

# Where It Went Wrong

"天下大乱，形式大好。”

-- Mao Zedong

# China's Vertical Political Systems



# The Fundamental Problem

- The economic shift required new institutions. These were created ad hoc, without the related political restructuring.
  - Ex: moving danwei benefits to municipal funds, enabling bankruptcy
  - Company Law and companies limited by shares—but no market for shares, so no leverage for shareholders
  - “Group” and “Umbrella” corporations without associated audit, tax, and legal regimes

# Local vs. Central

- Legacy of economic reform:
  - A steady release of central-government control over the economy and thus politics
  - Economic entities multiplied. Decision-making authority devolved.
  - The negotiated style of management broke down, as local governments lost their dependence on the central authorities
    - Tax sharing arrangements
    - Personnel assignments
  - Revenue mechanisms decayed before the central government could respond; central revenues plummeted. The new fiscal deficits were viewed as untenable.
  - Budget plunges from 33% of GDP in 1978 to 11% in 1990
  - Local governments devised every form of protectionist policy for their own markets.

# Crisis Points

- The Soviet break-up and the “color revolutions”
- Rogue exports and business ventures by military or other uncontrolled bureaucracies
- The 1987 democracy marches
- The 1987-88 Qigong craze
- The Tiananmen massacre
  - Inability of the government to act
  - Massacre of innocents
  - A literature of disintegration

# Responses

- Recapturing appointments control over financial bureaucracies. Regular regional rotation.
- Central authorities cut local governments off from borrowing.
- Banking reform: negotiated split of banks into those reporting to the central and local governments. PBOC restructuring by region.
- The “Five Golden” projects in IT and internet were designed to create virtual channels for central government control when older, direct channels had decayed

# The 1994 Tax Reform

## Measures

- Increased central government collections from 22% to 56% and more once the VAT was fully implemented.
- Direct collections by the central government, then rebates back, initially to maintain local governments' take.

## Effects

- Tax rebates trickled down 4 levels of government, with no clear rules about sharing. The levels at the bottom were swiftly impoverished.
- Aggrandizement of the central government, focus on concerns distant from those of the people—the “build the west” program, tech parks.

# Responsibilities of Local Governments

- Despite major gaps in delivery of revenue through five layers of government, local governments are responsible for substantially all social services—schooling, infrastructure, hospitals, and social security.
- In the 1980s, subsidies expenditures ballooned to cushion the transition from womb-to-tomb security to a market economy.
- 1995 Labor Law required local governments to create pooling funds for pension, health, unemployment, maternity, and disability.
- But local governments lack taxation authority.

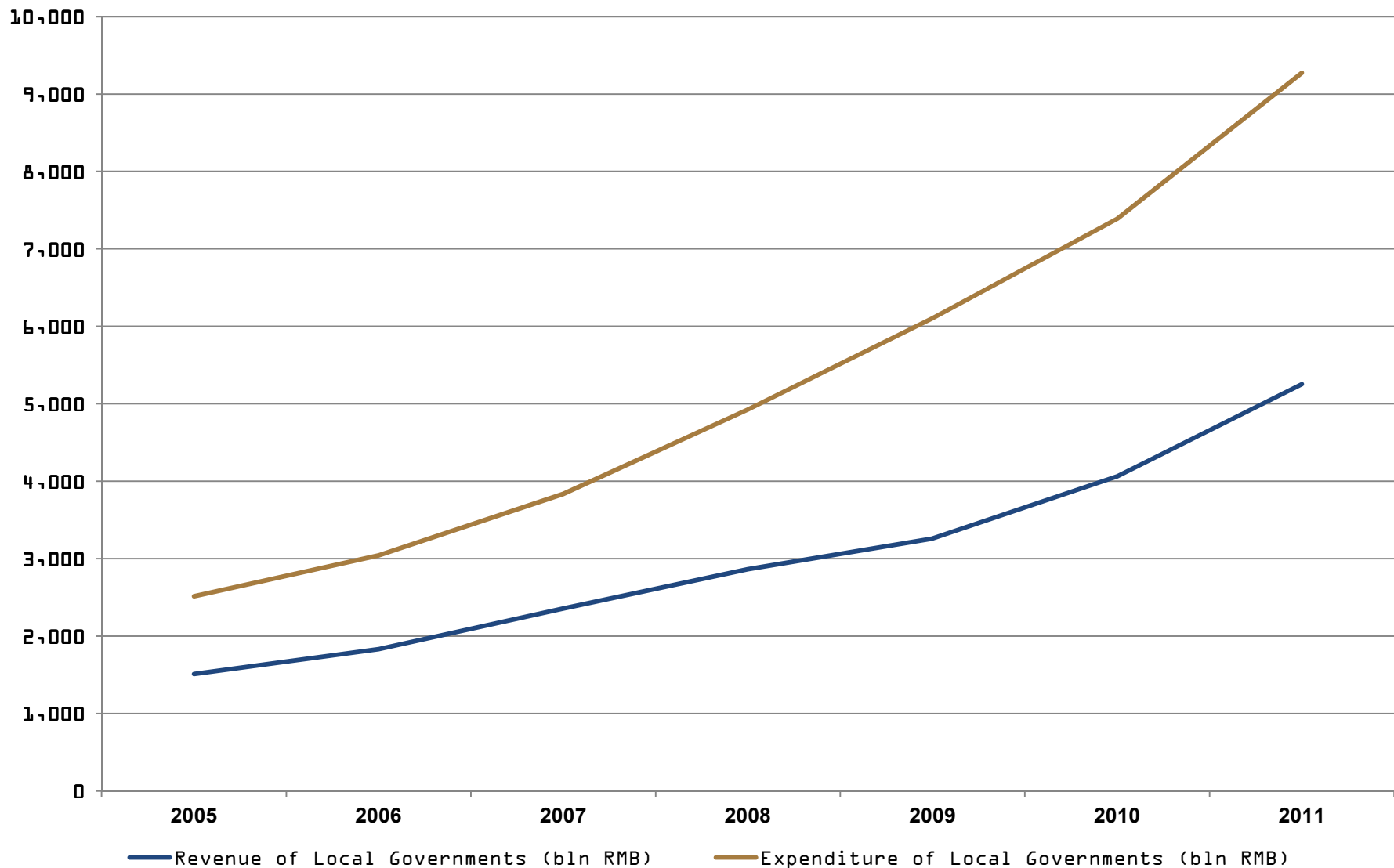


# 上有政策、下有对策

## How Local Governments Responded

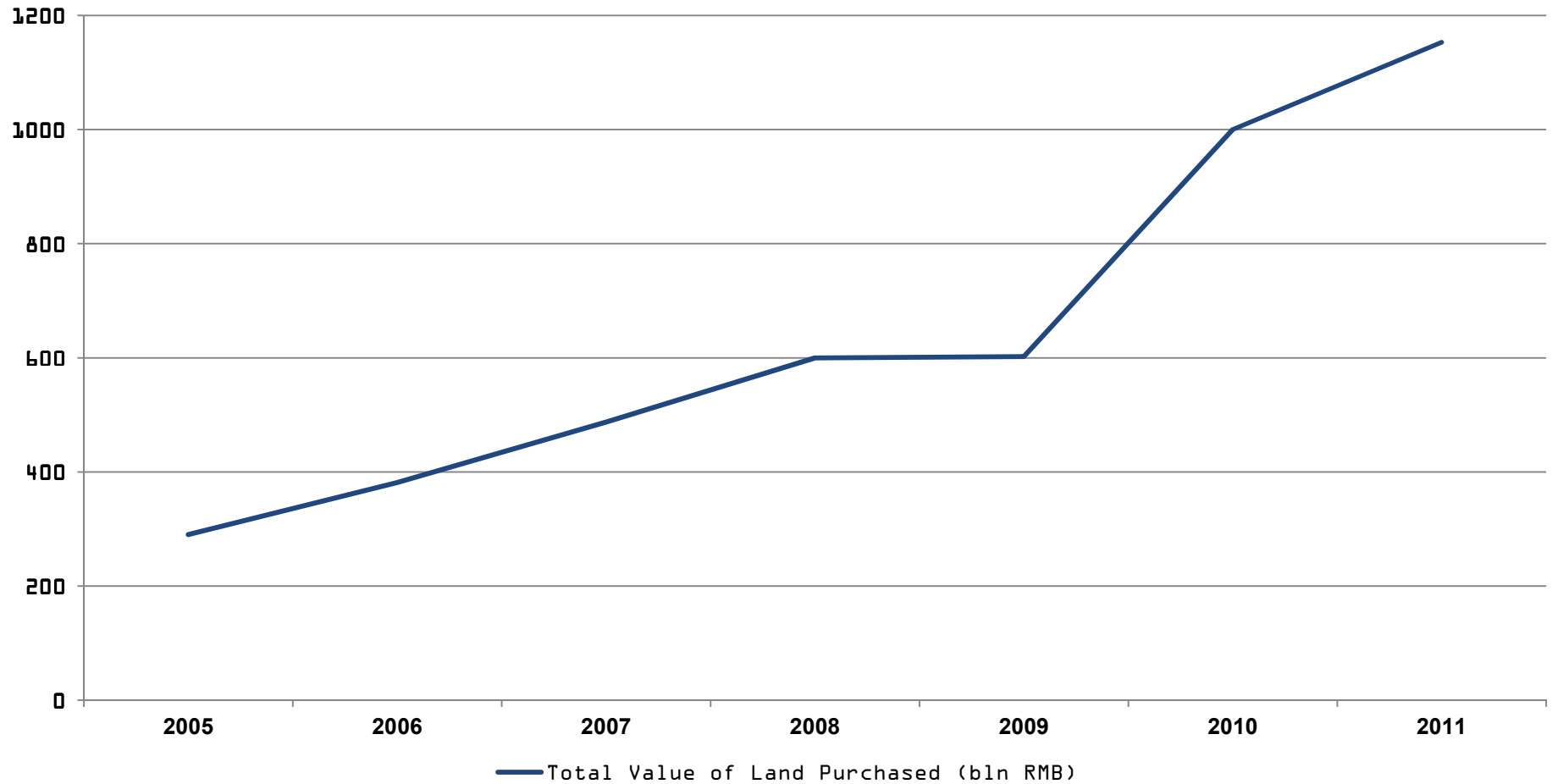
- Rapid increase in fees, especially land-related.
- Creative means: schools in the 1990s received only half their budgets in subsidies and had to find income for the rest, leading to events like the fireworks tragedy in Jiangxi.
- The big kahuna: land transfer revenues
  - By 2009, local governments were financing roughly 50% of their budgets by selling land. In some regions, the ratio is as high as 70%.
  - In addition to selling land, governments collateralize land for loans. These outstanding loans are well over 12 trillion RMB, or about 25% of GDP.

# Local Government Revenue vs Expenditure



# Land Sales 2005-2011

Total Value of Land Sold (bln RMB)



# The Demand Shock: Housing Reform

- As part of the SOE restructuring, China embarked on housing privatization in 1998. State enterprises were obliged to sell their housing stock at low prices to employees.
- This had two effects:
  - It generated a lot of cash for state enterprises
  - It created a private market for housing, as, after five years, the employees who purchased housing could sell. Also, new employees knew they would not be allocated housing.
- In 2004, to reduce corruption in the sale of land, the central government implemented an auction system. Supply shrunk as demand was rising. Cash + land scarcity + demand = bubble

# Infrastructure

- In 1998, the State Development Bank received quiet political support to create the “Wuhu model” of lending: the Anhui city of Wuhu hocked its land resources in return for loans. With the loans, it built infrastructure.
- Wuhu created “financing platform companies” to hold the debt. Classified as SMEs in the Chinese data system, these companies enable local governments to raise debt under the headlights.
- The LGFV model was the principal one used for the 2008-2010 build-out of infrastructure under the stimulus plan.

# Currency: Major Unrealized Losses?

- 1994: Currency unification, elimination of the swap markets
- Under-valuation of the currency, est. about 30%
- As a result, the bank has had to intervene constantly to maintain the rate, leading to an accumulation of foreign reserves.
- Each intervention represents an unrecognized loss on a trade. That loss in a sense can be measured in terms of domestic inflation, since the bank had to print RMB.
- Why is inflation nominally quite low? Because of over-production and warehousing of goods, a form of savings.
- A significant portion of China's economic growth, therefore, has been ephemeral.

## Currency— a big but underestimated story

12-5 emphasizes continued interest in making the RMB a regional or global trade settlement currency

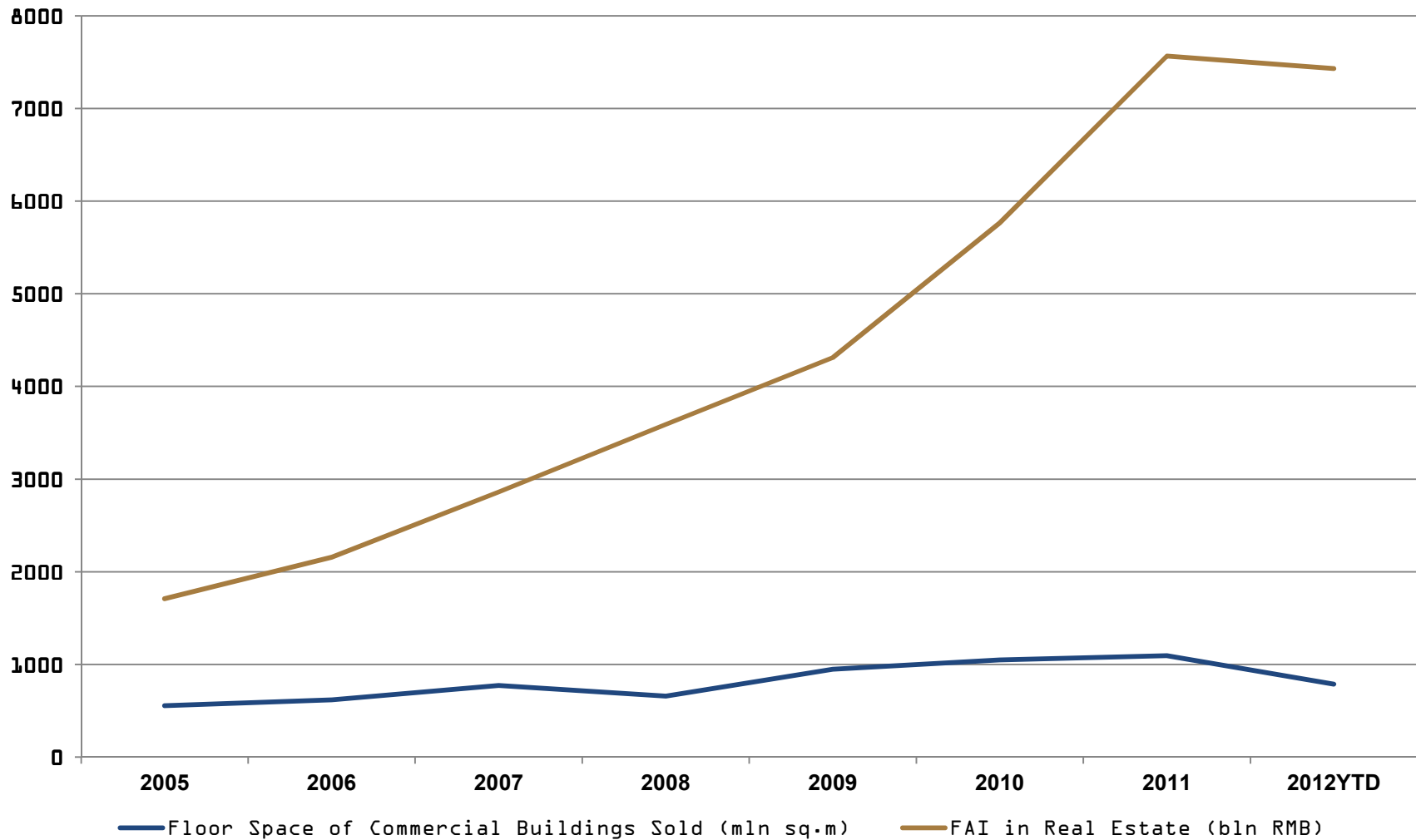
### ***The Policy Goal--***

- Reduce accumulation of FOREX by settling more exports in RMB,
- Improve efficiency of Chinese foreign aid and buyer credits,
- Improve efficiency of regional production sharing networks

### ***The Market Reality-***

- Trade and investment activity impossible to separate
- Some 450B RMB accumulated in Hong Kong, with rapidly diversifying services and financial products
- Shanghai monopoly in MNC financial services in RMB broken with intense competition from Singapore and Hong Kong
- Continued high levels of inflation and credit expansion may reduce returns and appeal of holding RMB

# Capital Deployment Becomes More Wasteful





# Ghost Cities: Ordos



# Tianjin



# Guiyang



# Shaoxing



# Manzhouli



# China's growth driver dilemma

The first 30 years cannot be the next 30 years

## Factors That Drove Growth and Wealth

- Concentration of investment capacity supports huge progress in physical modernization
- Ultra-light regulation of substantial capital flows allows great agility and speed in large scale financing
- Strong emphasis on tangible competitive assets throughout the system creates competitive advantage in mass production space on value chains
- Low wealth distribution to households drives investment and stunts consumption
- “Grey Space” laws and regulation provide agility to enlightened Government leaders/bureaucrats

## Are Now Driving Imbalance and Risk

- ➔ Over-concentration of investment capacity supports growing inefficiency of investment and entrains corruption
- ➔ Deficient debt measures and regulatory controls lets a huge amount of non-performing and triangular debt to accumulate
- ➔ Lack of attention to intangible competitive assets weakens access to high value and sustainable advantage on value chain and reduces potential for creating a knowledge economy
- ➔ Lack of household spending power makes quick shift to consumption driven growth very difficult
- ➔ Grey property rights allow public assets to be converted into private wealth of the political elite – and curtail innovation, entrepreneurship, and the competitiveness of the private economy overall