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Abstract

2011 saw China overtaken by alarming financial fallout from the 2008 economic stimulus package to counter the global financial crisis. This paper shows how the decision to rely on local governments to fund the bulk of the package imposed serious strains on the banking system and reversed a decade of reform initiatives. The analysis indicates that this costly outcome was predictable and caused by a long-standing failure to deal with the extraordinary fiscal and financial autonomy exercised by local officials at the expense of sound banking and stable property markets.

Keywords: Local Government, Banks, Fiscal Autonomy, Legal and Financial Infrastructures

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When world financial markets started to collapse in 2007, the Chinese government saw little reason for alarm. The economy seemed well insulated from turmoil elsewhere. The nation's financial institutions were still not integrated into the international financial system. Exchange controls had limited the freedom to invest overseas, and they could protect the exchange rate against currency speculation. [1] Indeed, until September 2008, the first priority was monetary stability and the suppression of inflationary pressures.[2]

But from mid-2008, fears grew that a world slump would weaken China's ability to maintain high-speed growth through continued expansion of its overseas markets.[3] In November, the government took dramatic steps to counter recession, including a USD586 billion economic stimulus package, equivalent to 84 per cent of the United States' Troubled Asset Relief Program (TARP). The outcome was impressive in terms of investor confidence and business sentiment, and China won international applause for its response to the 2007-09 global financial crisis.[4] Its reputation rose to the point where there was a general expectation that China's financial support would play a key role in the rescue of ailing European economies. [5] (China's response to the global financial crisis is analysed in a companion working paper.[6])

China had, however, suffered considerable 'collateral damage' from the global financial crisis whose full costs started to emerge in 2011. At first, overseas confidence remained resilient even after the Chinese authorities published a flood of grim data and comment.[7] The most serious threat came from local governments and their financial vehicles (LGFVs) whose record borrowings had played the major role in ensuring that the economy did not go into recession. A National Audit Office (NAO) report revealed that 'there were 78 cities and 99 counties whose governments were on the verge of bankruptcy' at the end of 2010, with debt-to-revenue ratios in excess of 100 per cent.

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1 See Zhou Xiaochuan, People's Bank of China (PBOC hereafter) Governor, 'Instability and Evolution of the Financial System' (5 December 2007), pp. 1-7. URL: http://www.pbc.gov.cn/publish/english/956/1947/19476/19476_.html

2 On the concerns about inflation, see Prime Minister Wen Jiabao, 'Premier: 2008 likely to be most difficult for Chinese economy', *New China News Agency* (*NCNA* hereafter), 18 March 2008 and 'Policy balance between inflation, growth sparks debate in China', *NCNA*, 7 July 2008. On the change in PBOC policy, see 'China central bank cuts interest rate, reserve requirement to stimulate economy', *NCNA*, 8 October 2008.

3 Zhou Xiaochuan, 'Central banker: China's economic prospect complicated by world slowdown', *NCNA*, 26 October 2008; 'China opens top economic work meeting with focus on stable growth', *NCNA*, 8 December 2008.

4 See, for example, the glowing assessment in OECD, 'China's Emergence as a Market Economy: Achievements and Challenges', China Development Forum (Beijing), 20-21 March 2011 URL: http://www.oecd.org/dataoecd/27/17/47408845.pdf

5 For a Chinese view of foreign sentiment, see 'Nations pin hope on Chinese investors amid faltering recovery', *NCNA,* 7 September 2011.

6 Leo F. Goodstadt, 'China's Financial Reforms: Why dysfunctional banking survives', *HKIMR Working Paper No. 2/2012* (January 2012).

7 A notable instance was the headline 'Not a solvency issue' in a report by the prestigious HSBC. This was justified with the statement: 'In contrast to many other countries where public debt has grown due to excessive operational expenditure (see table 1), more than 70% of the proceeds of local debt in China have been used to finance infrastructure and land investment, which boosts the amount of assets in the hands of the government'. 'Local debt: Three options', *Macro China Economics China Inside Out* (1 August 2011), p. 4. The Ministry of Land and Resources, among others, viewed this state of affairs with alarm. Its spokesman was quoted as explaining that many of the property transactions involved were unlawful. Furthermore, 'economic growth achieved by the selling of land and real estate development is simply not sustainable', he insisted. 'A growing land problem', *China Daily* (*CD* hereafter), 26 January 2011.

The NAO provided a breakdown of the total indebtedness.

- Loans accounted for 62 per cent. Their repayment obligations were equivalent to 52 per cent of local government financial resources.
- Bonds accounted for 22 per cent. Their repayment obligations were equivalent to 18 per cent of local government financial resources.
- Local government's obligations in respect of the remaining 16 per cent involved guarantees and other 'obligations to render assistance'.[8]

Much of the debt was short term.[9] A widely-quoted estimate was that 43 per cent of the total would have to be repaid in 2011-12.[10] In April 2011, the first default was only averted when the Yunnan provincial authorities injected the equivalent of USD313 million into an LGFV which could no longer meet more than its interest obligations.[11] In August, the People's Bank of China (PBOC) felt it necessary to ease pressures on the banks' capital provisions by adjusting its accounting practices to allow USD438 billion of their LGFV loans to be reclassified.[12] The NAO revealed in early 2012 that it was seeking to recover from LGFVs the equivalent of USD84 billion in 'misused funds' which they had borrowed in 2010. But the official media indicated that 'local governments' financial strains and … fast-spreading debt risks' remained a serious concern even after cleaning up the worst of the illegal and irregular borrowings.[13]

Management of the problems created by LGFVs was complicated by the multiplicity of these entities and their diversity in terms of their corporate structures, their ownership and control, their financial viability and their commercial prospects. Significantly, a 2011 IMF analysis of China's financial challenges highlighted the dangers posed by LGFVs but was unable to describe them except in such imprecise terms as 'as indirect vehicles to collect bank loans', heavily involved in infrastructure and construction projects and highly dependent on 'using state-owned assets such as land as collateral'. Otherwise, the IMF noted, 'publicly available information is imprecise, insufficient, or nonexistent', and

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8 Liu Jiayi, NAO Auditor-General, 'China's local government debts exceed 10 trillion yuan', *NCNA*, 27 June 2011. For the PBOC view of the situation, see PBOC Monetary Policy Analysis Group, 'China Regional Financial Performance Report' (中国区域金融运行报告) (1 June 2011), pp. 1-36. URL: http://www.pbc.gov.cn/image_public/UserFiles/zhengcehuobisi/upload/File/2010%E5%B9%B4%E4%B8%AD%E5%9B%BD%E5%8C%BA%E5%9F%9F%E9%87%91%E8%9E%8D%E8%BF%90%E8%A1%8C%E6%8A%A5%E5%91%8A%E4%B8%BB%E6%8A%A5%E5%91%8A.pdf

9 The Bank of China offered an interesting summary of the servicing risks which discarded official optimism in favour of a blunt warning that 'the LGFV loan risk may surface in the next two years'. 'China Banking: Local government financing vehicle loans' (3 June 2011), p. 3. URL: http://www.bocigroup.com/pub/sc/vision/yjbg/201106/P020110607653991560939.pdf

10 *e.g.*, Qiang Xiaoji, 'Risks of repaying local govt debt reduced', *CD*, 15 August 2011.

11 Hu Yuanyuan and Wei Tian, 'Local govt debt risk "is under control"', *CD*, 16 August 2011; 'Yunnan finance vehicles on credit watch', *CD*, 29 July 2011.

12 'China to re-book some local govt loans', *CD*, 15 August 2011.

13 'China recoups 259.2 bln yuan of misused funds in local debts', *NCNA*, 4 January 2012.

the LGFVs found no place in the report's description of China's formal financial structure and institutions.[14]

Moreover, the oversight of China's financial system is rendered all the more difficult by its size and complexity. Table 1 provides a summary of the banking industry in 2007 and 2010. Its data on the ratio of assets to GDP demonstrate the remarkably large and growing role played by the banks in financing the economy. But the table also shows that new and smaller institutions were proliferating and increasing their share of the market which, in turn, the IMF has indicated, added to the burdens on the regulatory system.[15]

1. A Banking Case Study

The leading authority on local government finance has summarised the collateral damage from the 2008 economic stimulus package. Its launch seemed very promising as 'the politicization of the whole stimulus effort' created 'an extraordinarily enabling environment'. But its consequences proved costly.

> … in the rush to ensure quick implementation of the stimulus program, the government went beyond pumping in new fiscal spending and easing monetary policy to changing fiscal rules and liberalizing financial regulations. While these changes were on the whole consistent with market reforms, they were sometimes pushed too far and too fast amidst the campaign style rhetoric coming from both the government and party urging "support" for the stimulus program. In the process, much painstaking progress on governance reform was reversed – building professionalism in the banking sector and cleaning up balance sheets… the process has also seen the private sector being squeezed out in some industries and services, reversing the decades-long retreat of the state from economic activities.[16]

The surge in local government borrowing in 2008-09 offers an illuminating case study of the challenges which continue to obstruct China's modernisation of the banking industry and its reform of the financial system. The 2008 economic stimulus package ignored the risk of a considerable rise in non-performing loans. Policy-makers set aside measures taken in previous years to improve the banking industry's credit management, while policies introduced to overcome dangerous defects in the fiscal and banking arrangements for local governments were abandoned.

The paper begins with a review of the political environment and the adverse consequences of the state's continued intervention in banking industry. It discusses the exceptional autonomy enjoyed by local administrations and the absence of effective legal and accounting supervision of their activities

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14 IMF, 'People's Republic of China: Financial System Stability Assessment', *IMF Country Report No. 11/321* (November 2011), pp. 17, 19, 25, 31. URL: http://www.imf.org/external/pubs/ft/scr/2011/cr11321.pdf

15 See IMF, 'People's Republic of China: Financial System Stability Assessment', pp. 42, 63. Table 1 also shows that there was a sharp reduction in the number of rural credit cooperatives in this period.

16 Christine Wong, 'The Fiscal Stimulus Program and Problems of Macroeconomic Management in China', 32nd Annual Meeting of OECD Senior Budget Officials (Luxembourg, 6-7 June 2011), p. 16. URL: http://www.oecd.org/dataoecd/31/54/48143862.pdf

which has created an environment which fosters illegal and imprudent bank lending. There follows a review of how local governments have been able to control local banking activities, causing considerable instability within the financial system. This section explains why the central authorities have tolerated this state of affairs for so long. The third section summarises the financial environment which made the LGFV crisis possible. It recounts the disregard for both law and regulatory practice in the implementation of the economic stimulus package and traces the Ministry of Finance's problems in creating more conventional arrangements to fund the package. The fourth section deals with the disappointing outcomes of the economic stimulus package; the promising but limited legal and auditing reforms introduced subsequently; and the continued risk of state intervention reducing financial stability.

2. Political Pressures

2.1 Political Control Vs Stable Finances

Despite three decades of sustained growth and liberalisation since 1978, the Chinese Communist Party has continued to command the economy. A distinguished China scholar noted in 2010: 'The state remains the "invisible hand" dominating the economy'. This control is maintained, he asserted, 'through state banks, state assets, state ownership, state manipulated prices, state cadres, and unpredictable state intervention in various economic sectors'.[17] In consequence, the Party has taken for granted its power to shift the rate and the direction of growth in line with Party policies. Thus, a prominent academic asserted in 2011, 'China's economy is led by the government and as long as it holds such huge resources, it can effectively face up to all kinds of crisis and challenges'.[18]

This centralisation of political power remains beyond challenge in making policy. But the central authorities' control of routine public and financial administration has long been far from total. Local governments, it will be explained later in this paper, enjoy a striking degree of freedom from control by the central government. Mao Zedong promoted a high and increasing level of economic autonomy for local administrations from the 1950s. Attempts after Mao's death in 1976 to redress the balance in favour of the central authorities, and of the Ministry of Finance in particular, failed. The dismantling of the state planning apparatus from 1978 onwards was followed by further, drastic reductions in the central authorities' power to regulate and even to monitor the activities of lower levels of the administration.

Ironically, the banking industry has remained subject to extensive political controls, and these have created special problems for the industry, this presentation will make clear. On the eve of the global

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[17] David Shambaugh, 'Is there a Chinese model?', *CD*, 1 March 2010.

[18] Qiao Xinsheng, Social Development Research Center Dean, Zhongnan University, 'Chinese economy will not derail', *CD*, 16 August 2011.

crisis in 2007, PBOC Governor Zhou Xiaochuan condemned two types of state interference for having inflicted severe losses on the industry in the past.

- *'Policy lending'*, which compelled banks to follow state directives and planning targets in making loans and to ignore the borrowers' credit standing.
- *'Relationship-based lending'*, which meant that a borrower's official or Party status was the overriding factor in making loan decisions.[19]

'Policy' and 'relationship' lending have been particularly prevalent at the local levels (as will be discussed below). The 2008 economic stimulus package was followed by a resurgence of both practices, and the banking industry retreated from the reform programme put in place over the previous decade.

The announcement of the economic stimulus package was welcomed with 'frenzied enthusiasm', an impressive account of the LGFV crisis has noted. Radical liberalisation of the financial system took place almost overnight. Former restrictions on ministry and local government financial activities were suspended. New financial products and investment vehicles were affirmed even though they were untried, unregulated and mostly unlawful. The 'frenzied' response reflected market as well as political realities.

- For local governments, this was 'an unprecedented windfall of funding opportunities for all manner of pet local projects'.
- For bankers, 'the directives from the government and political leaders effectively eliminated all personal responsibility for the lending decisions'.[20]

It was foreseen that these developments would encourage a surge of illegal and imprudent lending. This outcome was accepted as potentially beneficial in staving off recession, a banking economist argued in 2009.

> As long as senior bankers are appointed by the state, it is unlikely that they will deviate much from government policy. This is a negative factor because state interference often leads to unscrupulous lending practices and NPLs. However, during an economic downturn resulting from a large external shock, this could be a positive factor. As banks are under pressure to lend, this prevents procyclical lending behavior of banks.[21]

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19 Zhou Xiaochuan, 'Instability and Evolution of the Financial System', (5 December 2007), pp. 2-3. URL: http://www.pbc.gov.cn/publish/english/956/1947/19476/19476_.html

20 Christine Wong, 'The Fiscal Stimulus Program and Problems of Macroeconomic Management in China', pp. 12-5, 16.

21 Ligang Liu, 'Impact of the Global Financial Crisis on China: Empirical Evidence and Policy Implications', *China & World Economy,* Vol. 17, No. 6 (2009), p. 14.

2.2 'Unlawful Autonomy'

The global financial collapse was not the principal cause of the LGFVs' downfall, however. Their vulnerability was a consequence of long-standing weaknesses in the nation's fiscal and banking systems. A classic study of rural finances has asserted that 'the state in reform China continued to be shaped to significant degrees by the institutional legacies of the Mao era'. In particular, its authors stated, 'rural administrative behaviour continued to be strongly conditioned by deeply entrenched old ways'.[22] (That assertion has considerable validity for rural banking, it will be shown.) Local governments had been left with a gross mismatch between their extensive economic and social responsibilities and their limited legal and fiscal powers. In consequence, 'unlawful autonomy' had become a dominant feature of China's sub-national administrative system.

> The main priority for local officials is the accumulation of revenue and resources to meet fiscal goals, often at the expense of citizens' rights. Consequently, local government officials collude with employers, investors and land developers, in violation of citizens' basic and lawful rights.[23]

China had borrowed its financial arrangements for local government from the Soviet Union's system of relying heavily on 'extra-budgetary funds' derived from a host of fees and user charges, enterprise profits and other activities to finance the lower levels of the administration. As it happened, the Chinese Communist Party had encouraged local autonomy throughout China's post-1949 history, and Mao Zedong originally espoused it as a safeguard against the excesses of Soviet central planning which China had imitated in the 1950s. He insisted that even the lowest levels of local administration should 'enjoy their own proper independence and rights and should fight for them'.[24]

The 1966-76 Cultural Revolution took this Maoist doctrine to a new level, and the powers of the state planners and central ministries were drastically curtailed. Attempts by the Ministry of Finance and other state agencies to regain control after Mao's death in 1976 were frustrated by local officials because without autonomy, they would have been powerless to protect local interests.[25] They had the support of their constituents because of the success of local administrations generally in maintaining economic development and social services when national administration had fallen into chaos during the Cultural Revolution.[26]

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[22] Thomas P. Bernstein and Xiaobo B. Lü, *Taxation without Representation in Contemporary Rural China* (Cambridge: Cambridge University Press, 2003), pp. 3, 4.

[23] This observation is of general validity although drawn from a study that cites the law courts as its example of an institution 'captured' by local administrations. Ian Weber, 'Mobile, online and angry: the rise of China's middle-class civil society?', *Critical Arts*, Vol. 25, No. 1, pp. 26, 30, 35, 47, 53. URL: http://dx.doi.org/10.1080/02560046.2011.552204.

[24] This autonomy, he indicated, extended even in relation to submitting statistics to the central authorities. Mao Tse-tung, *Selected Works* (Beijing: Foreign Languages Press, 1977), Vol. V, pp. 293-4.

[25] Christine P. W. Wong, 'Rural Public Finance', in Christine P. W. Wong (ed), *Financing Local Government in the People's Republic of China* (Hong Kong: Oxford University Press, 1997), p. 200 *et seq*.

[26] Susan L. Shirk, *The Political Logic of Economic Reform in China* (Berkeley: University of California Press, 1993), pp. 198-208.

The dysfunctional conditions of local government financing were actually aggravated by the process of dismantling the 'command economy'. Delegation of both fiscal and planning authority took place in the 1980s at high speed but with little uniformity, enabling local governments to seize financial power on a scale that allowed considerable abuse and waste of resources.[27] These malpractices were to contaminate the banking system. The drive continued in the 1990s to decentralise public finances and to devolve financial responsibility as far down the administrative structure as possible. By the mid-1990s, an Asian Development Bank study described the outcome in bleak terms: 'Intergovernmental fiscal relations in the PRC can be characterized as reaching a state of crisis, with a high level of dissatisfaction on all sides'.[28]

Overall, China continued to be ruled at local level with much the same structures and procedures which evolved to cope with the drawbacks and defects of the 'command economy' in the pre-1976 Maoist era.[29] The retreat from state planning did not provide the remedy for this legacy from the past. Coordination between ministries and other national agencies was poor. There was a clumsy process of devolution which was not consistent across the whole nation. The administrative structure allowed virtually no direct flow of instructions or exercise of supervision from national or provincial levels down to the lowest administrative units.

The balance of fiscal and financial responsibilities between national and local levels involves far more than bureaucratic convenience or institutional management. It determines the rate of social development and the level of political stability. The disparity between urban and rural incomes in China has been among the world's worst. Yet, new fiscal policies introduced in 1994 intensified the long-standing insistence that rural areas should pay the full costs of developing their own infrastructure and social services. 'In many localities, rural governments were unable to finance mandated services in basic education, public health, water, sanitation, etc'. As a result, there has been a 'pervasive reliance on user charges', an impressive World Bank study reported in 2008. It has not been unusual for 'none of the most basic public services [to be] provided free of charge, not even police protection'.

For the local officials responsible for the 800 million rural population, this situation continues to foment social discontent and political protests, which makes the fiscal pressures almost unbearable. The only remedy has been to finance local development through exploiting every available opportunity to raise additional funds. (The receipts from unlawful land sales and property transactions often exceed government revenues from taxes and fees.) The legal and administrative barriers against misconduct

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27 Liu Zewei, 'Reflections on the current planning system and future reforms', *Jingji yu Guanli Yanjiu*, No. 1 (8 February 1991), pp. 1-5.

28 Christine P. W. Wong, Christopher Heady and Wing T. Woo, *Fiscal Management and Economic Reform in the People's Republic of China* (Hong Kong: Oxford University Press, 1995), p. 127.

29 The analysis of local autonomy that follows in this section draws heavily on Achim Fock and Christine Wong, 'Financing Rural Development for a Harmonious Society in China: Recent Reforms in Public Finance and Their Prospects', *World Bank Policy Research Working Paper 4693* (August 2008), pp. 3, 4, 8, 13, 18, 41-3, 58, in particular. URL: http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2008/08/14/000158349_20080814090712/Rendered/PDF/WPS4693.pdf.

have been limited. This World Bank investigation revealed how illegal borrowings from the banks constituted a source of extra-budgetary funds without which local governments could not hope to foster local economic growth and a minimal supply of social services.

The practice of 'forcing banks to lend to questionable projects and poorly managed firms, as was done in the past with disastrous results' was resented, nevertheless. Bankers became 'very conservative in their lending' whenever reforms increased their autonomy, according to another World Bank study. Its paradoxical conclusion was that more professional credit management and greater control by headquarters over local lending policies hindered rather than promoted the industrial and commercial development of rural areas. Furthermore, this report argued, market competition and the allocation of capital through competitive interest rates were largely irrelevant to the economic realities which these local governments faced.[30]

Local governments have had little choice but to ignore the formal limits to their powers in their efforts to maintain key economic and, even more, social services during the strains of prolonged, high-speed, economic growth. At the same time, the central authorities seemed to have nothing to lose by leaving the rural regions to their own devices. The initial results of this 'benign neglect' proved 'so widespread and powerful in terms of a double-digit real growth rate' that the central authorities were 'more likely to claim credit than to interfere'.[31] Perhaps more important still was the disillusionment among the rural population and its officials with the central authorities. The 1958 Great Leap Forward and its rural communes had been embraced enthusiastically by China's peasants convinced by the Maoist vision of the escape from rural penury that it promised. In fact, three years of famine followed in which at least 40 million died as a result of misguided national policies and attempts by officials to conceal the disaster.[32] The start of the 1966 Cultural Revolution was also welcomed as a promise of a better world. Ironically, as has already been explained, its ultimate message for the rural areas was that local autonomy made a bigger contribution to their economic progress than central directives.[33]

3. Local Banking

3.1 Local Takeover

Reforms in rural areas from 1978 were followed by industrialisation at such a rapid pace that acute financial bottlenecks emerged. A World Bank study noted how at the lowest level of the administration,

30 William A. Byrd, 'Entrepreneurship, Capital, and Ownership', in William A. Byrd and Lin Qingsong, *China's Rural Industry: Structure, Development, and Reform* (New York: Oxford University Press, 1990), pp. 204-5.

31 Kate Xiao Zhou, *How the Farmers Changed China: Power of the People* (Boulder: Westview Press, 1996), p. 101.

32 The best account of this tragedy is Frank Dikotter, *Mao's Great Famine: The History of China's Most Devastating Catastrophe: 1958-196*2 (New York: Walker Publishing Company, 2010).

33 It can be argued that the extensive political persecution suffered by the peasant population during the Cultural Revolution was another important factor in generating rural disillusionment with the central authorities. For details of the victims, see Andrew G. Walder and Yang Su, 'The Cultural Revolution in the Countryside: Scope, Timing and Human Impact', *China Quarterly*, No. 173 (March 2003), pp. 74-99.

township governments regarded local bank deposits as 'part of the community capital base'. Indeed, in the 1980s, these funds were not supposed to be transferred outside the locality in which the deposits originated. For their part, local banking officials linked their lending decisions directly to a township's investment priorities. With the local government's help, banks could go to considerable lengths (e. g., repayment holidays and interest-only terms for delinquent loans) to avoid closing down an enterprise and forfeiting all hope of obtaining repayment. An important consequence of this 'symbiotic relationship' was that the banks were expected to carry the credit risk.[34]

Thanks to effective control over banking activities in their areas, local officials were able to ensure that cheap loans and grants were available to local enterprises and projects in order to achieve their development goals. 'Local governments had an incentive to lend more funds than they had, since any extra loans to local firms provided substantial extra tax payments as well as interest payments sufficient to repay depositors (or the central bank) on the funds they provided', a 2002 academic study noted. At the same time, local officials had no incentive to support prudent management of bank lending. They assumed correctly that the central authorities would provide the funding to write off non-performing loans. In addition, 'a very rapid rate of economic growth and of productivity growth', according to the authors, was sufficient to offset the banking losses and the inflationary pressures experienced at the local levels.[35] But this environment was inimical to the prudent management of the banking system as it made it almost impossible to insist on due regard for moral hazard. Indeed, borrowers were provided with an incentive to default in the expectation that local officials would take over the debt and then 'help to restructure the loan'.[36]

To some extent, the banks' own leadership was complicit in these arrangements. A PBOC Governor has recalled the various reform initiatives of the 1990s and how 'making rules and regulations was to a great extent a means of shirking responsibility' because head offices knew that they would not be implemented.[37] At the same time, there was a considerable gap between the announcement of reforms at the national level and the promulgation of practical measures to deal with the mounting levels of non-performing assets and decisions on corporate structures and governance.[38] The introduction of modern business corporate structures, for example, was delayed for six years by

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34 William A. Byrd, 'Entrepreneurship, Capital, and Ownership', pp. 200-1, 204.

35 Roger H. Gordon and Wei Li, 'Taxation and Economic Growth in China', (May 2002), pp. 11-2 and 14. URL: http://www.econ.ucsd.edu/~rogordon/hongkng4.pdf. The authors' analysis is illuminating despite the fact that their description of the pre-reform era taxation system and its impact is open to debate. See, for example, Leo F. Goodstadt, 'Taxation and Economic Modernization in Contemporary China', *Development and Change*, Vol. 10, No. 3, July 1979, pp. 403-421.

36 Zhou Xiaochuan, 'Improve Legal System and Financial Ecology', speech at the 'Forum of 50 Chinese Economists' (2 December 2004), pp. 8-9. URL: http://www.pbc.gov.cn/publish/english/956/1942/19422/19422_.html, pp. 8–9.

37 Zhou Xiaochuan, 'Improve Legal System and Financial Ecology', pp. 2-3.

38 He Dexu, CASS Finance Institute, 'Financial reforms to expand in 1995', *Jingjixue Dongtai*, No. 3 (18 March 1995), pp. 14-5 especially.

ideological misgivings within the Chinese Communist Party.[39]

Delays were even more acute when dealing with the political obstacles to banking autonomy. At the bank branch level, an impressive analysis has shown, the real masters traditionally were the leading officials from the local Chinese Communist Party branch. ‘Managers in local branches were jointly appointed by the head office and the local CCP Party committee’. Inevitably, ‘the branch managers were primarily oriented towards cultivating good relations with the local Party committees’. In 1993, an initial but unsuccessful attempt was made to end this situation. Then, in response to the 1997-98 Asian financial crisis, extensive reforms were made to the banking system, including the conversion of state banks into commercial corporations and a transition to professional central bankers and financial regulators entrusted with a significant degree of autonomy. These initiatives did not resolve the problem of bank lending to local governments where political rank remained the crucial factor in ensuring they got the funding they demanded.

In 1997, a new mechanism was established so that the central Party and regulatory bodies were able to ensure that appointees to senior positions were ‘loyal to the Party centre and professionally qualified’. But personal integrity remained an elusive goal because ‘central control over bank managers’ irregular activities remained very shaky’. Worse still, in the light of the crisis which has overtaken LGFVs since 2007, the new mechanism applied only to the centrally-owned sector and did not apply to ‘the diverse provincial and municipal joint-stock banks and other financial companies that had sprung up since the 1990s’.

> Local Party committees still controlled the careers of the executives in local financial firms. And “as long as no serious scandals happen that trigger central supervisory bodies’ interference, these executives will do what the local government wants them to do,” even if this means giving loans to unprofitable enterprises and dubious investment projects.[40]

3.2 Money Laundering

Local financial autonomy has been matched by a level of unauthorised and often unlawful bureaucratic behaviour which may well be unique among successful economies. China’s administrative systems are complex and far from consistent. The formal fiscal and financial arrangements are labyrinthine. At a benign level, local governments have been able to evade state directives and controls which were not beneficial to their local economic or social development. But,

[39] Zhou Xiaochuan, ‘Improve Corporate Governance and Develop Capital Market’, speech at the *Euromoney* ‘China Forum: Capital Market and Corporate Governance’, Beijing (1 December 2004), pp. 1, 2. URL: http://www.pbc.gov.cn/publish/english/956/1942/19421/19421_.html. There were bitter controversies within the Chinese Communist Party about the merits of ‘replacing ownership by the whole people with ownership by shareholders’. Marxist doctrines inspired considerable opposition to allowing such a concession to capitalism. Many were doubtful of the superior efficiency to be expected from importing modern corporate systems. An excellent summary of the conflicting views can be found in Qin Qiaoqing, ‘Roundup of opinions on shareholding systems’, *Gaige,* No 3 (20 May 91), pp. 59-65.

[40] Sebastian Heilmann, ‘Regulatory Innovation by Leninist Means: Communist Party Supervision in China’s Financial Industry’, *China Quarterly*, No. 181 (March 2005), pp. 10, 14, 15.

inevitably, abuse of power and personal corruption are very much a part of the story, as the central authorities themselves admit.[41]

The safeguards against improper and illegal financial conduct have been far from effective in any case. Astonishingly, for a state which goes to such pains as China to control every aspect of its citizen's activities, bank accounts could be opened anonymously. As a result, the misuse of funds by officials and enterprise managers has been difficult to track, thus encouraging local governments and state-owned enterprises to launch speculative ventures, notably in real estate.[42] Officials seeking to evade oversight by the central authorities have had no great difficulty in doing so, according to the PBOC, even though the money is held within the state banking system.[43]

A national campaign was launched in 1996 to tackle the large quantities of 'extra-budgetary funds' which had been acquired by Chinese Communist Party and state agencies since the retreat from central planning and state controls had begun in 1978. The total sum involved was estimated at USD36 billion. To have such a large sum in public funds being operated outside the supervision of the central authorities led to 'lax management, illegal and irregular activities'.[44] This freedom of Party and state agencies below the national level to control considerable financial resources for which they are not accountable to any authority (other than the ranking Party member in the district or institution) has persisted, and yet another campaign to end such malpractices was launched in 2009.[45]

In the last decade, profit has been an added and powerful inducement for banks to collaborate with local officialdom. 'Lending rates for township governments and village committees are excessively high', the official media reported in 2006, 'generally above 15 percent, and even up to 30 percent'.[46] These returns were almost irresistible given the grim outlook for rural lending generally, with 'an average default rate of 45 per cent' for agricultural loans between 2003 and 2009.[47] The chief banking regulator complained in 2011 of the damage still being done by 'intentional failure' to comply with

[41] It is revealing that the priorities in a 2011 official campaign to enhance stability were to halt such abuses as unlawful seizure of rural land; misallocation of low-income housing units; neglect of food and drug safety; illegal highway tolls; and misappropriation of government funding for welfare projects. Ministry of Supervision, *NCNA*, 28 April 2011.

[42] The serious ramifications in terms of evading supervision of state resources and their diversion to unauthorised, unlawful and corrupt uses were well illustrated in Wei Li, 'Measuring Corruption under China's Dual-Track System' (October 2002), 1-24. URL: http://faculty.darden.virginia.edu/liw/papers/measuring-corruption.pdf. See also his 'Corruption during the Economic Transition in China', in Donatella Della Porta and Susan Rose Ackerman (eds), *Corrupt Exchanges: Empirical Themes in the Politics and Political Economy Corruption* (Baden-Baden: Nomos Verlagsgesellschaft, 2002).

[43] Ma Delun, People's Bank, quoted in Shi Mingshen, 'Economic Viewpoint: Assessing money market conditions: interview with the People's Bank press officer', *Renmin Ribao* (*RR* hereafter), 26 February 1996, p. 2.

[44] Jin Lianshu, CCP Central Commission for Discipline Inspection, *NCNA*, 21 April 1996.

[45] Even the 'petty cash' of such practices was not trivial. Thus, a hunt started in 2009 for 'small coffers', the covert reserves accumulated by Chinese Communist Party and government agencies. By September 2011, more than 58,000 illegal accounts containing USD4.2 billion had been uncovered. 'China increases reward for tipsters of unauthorized departmental coffers', *NCNA*, 25 August 2010; 'China cracks down on corruption', *NCNA*, 14 December 2011.

[46] 'Chinese gov't investigating rural authority debts', *NCNA*, 28 November 2006.

[47] Lu Zhengwei, Industrial and Commercial Bank chief economist, quoted in 'Minsheng Bank to open 3 rural banks', *CD*, 5 May 2011.

proper banking procedures and the continuing tendency for the local levels to ignore initiatives announced by the state or head office.[48]

4. The Financial Environment

4.1 Beyond the Law

A lack of legality was to prove a feature of almost all the anti-recession measures adopted in 2008-09. A crucial weakness of the USD586 billion economic stimulus package was that the central authorities would provide less than 30 per cent of the funds. Local governments were called on to finance most of the balance and to borrow extensively in the process. The central authorities expected to be able to mobilise the extra-budgetary and unauthorised financial resources accumulated by local governments (described in the previous section).The scale of the potential contribution from such sources was illustrated by the Guangdong Development District which in 2008 announced a commitment to spend over USD4 billion in the next three years to rescue firms hit by a fall in exports. This initiative was expected to generate additional investment by the private sector of more than USD10 billion over the same period.[49]

Another highly revealing display of local autonomy was provided by a county in Guangdong province with a population of 10 million and a GDP of USD44 billion in 2007. As its exports shrank the following year, the county's administration took the initiative to allocate USD570 million of the county's own funds for a package of unemployment benefits, tax concessions, business incentives and investment finance. No less significant, the county tried to counter a credit squeeze by providing local bank branches with a 50 per cent guarantee for their loans.[50] There appeared to be no legal authority to justify any of these initiatives, which did not deter the official media from hailing the county as a national model.

A more serious issue was the central authorities' assumption that most of the shortfall would be covered by local government borrowings. The National Development and Reform Commission acknowledged at a press conference that lower levels of the administration had no legal power either to borrow money or to guarantee loans. But the Commission's Vice Director assumed that this legal restriction could be circumvented.[51] His statement amounted to the informal validation of a long-standing but much criticised feature of China's fiscal arrangements. The 'common practice for a number of years', an IMF report later observed, had been 'for local governments to establish

48 Liu Mingkang, China Banking Regulatory Commission (CBRC hereafter) Chairman, speech at Lujiazui Forum (20 May 2011) URL: http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=201106134F7B8902E3BAC6C5FFA807B15F8A0E00

49 'China to inject 30 billion yuan into major economic development district', *NCNA*, 12 December 2008.

50 'China to monitor possible mass layoffs, large-scale labor disputes', *NCNA*, 18 November 2008.

51 The press conference and his remarks were reported in 'Top official: Severe challenge for China to stop slowdown in economic growth', *NCNA*, 14 November 2008.

corporate vehicles (capitalized by transfers of money, land, equity, or other government assets), which are then used to borrow' substantial sums, with 'implicit or explicit guarantees from the local government'.[52]

In practice, the economic stimulus package called for the reversal of a decade-long drive to halt local government borrowings, which were known to be a threat to financial stability. In 1999, a nationwide campaign had begun to end this unlawful practice but made little progress. By 2005, even the limited data available to the central authorities showed that these loans were a 'menace to the country's fiscal system', the Chinese Communist Party newspaper reported, and well beyond 'repayment capabilities'.[53] Local governments were determined not to give up this source of funding on which, according to a 2005 IMF report, depended their fiscal autonomy and their freedom to put local political and economic realities ahead of Party directives and state plans.[54] An additional but rarely publicised factor was the resistance encountered by local governments in collecting the fees payable by large and politically powerful state-owned enterprises.[55]

In 2006, the Ministry of Finance had been instructed to start a renewed drive to reduce the volume of local borrowings which one local official was reported to have described as 'so huge that no one except the central government can clear it'. The priorities for liquidation included loans raised for 'infrastructure construction and public welfare undertakings'.[56] Little wonder then that local administrations devoted less than 10 per cent of their spiralling 2009 loans to stimulus package projects. The balance was allocated to projects begun before 2008 and whose funding would otherwise have been in danger from the Ministry of Finance's 2006 restrictions.[57]

Predictably enough, the banks themselves were willing accomplices in the excessive expansion of LGFV borrowing because of the high interest rates they could earn. In 2010, the authority of central bankers and financial regulators was restored. They roundly denounced 'unscrupulous and unhealthy financial institutions' which had exploited the economic stimulus package by seeking 'excessive profits' created by 'a widening gap between lending and deposit rates'.[58]

[52] IMF, *People's Republic of China Staff Report for the 2010 Article IV Consultation* (9 July 2010), p. 15. URL: http://www.imf.org/external/pubs/ft/scr/2010/cr10238.pdf

[53] Xie Liqun, Zhejiang Provincial Audit Department Director, 'Local government debts detrimental to state treasury: Chinese legislator', *RR*, 12 March 2005.

[54] Era Dabla-Norris, 'Issues in Intergovernmental Fiscal Relations in China', *IMF Working Paper WP/05/30* (February 2005), p. 15.

[55] Nanjing has provided a striking example of this problem. 'Local authority in E. China uses microblog to publicize delinquent payments', *NCNA*, 23 December 2011.

[56] 'Chinese gov't investigating rural authority debts', *NCNA*, 28 November 2006.

[57] Liu Jiayi, Auditor General, 'China's local gov'ts 3 trillion yuan in red with infrastructure, stimulus spending', *NCNA*, 23 June 2010.

[58] Wang Zhaoxing, CBRC Deputy Chairman, 'Banking regulator urges structural reforms', *NCNA*, 24 October 2010.

4.2 Unfortunate Timing

The Ministry of Finance's original expectation had been that local governments would finance their contribution to the economic stimulus package through issuing bonds. The Ministry intended to impose 'very strict regulatory requirements' on these offerings, including full disclosure of their issuers' finances. In practice, this financing was only available to selected provincial-level administrations, and they raised a mere USD29 billion in 2009-10, with the Ministry acting as the issuer on their behalf.[59] The lower levels of the administration could not be brought to the market, the state media reported, because 'if they reveal their books, no one would agree to lend'. In consequence, there was no alternative but to ignore the law and allow local governments to borrow illegally if they were to fund their share of stimulus package spending.[60]

The Ministry was unable to put in place satisfactory arrangements for local administrations to issue bonds directly until October 2011. It was then announced that Zhejiang province had been selected to pioneer the issue of three and five-year bonds to raise the equivalent of USD1.25 billion to fund city-level and county-level infrastructure projects. The bonds had been 'been ratified by the central government', the province stated.[61] The circumstances for the start of such a bond programme were to prove inauspicious. Almost simultaneously, a leading city in the province was struck by a financial crisis that attracted international as well as local media coverage.

Zhejiang itself is an impressive example of how coastal provinces have benefitted from three decades of economic modernisation and liberalisation. Zhejiang also contains Wenzhou, a city with a national reputation for its free-market culture, 'where BMWs, Ferraris or Lamborghinis' and 'self-made millionaires abound and locals are known among their fellow countrymen for having the "business gene"'.[62] The downturn in the global economy from 2007 hit its export factories hard.[63] Furthermore, its economy was so open that its intrepid property developers attracted notoriety for being caught in Dubai's property collapse.[64] Wenzhou's image deteriorated still further in 2011 when the PBOC's renewed anti-inflation drive squeezed local bank credit so hard that the city became alarmingly dependent on loan sharks and unauthorised financial institutions.[65]

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59 These were issued in the form of 'book-entry national treasury bonds tradable … on the inter-bank market and securities exchanges'. 'Local bonds of Liaoning, Tianjin set for sale', *RR*, 14 April 2009; '9b yuan Sichuan province local bond sale to open on Wed.', *NCNA*, 8 April 2009; 'China to sell local gov't bonds next week', *NCNA*, 18 June 2010.

60 Jing Ji, 'Local govts may be allowed to issue bonds', *CD,* 23 October 2008.

61 Qian Juyan, Zhejiang Provincial Finance Department Head, 'China's Zhejiang Province to issue 8 bln-yuan bonds on infrastructure', *NCNA*, 5 October 2011.

62 Zhao Yanrong, 'Small businesses boost Wenzhou', *CD*, 16 December 2010.

63 Although city officials sought to play down the losses. Yu Ran, 'Wenzhou denies manufacturing base is withering', *CD*, 25 May 2011.

64 'Houses built on sand burn Chinese investors', *CD*, 4 January 2010. For an overview of Wenzhou's involvement in Dubai, see 'Chinese investors head to Dubai for property bargains', *NCNA*, 12 January 2010.

65 Data on the growth of non-banking loan business in Wenzhou and some other Chinese cities were reported in 'Monetary tightening takes toll on China's small, mid-sized businesses', *NCNA*, 30 September 2011.

The situation in Wenzhou was grave enough for Prime Minister Wen Jiabao to personally intervene and direct the city's banks 'to lend more money to small firms and tolerate higher levels of debt' and also to call for 'a crackdown on the high-interest informal lending market'. So tight was liquidity in the city that all the local management of the Bank of China could promise in response to the Prime Minister's instruction was 'to issue loans with interest rates lower than 30 per cent to corporate borrowers that are having liquidity problems but able to sustain production'.[66] By this time, the city's woes had attracted international attention. This was not the most promising environment for Zhejiang to launch its bonds.

To make matters worse, the national banking system was under such pressure during this period that a state investment vehicle, Central Huijin Investment Ltd, started to buy shares in China's four biggest banks. This move was officially described as 'aimed at supporting the steady operation and development of major financial institutions and stabilizing their stock prices'.[67]

5. Crisis Outcomes

5.1 Data Deficiencies

An important factor in the LGFV crisis was an acute data deficit. The background of incomplete legal, audit and regulatory institutions described above created an unavoidable dearth of accurate and comprehensive statistics about government activities below the national level. Until the reforms of the last three years (listed below), the authorities could have no certainty about the way in which publicly-owned assets (land especially) and the state's financial resources were being used. The consequences for oversight of the financial system have been particularly severe in the case of local governments and their funding.

In a 2010 report, the IMF expressed alarm about 'the use of local government investment platforms to finance infrastructure and other projects [which] has been extraordinary'. 'Some part of the expansion in this quasi-fiscal lending will end up as nonperforming loans', the IMF predicted, 'with negative implications for both local government finances, bank balance sheets, or, potentially, central government finances'. The risks involved could not be quantified, however, because 'information on the activities of these [LGFVs] (and their underlying financial condition) is sparse', the IMF discovered, and the central authorities were 'only now putting in place systems' to uncover how much they had borrowed.[68]

The broad figures that were initially produced were worrying enough. Local government borrowings were estimated to have risen by 70 per cent to USD1.1 trillion in 2009. As a result, Xiao Gang, Bank

[66] 'China ensures bank loans to help private sector', *NCNA*, 12 October 2011.

[67] 'Central Huijin buys stocks in 4 Chinese major banks', *NCNA*, 10 October 2011.

[68] IMF, *People's Republic of China Staff Report for the 2010 Article IV Consultation*, pp. 15, 16, 27.

of China Chairman, declared, the financial system was threatened by 'systemic risks' because of borrowings by local governments 'beyond their repayment capacity'.[69] In 2010, the amount of such borrowings classified as 'questionable' by the banking regulator was equivalent to 4 per cent of GDP.[70] He was concerned that 'surging bad loans could hamper efforts to overhaul the banking sector'.[71] Local governments were now ordered to halt this unlawful practice; clear existing debts; and wind up vehicles that were being funded illegally.[72] But full details of the financial liabilities involved were not available.

Subsequent efforts to remedy the data deficit compounded the confusion because three separate agencies were involved, and each 'used different definitions and accounting methods in the audit, leading to the discrepancies in the figures', the National Audit Office (NAO) admitted in 2011. The three did not agree even on the total number of local government financing vehicles involved:

> [According to the NAO], the country had 6,576 local government financing vehicles, while the central bank and the banking regulatory commission estimated that the figure would be more than 10,000 and 9,000, respectively.[73]

The NAO appears to have been successful in imposing its more conservative estimate of the LGFVs on both the central bank and the banking regulator. Thus, NAO data are now cited as the authoritative statistics, and they show a total of USD 1.66 trillion for local government borrowings at end-2010.[74] Associated with this figure are reassuring estimates for ratios of indebtedness to GDP. A senior state planning official, for example, said that the local government borrowings were the equivalent of 26.9 per cent of China's GDP. 'If debts owed by the central government are included, the total debt is still less than 50 percent of China's GDP', he added.[75] The Ministry of Finance's research indicated that these figures underestimated total LGFV borrowings because insufficient attention had been given to the 'invisible debt' — 'money that has been lent but does not have any official documentation'.[76]

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[69] Xiao Gang, Bank of China Chairman, 'Top Chinese banker warns of lending risks', *NCNA*, 9 November 2009.

[70] See Liu Mingkang, 'Third economic and financial situation briefing' (20 July 2010) (URL: http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=2010081369FB40E8533AAEBBFF3BDD3E98643100; Wang Bo, 'Regulator sees no risks from local govt loans', *CD*, 28 July 2010; Jia Kang, Ministry of Finance Institute of Fiscal Science Research Director, 'China should be aware of local govt debt risks: official', *NCNA*, 2 November 2010.

[71] Liu Mingkang, 'Address at the third economic and financial situation briefing of CBRC' (20 July 2010) URL: http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=2010081369FB40E8533AAEBBFF3BDD3E98643100; Wang, *CD*, 28 July 2010.

[72] 'China regulates local gov't financing companies', *NCNA*, 14 June 2010.

[73] 'China never underestimates local government debt: NAO', *NCNA*, 11 July 2011.

[74] NAO's statistical 'supremacy' is plain from Liu Mingkang, interview, *RR*, 17 August 2011.

[75] Xu Lin, National Development and Reform Commission, Monetary and Financial Department Director, 'Local gov't debts differ from those in other countries, default unlikely: official', *NCNA*, 29 August 2011.

[76] Jia Kang quoted in Wei Tian and Gao Changxin, 'Finance ministry focuses on local government debt', *CD*, 28 July 2011.

A comprehensive solution for the data deficit was slow to emerge. In 2011, the Ministry of Finance promised that 'a sound system of debt information, as well as a regular reporting mechanism on the statistics, should be established to implement dynamic monitoring over local government debt'. However, the 'details' of the new arrangements remained under negotiation between the central and local authorities, according to a senior member of the Ministry's fiscal research agency.[77]

In the meantime, the financial authorities decided that the strain had to be taken off the banking industry. A total of USD438 billion —about a third of the LGFVs' borrowings — would be reclassified and 'booked as general corporate loans'. As a result, banks would be able to reduce their provisions for these loans, it was reported officially, 'a move that is set to relieve the pressure on banks to raise fresh capital'.[78] Coincidentally, this sum was equivalent to 75 per cent of the China's USD586 billion economic stimulus package introduced in 2008, for which local governments (and the private sector) had been expected to find some 70 per cent of the total funding from their own resources, as earlier noted.

5.2 Targets Missed

In an early review of the economic stimulus package and its impact, the IMF had described its scale as 'unprecedented', adding the comment that 'international history' provided 'compelling' evidence that it would lead to a decline in the quality of bank loans and an increase in nonperforming assets.[79] The pessimism was well-founded: the role assigned to local governments in the economic stimulus package proved over-ambitious, and its results fell short of expectations.

- The spending targets were missed despite the decision to condone unlawful borrowings. Local governments had exhausted their available resources of both cash and credit before the end of 2009.[80]
- It proved impossible to ensure that local governments complied with the state planners' targets. Of the 2009 surge in local government borrowings, over 90 per cent was spent on 'transport and other infrastructure facilities that were started before 2008', according to the NAO, and local governments had 'constantly violated state law'.[81]
- The heavy reliance on loans made local governments increasingly dependent on their property portfolios, both to borrow from the banks and to service their debt. In October 2008, the Ministry of Finance was struggling to find an immediate USD173 billion to support the stimulus package. In desperation, the Ministry abandoned its previous efforts to reduce local governments'

77 Jia Kang, *CD*, 28 July 2011.

78 'China to re-book some local govt loans', *CD*, 15 August 2011.

79 IMF, *People's Republic of China Staff Report for the 2010 Article IV Consultation*, p. 16.

80 National Development and Reform Commission, 'NDRC to review status of stimulus driven projects', *CD*, 18 September 2010.

81 Liu Jiayi, *NCNA*, 23 June 2010.

dependence on property to fund their budgets, and they were allowed to sell publicly-owned land to finance stimulus projects.[82]

- In 2009, land-related transactions generated 46 per cent of total local government revenues and were associated with 'illegal land acquisition and soaring house prices'. The official view was that local governments now had an almost irresistible incentive to promote real estate bubbles.[83]
- In addition to the unlawful financial arrangements for local government property dealings, the legality of their expropriation and sale of sites in rural areas was usually dubious and provoked serious political and social unrest, according to the official media.[84]

5.3 Modest Reforms

Officially, no direct connection has been made between the financial scandals and mismanagement that followed the economic stimulus package and a series of fiscal and financial reforms introduced since 2010. Their announcement has been given relatively modest publicity. Their provisions are presented as preliminary and restricted in scope. Nevertheless, they represent the first steps towards eliminating some of the most serious sources of administrative misconduct and financial mismanagement. They have considerable implications for improving credit management by bank branches.

- The nation's banking system has long been handicapped by the absence of any 'clear regulations' to control state finances. In 2010, the Ministry of Finance released 'tentative measures for managing government funds [including] …requirements for the definition, application and approval procedures, collection, budget management and supervision of government funds'.[85]
- In 2010, legal provisions were announced to ensure that there should be full accounting wherever public money was spent to ensure the financial integrity of 'all fiscal funds and all government-related construction projects'.[86]
- Banks have suffered heavily from the chaotic state of local government funding. In 2011, 'a rudimentary mechanism for ensuring basic funding for county-level governments' was reported to have been set up. (Less than half the county and lower-level administrations appear to have

[82] The negative consequences were reported in some detail for an international audience by *CD*: e.g., Wang Zhuoqiong, 'Officials punished for misuse of funds', 16 October 2009; Hao Yan, 'Local govts "want land sales" to pay back loans', 23 June 2010; 'Proceed cautiously on land-based funds', 13 October 2009.

[83] See the critical observations of Professor Ye Jianping, Renmin University, and Huang Xiaohu, China Land Science Society Vice President, reported in *RR* and *NCNA*, 27 December 2010.

[84] Ministry of Land and Resources, 'China stresses rightful use of rural land, protection of farmers' rights' and 'Chinese supreme court pledges to protect citizens' rights in demolition cases', *NCNA* ,16 February 2011; State Council, 'Chinese central government says no to forced eviction of farmers', *NCNA*, 3 April 2011. The complex and costly consequences of the failure to clarify rural property rights were well summarised earlier in Bryan Lohmar, 'Feeling for Stones But Not Crossing the River: China's Rural Land Tenure After Twenty Years of Reform', *Chinese Economy*, Vol. 39, No. 4 (July–August 2006), pp. 85–102.

[85] Qiang Xiaoji, 'Ministry of Finance regulates government funds', *CD*, 28 Sep 10.

[86] Wen Jiabao had personally called for this reform the previous year. 'China boosts auditors' power as stimulus package spending prompts corruption concerns', *RR*, 21 February 2010.

implemented these reforms in full.)[87]

- Collectively-owned land is a crucial building block for local governments' finances. Plans for a comprehensive national register of 'ownership, boundaries, size and usage of all rural land' were announced in 2011.[88]

5.4 Perils Persist

The state has acknowledged how damaging was the surge in bank lending to LGFVs. Yet, local governments and their investments continue to play an apparently irreplaceable role in executing the nation's priority policies. This reality is particularly evident in an urgent new programme to boost the supply of affordable housing. In early 2011, Prime Minister Wen personally endorsed this programme to increase the existing housing stock by 20 per cent over the next five years. Its targets were to build a total of 36 million units, with construction of 10 million units to start in 2011 of which 4 million were to be completed before the year's end.

How it was to be financed was still not settled at this point, although various versions of an enhanced public housing plan had been given considerable publicity by national and provincial leaders for several years. After the Prime Minister's intervention, the Ministry of Housing and Urban-Rural Development felt able to take the initiative and urged local governments 'to innovate new financing mechanisms' to raise funds to finance the national programme.[89] The state planning authorities approved the use of local bond issues to boost funds for affordable housing in mid-2011.[90] These measures were not deemed adequate to overcome the financial obstacles to meeting the construction targets. So, this limited and essentially optional funding source was upgraded both in scope and political priority.

The State Council directed local governments 'to give more support for the construction of low-income housing projects, especially low-rent public housing units'. Listed among the measures to be used in raising the necessary finance were 'increased land sale premiums, bond issuances and loans for qualified local government financing vehicles (LGFVs)'.[91] This funding strategy, — and the process by which it emerged — had much in common with the steps taken to maximise the contribution from local governments to financing the economic stimulus package in 2008-09, as described earlier. The LGFVs have been given a new lease of life. It also seems inevitable that local governments will find it

87 Wen Jiabao, 'Report on the work of the government delivered at the Fourth Session of the 11th National People's Congress on March 5, 2011', *NCNA*, 17 March 2011; Ministry of Finance, 'Report on the implementation of the central and local budgets for 2010 and on the draft central and local budgets for 2011' (Fourth Session of the 11th National People's Congress, 5 March 2011), *NCNA*, 17 March 2011.

88 Zhu Liuhua, 'China to complete registration of collectively-owned land', Ministry of Land Resources, *CD,* 14 May 2011.

89 'China mulls new channel for financing affordable house building', *NCNA*, 14 June 2011.

90 Yin Mingzhe, 'Local financing approved for affordable housing', *CD,* 21 June 2011.

91 'China's cabinet urges more support for low-income housing projects', *NCNA,* 19 September 2011.

as difficult as ever to reduce their dependence on real estate to meet the affordable housing targets set for them by Party. How else can the ambitious programme be implemented?

6. Conclusions

This paper has argued that the lessons from the past were ignored in the response to the 2007-09 global financial crisis. Banks were encouraged to lend to local governments despite their poor credit ratings, the unlawful nature of such borrowings and the adverse monetary implications, although the danger signs had been signposted well in advance by China's own financial officials as well as the IMF. And thus it proved: 2011 saw desperate efforts to buttress financial stability, to check inflationary pressures and to bring the property 'bubble' under control.

The policy-makers have not been discredited by the mounting costs of their original decision to disregard experience from past crises and to suspend the fiscal, financial and banking reforms introduced in previous years. In fact, state leaders and financial officials insisted throughout that the strategy they adopted was prudent and successful. Soon after the launch of the economic stimulus package, for example, Prime Minister Wen declared himself confident that the financial sector would not be at risk because of the stability it had achieved 'after more than 10 years of reform'.[92] The chief bank regulator asserted in 2011 that the banks' performance since 2007 surpassed all reasonable expectations.

> Thanks to over 8 years of prudential guidance, the banking sector has withstood the impact and test of the international financial crisis that rarely occurs in everything 100 years. Remarkable changes have taken place in internal mechanisms and external image. In particular, the operating mechanisms and managerial efficiency have seen some delightful changes, which is not easy to achieve.[93]

In addition, officials were anxious that mounting evidence of financial mismanagement and worse since 2009 should not bring the reform process itself into disrepute.[94] Thus, Vice President Xi Jinping lauded Wenzhou's entrepreneurial spirit, while, simultaneously, Zhejiang's senior Party leader was revealing that 'more than 90 of that city's leading businessmen had 'disappeared, committed suicide or declared bankruptcy' leaving behind personal debts of USD1.6 billion.[95]

92 Wang Xiuqiong and Chang Ai'ling, 'Premier Wen says financial crisis not bottom out, impact spreading', *NCNA*, 28 February 2009.

93 'Liu Mingkang, speech at Lujiazui Forum (20 May 2011).

94 From the start of the economic stimulus package, the leadership was concerned that the nation's commitment to economic reform should not waver in the global crisis. For example, Wen Jiabao: 'The more difficulties we face, the more firmly we should stick to reforms and opening up'. 'Chinese premier calls for further reforms, opening up to tackle crisis', *NCNA*, 10 March 2009.

95 Vice President Xi Jinping, 'Chinese Vice President applauds Zhejiang entrepreneurial spirit', *NCNA*, 25 October 2011; Zhao Hongzhu, Zhejiang CCP First Secretary, 'Officials note E China economic powerhouse's resilience in debt crisis', *NCNA*, 25 October 2011.

This paper has shown how China's local governments' autonomy has been strengthened by the delays in creating the legal, regulatory and administrative structures which a modern economy requires, particularly in managing economic affairs and ensuring financial integrity and accountability. Early in the reform era, it was believed that gaps in the legal and administrative systems would hinder modernisation.[96] China's earlier reform experiences indicate that this fear was misplaced because there has been no apparent damage to the economy's rate of growth despite the additional transaction costs from reduced institutional efficiency.

There have been painful 'social' costs, of course, and these have been borne largely by local governments and their constituents. Financial constraints have made it virtually impossible to provide local services that do not generate direct economic benefits, a point made earlier in this paper. According to studies by two academics specialising in this field, a local government had little to gain from investing in agriculture or education, for example, because returns from industrial expansion were always higher than from agriculture, while improved schooling generated no quantifiable economic gain in the short run at least. Similarly, in managing local land resources, the biggest gains for local administrations have come from partnerships with property speculators.[97]

The challenges which China faces are changing. Under the current five-year plan, obsession with GDP growth is to be jettisoned. 'New performance evaluation criteria' have been set for local governments which 'give more weight to efficiency, environment protection and living standards'.[98] In addition, the rural regions are supposed to be expanding their spending on education, health and housing in order to buttress 'social harmony and stability' which China's leaders believe to be under attack.[99]

No quick remedy seems in sight for financial shortfalls, however. 'China's local governments (provincial, prefecture, county, and township) have not been granted any legal authority for taxing or borrowing and are overloaded with unfunded central mandates', a recent academic study insists. The result is that 'subnational governments in China account for 79 percent of total government expenditure but only 47 percent of total government revenues', a mismatch which has been described as far exceeding 'other developing countries, transitional countries, and even OECD countries'. To fill

96 In 1980, Deng Xiaoping had identified the absence of formal rules and regulations as a major shortcoming in the management of public administration at every level. Zheng Lin, 'Overhaul administrative law and strengthen the socialist legal system: learning from the "Selected Works of Deng Xiaoping"', *Faxue Yanjiu*, No. 2 (23 April 1984), p. 10.

97 Roger H. Gordon and Wei Li, 'Provincial and Local Governments in China: Fiscal Institutions and Government Behavior', *NBER Working Papers* 16694, National Bureau of Economic Research (May 2010), pp. 1-31. URL: http://www.nber.org/papers/w16694.pdf. This article remains useful although some features of local government's challenges it discusses had already altered before publication.

98 Wen Jiabao quoted in 'China eyes 7% annual growth', *NCNA*, 28 February 2011.

99 See, for example, Liu Yunshan, CCPCC Publicity Department Head, 'Senior CPC official stresses publicity that caters to public understanding', *NCNA*, 30 August 2011; 'China hopes to innovate social management by restructuring governmental organs', *NCNA*, 8 October 2011.

this fiscal gap, local governments have no alternative but to rely on loans and land sales.[100] These transactions almost always involve a disregard for the law and state policies.

The new regulations listed in an earlier section will expand the monitoring of local government finances and their use of land resources. But these legal measures are very new, and enforcement arrangements are still being developed, while the steps taken to improve the funding of the lower levels of the administration are still at a very rudimentary stage. More troubling still is the reluctance of the central authorities to curtail local autonomy. In late 2011, Deputy Prime Minister Wang Qishan publicly identified 'the country's local financing platforms' as one of the potential 'triggers for a destructive financial crisis'. The only solution he was able to offer was moral suasion as he 'urged the country's financial authorities ... to "increase exchanges, coordination and cooperation with local governments", and try their best to help solve difficulties and problems faced by local governments and enterprises'.[101]

There is one, new factor that may force changes on the financial arrangements for local governments. China hopes to make its currency fully convertible by 2015, the last year of the current, 12th five year plan.[102] One of the lessons from 2011 is that, already, China cannot completely ignore international markets and their assessment of the stability of its domestic financial institutions.[103] In an increasingly free-market environment, banking and currency stability will depend heavily on transmitting accurate information to foreign business partners about financial and monetary policies and the state of the banking industry.[104] The proper management of LGFVs may thus force its way higher up the national agenda because of the market costs of financial scandals as the RMB seeks the status of an international currency.

This new reality was signalled in 2011 when a prominent Chinese political personality declared at an international business forum: 'Borrowing by thousands of companies set up by China's local

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100 Joyce Yanyun Man, 'Local Public Finance in China: An Overview', in Joyce Yanyun Man and Yu-Hung Hong (eds), *China's Local Public Finance in Transition* (Cambridge: Lincoln Institute of Land Policy, 2011), pp. 3, 6.

101 This plea was addressed specifically to 'the People's Bank of China, the China Banking Regulatory Commission, the China Securities Regulatory Commission and the China Insurance Regulatory Commission'. 'Vice Premier urges efforts to deepen financial reforms, prevent risks' *NCNA*, 19 November 2011; Yi Xianrong, 'Vice-Premier Wang Qishan Effective risk prevention', *CD*, 30 November 2011. These official media items were reporting a preparatory forum for the annual Central Economic Work Conference.

102 The 2015 target was announced by the State Administration of Foreign Exchange. Yi Gang, State Administration of Foreign Exchange Head, 'RMB capital account liberalization to be achieved in five years', *NCNA*, 18 January 2011; 'China to push forward capital account convertibility over next 5 years', *NCNA*, 1 February 2011). PBOC officials, however, denied that there was a fixed timetable for convertibility: *e.g.*, Zhou Xiaochuan, 'Yuan will be fully convertible by 2015'[*sic*], *CD*, 9 September 2011; Hu Xiaolian, PBOC Deputy Governor, 'China has no timetable for Yuan's full convertibility: central bank official', *NCNA* 11 March 2011.

103 Negative international market sentiment was illustrated by: UBS Investment Research, 'Chinese Banks For Beginners (Transcript)' (26 September 2011), pp. 1-16; RBS, 'Alert Financials: Chinese banks: More reserves required' (29 August 2011); Patrick Chovanec , 'Chinese banks are worse off than you think: Rosy loan-to-deposit ratios hide a serious nonperforming-loan problem', *Wall Street Journal*, 22 July 2011; Lisa Pollack and Robin Wigglesworth, 'China sees surge in CDS on slowdown fears', *Financial Times*, 5 October 2011; Denise Law, 'China bank shares dip on credit crisis fears', *Financial Times*, 7 October 2011.

104 Awareness of these risks was high. Xia Bin, PBOC Monetary Policy Committee Member, 'China may continue managed floating rate regime', *NCNA*, 4 August 2011; Professor Huang Yiping, Peking University, 'Is China Ready for Full Yuan Convertibility?', *Beijing Review*, 4 August 2011 URL: http://www.china.org.cn/opinion/2011-08/04/content_23141445.htm.

governments to fund construction is the nation's equivalent of the United States' subprime mortgage crisis'.[105] A statement by a personality of such status and in such unflattering terms would have been difficult to imagine before globalisation of the RMB became a national goal.

[105] Cheng Siwei, formerly National People's Congress Standing Committee Vice-Chairman, quoted in 'Local government financing is China's "subprime": Cheng', *CD*, 17 September 2011.

Table 1. China's Financial System 2007-10, by Institution and Percentage Shares in National Totals[106]

	2007			2010		
	No. of institutions	Share of total assets	Share of GDP	No. of institutions	Share of total assets	Share of GDP
All banking institutions	8,721	84	194	3,639	88	234
Large commercial banks	5	46	105	5	44	118
Joint stock commercial banks	12	12	27	12	14	37
City commercial banks	124	5	13	147	7	20
Rural commercial banks	17	1	2	85	3	7
Policy banks	3	7	16	3	7	19
Foreign banks	29	2	5	130	2	4
Postal savings bank	1	3	7	1	3	9
Rural cooperative banks	113	1	2	223	1	4
Rural credit cooperatives	8,348	7	16	2,646	6	16
Urban credit cooperatives	42	0.2	0.5	1	0	0
New-type rural financial institutions	27	0	0	386	0	0.3

106 Based on 'Table 4. Structure of the Financial Sector, 2007–10', IMF, 'People's Republic of China: Financial System Stability Assessment', p. 21.