a Harmonious Society*, edited by Jiwei Lou and Shuilin Wang, Washington, D.C.: World Bank.

[57] As for further "marketization," experts favor the idea of issuance of local government bonds. In July 2009, Zhou Xiaochuan, Governor of the PBoC, reportedly said that instead of the "back door (hòumén/后门)," i.e., local governments' LICs, a "front door (zhèngmén/正门)," i.e., local government bond, should be preferably used. See, for example, "周小川:为地方政府融资开'正门,'" *Caijing Baodao* (《财经报道/World Finance Report》), July 6, 2009, http://finance.icxo.com/htmlnews/ 2009/07/06/1393587.htm. Jia Kang, Director of the Institute of Research at the Ministry of Finance, echoes Governor Zhou's opinion by calling the issuance of bonds through different legal entities by local governments a "back door." See Jia Kang (贾康), 2010, "Difang Zhaiwu Ying Zhubu Touminghua/地方债务应逐步透明化/Local Governments' Liabilities Should Be Transparent Gradually," *Zhongguo Jinrong* (《中国金融/China Finance》), No. 16.

[58] The authors understand that the Chinese leadership has made effort to introduce "marketization," by introducing a Western-style institutional framework including rating agencies. However, these assimilations have not reduced the risks of information asymmetry, leaving an impression of a perfunctory façade of the market economy in China.