# NYT

# As Its Economy Sprints Ahead, China’s People Are Left Behind



A shopkeeper napping on a busy shopping street in Jilin. While Western companies look at China as a potentially huge market, consumers in Jilin and other heartland cities mostly settle for what state-run department stores and mom-and-pop shops offer.

###### By [DAVID BARBOZA](http://topics.nytimes.com/top/reference/timestopics/people/b/david_barboza/index.html?inline=nyt-per)

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JILIN CITY, China — Wang Jianping and his wife, Shue, are a relatively affluent Chinese couple, with an annual household income of $16,000 — more than double the national average for urban families.

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Yang Yang and her son, Guo Liming. To save money, Ms. Yang, her husband and son recently moved in with her parents.

They own a modest, three-bedroom apartment here in this northeastern industrial city. They paid for their son to study electrical engineering at prestigious Tsinghua University, in Beijing. And even by frugal Asian standards, they are prodigious savers, with $50,000 in a state-run bank.

But like many other Chinese families, the Wangs feel pressed. They do not own a car, and they rarely go shopping or out to eat. That is because the value of their nest egg is shrinking, through no fault of their own.

Under an economic system that favors state-run banks and companies over wage earners, the government keeps the interest rate on savings accounts so artificially low that it cannot keep pace with China’s rising inflation. At the same time, other factors in which the government plays a role — a weak social safety net, depressed wages and soaring home prices — create a hoarding impulse that compels many people to keep saving anyway, against an uncertain future.

Indeed, economists say this nation’s decade of remarkable economic growth, led by exports and government investment in big projects like China’s [high-speed rail](http://topics.nytimes.com/top/reference/timestopics/subjects/h/high_speed_rail_projects/index.html?inline=nyt-classifier) network, has to a great extent been underwritten by the household savings — not the spending — of the country’s 1.3 billion people.

This system, which some experts refer to as state capitalism, depends on the transfer of wealth from Chinese households to state-run banks, government-backed corporations and the affluent few who are well enough connected to benefit from the arrangement.

Meanwhile, striving middle-class families like the Wangs are unable to enjoy the full fruits of China’s economic miracle.

“This is the foundation of the whole system,” said Carl E. Walter, a former J. P. Morgan executive who is co-author of “Red Capitalism: The Fragile Financial Foundation of China’s Extraordinary Rise.”

“The banks make loans to who the Communist Party tells them to,” Mr. Walter said. “So they punish the household savers in favor of the state-owned companies.”

It is not just China’s problem. Economists say that for China to continue serving as one of the world’s few engines of economic growth, it will need to cultivate a consumer class that buys more of the world’s products and services, and shares more fully in the nation’s wealth.

But rather than rising, China’s consumer spending has actually plummeted in the last decade as a portion of the overall economy, to about 35 percent of [gross domestic product](http://topics.nytimes.com/top/reference/timestopics/subjects/u/united_states_economy/gross_domestic_product/index.html?inline=nyt-classifier), from about 45 percent. That figure is by far the lowest percentage for any big economy anywhere in the world. (Even in the sleepwalking American economy, the level is about 70 percent of G.D.P.)

Unless China starts giving its own people more spending power, some experts warn, the nation could gradually slip into the slow-growth malaise that now afflicts the United States, Europe and Japan. Already this year, China’s economic growth rate has begun to cool off.

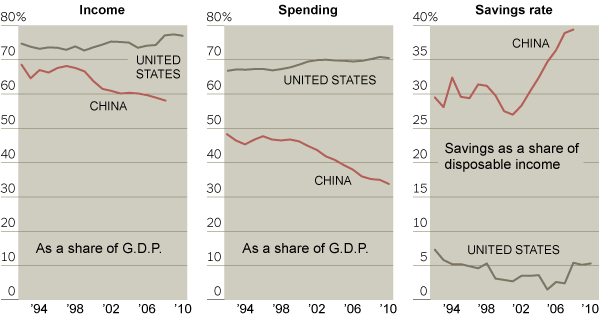
“This growth model is past its sell-by date,” says Michael Pettis, a professor of finance at Peking University and senior associate at the Carnegie Endowment for International Peace. “If China is going to continue to grow, this system will have to change. They’re going to have to stop penalizing households.”

The Communist Party, in its latest [five-year plan](http://www.nytimes.com/2011/03/15/world/asia/15china.html), has promised to bolster personal consumption. But doing so would risk undermining a pillar of the country’s current financial system: the household savings that support the government-run banks.

Here in Jilin City, where chemical manufacturing is the dominant industry, the state banks are flush with money from savings accounts. The banks use that money to make low-interest loans to corporate beneficiaries — including real estate developers, helping fuel a speculative property bubble that has raised housing prices beyond the reach of many consumers. It is a dynamic that has played out in dozens of cities throughout China.

# China’s Reluctant Consumers

Despite China’s rapid growth in recent years, personal income and spending has declined in relation to the overall economy, as household wealth has taken a back seat to state-run businesses. And to gird against future uncertainties, Chinese households have put a higher portion of their income into savings accounts — even though the government keeps interest rates low to subsidize state-run banks and industries. The data are in sharp contrast to the United States, with its consumer-focused economy and meager savings rate.



Meanwhile, China’s central bank in Beijing also depends on the nation’s vast pool of consumer savings to help finance its big investments in the foreign exchange markets, as a way to keep the currency artificially weak. The weak currency helps sustain China’s mighty export economy by lowering the global price of Chinese goods. But it also makes imports unaffordable for many Chinese people.

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Wang Shue and her husband live frugally and put much of their income into savings.

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Left, a billboard announcing Jilin Fortune Plaza, a real estate project in Jilin, China. Local governments have come to view such projects as a source of easy riches.

News reports of the nouveaux riches in Beijing and Shanghai snapping up Apple iPhones, Gucci bags and Rolex watches may conjure Western business dreams of China’s becoming the world’s biggest consumer market. But consumer choice here in Jilin and many other heartland cities is confined largely to the limited offerings of dingy state-run department stores and mom-and-pop shops. Any sales of global “brands” come mainly in the form of the counterfeits and knockoffs often sold at outdoor markets.

On a recent weekday at the Henan Street flea market, crowds sifted through stacks of clothes that included $3 T-shirts with images of Minnie Mouse and $5 imitation Nike sports jerseys. Just a few yards away, an authentic Nike store selling the real thing for $35 had nary a shopper. Because consumers have so little spending power, many global-brand companies do not even bother to open stores in cities like Jilin.

With the faltering economies of the United States, Europe and Japan limiting China’s ability to continue relying on growth through exports, the Chinese government knows the importance of giving its own consumers more buying power. Already, the central government has pushed to raise rural incomes and has even offered subsidies to buy cars and [household appliances](http://english.peopledaily.com.cn/90001/90776/7372604.html).

The question is whether the government can change its entrenched economic system enough to truly make a difference. “The central government is committed to increasing the share of consumption in G.D.P.,” says Li Daokui, a professor of economics at Tsinghua University and a longtime government adviser. “The issue is what is going to be the means.”

THE SAVERS

Frugality Born

Of Necessity

If China is to make consumer spending a much larger share of the economy, it will need to encourage big changes in the habits of people like Mr. Wang, 52, a highway design specialist, and Ms. Wang, also 52, who retired as an accountant seven years ago because of health problems.

“We’re quite traditional,” says Ms. Wang, who draws a pension. “We don’t like to spend tomorrow’s money today.”

But tomorrow’s money may not be worth as much as today’s — not as long as their savings account earns only a 3 percent interest rate while inflation lopes along at 6 percent or more.

Yet the Wangs see no good alternatives to stashing nearly two-thirds of their monthly income in the bank. They are afraid to invest in China’s notoriously volatile stock market. And Chinese law sharply limits their ability to invest overseas or otherwise send money outside the country.

Nor do the Wangs feel flush or daring enough to join the real estate speculation that some Chinese now see as one of the few ways to get a return on their money — risky as that might prove if the bubble bursts.

Mainly, like many in China, the Wangs save because they worry about soaring [food prices](http://topics.nytimes.com/top/reference/timestopics/subjects/f/food_prices/index.html?inline=nyt-classifier) and the high cost of health care, which the People’s Republic no longer fully provides. They also worry about whether they can afford to buy a home for their son, a cost that Chinese parents are expected to bear when their male children marry.

“If you have a daughter, it’s not so expensive,” Wang Shue said. “But with a son you have to save money.”

Housing prices have become crucial in pushing up savings rates. Here, too, analysts say government policies are shifting wealth away from households.

In the case of the Wangs, they are being forced to move to make way for a new real estate development authorized by municipal authorities — the sort of project that local governments throughout China have come to regard as an easy source of riches.

Although the Wangs and other current residents have received some cash compensation for the apartments they are leaving, the Jilin City government has sold the land to a developer that plans to demolish the current dwellings and erect a new complex with more, and more expensive, apartments.

The Wangs are not sure they will be able to find a home comparable to their current apartment from the money they are being paid. But the developer and the local government are expected jointly to earn a profit of more than $50 million.

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A POLICY’S HISTORY

Averting a Crisis,

But Forming a Habit

Why would China, which hopes eventually to surpass the United States as the world’s biggest economy, deliberately suppress the consumer market that might help it reach that goal?

Some analysts trace the current policies to habits formed in the late 1990s. That’s when the bloat of China’s giant, uncompetitive state-run corporations nearly brought China’s economic expansion to a standstill. Suddenly, with state-owned companies facing bankruptcy, the state banks were saddled with hundreds of billions of dollars in nonperforming loans; many banks faced insolvency.

To avert a crisis, Beijing allowed state-owned companies to lay off tens of millions of workers. In 1999 just one of those companies, the parent of PetroChina, a big oil conglomerate, announced the layoff of a million employees. And to shore up the banks, Beijing assumed tighter control over interest rates, which included sharply lowering the effective rates paid to depositors. A passbook account that might have earned 3 percent in 2002, after inflation, would today be effectively losing 3 to 5 percent, once inflation is factored in.

That is how Chinese banks can provide extremely cheap financing to state-owned companies while still recording huge profits. It has also helped the banks provide easy financing for big public works projects, which besides the high-speed train system have included the 2008 Beijing Olympics and the monumental Three Gorges Dam.

It was during this same period that the Communist government discarded the longstanding “iron rice bowl” promise of lifelong employment and state care. Beijing shifted more of the high costs of social services — including housing, education and medical care — onto households and the private sector.

Together, these measures added up to the managed-market system now known as state capitalism. They worked so well that they not only helped resuscitate China’s failing banks and state companies, but also fueled the nation’s economic boom for more than a decade. But the system also took an enormous economic toll on personal pocketbooks.

“We’d like to spend, but we really have nothing left over after paying the bills,” said Yang Yang, 34, a school administrator who lives in Jilin City with her husband, a police officer, and their son, 10. “Even though our son goes to a public school, we need to pay fees for after-school courses, which everyone is expected to take. Almost every family will do this. So there’s a lot of pressure on us to do it, too.” To save money, Ms. Yang, her husband and son recently moved in with her parents.

Nicholas R. Lardy, an economist at the Peterson Institute for International Economics in Washington, calculates that the government policies exacted a hidden tax on Chinese households that amounted to about $36 billion in 2008 alone — or about 4 percent of China’s gross domestic product. Over the last decade, Mr. Lardy says, that figure probably amounted to hundreds of billions of dollars — money that banks essentially took from consumers’ hands.

The distortions may have actually cost households far more, because his figures do not include hidden costs like artificially high prices for imports.

For many Chinese economists, the state capitalism that helped jump-start growth has become counterproductive.

“China is already beyond the point where the law of diminishing returns starts biting,” said Xu Xiaonian, an economist who teaches at the China Europe International Business School in Shanghai.

Mr. Xu argues that China risks repeating the mistakes Japan made in the 1980s and early 1990s, when it relied too long on a predominantly export economy, neglected domestic markets and allowed real estate prices to soar. Since Japan’s bubble burst in the mid-1990s, its economy has never really recovered.

“If we don’t change, we will follow those same footsteps,” Mr. Xu said. “We have already seen the early signs of what we might call the Japanese disease. China invests more and more, but those investments generate less and less growth.”

PREDICTIONS FOR CHANGE

A Radical Overhaul,

But Within Reach

Some economists predict major changes, noting that the Chinese government has the cash and the power to alter course as drastically as it did in the late ’90s, this time in the people’s favor.

“China has faced more daunting challenges in the past,” said Wei Shangjin, a professor at the Columbia Business School. “I don’t doubt that they want to do it. The question is, Can they successfully engineer such a major restructuring of the economy?”

Certainly, multinationals like McDonald’s, Nike and Procter & Gamble are still betting billions of dollars that China will grow into the world’s biggest consumer market within a few decades.

But raising consumption will require a radical overhaul of the Chinese economy — not just weaning state banks off household subsidies but forcing state-run firms to pay much higher borrowing rates. It would also mean letting the currency rise closer to whatever value it might naturally reach. It would mean, in other words, a significant dismantling of the state capitalism that has enabled China to come so far so fast. “To get consumption to surge,” said Mr. Pettis, the Peking University lecturer, “you need to stop taking money from the household sector.”

# Building Boom in China Stirs Fears of Debt Overload



An empty lot in Wuhan, China, where developers intend to build a tower taller than the Empire State Building in New York.

<http://www.nytimes.com/interactive/2011/07/07/business/global/wuhan-china-construction.html?ref=global#14>

###### By [DAVID BARBOZA](http://topics.nytimes.com/top/reference/timestopics/people/b/david_barboza/index.html?inline=nyt-per)

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WUHAN, China — In the seven years it will take New York City to build a two-mile leg of its long-awaited Second Avenue subway line, this city of nine million people in central [China](http://topics.nytimes.com/top/news/international/countriesandterritories/china/index.html?inline=nyt-geo) plans to complete an entirely new subway system, with nearly 140 miles of track.

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A bridge under construction in Wuhan, China.

And the Wuhan Metro is only one piece of a $120 billion municipal master plan that includes two new airport terminals, a new financial district, a cultural district and a riverfront promenade with an office tower half again as high as the Empire State Building.

The construction frenzy cloaks Wuhan, China’s ninth-largest city, in a continual dust cloud, despite fleets of water trucks constantly spraying the streets. No wonder the local Communist party secretary, recently promoted from mayor, is known as “Mr. Digging Around the City.”

The plans for Wuhan, a provincial capital about 425 miles west of Shanghai, might seem extravagant. But they are not unusual. Dozens of other Chinese cities are racing to complete infrastructure projects just as expensive and ambitious, or more so, as they play their roles in this nation’s celebrated economic miracle.

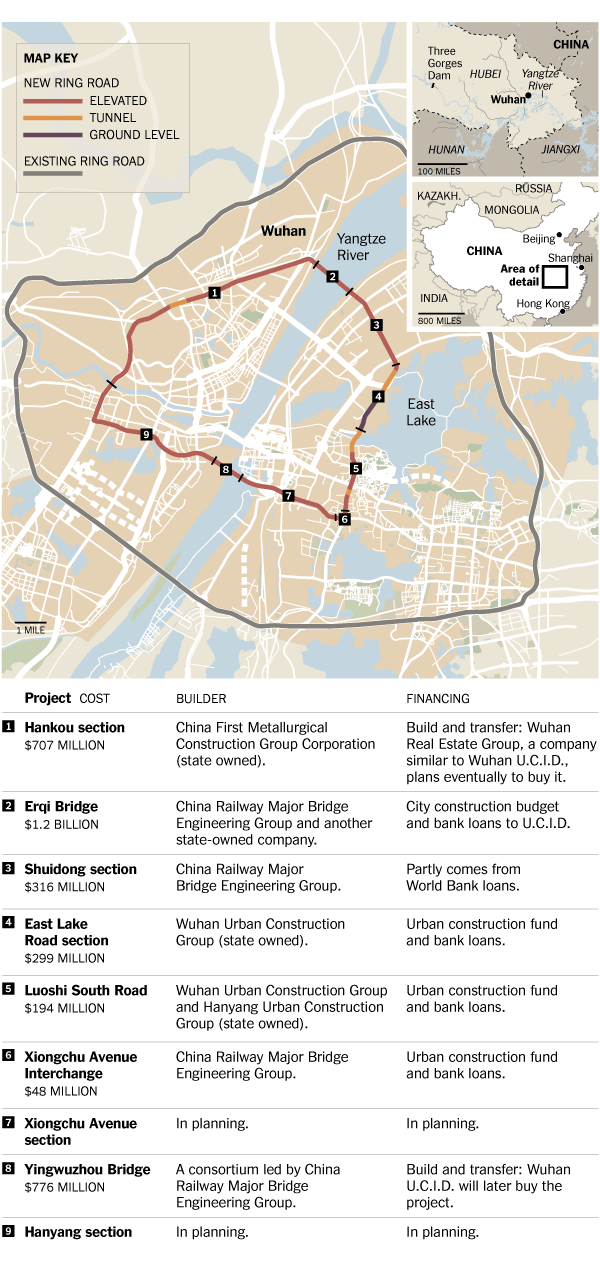
In the last few years, cities’ efforts have helped government infrastructure and real estate spending surpass foreign trade as the biggest contributor to China’s growth. Subways and skyscrapers, in other words, are replacing exports of furniture and iPhones as the symbols of this nation’s prowess.

But there are growing signs that China’s long-running economic boom could be undermined by these building binges, which are financed through heavy borrowing by local governments and clever accounting that masks the true size of the debt.

The danger, experts say, is that China’s municipal governments could already be sitting on huge mountains of hidden debt — a lurking liability that threatens to stunt the nation’s economic growth for years or even decades to come. Just last week China’s national auditor, who reports to the cabinet, [warned of the perils](http://www.nytimes.com/2011/06/28/business/global/28iht-yuan28.html) of local government borrowing. And on Tuesday the Beijing office of Moody’s Investors Service issued a report saying the national auditor might have understated Chinese banks’ actual risks from loans to local governments.

# Building a Ring Road in China

To ease traffic congestion as Wuhan, China, pursues ambitious development projects, the city is building a new ring road. But the work, divided into project segments, is being financed in complex ways that some analysts say pose risks to the local government. In one method, called build and transfer, the builder pays for the work with the plan to later sell it to the city. Under another technique, the city sets up a separate entity to borrow money for the projects — debt that shows up nowhere on the city’s official balance sheet. Wuhan Urban Construction Investment and Development is the city’s largest such entity.



Because Chinese growth has been one of the few steady engines in the global economy in recent years, any significant slowdown in this country would have international repercussions.

As municipal projects play out across China, spending on so-called fixed-asset investment — a crucial measure of building that is heavily weighted toward government and real estate projects — is now equal to nearly 70 percent of the nation’s [gross domestic product](http://topics.nytimes.com/top/reference/timestopics/subjects/u/united_states_economy/gross_domestic_product/index.html?inline=nyt-classifier). It is a ratio that no other large nation has approached in modern times.

Even Japan, at the peak of its building boom in the 1980s, reached only about 35 percent, and the figure has hovered around 20 percent for decades in the United States.

China’s high number helps explain its meteoric material rise. But it could also signal a dangerous dependence on government infrastructure spending.

“If China’s good at anything, it’s infrastructure,” said Pieter P. Bottelier, a China expert at the Johns Hopkins School of Advanced International Studies in Washington. “But right now it seems the investment rate is too high. How much of that is ill-advised and future nonperforming loans, no one knows.”

For the last decade, as economists have sought to explain China’s rise, a popular image has emerged of Beijing technocrats continually and cannily fine-tuning the nation’s communist-capitalist hybrid. But in fact, city governments often work at odds with Beijing’s aims. And some of Beijing’s own goals and policies can be contradictory.

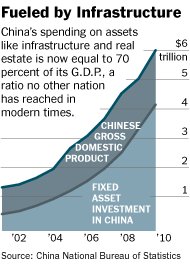
As a result, China’s state capitalism is much messier, and the economy more vulnerable, than it might look to the outside world.

In the case of Wuhan, a close look at its finances reveals that the city has borrowed tens of billions of dollars from state-run banks. But the loans seldom go directly to the local government. Instead, the borrowing is done by special investment corporations set up by the city — business entities whose debt shows up nowhere on Wuhan’s official financial balance sheet.

Adding to the risk, the collateral for many loans is local land valued at lofty prices that could collapse if China’s real estate bubble burst. Wuhan’s land prices have tripled in the last decade.

The biggest of the separate investment companies set up by the municipal government here is an entity known as Wuhan Urban Construction Investment and Development, created to help finance billions of dollars’ worth of projects, including roadways, bridges and sewage treatment plants.

According to city records, Wuhan U.C.I.D. has 16,000 employees, 25 subsidiaries and $15 billion in assets — including the possibly inflated value of the land itself. But it owes nearly as much, about $14 billion.



“U.C.I.D. is heavily in debt,” a company spokesman, Sun Zhengrong, conceded in an interview. “This may lead to potential problems. So we are trying to make some adjustments.” He declined to elaborate, saying the state company’s finances were “our core secret.”

Dozens of other cities are following a similarly risky script: creating off balance-sheet corporations that are going deeply into debt for showpiece projects, new subway systems, [high-speed rail](http://topics.nytimes.com/top/reference/timestopics/subjects/h/high_speed_rail_projects/index.html?inline=nyt-classifier) lines and extravagant government office complexes. And they are doing it despite efforts by the central government in Beijing to rein in the excess.

To limit the cities’ debt, Beijing has long prohibited municipalities from issuing bonds to finance government projects — as American cities do as a matter of course. Lately, too, China’s central government has put tighter limits on state-owned banks’ lending to municipalities. But by using off-the-books investment companies, cities have largely eluded Beijing’s rules.

Zhang Dong, a municipal government adviser who also teaches finance at the Zhongnan University of Economics and Law in Wuhan, estimates that less than 5 percent of the city’s infrastructure spending comes from Wuhan’s general budget. “Most of it comes from off-the-books financing,” he said.

This system is not a secret from Beijing, which now says there are more than 10,000 of these local government financing entities in China. In fact, because Beijing now takes a large share of government tax revenue, local governments have had to find their own way to grow, and land development is primarily how they have done it.

But it is a risky game. A recent report by the investment bank UBS predicted that local government investment corporations could generate up to $460 billion in loan defaults over the next few years. As a percentage of China’s G.D.P., that would be far bigger than the $700 billion troubled-asset bailout program in the United States.

As frightening as that may sound, many analysts see no reason for panic — no imminent threat of an economy-collapsing banking crisis in China. That is largely because of Beijing’s $3 trillion war chest of foreign exchange reserves (much of it invested in United States Treasury bonds), and the fact that China’s state-run banks are also sitting on huge piles of household savings from the nation’s 1.3 billion citizens.

Because all that cash is protected by government restrictions on money flowing in and out of the country, a global run on China’s banks would be unlikely.

The real problem, analysts say, is that municipal government debt in China has begun casting a large shadow over the nation’s growth picture. If instead of investing in growth, China had to start spending money to gird the banks against municipal defaults, some experts see a possibility of China eventually lapsing into a long period of Japan-like stagnation.

**A Recession Peril**

Kenneth S. Rogoff, a Harvard economics professor and co-author of “This Time Is Different: Eight Centuries of Financial Folly,” has studied China’s boom. He predicts that within a decade China’s lofty property bubble and its mounting debts could cause a regional [recession](http://topics.nytimes.com/top/reference/timestopics/subjects/r/recession_and_depression/index.html?inline=nyt-classifier) in Asia and stifle growth in the rest of the world.

“With China, you have the ultimate ‘this time is different’ syndrome,” Professor Rogoff said. “Economists say they have huge reserves, they have savings, they’re hard-working people. It’s naïve. You can’t beat the odds forever.”

By Beijing’s estimate, total local government debt amounted to $2.2 trillion last year — a staggering figure, equal to one-third of the nation’s gross domestic product. A wave of municipal defaults could become a huge liability for the central government, which is sitting on about $2 trillion in debt of its own.

And Beijing’s estimate of what the cities owe might be too low, in the view of Victor Shih, a professor of political economy at Northwestern University who has studied China’s municipal debt. He says that by now, after even more borrowing in early 2011 and some figures hidden from government audits, total municipal debt in China could be closer to $3 trillion.

“Most of the government entities that borrow can’t even make the interest payments on the loans,” Professor Shih said.

Around the clock, seven days a week, the construction crews burrow to build Wuhan’s $45 billion subway system. One segment snakes beneath the mighty Yangtze River.

“For most areas we dig down 18 to 26 meters,” said Lin Wenshu, one of the planning directors of the Wuhan Metro. “But for part of this line we’ve had to go down 50 meters because there’s high pressure and a lot of mud from the river,” he said. “But the citizens want a subway system, and so we’re going to build it as fast as possible.”

[](http://www.nytimes.com/interactive/2011/07/07/business/global/wuhan-china-construction.html?ref=global)

In all, city officials say there are more than 5,700 construction projects under way in Wuhan. In some neighborhoods, workers demolish old homes with little more than sledgehammers and their bare hands to make way for shopping malls, high-rise apartment complexes and new expressways.

Having seen Beijing, Shanghai and other coastal metropolises thrive on big infrastructure projects, cities thousands of miles inland, like Wuhan, are trying to do likewise. Wuhan wants to become a manufacturing and transportation hub for the heartland — China’s version of Chicago.

But it is a dream built on debt. This year, relying largely on bank loans, Wuhan plans to spend about $22 billion on infrastructure projects, an amount five times as large as the city’s tax revenue last year. And aspirations notwithstanding, Wuhan is still relatively poor. Residents here earn about $3,000 a year, only about two-thirds as much as those in Shanghai.

But Wuhan has made the most of the soaring value of its land. In the northwest part of the city, for example, bulldozers have cleared a huge tract more than twice the size of Central Park. A dozen years ago it was a military air base.

Giant billboards advertise a new purpose: future home of the Wangjiadun Central Business District, featuring office towers and luxury apartments for 200,000 people. That assumes, of course, that financing for the project — a web of loans and deals based largely on the underlying value of the land — holds up.

Planning began in 1999, when the city decided to relocate the air base. After the city ran short of cash for the project, in 2002, it turned to a deep-pocketed Beijing developer, the Oceanwide Corporation. Oceanwide agreed to chip in $275 million and pay some of the infrastructure costs in exchange for a prime piece of the land.

Since then, the city has sold large plots of the former air base to other developers, while earmarking yet other parcels for future sale to help pay for the new business district.

There is no question that China needs new infrastructure and transportation networks if it is to meet its goal of transforming most of its huge population into city dwellers. Less certain is whether the country can afford to keep building at this pace, and whether many of these projects will ever pay off in terms of the economic development they are meant to support.

Beijing helped ratchet up the municipal building boom in early 2009, when in response to the global recession, it pressed local governments to think big and announced a huge economic [stimulus package](http://topics.nytimes.com/top/reference/timestopics/subjects/u/united_states_economy/economic_stimulus/index.html?inline=nyt-classifier). That unleashed a wave of government-backed bank lending.

“What we’re seeing was not very common before 2008,” said Fu Zhihua, a research fellow at the Research Institute for Fiscal Science. “Now, all cities are rushing headlong into this.”

And now, try as it might, Beijing seems unable to stop the stampede.

Part of the problem may be incentives in China’s Politburo-driven economic system. Simply put, municipal officials in China keep their jobs and earn promotions on the basis of short-term economic growth.

“The fact is, local governments in China compete to grow G.D.P. in order to get promoted as government officials,” said Zeng Kanghua, who teaches finance at the Central University of Finance and Economics in Beijing.

Ruan Chengfa, Wuhan’s 54-year-old local Communist party secretary, who was promoted earlier this year from mayor, has certainly benefited politically from his “Mr. Digging” reputation.

He declined to be interviewed for this article. But in a speech in February, he said, “If we want Wuhan to have leapfrog development and enhance people’s happiness, then we must build subways and bridges.”

**Pressure From Beijing**

Wuhan is starting to show symptoms of financial stress.

Despite selling about $25 billion worth of land over the last five years, according to Real Capital Analytics, a research firm based in New York, Wuhan is struggling to pay for its projects. City officials have announced a big increase in bridge tolls. Under pressure from Beijing to reduce Wuhan’s debt, they have promised to pay back $2.3 billion to state-backed creditors this year.

Whether the city would do this by borrowing more money or selling land or assets is unclear. But rolling over old debts with new borrowing is not uncommon among Chinese cities. In 2009, for instance, Wuhan’s big investment company, Wuhan U.C.I.D., borrowed $230 million from investors and then used nearly a third of the money to repay some of its bank loans.

Mainly, Wuhan’s leaders are counting on property prices to continue defying gravity, even if some analysts predict a coming crash.

In a report this year, the investment bank Credit Suisse identified Wuhan as one of China’s “top 10 cities to avoid,” saying its housing stock was so huge that it would take eight years to sell the residences already completed — never mind the hundreds of thousands now under construction.

But criticism has not deterred Mr. Ruan, the local party secretary, who has vowed to keep his foot on the shovel. “If we don’t speed up construction,” he said in the speech in February, “many of Wuhan’s problems won’t be solved.”

## China's Debt Monster

#### Introduction



The Wuhan Railway Station connects high-speed trains from Wuhan to other large cities in China.

China's booming economy has been showing [signs of slowing down](http://www.nytimes.com/2011/06/21/business/global/21yuan.html) in recent months. Some economists say this is linked in part to [rising levels of local government debt,](http://www.nytimes.com/2011/07/07/business/global/building-binge-by-chinas-cities-threatens-countrys-economic-boom.html) which is the result of aggressive spending for projects like new airports, business districts or [high-speed railways](http://www.nytimes.com/2011/06/23/business/global/23rail.html). These ventures have helped China modernize and prepare for future growth, but are financed through [borrowing and complex accounting techniques](http://www.reuters.com/article/2011/06/01/china-banks-idUSL3E7H10FS20110601) that hide the true size of the debt.

Is China's spending on huge public works a worthwhile investment, or does the accumulating debt pose a threat to the Chinese economy?

### Pumping Up the G.D.P.

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[**Yasheng Huang**](http://web.mit.edu/yshuang/www/) is professor of international management at Sloan School of Management, Massachusetts Institute of Technology. He is the author of “Capitalism With Chinese Characteristics.”

Many Western economists heralded China’s massive stimulus program as proactive and decisive. They had no idea just how proactive and decisive the Chinese government was. The local governments have piled on their own programs. One estimate is that these local investment platforms have accumulated massive debts in the neighborhood of 7 to 9 trillion renminbi (equivalent to about 1 to 1.39 trillion dollars).

One theory is that these investments help prepare for the coming wave of urbanization. This is a myth.

But few analysts stopped and asked: Why should China, a country credited for having a vibrant middle class, a huge internal market and a rapid pace of wealth-creating urbanization, undertake a stimulus program larger both in relative and absolute terms than the stimulus program in the United States, which was at the epicenter of the financial crisis?

The answer is that China’s middle class is far less vibrant than commonly assumed; its internal market (relative to its G.D.P.) is actually modest, and its urbanization is rapid but not wealth-creating. In the face of a precipitous collapse of the demand for exports, the country resorted to the only thing it knew how to do -- embark on a government-organized, debt-financed investment binge to raise the G.D.P.

One theory is that all of these investments are made to prepare for the coming wave of urbanization. This is a myth. The Chinese cities do not lack buildings, which they have in surplus. The cities lack people. Beijing and Shanghai have some of the lowest population densities among the world’s big metropolises. The current infrastructure is more than adequate to accommodate China’s urbanization.

It is likely that a sizable portion of this investment binge is sheer waste and will surely end up as non-performing loans on the banks’ balance sheets. The Chinese term for crisis comprises of two words: danger and opportunity. The corrupt local officials saw abundant opportunities to amass wealth for themselves, and the central government completely lost sight of the inherent danger. The structural distortions of the Chinese economy grew worse and the government did exactly what it should not have done: It wasted a perfectly good crisis.

### Serious, but Not Devastating

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[**Yang Yao**](http://www.world-economics-journal.com/Contents/AuthorDetails.aspx?AID=335) is the director and professor at the China Center for Economic Research, Peking University.



Erqi Bridge under construction in Wuhan in April.

The slowdown in China is an intended consequence of the Chinese government’s efforts to cool the economy. The signs of slowdown actually show that the authorities have been effective in achieving their goals. If there were signs of a hard landing, the central government would have eased its control on credit expansion.

Even if the central government is determined to continue its tight monetary policy, local governments will voice loud complaints and force the central government to think twice.

However, the accumulation of local government debts is a serious problem. According to People's Bank of China’s recent report on regional financial development, local governments have accumulated a total debt of 14 trillion yuan through the “local government financing platforms.” Many people believe that a large chunk of this debt will not be repaid.

China is repeating what happened in the early 1990s when local governments established many trust funds and other financial companies.

China is repeating what happened in the early 1990s when local governments established many trust funds and other financial companies. One consequence of that financial expansion was that non-performing loans reached the equivalent of one fourth of China’s G.D.P. by the end of 1990s. Indeed, the four large state-owned banks were technically in bankruptcy. Nevertheless, the Chinese economy did not collapse. The main reason was that thanks to enterprise reform and China’s admission to the World Trade Organization, the Chinese economy was able to grow so fast that the government could write off the non-performing loans without much pain.

This time around, the amount of non-performing loans is likely to be larger than last time, but the Chinese economy has become even larger. Therefore, non-performing loans alone will not cause the Chinese economy to experience a sharp downturn. In addition, the central government has tightened control on loans issued to local governments, so the problem will not get worse.

The Chinese economy does not have serious problems with its fundamentals. Once government investment slows down, private investment will pick up. We can expect the Chinese economy to continue growing at a reasonable rate in the next few years.

### Where Is This Train Going?

July 6, 2011

[**Michael Pettis**](http://mpettis.com/about/) is a professor of finance at the Guanghua School of Management at Peking University and a senior associate of Carnegie Endowment.

For the past decade, analysts have been able to describe economic conditions in China with some accuracy but have failed generally to understand the underlying growth dynamics. We’ve done a great job, in other words, of describing the landscape through which the train is passing, but because we don’t understand where the train is headed we are constantly shocked when the landscape changes.

Unless China can change its economy’s underlying dependence on accelerating investment, the debts won't go away.

It should have been clear for many years that China’s investment-driven growth model was leading to unsustainable increases in debt. As recently as two years ago, most analysts were ecstatically – and mistakenly – praising the country’s incredibly strong balance sheet. But when Victor Shih's analysis of local government borrowing came out last year, the mood began to change. Now the market has become obsessed with municipal debt levels.

But dangerously high levels of municipal debt are only a manifestation of the underlying problem, not the problem itself. Even if the financial authorities intervene, unless they can change the economy’s underlying dependence on accelerating investment, it won’t matter. They will simply force the debt problem elsewhere.

In all previous cases of countries following similar growth models, the dangerous combination of repressed pricing signals, distorted investment incentives, and excessive reliance on accelerating investment to generate growth has always pushed growth past the point where it is sustainable, leading to capital misallocation and waste.

China’s problem now is that the authorities can continue getting rapid growth only at the expense of ever riskier increases in debt. Eventually, they will choose to curtail investment sharply, or the excessive debt will force them to do so. When that day arrives, they can expect many years of growth well below even the most pessimistic current forecasts.

But not yet. High investment-driven growth is likely to continue for at least another two years.

### The Investment Will Pay Off

July 7, 2011

[**Shuanglin Lin**](http://cba.unomaha.edu/dir/HomePagebio.cfm?id=34) is the Noddle distinguished professor of economics at the college of business administration at the University of Nebraska Omaha. He is also the chairman of the department of public finance in the school of economics at Peking University.

In China, local governments do not have the right to issue bonds or establish their own tax laws. Local governments received only a small proportion of total government revenue, but undertake a large proportion of government expenditure. They rely on central government transfers to balance their budgets.

China’s total government debt is actually much smaller than it was 10 years ago.

Besides the formal budget, local governments have an informal account, which is not transparent. This account includes revenue raised through fee collections, land sales and borrowing from banks through local government financing platforms. The revenue from this account is used for local governments' preferred projects. Local government debt comes from this informal account. At the moment, one should not be worried too much about local government debt.

China’s total government debt is much smaller than it was 10 years ago. Back in 2001, it was about 70 percent of G.D.P., including explicit central government debt (16 percent) and banks’ non-performing loans (41 percent). Now, China’s government debt is around 50 percent of G.D.P., including explicit central government debt (18 percent) and implicit local government debt (25 percent).

Most of the local government public projects such as new airports, transportation systems, local water and sewer systems, and other local utilities are worthwhile investments. Many projects will bring revenues to local governments in the future.

Serious measures have been taken to curb the local government debt. The central government has announced regulations on local government financing platforms and forced local governments to reduce their debt. The government successfully reduced state banks’ non-performing loans from 41 percent of G.D.P. in 2001 to less than 2 percent now. Similarly, it can reduce local government debt.

Local governments have many assets, such as urban land and assets of local state-owned enterprises, which can be used to repay the debt.

The central government may reform the fiscal system and allow local governments to have more revenues through increasing the revenue share of local governments and allowing local governments to collect new taxes, such as personal property taxes. The increased revenues can also be used to repay debt.

Overall, China’s local government debt is large but manageable. As industrialization and urbanization proceed, local governments will play a more important role in urban development. Infrastructure investment will stimulate China’s future economic growth and help China modernize.

### A Time Bomb

July 6, 2011

[**Lina Song**](http://www.nottingham.ac.uk/sociology/stafflookup/lina.song) is a professor of economic sociology and social policy at the University of Nottingham.

Local government debt in China is a time bomb waiting to go off. In 2008 alone, propelled by the central government's stimulus package, local government debt grew by 62 percent. Seventy-nine percent of that borrowing consists of bank loans. This poses a threat to an already weak Chinese banking system.

For poorer areas, a sharp reduction of local public investment would mean a drop in employment and a rise in poverty.

The level of local government debt is not necessarily unsustainable. Most of it is used for business investment. Fifty percent of the debt goes to the most productive region of the country -- China's eastern provinces. And most of it is used to finance spending on assets: 62 percent went to infrastructure (urban development, airports, transportation, etc.) and 11 percent to land reservations. It is possible that some assets could be sold for debt repayment, but investment values for local government would be reduced and other debts would remain.

With these debts, tension between the central and local governments may rise when China enters the post-stimulus period. As central funding becomes more scarce, negotiations over transfer payments to local governments will become fiercer.

For poorer areas, a sharp reduction of local public investment would mean a reduction in employment and a rise in poverty. Small- and medium-sized firms in the private sector will suffer the most from a lack of available bank loans as lending policy is tightened to reduce high inflation. Bankruptcies for these firms have already began to soar and the consequences are concerning. The recent riot between Sichuan migrant workers and Chaozhou entrepreneurs in Guangdong arose because a firm was short of funds to pay its workers. Reports show many similar firms are nearing bankruptcy.

Reduced investment will slow China's G.D.P. growth. The impact of the international recession on Chinese economy, although delayed, will eventually appear. Crisis is the spur for change. Will the challenges be met? Only time will tell.

### Addicted to Subsidies

July 6, 2011

[**Derek Scissors**](http://www.heritage.org/about/staff/s/derek-scissors) is a research fellow in the Asian Studies Center at the Heritage Foundation.

Large-scale public works are almost always a bad idea, in China and everywhere else.

Deng Xiaoping’s recognition that the market creates prosperity has governed Chinese policy for 25 years, producing fast growth, a balanced economy and low debt. Starting about seven years ago, however, the state began again to intervene more aggressively in the economy and three years ago this intervention intensified, with a focus on infrastructure.

Wasteful spending on high-speed trains and other mega-projects will drive down investment returns. Didn't this happen in Japan?

We’re starting to see the results. As an accounting matter, deficit spending automatically adds to the G.D.P. while infrastructure projects create jobs. The problems come when it turns out that the infrastructure was chosen, as it almost always is, for short-term stimulus and not long-term return. What’s left after a few years is less stimulus and sizable debts.

There is a further risk of political addiction. Governments, national and local, can become dependent on public works, even when the gains go to a few and come with huge costs. Those who receive subsidies complain and fear an economic contraction should the subsidies end. This is what happened to Japan.

The threat to China is if the political addiction cannot be broken. China has powerful economic advantages and much room for growth through reform. But continuing with the wasteful, even dangerous, overspending on high-speed rail, urban zoning, and the like will drive investments returns lower and further strain the environment. China must choose to break away from infrastructure investment and return to market reform, or risk Japan’s fate.

The implication for the world economy is loss of potential benefits. China runs the world’s largest trade surpluses, so it subtracts from the rest of the world’s G.D.P. Chinese stagnation would therefore harm certain countries, but not the global economy. However, Chinese reform and rebalancing could bring another 20 years of consumption-led growth, a marvelous boon to the world economy. These are the stakes.

### China Needs More Public Works

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[**Albert Keidel**](http://www.acus.org/users/albert-keidel) is a senior fellow at the Atlantic Council and an adjunct professor at Georgetown University's Public Policy Institute.

Shiho Fukada for The New York Times A development site in Wuhan.

Because most of China's banks are state-owned or controlled, and because the stimulus program that initially prompted the large outlay of credit was a high priority government effort, local government debt that has resulted from this bank lending will cause neither a financial crisis nor a dramatic economic slowdown.

Across the board, much of the lending went to speed up infrastructure and other public investments that have long-term benefits for the country even if they don’t have significant financial returns.

Even before the Chinese State Council issued its June 2010 requirement that local governments “sort out” the debt obligations of investment platform companies in their jurisdictions, many local governments had already done just that.

Projects that were initially in the stimulus program to keep China growing during and after the financial crisis would be allowed to continue to completion with guaranteed government (local and central) support for their financing.

However, local projects that made use of the stimulus-era easy money but applied it to non-stimulus projects, especially those operated for a profit, have been denied such stimulus guarantees. In the end, those projects not backed by stimulus public investment plans could be in financial difficulty and cause an increase in bad bank loans. The first-tier losers would be those projects themselves. As for the banks, because they are largely state-controlled, their balance sheets may (or may not) show a degree of deterioration, but to surmise that this threatens their credit worthiness would be a mistake.

China’s public works investments are much needed and, if anything, still inadequate given China’s very low level of per-capita output and per-capita capital stock. At the very least, China’s economy will continue to grow in the very high single-digit range. The various rating agencies’ and bank analysts’ conclusions regarding the growth and financial health impact of these debts are overly fine-tuned, if not overwrought.

EIU

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# Second-quarter provincial growth

**As China's growth shifts into lower gear, the larger eastern provincial economies are bearing the brunt of the slowdown. Expansion in trade, investment and industrial production has slowed to—by national standards—a crawl. Inland provinces continue to outperform their coastal counterparts, much as they did in the aftermath of the 2008-09 downturn. Even though many western provinces are seeing a deceleration from their previously heady growth rates, they continue to maintain year-on-year GDP expansion of over 12%. They are also recording faster growth in disposable income and household consumption than the coastal provinces—a welcome development.**

Although one might expect that the poorest would be most adversely affected in periods of economic difficulty, this has not been the case in China. In the second quarter of the year, Beijing, Shanghai, Guangdong and Zhejiang—the country's political, financial and entrepreneurial capitals—continued to record the slowest GDP growth rates in the country at under 8% year on year, after falling below this threshold in the first quarter.

**Eastern exposure**

The eastern provinces were hit hardest because they are much more highly exposed to the property downturn and weakened external environment than the rest of the country. Property investment accounts for roughly one-half of total fixed asset investment in Beijing and Shanghai, for example, compared with less than 20% for poorer provinces, such as Hubei. The government's tightening of purchasing restrictions has been carried out with an eye towards more developed markets, where prices have skyrocketed in recent years. This, in turn, has caused construction and investment to grind to a halt.

The eastern seaboard is also more highly exposed to fluctuations in external demand, as many of its manufacturing facilities operate in export-processing. The industrial sector's struggles in eastern China are compounded by industrial transfer spurred by rising labour and land costs.

**Western advantages**

In contrast with the downturn in external demand in 2008-09, however, falling exports in the eastern provinces have been accompanied in 2012 by accelerated export growth in central and western provinces, to where a significant amount of manufacturing capacity has since relocated.

Chongqing, Henan and Sichuan, for example, have all recorded a breakneck pace of export expansion in the first half of the year. This has helped to soften the impact of the recent downturn on China's labour market, as migrant labourers forced out of work in the eastern provinces have instead been able to find employment inland.

Sweetened policy incentives and improved infrastructure to support inland trade, such as dredged rivers, expanded river ports and improved highways, have encouraged manufacturers to move inland. In July Chongqing and Henan saw export growth of 160% and more than 60% respectively, in sharp contrast to the 1% growth rate seen at the national level. Although they are growing from a much lower base, the expansion of trade in central and western provinces should continue as input costs remain lower and infrastructure improves.

More broadly, the west has remained fairly insulated from the wider downturn. Among the fastest-growing provinces are Shaanxi and Chongqing, which are at the centre of the national western development policy, and Guizhou, which has the lowest average GDP per head in the country. All three maintained annual growth rates above 13% in the second quarter. Growth in these provinces is spurred both by development from a low base and by continued central government backing, which ensures a steady flows of funds for infrastructure development.

Guizhou, for example, is now seeing huge outlays of industrial investment, as well as a massive government drive to develop tourism infrastructure. Property-related investment in July rose by a massive 90% year on year. Although the central government has made it clear that a lower national growth rate will be tolerated over this five-year period, the poorer western provinces will continue to benefit from strong policy support.

For instance, following the political upheaval that accompanied the removal in March 2012 of Bo Xilai, Chongqing's party secretary, state-owned enterprises signed contracts worth more than Rmb350bn (US$55.6bn) with the new municipal government.

**The poor get richer**

A further notable development is that growth in disposable incomes and consumption expenditure has picked up considerably in many inland provinces. For example, in the second quarter the south-western province of Yunnan saw expansion in disposable income per head and consumption expenditure of 14.3% and 18.3% respectively, outpacing real GDP growth of 12.6%.

By contrast, the eastern port municipality of Tianjin recorded expansion of just 10.8% in consumption expenditure and 10.1% in disposable incomes. Narrowing the income gap between coastal and inland provinces has long been a priority for the government; the fact that incomes and expenditure in inland provinces are now growing more quickly than on the coast will therefore be welcomed.

Although further loosening of monetary policy is expected in the coming months, it is unlikely to have much of an impact on the dominance of the western provinces in the growth league tables, which is driven by structural changes in China's economy. The interest rate cuts in mid-2012 spurred an uptick in property sales in Beijing and Shanghai, but the authorities have also made clear that they are not about to loosen property-purchasing restrictions.

As developers already have significant levels of inventory to clear, recent credit-easing moves are unlikely to generate a significant upsurge in construction activity. Indeed, a resurgence in property development would risk the reinflation of China's dangerously frothy property market.

Developing the services sector offers a more sustainable means of generating long-term growth in China's eastern provinces. Such a transition is under way (slowly); Shanghai is piloting tax reforms that should encourage the growth of smaller services enterprises, for example. However, such changes are slow and difficult, and much more complex than building an industrial centre.