

An Analysis on the Overheated China Economy And the Local Government Behaviors

(Summary)

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The question of whether China economy was overheated had been heatedly discussed three times in 1986, 1988 and 1993. Since April 2004, this question has become a focus attracting the attention of the public again. Is China economy really overheated? If yes, what kind of role the local governments have been playing in this new round of overheated economy? What responsibilities should the local governments should undertake for the overheated economy? What measures should the local government implement to curb the investment impulse?

1. To Judge whether an Economy is overheated: Criteria and Evaluation

Whether an economy is overheated should not be simply judged by the growth rate of GDP because a fast growing economy not necessarily means the economy is overheated. The key is to see whether the fast growth is sustainable: if the fast growth rate is unsustainable, the economy is overheated. Therefore, to select appropriate criteria is the premise to discuss whether an economy is overheated.

1) First criteria: whether the real economic growth rate has surpassed the potential growth rate. The annual growth rate of GDP of China is 9.1% in 2003, yet reached 9.8% in the first quarter of this year. According to the commonsense, this figure is an underestimated one since there are serious discrepancies between the output statistic approach and expenditure statistic approach. The growth rate of fixed asset investment in 2003 is 26.7% yet soared as high as 43% in the first quarter of this year. The real growth rate of consumption is 9%, also a relatively high one, though the momentum of consumption is not as potent as that of investment. Besides, the import growth rate nearly hitting 40% shows a strong domestic demand. So it is reasonable to predict that the GDP growth rate is above 10%. If we can agree on the prediction from the growth trend of China in the past 20 years that the growth potential or sustainable growth rate of China economy is between 8% and 10%, we can undoubtedly conclude that the present economy is indeed overheated.

2) The second criteria: whether the economic growth is bounded by the bottlenecks of resources and technology. When economy is growing mildly which means the aggregate supply and demand is at an equivalent level, the constraint from resources and technology is neglectable. However, now the investment structure is not in accordance with the demand of "a newly industrial road" and the economic growth in China is now encountering the double constraints of both resources bottleneck and technology bottleneck. In these years, the fastest growing industries mainly lie in the extensive industries characterized by high consumption, high input yet low output, while those newly emerging industries such as electronical information industry, equipment manufacturing, the third industry and hi-tech agriculture have attracted quite few investments. Such an unsustainable investment pattern is doomed to cause the shortage of energy, electronic power, major basic raw materials and transportation power, especially the railway transportation power. According to the statistics, by the end of last

year, the ratio of fixed asset investment to GDP skyrocketed to the level of 47% and the ratio reached 50% if the capital inventory is also counted, which is far higher than the ratio of other economies, even those economies before the Asian Financial Crisis in 1997 such as Malaysia, Singapore (Xu Xiaonian, 2004). Now we are still utilizing the resources very inefficiently and have entered a stage of serious shortage of electronic power, coal, etc. Apparently, such a growth model is unsustainable.

3) The third criteria: whether the economy is facing the pressure of inflation and risking the accumulation of nonperforming loans (NPLs). Customarily, we use CPI as the index to show the inflation level. The growth rate of CPI in the first four months is slightly above 3%, which seems as if the situation was not so serious. Actually, this judgement is not correct, at least not comprehensive, since in this new era CPI probably can no longer act as the sole index to evaluate the inflation level. The first round of industrialization has caused the production power of downstream products that is consumption products, to overpass the real demand, which has made the expansion of the upstream industries difficult to bring about the corresponding expansion of the downstream industry. If the inflation is the result of issuing too much currency, the rising price of other products except for everyday commodities is also the result of inflation. According to the data from the website of the National Bureau of Statistics of China (NBS), the buy-in price index of raw materials has risen by 8.7%; the price index of productive materials has risen by 13.8%; the price index of investment products has risen by 7.5%; and the average index of GDP is as high as 4.9%. All of these data show that the inflation level is high. To make things worse, if the price conduction mechanism is not so smooth due to the surplus downstream production ability, the expansion of upstream industries will be unsustainable and will also cause the production ability surplus and will subsequently cause large volume of non-performing loans (NPLs). According to the data from *The Report on Executing China Monetary Policy* by the People's Bank of China, the investment to the industries of steel, cement and electrolyte aluminum have increased by 96.6%, 121.9% and 92.9% respectively. In the first quarter of this year, the expansion momentum remains strong: the increase rates are 107.2%, 101.4% and 39.3% respectively. Such an amazing investment growth makes the development of these three industries depend on the banking system to a dangerous degree, which will not only increase the investment risks within these industries, but raise the credit risks of the banking system and bring about unignorable potential haphazard to the banking system. (The Monetary Policy Commission of the People's Bank of China, 2004)

2. The overheated economy has reached its summit and can see the hope of soft landing

Although we no longer argue about whether China economy is overheated, yet unanimous answer has not been reached to the question that whether the overheated economy has reached the summit. According to our recent study, the answer is "yes" and it is possible for overheated China economy to achieve the goal of soft landing. The major two measures of the macro-control is to control the scale of land use and bank loans to make due contributions to helping the economy to achieve a stable growth and to stride over the crucial threshold. As the macro-control policies and measures have been expedited to be executed, the phenomenon of partially overheated economy has been curbed in some degree and we have passed over the summit of overheated economy. There are four evidences to support this conclusion. Firstly, investments are showing a sign of being cooled down after the macro-control measures have been executed quickly. The fixed asset investment in cities and towns increased at a rate of 53% in January and February this year compared to the amount of last year, but dropped to the level of 43.5%, 34.7% and 18.3% in March, April and May respectively, which shows that the macro-control measures mainly aiming at curbing the too fast growth of the fixed asset investment have been successfully and effectively executed. Secondly, the prices are dropping to the normal level. The prices of wire, screw thread steel have dropped down more than 750 RMB Yuan to the level of 3250 and 3440 RMB Yuan per ton. In April, the prices of productive materials have showed a negative growth rate. In

May, the general CPI nationwide has raised 4.4% compared to the same period last year, yet dropped 0.1 percentage point by chain comparison, which is a pleasant signal. Thirdly, the bank credit scale has been curbed to some extent. In the end of this May, the amount of M2 is 23.4 trillion Yuan, which increased 17.5% compared to last year, yet dropped 1.6 percentage point compared to the end of April. The amount of M1 is 8.7 trillion Yuan, which increased 18.6% compared to last year, yet dropped 1.4 percentage point compared to the end of April. The amount of M2 is 1.9 trillion Yuan, which increased 11.3% compared to last year, yet dropped 2.7 percentage point compared to the end of April. In May, the net currency withdrew from circulation amounts to 83 billion RMB Yuan, which is 50 trillion RMB Yuan more than the amount of last year. All these figures mean that the measures to control the growth of money supply are effective. Fourthly, the external trade deficit has been reversed to be trade surplus in May, the external trade amount is 87.6 billion RMB Yuan and the growth rate is 34.1% compared to the amount of last year, yet 3.5 percentages lower than the level of April. The exports amount is 44.9 billion RMB Yuan, and the growth rate is 32.8% compared to the amount of last year, and 0.4 percentages higher than the level of April; the imports amount is 42.8 billion RMB Yuan, and the growth rate is 35.4% compared to the amount of last year, and 7.4 percentages lower than the level of April. The external trade surplus is 2.1 billion RMB Yuan and has reversed the continuous trade deficit from January to April. The trade surplus shows that the aggregate domestic demand, especially the demand for the productive materials has declined.

Now the question people care much about is whether China economy is “hard landing” or “soft landing”. What can be called “hard landing” or “soft landing”? The basic economic implication of “soft landing” is that the national economy returns to the appropriate growth speed after a period of moderate expansion. According to the studies on the China economy and world economy environment, the result of the macro-control is probably a “soft landing”, which means that the economic growth rate lies between 7.5% and 8.5%; the inflation rate is about 3%; and the external trade growth rate lies between 10% and 15%. Judged by the actual economic situation, the macro-control has a solid base: the fiscal policy and monetary policy have quite large room to be further executed since the fiscal income has been growing by over 20%, and the industry policy has been rarely made use of in a large scale.

3. An Analysis on the Overheated China Economy and the Local Government Behaviors

There are four layers in the local governments: the Province government, the District & City government, the County government and the Village & Town government, whose leaders’ behaviors are mainly manipulated by the principle of “political achievements”. It is not new for the local governments to deal with investments positively to satisfy the political needs rather than the economic needs since there is a concealed rule that the GDP growth rate has been a major index to evaluate the achievement of the local governors, which is the most fundamental factor leading the local governments to invest irrationally.

In pursuing “political achievements”, some governors aim at increasing local tax income and lower local unemployment rate; some governors are motivated by being promoted or seeking power rents. No matter what these two types of governor are seeking, both types are playing games with the Central Government. When they are developing the local economy, their major concerns are how to ask the Central Government for construction projects and preferential policies and how to try every effort to get loans and capital support from the four large State-owned Commercial Banks as much as possible, whilst they care much less about the effects of the construction projects, the execution effects of the preferential policies and how to run the bank loans safely. Thus, as we can see, so many “political achievements projects”, “image projects” and investment projects, obviously overlapping yet useful for increasing the local GDP, have been launched one after another, that the local project investment growth rate reached as high as 60% in the

first quarter of 2004. The local project investments are the major dynamics for causing the fixed asset investment to increase with too strong a momentum and with too large a scale (Wang Songqi, 2004).

Why local governments favor launching new investment projects? Undoubtedly, the local governments and governors can take advantage of these projects. Another factor is the heavier and heavier fiscal pressure, which has goaded the local government to do so. Moreover, the stereotype governor evaluation system aggravates the situation. Actually, this problem concerns the reforming the fiscal relation between the Central Government and the local governments.

The local governments, especially the local governments in the Middle and Western regions are tolerating heavier and heavier fiscal pressure because the tax-split system has taken back the income rights but has not adjusted the expenditure tasks and the payment system construction has not completed. In the current income and distribution system, the fiscal budget is extremely tight in many regions, especially the less developed regions, since the governments under the Province government are in charge of providing important social support and nearly all of the public services, which forces the local governments to regard on raising local GDP as their principal task. Besides, the current government personnel system and “political achievements” evaluation mechanism attach too much attention to the aspect of economic growth, exaggerating the importance of attracting investments, raising fiscal income and GDP growth. The fiscal decentralization since 1994 has reinforced the importance of the interests of local governments, which give the local government an impulse to expand the investment scale for realizing the social goals such as increasing the fiscal income and providing more employment opportunities (Xuan Xiaowei, 2004). We should admit that the interregional divergence, comparison and competition can motivate the local governments to improve the service efficiency, to make positive contribution to developing local economy and lifting the living standard of local people, which is also what we should appreciate. But at the same time, under the great pressure of tense interregional competitions, some local governments will connive at the fast expansion of local enterprises regardless of the constraint of the cost and resources, which will bring about serious snakes in the grass to the capital chains, industry chains and ecological chains.

4. Institution Innovation: The Ultimate Way to Curb the Investment Impulse of Local Governments

1) The interest coordination mechanism must be built and improved to fit for the market economy. The interest relation between the Central Government and local governments, between local governments and local governments must be re-coordinated in accordance with the objective demands of market economy. To reinforce the macro-control on the local governments, the reforms of the current financial system, investment system and financing system should be accelerated on the one hand, the mass supervision on the local governor should also be fully made use of on the other hand, since the “head’s word is everything” institution has given birth to the phenomenon that the projects of local government can be smoothly carried out without any barriers. To help the society and mass to supervise local governments and to effectively enter the policy-making process is a fundamental way to curb the local governments to make blind investments.

2) The fiscal relation between the Central Government and local governments must be rearranged. The fiscal relation between the Central Government and local governments is the core of the whole fiscal system. From the perspective of public finance, the relation between the Central Government and local governments mainly consists of the distribution of inter-governmental fiscal expenditure, distribution of inter-governmental fiscal income and the transfer payments system. Therefore the reform and improvement on the relation between the Central Government and local governments

should be made in these three aspects. Firstly, the fiscal expenditure distribution between the Central Government and local governments should be rearranged. Secondly, the fiscal income distribution between the Central Government and local governments should be rearranged. The key is to reconstruct and improve the tax items in the Central and local tax system in accordance with the tax system reform. The Central tax structure should take the consumption tax and personal income tax as the core tax and take the customs tax, security transaction tax, land value added tax, general environment tax, the consumption tax and value added tax levied by the customs as the affiliated tax. Besides, the Central Government should also share the value added tax and enterprise income tax with local governments. The local tax structure should take the asset tax (estate tax), business tax as the core tax, and take the city & country maintenance & construction tax, resource tax, social security tax as the major tax, and take other taxes as the affiliated taxes. Thirdly, the transfer payments system should be rearranged.

3) The institutional official evaluation system should be set up. There is a characteristic in the macro-control this year: the State Department will treat the investment projects separately. The investment projects that are apparently out of the market demand, overlapping constructed with low quality, highly polluted and high energy consumed will be strictly controlled, while the projects in the fields of agriculture, forest industry and irrigation works, ecological construction, environment infrastructure, special social construction will be encouraged. Separately treating model should also be introduced into the local official evaluation system, since the sole GDP index is far from persuasive and is no longer fit for the new situation that the opening degree has been lifted, the economy has developed to a new stage, and the market adjustment mechanism has been enlarged and reinforced. In the short future, the functions of local governments should be adjusted further and the government should fulfill their responsibilities in the track of laws and regulations. The governor evaluation should not only count the “political achievements” projects, but also only take consideration of other non-countable indices, such as environment protection, agriculture, forest industry and irrigation works, education, anti-corruption, and the public security. Only by the “institutional official evaluation mechanism” which takes all of the important indices other than the “political achievements” into one evaluation package, can we avoid overheated economy next time due to the impulse to launch “political achievements” projects.

4) The local governments should be separated from the financial system and the financial relation between the Central Government and local governments should be rebuilt. As we can see, the major reason causing overheated economy is the investment impulse of local governments, which has formed a lot of long term and medium term loans. How many of these projects leaded or guaranteed by local governments can reach the balance of payment? Since there is no strong market demand behind these investment projects, not to mention the possibility of earning profits, if these projects have been launched too rashly, they will depend on bank loans too much and will have difficulty in repaying bank loans, which will transfer the high risks to the banking system. The key to cool down the overheated economy lies in the financial system reform. The financial institution reform and innovation should be speeded up to separate the local governments from the financial system and help the banks to be independent financial agencies without the direct intervention of local governments. The financial relation between the Central Government and local government should be reconstructed to let the local governments rather than the Central Government fulfill the responsibilities of keeping the financial system stable, eluding and dissolving the financial risks. Only by doing this, can we avoid making the same mistakes any more.

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