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**Working Paper**

## State Intervention, Local Indebtedness, Investment Overheating and Their Systemic Background During Global Crisis in China

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MŰHELYTANULMÁNYOK

DISCUSSION PAPERS

**MT-DP – 2013/40**

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Investment Overheating and Their Systemic  
Background During Global Crisis in China**

MARIA CSANÁDI

Discussion papers  
MT-DP – 2013/40

Institute of Economics, Centre for Economic and Regional Studies,  
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State Intervention, Local Indebtedness, Investment Overheating  
and Their Systemic Background During Global Crisis in China

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# **State Intervention, Local Indebtedness, Investment Overheating and Their Systemic Background During Global Crisis in China**

Maria Csanádi

## **Abstract**

This paper focuses on the immediate economic and systemic reasons of steadily increasing local government indebtedness and investment overheating in China. These two phenomena emerged between 2008 and 2011 as a direct consequence of an external shock caused by the global crisis and the subsequent internal reaction in the form of intensified stimulating state intervention. New chances for resource distribution and investments through state intervention mobilized distribution priorities and politically rational economic behavior of actors, characteristic to party-state systems. Locations of mobilization were defined by the decentralized Chinese system specifics along the intertwined institutional party-state structure. Systemic characteristics and its Chinese specifics together resulted in investment overheating, and steadily growing local indebtedness through large and state-owned enterprises and local governments. This process was further amplified by the characteristics of transforming economy in China as actors in the private sphere were mobilized by the increased input demand of those privileged by the systemic priorities of state intervention.

**Keywords:** local indebtedness, crisis, party-state systems, resource distribution, state intervention, overheating

**JEL classification:** F5, D78, R58, J08, 015, E24

## **Acknowledgement:**

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# **Állami beavatkozás, helyi eladósodás, beruházás túlfűtöttség és rendszerbeli háttere Kínában a globális válság idején**

Csanádi Mária

## **Összefoglaló**

A cikk a Kínában kitartóan növekvő helyi eladósodás és túlfűtöttség közvetlen gazdasági, intézményi és rendszerbeli okaival foglalkozik. Ez a jelenség legutóbb 2009 és 2011 között vált érzékelhetővé a globális válság okozta külső sokk, és az azt követő belső reakció következményeként. Az állam 2008-ban nagyszabású élénkítő csomag bevetésével avatkozott be a gazdaságba, hogy kompenzálja a válság hatását. A forráshoz jutás új lehetőségei a gazdasági és gazdaságpolitikai döntéshozók pártállami rendszerben jellegzetes – politikailag racionális – gazdasági magatartását mobilizálták. A mobilizálódás lehangsúlyosabb területeit a kínai pártállam sajátosan decentralizált szerkezete határozta meg. Az általános pártállami rendszer, valamint a kínai pártállam sajátosságainak együttes következménye a beruházások túlfűtöttsége s a tartósan növekvő helyi eladósodás. Ezt a folyamatot felerősítik a kínai pártállami gazdaság átalakulási sajátosságai, amelyben a növekvő privát szféra szereplőit az állami beavatkozás rendszerszerű prioritásait élvező szereplők input igényei mozgósították.

**Tárgyszavak:** helyi eladósodás, pártállami rendszerek, forráselosztás, állami beavatkozás, túlfűtöttség

**JEL kódok:** F5, D78, R58, J08, 015, E24

## INTRODUCTION

China's crisis management between 2008 and 2011 proved to be successful. The national and local level responses to the global crisis met the original goals of compensating economic decline and decreasing export reliance. Different level governments and banks became promptly active, investments accelerated, economic indicators quickly improved, and unemployment rate soon dropped to the pre-crisis level. Infrastructural investments at prioritized central and western regions skyrocketed, attracting similar growth pace in manufacturing sector; moreover, input demands of preferred state owned enterprises activated the market field as well.

However, stimulating state intervention turned into overheating; budgetary expenditures increased in enormous pace; legal and illegal land-requisitions and land-use sales grew unlimited; expansion of local bank lending became hardly controllable; bad loans widely re-emerged; growth of local governments' indebtedness through fiscal vehicles increased steadily; bubbles developed in production and infrastructure-building requiring new state intervention. This paper deals with the above economic consequences on national and regional level. It argues that though the transformation of the Chinese economy advanced substantially towards the market, state intervention activates the characteristics of party-state systems and their Chinese specifics. These characteristics will catalyze the translation of economically rational goals into politically rational criteria of distribution and similar motivations in investment behavior of actors and institutions, both at national and local levels. These general and specific Chinese characteristics and according behavior will cause the overheating and the local government indebtedness.

Methodological concerns emerge in the analysis independent of the author's will. Data on investments connected to the stimulus package were not monitored separately. Only its elements at different dimensions of the economy may be traced and conjoined. Different statistical sources on the same indicator do not overlap. Even macro statistical data of the years concerned substantially change retrospectively in more recent publications of the National Bureau of Statistics (NBS). Severe scientific concerns regarding the reliability of such main macroeconomic data as GDP are repeatedly formulated (Rawski, 2001; 2009). Data on local indebtedness containing budgetary and off-budgetary items are not clearly discernible on local and national level. I did not have access to individual enterprise level census data, neither bank financial enterprise level data for local financial vehicles to empirically find out the amassed debts and non-performing loans by these local government founded enterprises. Regarding these issues, occasional publications are available, on

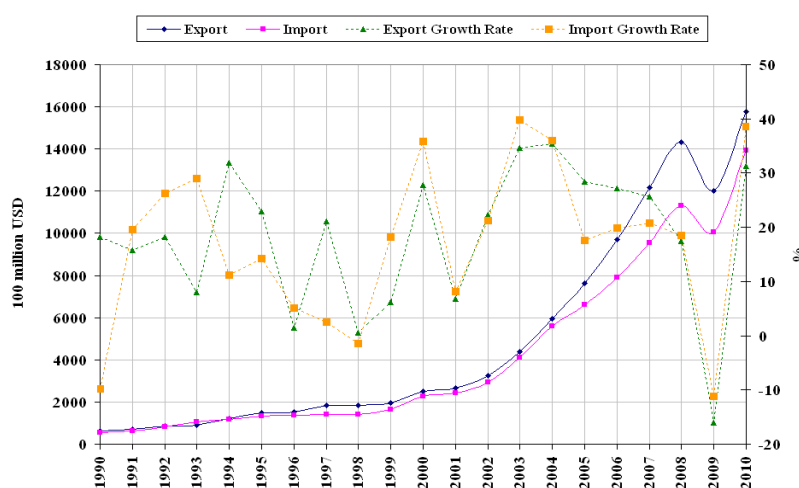
nationwide or partial deep drilling audits by the National Audit Office on different level governments' debt at the request of the State Council (2010, 2013). In between those occasions data are mostly estimations that range extremes. The main purpose of this paper is not an exact and complex statistical analysis of primary data on central sources, loans, debts, inflation, budgetary revenues, expenditures, bonds, land use sales, local financial vehicles etc in themselves. Neither is willing to analyze separately enterprise and government or bank behavior based on those primary data. Instead, both primary data and secondary sources serve together as means to interpret developments in the framework of a complex structural, functional, institutional and systemic setting. This approach allows us to give a systemic response to repeated overheating and steady local indebtedness in China. Next, we shall introduce the sensitivity of the Chinese economy to external shocks, its adaptation to those shocks and the economic and systemic consequences of that adaptation on national and local levels.

## SENSITIVITY TO GLOBAL DYNAMICS

Finely disaggregated data of 2008-2009 reveal short-lived but dramatically deep set-back in export, import, GDP and Gross Industrial Output Value (GOV) (Figure 1 and Figure 2).

*Figure 1.*

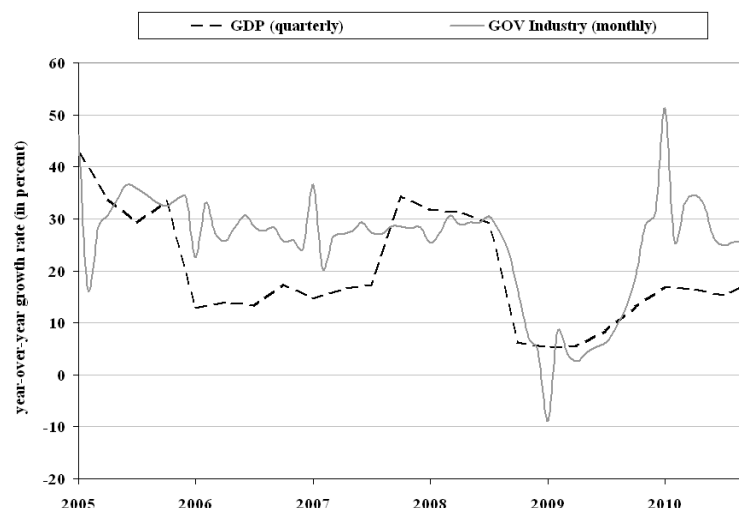
### Deep but short set-back in the dynamics of foreign trade and fast revival



Source: Michigan University China Data Center <http://chinadataonline.org/>

Figure 2.

### Deep but short set-back in the dynamics of GDP and GOV and fast revival



Source: Michigan University China Data Center <http://chinadataonline.org/>

Even yearly dynamics of the same indicators testify for substantial slow down or drop (Table 1). In 2008, the export growth slowed down to 17.2 percent from 26 percent in 2007, and in 2009 it precipitated to -16 percent. Meanwhile, by 2008 the GDP growth pace dropped to its two-thirds (from 14.2 percent in 2007 to 9.6) and slightly slowed further in 2009 to 9.2 percent. The pace of gross industrial output value (GOV) even more radically declined by 2009 to less than one third of its 2007 value. Due to shrinking export, the export ratio in the GDP steadily declined from 35.2 percent in 2007 to 32.0 in 2008 and 24.1 in 2009.

Table 1.

### Main economic indicators from 2007 to 2011

Percentage	2007	2008	2009	2010	2011
GDP y/y	14.2	9.6	9.2	10.4	9.3
Export y/y	26.0	17.2	-16.0	31.3	20.3
Export/GDP	35.2	32.0	24.1	26.7	26.1
GOV y/y	28.0	25.2	8.1	27.4	20.9

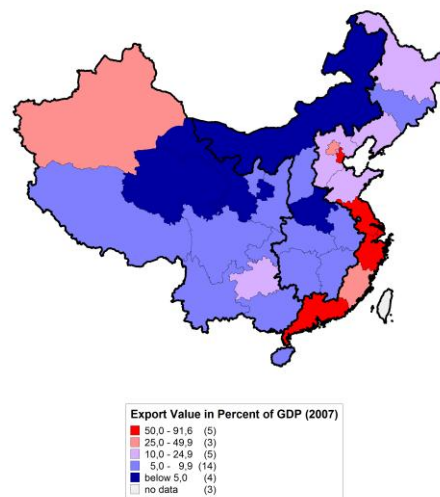
Source: China Statistical Yearbooks; GDP (Index of Gross Domestic Product): China Statistical Yearbook 2012, Table 2-4; Export (USD): China Statistical Yearbook 2012, Table 6-3; Export/GDP: own calculations based on GDP (yuan; CSY 2012, Table 2-1), export (USD; CSY 2012, Table 6-3; and Reference exchange rate of Renminbi to US Dollars (CSY 2012, Table 6-2); GOV: CSY, 2012, Table 14-4. <http://www.stats.gov.cn/english/statisticaldata/yearlydata/>



External shock proved to be regionally focussed to coastal provinces due to spatial concentration of the above-average Export/GDP (Map. 1). Regional concentration of export in 2008 attracted 71% of the migrants to the east, while 13.2 percent worked in the central provinces and 15.4 in the western provinces<sup>1</sup>. Regional sensitivity to global crisis was reflected in the sudden close-down of 600 thousand enterprises by late 2008,<sup>2</sup> most of them small and medium-sized enterprises located in the eastern region (Kong et al. 2009, 237). Partly as a result of regionally concentrated close-downs and migrant regional concentration, 16 percent of the 140 million migrants were suddenly laid off between late 2008 and early 2009 (Chan, 2010, p. 251).

Map 1.

### Regional distribution of Export/GDP size in 2007



Source: Michigan University China Data Center [http://: chinadataonline.org](http://chinadataonline.org)

Sudden lay-off and its regional and regional-sectoral concentration increased the frequency and number of participants of mass demonstrations and the radicalization of requests (Cai Y, 2008, 2010).

Forecasts were gloomy: the prevalence and expansion of the crisis was uncertain, reflected also in bottomed consumer confidence by the end of 2008, inflation of food prices (World bank, 2009).<sup>3</sup> Business confidence at the end of 2008 reached the lowest rate during

<sup>1</sup> For 2009 data, see China Migrants' Monitoring Report 2009 NBS, [http://www.stats.gov.cn/was40/gjtj\\_detail.jsp?channelid=33728&record=21](http://www.stats.gov.cn/was40/gjtj_detail.jsp?channelid=33728&record=21)

<sup>2</sup> Data do not only reflect the impact of the global crisis in 2008 but the Labor Law introduced in 2007 that required the fulfillment of several obligations to enhance the conditions of migrant labor drove many enterprises to close down even before the crisis.

<sup>3</sup> World Bank, Quarterly update, June, 2009 [http://www-wds.worldbank.org/external/default/WDSPContentServer/WDSP/IB/2009/06/18/000333037\\_20090618234810/Rendered/PDF/489910NEWSOP1110June020090quarterly.pdf](http://www-wds.worldbank.org/external/default/WDSPContentServer/WDSP/IB/2009/06/18/000333037_20090618234810/Rendered/PDF/489910NEWSOP1110June020090quarterly.pdf)

the last eight year (China.org.cn, 2009)<sup>4</sup>. Low were the chances of recovery and severe its impact on party legitimacy, strictly and institutionally intertwined with the economy (Csanádi, 2006; Bukley, 2009; Cai and Chan, 2009; Demick, 2008; Chan, 2010; Kong at al, 2009; Meng at al, 2010; Wong, S., 2008; Charter 2008; Chen N.; 2009, Yu 2009).

However, uncertainty soon withered away. The dramatic set-back was short-lived. From the second quarter of 2009 foreign trade boomed again (Figure 1 and Table 1): in 2010 export grew by 31.0 percent from -16.9 percent and 20.3 in 2011, the import to 38.8 percent from – 11.2 percent and further 24.9 in 2011. GDP growth was slower compared to export growth but also accelerated to 10.4 by 2010, while the pace of gross industrial output also substantially increased in 2010 after a dramatic slow down to 8 percent in 2009. Already by mid 2009 the unemployment rate among migrants dropped to 3 percent compared to the 16 percent of the previous two quarters' (Cai and Chan, 2009, 521) and by 2010, the growthrate of migrant employment rose to 5.53 percent from 3.5 percent of the previous year.<sup>5</sup>

What is behind the fast recovery? How can we explain the success of the economic policy to regenerate economic growth despite the persistence of the global crisis, and despite the export-, regional- and political sensitivity of the Chinese economy and the growing tensions in the society?

## **A PROMPT STATE INTERVENTION: THE INTRODUCTION OF A STIMULUS PACKAGE**

The set-back prompted the central and local government to immediately introduce regulations that would compensate losses and stimulate growth. However, the stimulus package introduced in November 2008 and supporting fiscal policy strongly exceeded the importance of those instruments (Schmidt and Heilmann 2010). The original amount of the stimulus package was planned to 4 trillion yuan for 2008-2010, about 13 percent of the 2008 GDP (Table 2), half of the ratio of export in the same.

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<sup>4</sup> Business confidence index pointer to recovery China.org.cn  
[http://www.china.org.cn/business/news/2009-07/10/content\\_18106881.htm](http://www.china.org.cn/business/news/2009-07/10/content_18106881.htm)

<sup>5</sup> China Development Report, [http://www.stats.gov.cn/tjfx/fxbg/t20120427\\_402801903.htm](http://www.stats.gov.cn/tjfx/fxbg/t20120427_402801903.htm).

Table 2.

**Break-down of the four trillion yuan Stimulus Package**

<b>Name</b>	<b>Billion Yuan</b>	<b>%</b>
<b>Public infrastructure</b>	<b>1,500</b>	<b>38</b>
<b>Post-earthquake reconstruction</b>	<b>1,000</b>	<b>25</b>
<b>Sustainable development</b>	<b>210</b>	<b>5</b>
<b>Rural development</b>	<b>370</b>	<b>9</b>
<b>Technology advancement</b>	<b>370</b>	<b>9</b>
<b>Social welfare</b>	<b>400</b>	<b>10</b>
<b>Educational projects</b>	<b>150</b>	<b>4</b>

Source: Compiled from Economic Observer On-line China's Stimulus Package:  
 A Breakdown of Spending  
[http://www.eeo.com.cn/ens/finance\\_investment/2009/03/07/131626.shtml](http://www.eeo.com.cn/ens/finance_investment/2009/03/07/131626.shtml)

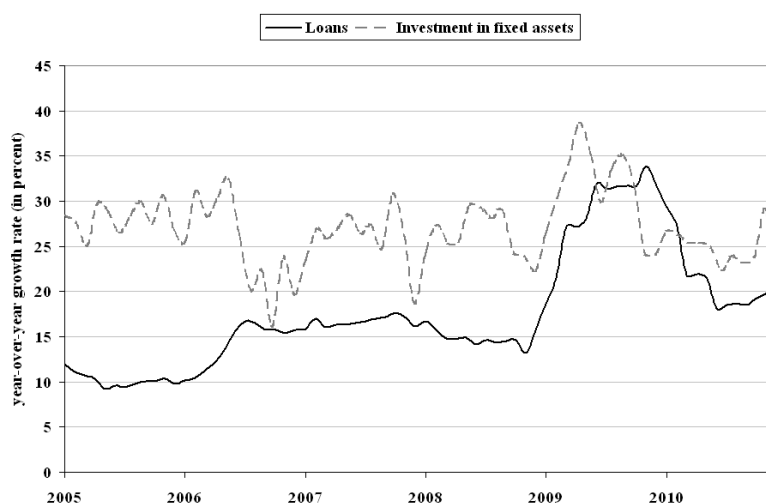
The main goal of the stimulus plan was to drift the production away from export orientation, by shifting regional and sectoral and trade focus, enterprise scale and ownership characteristics. Thus, it preferred investments in central and western regions, the origin of 80 percent of migrants (Small census, 2005 NBS), on domestic field rather than foreign, in construction sector instead of manufacturing, large and state owned enterprises rather than private small- and middle sized ones overwhelmingly foreign owned (Liu, 2009).

Prompt government reaction is reflected in the increased growth pace of overall investments already in 2008 (Table 3). Judging from CEIC World Bank estimates on state and private investments, the ownership priorities of the stimulus package were evident in the steep growth of governments' investment in fixed assets, compared to the decline of private investments in 2009 (World Bank, 2009, Fig. 2).

The announced package appointed nine sub-sectors to be supported in the manufacturing industry: light industry, textile industry, steel industry, other metal industry, car industry petrochemical industry, ship building, electronics and telecommunication (xinhuanet, 2008;). Still, two-thirds of the investments was focused on infrastructure building, including post-earthquake recovery and reconstruction, subsidised housing and public infrastructure (Table 2). Most of the loans were made to finance infrastructure projects under the control of local government urban development and infrastructure corporations (OECD 2009, 236).

Figure 3.

### Dynamics of loans and investments in fixed assets during crisis and stimulus



Source: Michigan University China Data Center <http://chinadataonline.org/>

Sectoral investment priorities on construction were clearly reflected in the sectoral investment data, where the pace of investment in construction increased in 2009 and so did the reacting boom of loans in the same year (Table 3). Meanwhile, the investment growth pace in the manufacturing sector, where the crisis hit the most, continuously slowed since 2007. The dynamics of foreign direct investment reflects the global consequences of the crisis, even shrinking in 2009.

Table 3.

### Dynamics of Investment and loans between 2007 and 2010 (y/y)

	2007	2008	2009	2010
<b>Investment y/y</b>	<b>32.1</b>	<b>40.6</b>	<b>26.0</b>	<b>20.2</b>
<b>Inv. manuf. y/y</b>	<b>30.6</b>	<b>27.4</b>	<b>24.5</b>	<b>25.5</b>
<b>Inv. constr.y/y</b>	<b>16.5</b>	<b>20.2</b>	<b>45.1</b>	<b>29.1</b>
<b>Loans y/y</b>	<b>46.5</b>	<b>28.1</b>	<b>102.6</b>	<b>1.7</b>
<b>FDI y/y</b>	<b>18.6</b>	<b>23.6</b>	<b>-2.6</b>	<b>17.4</b>

Source: Investment (Total investment in fixed assets, RMB): China Statistical Yearbook 2012, Table 5-7 inv. manuf, inv. constr (RMB): China Statistical Yearbook 2012, Table 5-7; loans (RMB): "Social Financing" from China Statistical Yearbook 2012, Table 19-11; FDI (Foreign Direct Investment Actually Utilized, USD): China Statistical Yearbook 2008, Table 17-15; 2009, Table 17-15; 2010, Table 6-14; 2011, Table 6-14; 2012, Table 6-14 China Statistical Yearbooks, <http://www.stats.gov.cn/english/statisticaldata/yearlydata/>

China's institutional structure and budgetary financing tasks are strongly decentralized. The overwhelming majority of public commitments, including infrastructure building are delegated to the level of local governments. Thus, sectoral priorities of the stimulus project and the decentralized nature of institutional responsibilities in China directed the financing of investment expenditures and loans towards local activity. This was reflected in the planned division of resources of the package among central and local levels. Accordingly, despite the central initiative, only one third of the planned investments were to be covered from central budget between 2008 and 2010, the remaining two-thirds were to be provided by local governments (31 percent), and local enterprises and banks (40 percent) (World Bank, INFRA, 2010).

Besides the so-far analyzed priorities of the stimulus package to decrease export reliance by spurring the expansion of state ownership, domestic large enterprises, infrastructure building and with those the investment activity of local governments, we can trace strongly accentuated regional preferences towards central and western regions.

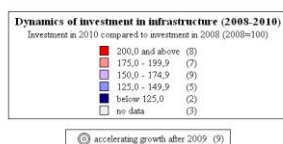
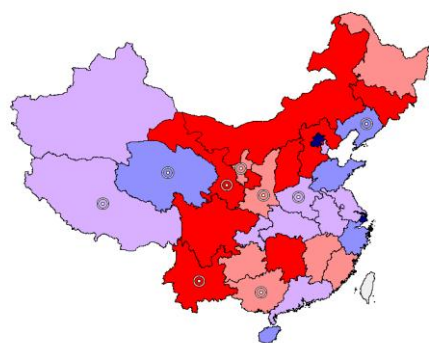
## **SPATIAL DISPARITIES OF ADAPTATION**

National level characteristics of growth (Table 1 and Table 3) were not homogeneously reflected in space. Instead, spatial clusters of different dynamics may be perceived partly due to the impact of incentives and regulations before the crisis and to the impact of economic policy after the crisis as well as to the deterioration and slow rebound of foreign trade.

Spatial differences become even more accentuated if we take the paces of the skyrocketing regional dynamics of investments in the manufacturing and construction sectors. (Maps 2/a and 2/b). During the researched period 65 percent of the provinces in manufacturing, and 77 percent of those in construction were concentrated in the intervals with higher than 50 percent and over 100 percent of growth pace. Highest rates in both sectors are found in the central and western regions. Highest pace investment provinces are more concentrated in construction and outnumber those in manufacturing. However, acceleration after 2009 is perceived only in manufacturing, visible also at the coastal region, suggesting its surge from the crisis.

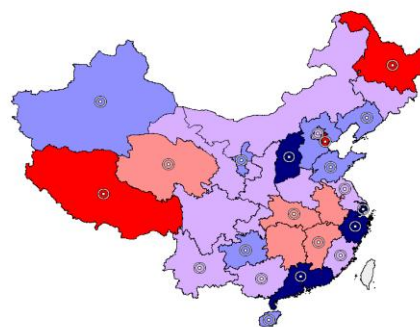
Map 2/a

### Spatial dynamics of investments in construction by provinces between 2008-2010



Map 2/b

### Spatial dynamics of investments in manufacturing by provinces between 2008-2010



Note: The colors show the different speed of growth for investments in infrastructure and manufacturing. Little circles within provinces are signs of acceleration in growth-rate after 2009

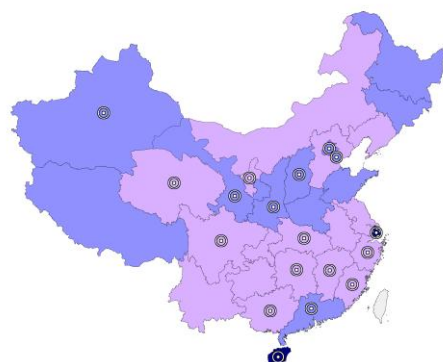
Source: China Statistical Yearbook 2009, Table 5-7; 2010, Table 5-7; 2011, Table 5-7

<http://www.stats.gov.cn/english/statisticaldata/yearlydata/>

High investment dynamics in both sectors is not only reflected in the explosive 102.6 percent increase of loans in 2009 (Table 3) but also in its dramatic regional impact compared to the period before the crisis. On Map 3/b radical changes may be perceived in the regional distribution of credit growth in 2008-2010 compared to 2005-2007 (Map 3/a), despite widespread regional acceleration of credit growth during the earlier period. The highest regional level growth during the whole period of 2008-2010 surpassed those of the previous period by two intervals. Map 3/b shows that besides the credit increase having spread almost overall, the highest growth is demonstrated at provinces located at central and western regions.

Map 3/a

### Spatial dynamics of loans from financial institutions by provinces between 2005-2007



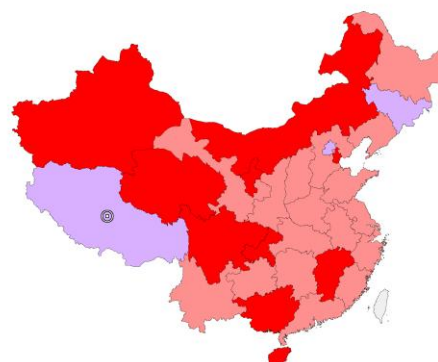
**Dynamics of loans from financial institutions (2005-2007)**  
Value in 2007 compared to value in 2005 (2005=100)

170.0 and above	(0)
150.0 - 169.9	(0)
130.0 - 149.9	(17)
110.0 - 129.9	(12)
below 110.0	(2)
no data	(3)

⊙ accelerating growth after 2006 (18)

Map 3/b

### Spatial dynamics of loans from financial institutions by provinces between 2008-2010



**Dynamics of loans from financial institutions (2008-2010)**  
Value in 2010 compared to value in 2008 (2008=100)

170.0 and above	(10)
150.0 - 169.9	(18)
130.0 - 149.9	(3)
110.0 - 129.9	(0)
below 110.0	(0)
no data	(3)

⊙ accelerating growth after 2009 (1)

Note: The colours show the different speed of growth for loans. Little circles within provinces are signs of acceleration in growth-rate after 2006 and 2009

Source: Compiled from NBS data, Michigan University China Data Center  
<http://chinadataonline.org/>

At the same time, we cannot turn a blind eye to the fact that even the lowest rate intervals on the maps rarely demonstrated stagnation or setback in the researched period. Based on the above indicators and their rate and acceleration we suggest that the successful realization of the package priorities directly contributed to the overheating of the Chinese economy and to its regionally differing manifestation.

## LABOR MARKET IMPACT OF THE CRISIS AND THE STIMULUS PACKAGE

According to the research report of the National Development and Reform Commission (NDRC) in China the stimulus package had remarkable labor market impact. Investments created 5.6 million permanent jobs and 50 million temporary workplaces (Blomberg 2010, June 15). During the researched period the estimated number of migrants increased by almost 20 million: from 140.41 million in 2008 to 158.63 million in 2011 (NMS 2012). Regional and sectoral priorities of foreign and domestic investments have restructured the regional direction of migrant flow, shortening migration distances: in 2009 the number of migrants from all regions whose destination were the eastern provinces declined 8.9 percent in the east while the ratio and number of those heading to the center and west increased 34.6 percent (Csanádi, Nie, Lishi, 2013; Xu, Y, 2010, 2; Knight, John, Deng Quheng and Li Shi 2010). The same move was reinforced by the drastic decline of export production and enterprise close-downs in the east. By 2011, overall more migrants became employed within

the province of their home-town compared to those who left to other provinces than in 2008 (Table 3 in Csanádi, Nie and Li 2013). The tension between catching up labor demand owing to positive market and export structure developments in the east and the attraction of the stimulus package in the western and central regions improved migrants' working conditions, narrowed migrants' regional income disparities and increased education level both in general and among new migrant generation (Csanádi, Nie, LiShi 2013).

We have traced the national, sectoral and regional impact of the stimulus package in investments, loans and migration routes on national and regional level. However, the priorities of the stimulus package had characteristic consequences also on local dynamics. Next we shall focus on the direct impact of state intervention on the institutional structure and its systemic background

## **NATIONAL AND LOCAL DEVELOPMENT PROCESSES OF THE STIMULUS PACKAGE**

### **DECENTRALIZED COMMITMENTS AND ITS FINANCIAL PREMISES**

This was not the first, neither the last time for similar priorities of stimulating state interventions in China in the event of an external shock. For example, the 10th Five Year Plan (2001-2005) also strongly emphasised the importance of urbanization and infrastructure building. Goals were directly influenced by the Asian financial crisis by the end of 1990s that caused serious economic set-backs in South- Korea, Singapur, Taiwan, Malaizia and Indonezia. Focus points of the plan served to prevent the crisis to spread in China. The stimulus package announced in late 2008 was also an instrument of adaptation to external shock, similar to the reactions to the Asian crisis.

Investment financing, however differed from the methods used during the Asian crisis. During the period of the Asian crisis overwhelmingly government resources were deployed and distributed through policy banks. From 2003 onwards and specifically regarding the 2008 stimulus package, major role was attributed to four specialized state banks (Industrial&Commercial Bank of China, China Construction Bank, Bank of China, Agricultural Bank of China) and to the loans provided by them (IMF 2011, 12-13).

In other respect, the one-off state intervention did not imply new institutions. Procedures of investment authorization connected to the stimulus package ran through the routine institutional routes and decision-making mechanisms. Stimulus package did not have distinct statistical monitoring either. According to routine procedure the National Development and Reform Commission (NDRC) is responsible for the formulation of the national development plan and the approval of the projects to be supported. As soon as the



NDRC approved a project this latter was eligible for receiving budgetary support and bank loans. NDRC approval is required above a certain value of a given project.

Financial expectations facing local governments who initiated three quarters of the allowed development projects were substantially higher than during the Asian crisis. To get the project accepted, enterprises had to offer financial guarantee for their own contribution both in case of central budgetary support and connected bank loans. Size of the contribution was regularly the 25-35 percent of the project costs. For the sake of fast fulfillment of the projects the NDRC generally chose local government projects that had sufficient own resources to meet co-financing criteria (Wong 2011a, 61). While China's Budget Law (*yusuanfa*) and Guarantee Law (*danbaofa*) prohibit local governments from running deficits that are financed by debt or to serve as guarantors for local projects,<sup>6</sup> central policy measures were taken to ease the provision of own resources. State Council decided over the release of a 200 billion Rmb state bond package by the Ministry of Finance on behalf of local governments (Xu, W., 2009; Na, 2011) for whom bond issue was centrally forbidden. Income from those bonds was quickly forwarded to provincial budgets. The main goal was to centrally secure the financial background required for budgetary supports and loans. Also enterprises owned by local governments (investment vehicles) could issue bonds that would serve for investment source with top tier credit ratings, since they are guaranteed by local governments (Rabinovich, 2013). But not only bonds ensured financing preconditions but also land and buildings to be built on the lands served as collateral. Land use practice as collateral benefitted from the extremely complicated land management system.

#### LAND MANAGEMENT SYSTEM AS THE LOCAL INSTRUMENT OF FINANCIAL GUARANTEE

Land law enacted in 2003 deals in detail with the unalienability of the 47 percent of collectively owned rural land and of the 53 percent urban state owned land by its tenant. It regulates land management rights, possibilities for the expropriation of collective land by the government in case of public interest in exchange of proper compensation of the tenant. It disposes of the protection of cultivated land, of the conditions of provincial or higher level authorization of collective land expropriations, commercialization of land management rights in case of non-agricultural land, sharing ratio of land reallocation prices between local

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<sup>6</sup> The prohibition of issuing local bonds: Budget Law of the People's Republic of China – 1994, <http://www.lehmanlaw.com/resource-centre/laws-and-regulations/banking/budget-law-of-the-peoples-republic-of-china-1994.html>, Article 28; The prohibition of state owned and collectively owned land as mortgage: Guarantee Law of the People's Republic of China <http://www.asianlii.org/cn/legis/cen/laws/glotproc373/>, Article 37

government who allowed the transfer and the central government.<sup>7</sup> Neither real estate for building is alienable by its user but state can expropriate the land and commercialize its use. Land owned by the village collective should first be nationalized by a higher level government and only after circulate land use rights (contractual management rights).

Until 2006, circulation of land use rights were based on arrangement among interested parties that allowed local governments to sell the land management rights for industrial, commercial and construction ends at low prices in exchange of corruption money. The other method is holding tenders or auctions, where real competition is taking place among potential investors. In those cases prices by hectare on tenders exceed manifold the outcome of those settled ones, both at regional or at national level and strongly differ regionally (Tsui 2011, Table 3). Though average prices are the highest in the eastern provinces, the frequency of deals based on settled prices is higher owing to stronger local corruption interests (Tsui 2011, 695).

The minimum compensation fee for the actual land user is not settled in the law (Chen 2010, 2). In practice, the possibility of government expropriation of collective farmland and buildings in the name of “public good”, as well as the vague criteria for compensation of the user open up a vast room for manipulation and corruption. According to the results of an official survey in 90 locations by China News Agency 20 to 80 percent of land projects are illegal. According to the authors, typical example is when local officials, in agreement with the leaders of the local collective, requalify farmland into building real-estate and in exchange of corruption money sells land use rights at low prices to investors and hire gansters to carry out forced eviction of peasants (referred by Hays 2012). The farmer, who formerly got the land use rights received either none, or minimal compensation in case of expropriation that was only a fragment of real market prices. The mean compensation that the local government paid to the farmers was approximately \$17, 850 per acre. When it was resold by local authorities, mostly to commercial property developers, the mean price was \$740,000 per acre (Michigan State University, Landesa and Renmin University 2011). Only in 2009 local governments acquired 2.9 billion yuan from the difference between compensation and market price in circulating land use rights (Page and Spegele, 2011). This was the double of the volume of central budgetary resources planned in the stimulus package in 2008. Factories, commercial centers, and buildings were built on 55 percent of the expropriated rural non-agricultural land and 30 percent of arable land (Michigan State University, Landesa and Renmin University 2011).

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<sup>7</sup> Law of the People's Republic of China on Land Contract in Rural Areas [http://english.gov.cn/laws/2005-10/09/content\\_75300.htm](http://english.gov.cn/laws/2005-10/09/content_75300.htm)

Experts estimate that since 1990, different level governments expropriated about 16.6 million hectare of farmland for the sake of investments for public interest. According to Landesa every year local governments appropriate land from 4 million rural Chinese. About 43 percent of the villages surveyed by Landesa have been subjected to such land takings over the past decade. Farmers involved in the survey lost their homes in the 35.9 percent of the cases and in 54.9 percent both their home and their land (Michigan State University, Landesa and Renmin University 2011).

Corruption connected to land confiscations provoked frequent mass demonstrations. According to CASS data 65 percent of the mass demonstrations are related to illegal land confiscations and arable land reclassification for the sake of investments of „public interest” building luxury apartments, roads, dams, power stations, factories, waste disposures, carrying out forced demolitions, or obstructing irrigation pipes (referred by Hays 2012; Economy 2012). According to another report between 1994 and 2004 70 million peasants were subject to illegal land seizures (Hays 2012). China Construction Management and Property Law Research Center reported that the pace of forced expropriations is increasing. Based on their survey local governments’ revenue through the commercialization of land use rights in 2009 was equal to 219 billion dollars 43 percent higher compared to 2008. In 2010 this value further increased by 70 percent (Hays 2012). Growth of local revenues from land use commercialization had social response: according to official data in 2008 127 000 mass demonstrations were registered. From those 467 were occupation of government departments, 615 were strikes against police and court buildings, 110 against government buildings and cars (Walsh 2009). In 2009, there were 110,000 demonstrations, in 2010 that figure soared, with reports of 280,000 “mass incidents” taking place across China. Moreover, the number of people involved in these demonstrations has also increased by an average of 17 percent every year in the past decade. In 2000, there were a total of 1.63 million demonstrators involved, but in 2009, 5.72 million protested. Growing social pressure accelerated the implementation of a new law by China’s legislative body in 2011 which took twelve years to draft. This law limits the use of violence in forced evictions, as well as outlaws the clearing of property at night and during holidays. Under the 2011 regulation, violent law enforcement measures are to be used only in "emergencies," though the term is not defined. Chinese authorities declared that the law would help to protect human rights (Hogg 2011).

Evicted and requalified collective land by local government may be transferred to state owned enterprise use (Hu 2006, 27). Thus, potential profit from marketing land use rights remains off-budget, being used by local government owned enterprises (local financial platforms) that may use them as collateral for bank loans, though banks, by law, cannot take land as collateral (Jacoby, Li, and Roselle 2001, 5).

## LOCAL FINANCIAL PLATFORMS AS INSTRUMENTS OF LOCAL INVESTMENTS

After 2008, central government allowed and encouraged again earlier restricted financial platforms (joint document released by Peoples Bank of China and Chinese Bank Regulatory Commission in 2009. March 24 referred by Wong 2011a, 62-63). Restrictions then served to control overheating and ease inflation pressure. However, these platforms were used by local governments well before easing restrictions, in order to circumvent regulations that prohibited the direct extension of loans to local governments.

It was by the end of the 1980s when provincial and other local governments founded enterprises that took charge of public investments and urban development. These financially independent enterprises were brought to life for well defined individual goals. They were meant to bridge over the gap between decentralized state development functions and higher share of centralized tax revenue since 1994, restrictions over off-budget revenues, and prohibitions of acquisition of additional local budgetary revenues from loans and bonds (Csanádi and Lai, 2003), cutting down on the activity of local platforms or forbidding to use government assets as collateral (Chang 2010; Wei 2009).

Further stage in the development of local financial platforms, still before the Asian crisis in 1998, was the foundation of a local government enterprise in Shanghai with overall rights to manage local government assets. Besides its ability to get loans it got wide ranging rights for local infrastructural investment and servicing duties and real-estate development. Substantial part of local revenues was managed by the enterprise that grew large as a result of growing income from increasing land- and real-estate prices and revenues from commercialized land and rents. Thus, overwhelming part of Shanghai's capital development expenditures and revenues were transferred outside the budget (off-budget) (Wong 2011a, 62). Similar example is mentioned by Tsui regarding six government owned enterprises founded and developed by government resources (financial subsidies, land use right transfer revenue, land transfer, etc) in Chongqing province that were registered at the stock exchange (Tsui 2011, 699). This solution spread quickly along local governments. Subtle variations of financial innovations came to life. Financial platforms allowed to include revenues in the balance sheet of local enterprises that made them suitable for loans and to issue bonds.

After 2008 financial crisis financial platforms played a crucial role in benefiting the stimulus package, by using bank loans. Central government's official acknowledgement and encouragement of their activity as financial platforms (Local Investment Companies LIC) of local governments provided strong impetus to their activity. According to a China Banking Regulatory Commission (CBRC) report, local governments founded all together 8,200 such

enterprises to realize investment projects (Chang 2010). Easing chances for resource acquisition allowed the speed up of infrastructural projects in process and the earlier fulfillment of local government and ministries' middle- and longterm development plans, as well as those investments not in the plan but among the priorities of the stimulus package (Csanádi 2012).

As a result of the above, fairly one month after the introduction of the package local governments already applied for 18 trillion yuan worth investment projects. Later this number increased to 25 trillion as opposed the 4 trillion yuan of the stimulus package (Wong 2011a, 63).

## **CONSEQUENCES OF STATE INTERVENTION: INVESTMENT OVERHEATING**

### **THE OVERHEATING OF LOCAL INVESTMENTS**

More than half of the loans in 2009 were given for infrastructure building (World Bank, INFRA 2010, Table 2;). However, owing to the decentralized functions of infrastructure building, overwhelming part of these loans appeared at the level of local governments. They were received by local financial platforms, provided by local branches of large state banks integrated into the local power network. According to the China Banking Regulatory Commission (CBRC), in 2009 financial platforms received one third of new loans thereby increasing their debt asset by the end of the year from 3.0 trillion RMB to 7.4 trillion RMB. By the end of 2010, already 40 percent of new loans were received by the group of financial platforms (IMF 2011, 14). Growing local indebtedness worried the highest government bodies: the CBRC, the NDRC, the Ministry of Finance and the Chinese National Audit Office (CNAO) who initiated investigations ([Audit Findings on China's Local Government Debts](#) 2011, 11-16).

According to CNAO data, local governments have accumulated 10.7 trillion RMB of debts that made 26.9 percent of the 2010 GDP. Local governments are directly responsible for 62.6 of those debts, for 21.8 they have guarantee commitments and partial repayment obligations for 15.6 percent of the loans (URBANOMICS 2011). The CNAO judged 26 percent of these loans of high risk in mid 2010 (GaveKal, DragonWeek 2010 November 8 ). According to the CBRC report 47 percent of loans received by the financial platforms was secured by local government budgetary guarantees, while revenue from land use rights were taken as general budgetary guarantee (negative pledge). Debts of local financial platforms however further increased: in mid 2013 a new nationwide audit was ordered by the State Council to determine the overall debt of these enterprises and through those that of local governments (Keohane, 2013). Results are still unpublished.

Indebtedness problems of local governments date back to earlier periods. Similar processes took place during earlier state interventions. By the time of the global crisis, locally amassed debts according to the CNAO exceeded the 5.5 trillion RMB (CNAO 2011), overwhelmingly in loans. This happened despite the fact that in 2006 the central government prohibited mega-loans for large state-owned enterprises (Tsui 2011, 696). Some calculations estimate loans received by local platforms including other hidden items to over 150 percent of the GDP in 2010 (The Economist, 2011). According to Nomura estimations, in the period 2010-12, LGFV debt rose by 39%, which implies total government debt of RMB31.7trn, or 61% of GDP at end-2012 (referred by Keohane, 2013).

## OVERHEATING ON NATIONAL LEVEL

The real value of the stimulus package substantially exceeded originally planned volumes, fitting into an earlier tendency where investments grew by 32.1 percent in 2007, 40 percent in 2008 as the prompt reaction to the crisis, they further grew by 23 percent in 2009 and still another 20 percent by 2010 (Table 1). Moreover, investments in somewhat slower pace but further increased in 2011 by 17.2 despite the formal termination the stimulus program in 2010 (NBS 2012). The pace of GDP growth was much lower than that of investments: it grew from 9.2 percent in 2009 to 10.4 percent in 2010 (NBS 2011). Investment in fixed assets in 2010 was 70 percent of the GDP (Derek, 2011).

Behind the GDP growth and the much higher pace of the investment were the unexpected increase of investment sources: the originally planned amount of the stimulus package was quickly overfulfilled. Budgetary intervention and loans together achieved 4.8 trillion already in 2008 that surpassed the whole sum planned for the period of the stimulus package. By mid 2009, central resources were increased by further 30 percent (Wong, 2011b, 7-9), money supply was increased by 22 percent that was accompanied by an even greater expansion of credits (Figure 3 and Table 3). Loans constituted two thirds of the invested volume instead of the originally planned 40 percent (World Bank, INFRA 2010).

Experts' estimations regarding its share in the GDP are diverse: according to the World Bank debt ratio in the GDP was 30 percent (World Bank, INFRA 2010), while according to Wong's estimations it was only 15 percent (Wong 2011a, 65). In 2010, official Chinese sources estimated local and central debts to the 45 percent of the GDP in 2010 and to 38.5 percent of the GDP in 2011 (CIA 2012). These calculations, however, omitted several factors that should have been included, thus, real share might have been much higher. CIA mentions that these data provided by the National Audit Office do not contain bonds issued by policy banks, the debts of the Ministry of Railway Transport, the debts of Asset Management Companies that took over debts of state owned enterprises and the bad loans. Taking into consideration

these missing factors a fourth quarterly monetary policy report estimated the debts to the 74 percent of the GDP in 2010. (ALSOSPRACH 2011).

The skyrocketing expansion of debts also increased the volume of non-performing loans. Direct reason emerges from the fact that managers of local branches of large state-owned banks are integrated into the local power structure. They take the agreements settled with government organizations and the servicing of debts amassed by priority enterprises for granted. The share of non-performing loans was estimated to 8-12 percent of all loans in 2011 (Fitch in BBC 2011 and Moody in URBANOMICS 2011), according to which experts forecasted 60 percent chance for a credit crunch by mid 2013 as a result of record volume of credits and burst of real-estate bubble (Wealth Daily, 2012).

## **MEASURES AGAINST INVESTMENT OVERHEATING**

Central government was alarmed by the increasing risk conditions of banks. It steadily tried to control credit-debit spiral since mid 2009 set free by the increased state intervention through the stimulus package and the decentralized functional structural specifics of the institutional system. The implementation of restrictive monetary and fiscal instruments accelerated from early 2010: the central bank raised the discount rate by four basis points, raised reserve ratio and began open market operations to repurchase 30 billion RMB worth bonds in 2010.

Central measures failed to contain overheating: credit expansion already in January met the size of the credit boom of the first quarter of 2009. The Monetary Committee decided over further credit tightening. However, as banks were forced to further tighten loans while the hunger for resources remained steady, the circulation of off-balance-sheet financial products doubled from 1.6 trillion to 3.8 trillion yuan in order to evade regulatory oversight, to bypass loan quotas, interest rate caps, and other restrictions. Consequently, despite focused efforts, expansion of loans in 2010 remained at the level of those in 2009 (GaveKal-Dragonomics, 2011a, 2-3).

In 2011 loans shrunk by 4.1 percent, government budgetary expenditures grew 10.8 percent as restrictive efforts seemed to become efficient (Table 3). Decline was caused by cutting down trust companies' lending as an off-balance sheet vehicle. However, meanwhile, designated loans, as another off-balance sheet instrument, more than doubled in the first quarter, with large SOEs and listed companies profiting of high interest rate lending to property developers whose access to bank loans has been sharply curbed in the process of tightening (GaveKal-Dragonomics 2011b). Consequently, central efforts to curb overheating had less impact on local investments and even less on off-balance sheet investments: investments grew by 17.2 percent in 2011, within those central investments decreased by 9.7

percent while local investments grew further by 27.2 percent and off-balance sheet investments by 28.6 percent (UMICH, NBS 2012). Despite several counter measures, this tendency still prevails in 2013 and poses risks to the whole economy (Jingu, 2013, 5). According to Fitch Ratings local governments are sitting on 12.8 trillion yuan in debt. Add in loans from the shadow banks and the total could be closer to 18 trillion yuan (Roberts, 2013).<sup>8</sup>

According to Moody, the official debt burden of central and local government, which does not take the localities' shadow banking activities into account, is just below 30 percent of GDP in mid 2013. In contrast, other experts estimate that shadow banking liabilities and consumer, corporate, and government debt are now more than 200 percent of GDP (Business Week, 2013, May 16). The ratio of investments in the GDP despite the economic policy promises and measures to increase GDP growth increased from the 40.7 percent share before crisis to a record high of 46.2 percent in 2010 (NBS 2012 and NBS 2011 referred by Tsui 2011, 705). This ratio minimally decreased in 2012 to 45.9 according to CIA estimates (CIA World Factbook 2012), though we also have to consider, that GDP growth itself slowed down from 10.4 percent in 2010 to 9.3 in 2011 and further to 7.8 in 2012 (World Bank 2013).

## **SYSTEMIC BACKGROUND OF ADAPTATION, OVERHEATING AND LOCAL INDEBTEDNESS**

Looking at Chinese reform history, overheated investment and lending is not an accidental phenomena caused by global crisis but instead, a re-emerging issue (Figure 4). Investment overheating had higher and lower peaks. First, unleashed in 1992-1993 after Deng's Southern tour. This event was preempted by economic set-back, the economic retrenchment and bloody military clamp-down of the Tiananmen square movement fuelled by the inflation and corruption and the domino collapse of the communist block countries. Actions were intended to freeze the process of economic and political transformation. The second was a less severe overheating during the Asian crisis in late 1990s initiated to avoid the multiplicative effect of the Asian crisis. A third one occurred after the accession to the WTO in 2002-2003 when external constraints suddenly softened resulting directly or indirectly in abundant resources through increased export or FDI. The fourth process of overheating developed after the global crisis in 2009. Each period demonstrates that despite the substantial advancement of the market economy, key characteristics of the communist systems and its Chinese specifics continued to shape ways of adaptation. Ways of adaptation depend on the nature of constraints the interacting external and internal pressures form and

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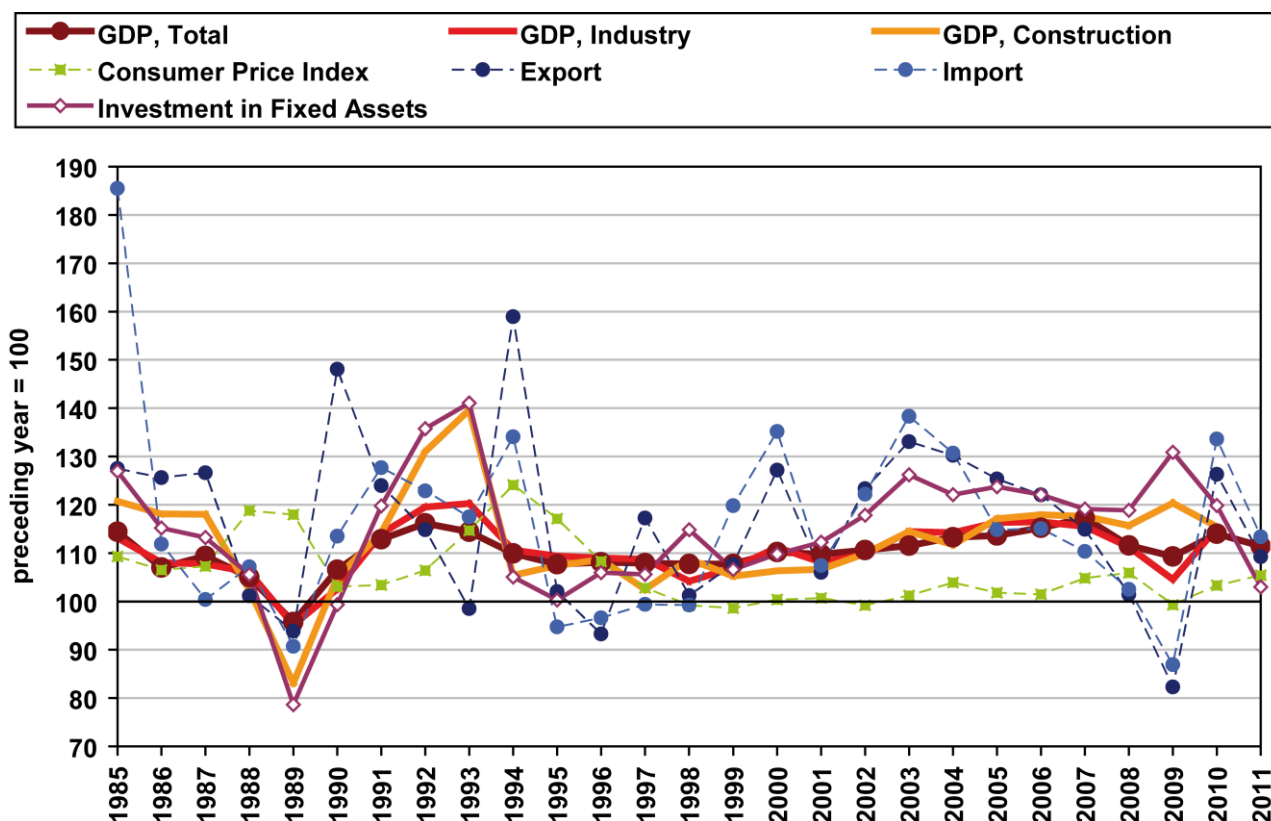
<sup>8</sup> Though credit crunch did not occur in 2013, the pressure on central government seems to be high. The State Council ordered CNAO in July to inspect local government indebtedness throughout the whole country at all levels expected to be published by the end of the year.



the persistence of those constraints. Still, all of them involved state intervention, though with different motifs that initiated overheating. Overall growth of investment booms went parallel to investments in construction though to different extent.

Figure 4.

### Periods of overheated investment and parallel dynamics of GDP in construction



Source: compiled from NBS statistics, University of Michigan China Data Center. chinadataonline.org

Repeated phases of overheating in general and the similar development in 2009 in particular cannot be explained by the loss of central and local control over investments during the stimulus package, since institutional control over investments is tight. Projects are authorized by major central decision-making organization (NDRC) or its respective local bureau depending on the type of distributed resources (central or local) and the size of the investment. Similarly tight is the political control of those taking part in the decisions: leadership of policy and commercial state banks, SOEs and other institutions are in the nomenklatura (cadre responsibility) of the cadres of local or higher level party apparatuses. Local power in turn, is controlled politically since decades from one level above. Neither shortcomings of institutional incentives of economic-, government- and state bank managers is sufficient in itself to explain why decisions are driven towards unlimited growth and unlimited resource distribution just as they are (were) in other party-state systems. If this incentive system repeatedly causes such a big problem why don't they introduce a different

one that drives decision-makers towards economic efficiency rather than volume, or why does it fail if introduced?

We argue that this is because it is system specifics rather than control, regulation problems or wrong incentives lie behind the institutional, functional, interest and behavioral phenomena of repeated overheating. Local indebtedness, investment overheating and motivations of decision-makers should be ascribed to the decision-making mechanism that derives from the general features of party-state systems and its Chinese specifics. In this mechanism party-, state-, and economic decision-makers are institutionally tightly interrelated through the power instruments of the party forming a politically monopolized network of dependency and interest promotion. Power instruments permeate institutional boundaries of non-party organizations<sup>9</sup> and directly overlap the decision-making process in non-party organizations through the positional, activity and organizational structure and bind individuals through party discipline (Csanádi 2011).<sup>10</sup>

Through the power instruments of the party a politically monopolized power network is constructed. Politically rational economic motivations of decision-makers integrated into this network evolve from its elements, connecting and operating principles of the structure are constructed on political purposes that are self-similar in time, space and different level of aggregation of the network (Csanádi 2006). Politically, rather than economically rational economic motivations of behavior present themselves in the priorities of resource distribution (priorities to large scale, state ownership, political position) and in the investment motivation of those applying for resources (drive for growth, drive for resources, and accumulation of connections (*guangxi*)) and structural rather than efficiency constraints influence the self-reproduction of the network. These general system characteristics will result in selectively soft reproduction constraints of those prioritized by the politically rational motivations of distribution and will cause overheating. This latter, owing to the self-similarities it may be revealed in different time, in different space and different aggregation levels.

Besides the above general characteristics of party-state systems prevailing at different level aggregations, the relatively decentralized nature of the Chinese power network accentuate overheating at local levels resulting in deep indebtedness of local governments. Characteristic distribution of power within the Chinese party-state network developed as a

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<sup>9</sup> Non-party institutions mean all units of those subspheres that do not belong directly to the party apparatus, embracing trade-union, education, culture, finance, and state-owned enterprises (Csanádi 1997).

<sup>10</sup> Thus, the network deriving from dependencies and interest promotion relationships includes banks overlapped by local and central party apparatuses both as an organization, as an activity, as leading position and as party members in those positions. The party exerts tight control over the leaders of large state-owned banks, involved in selecting, appointing, financially motivating or demoting them (Csanádi 1997).

result of Mao's repeated decentralizing campaigns from the late 1950s on. Decentralized nature of the power network means the capacity of resource extraction and allocation of local governments through the decentralized subordination of SOEs and other institutions (e.g. local branch of large banks) to local level party and state authorities as opposed to centralized subordination and extraction and allocation capacity of the European party-states. Decentralization provided them relative independence from central decisions and more resisting capacity to central intervention.

This structure became stable by 1978 and was further reinforced through Deng Xiaoping's decentralizing reforms (Csanádi 2006). The formal institutional appearance of the decentralized power structure are the decentralized subordination of SOE to local governments (except for those centrally subordinated), the local governments' chances for local taxation, selling land use rights and the decentralized commitments for local investment (eg, infrastructure building), forming local financial vehicles and manage the financial background of investments through local banks. The decentralized institutional structure is characterized by the cadre responsibility (be it appointment, promotion, dismissal, transfer, awarding etc.) of local and one level up party organizations over the positional structure of all local non-party organizations be they banks, schools, enterprises, theatres, SOEs etc. This locally intertwined power network allows for the influence of the local party organization on economic decisions provides the local channels for the political rationality of economic behavior through existential exposure of economic actors. Important are also the chances for integration of provincial level governments and large SOEs into higher level party and government decision-making forums that allow for insider information, accumulation of connection, promotion of interest and easier resource attraction and resistance to, or preparation for unavoidable interventions.

The decentralized character of the Chinese power network or other variations in the distribution of power in party-states (Csanádi, 2011), do not modify the general characteristics of the system. Instead, they prevail along the stabilized individual structure. This is the individual specific that becomes flagrant on the occasion of major interventions that increase the activity along the network (Csanádi, 2012/35). It is due to the specific distribution of the Chinese power network that the drive for growth, loan overload, risky loans, indebtedness and overheating emerged at local level, absorbing three quarters of the stimulus package. The same decentralized power structure is responsible for the fact that only after repeated, and major restrictive interventions can the central government subdue local drive for growth.

Not only operation but also economic transformation may be defined from systemic point of view. Transformation means the retreat of the politically monopolized network either first from the political sub-field or from the economic subfield. In case of China, economic

transformation is taking place first as opposed to its European counterparts by the end of 1980s. The retreat of the network from politically monopolized economic sub-sphere means the transformation of the economic subsphere towards the market system. Retreat may be absolute or relative, no matter which subfield is transforming first. Relative retreat of the network from economic subfield means the higher pace of expansion of the private sphere compared to that of the network sphere. It evolves through the increasing number of new private ventures, privatized enterprises, price liberalization, marketized agriculture, dual-track prices etc. Absolute retreat of the network means the different modes of waning of the network connected to the economic subsphere. This process takes place through the transfer of competitive capital, economic units or activities outside the network (emptying the network), through privatization or close-downs (cutting off the network), through squeezing distributive functions at lower levels (withdrawing the network), through the infiltration of alternative capital and organizations entering the network (thereby weakening the influence exerted through it), parallel to the expansion of the private field (Csanádi 2011).

However, within the realms of the absolutely or relatively retreating network motivation of decisions follows unchanged rules and selection mechanisms. Moreover, major state intervention and new chances for resource acquisition will mobilize the network and activate its characteristics of operation and distribution. Economically rational goals within the network are invariably realized according to politically rational motivations where priorities of resource distribution accommodate to state ownership, size of economic units, political positions and accumulation of connections of their leaders. This is why the winners of the stimulus package were domestic, mostly state-owned enterprises whose investments grew by 40.6 percent between 2008 and 2011 (Luk'yanenko 2011).<sup>11</sup> Same system specifics motivate banks in the distribution of loans and in being involved in risky loans and engage in shadow banking (Roberts, 2013; Perkins, 2013). This is the reason why the central government took over the bad debts of larger state-owned enterprises and those of local governments.

In this system resource distribution, drive for growth and for hoarding resources have no efficiency constraints, instead structural constraints of power distribution within the network determine the hardness or softness of resource extraction and distribution. Structural constraints mean the distribution of bargaining capacities of actors integrated into the network dressed up with unequal resource attracting, resource extracting, resource distributing capacities and resisting capacity to interventions, together providing their different constraints in self-reproduction. Different distributions of bargaining capacities will

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<sup>11</sup> "State enterprises enjoy extensive privileges: they have special access to sources of credit, a strong bargaining position over industrial prices and the right to make legislative proposals; they are not obliged to share profits and often enjoy lower taxation levels. Given these privileges, it is not clear to what extent they are really profitable ..." (Kundnani, 2010, 5)

provide the distribution of power in the network and determine the whole network's capacity and constraints for self-reproduction in a given period. If structural constraints become soft, as they were during the stimulus package through state intervention, characteristic motivations of resource distribution and hoarding will quickly overheat the economy as they did within one year from the 2008 crisis shock.

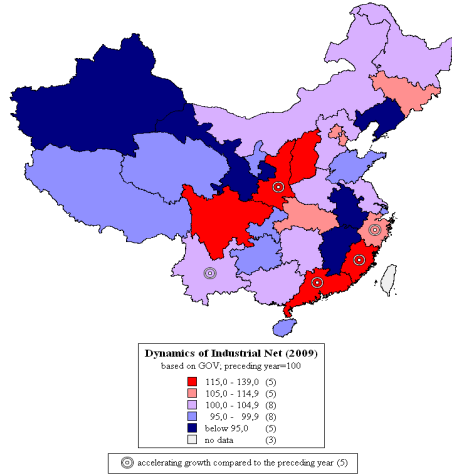
The general economic factors of overheating and overcapacity and its repeated periods in China are defined by Yu Yongdin in his paper dealing with the Chinese stimulus package (Yu, 2009, p. 3-5). Overheated and cyclical character of communist systems was revealed by Tamás Bauer (Bauer, 1978,1981, 1986) for the period of the 1950s and Károly Attila Soós for the period of the 1980s (Soós, 1976, 1986, 1987, 1989). Their analysis for Eastern Europe and the Soviet Union in the 1950s, 1970s and 1980s, confronted by similarly repeated phenomena in China earlier and in 2011-2012 support that the overheating is a system characteristic independent of time and space.

The inter-connectedness of system characteristics, individual specifics and the transformation of the Chinese party-state system is also palpable. Interventions work according to systemic priorities: expand the network through the prioritized growth of those integrated into it, thereby temporary halting or slowing down transformation. On the other hand, the amplitude of overheating is increased by the the private sphere activated by the input demand of prioritized economy that incites the expansion of the private sphere outside the network, accelerating transformation. This process is spatially detectable both in the case of construction or in manufacturing if we compare the output of units integrated into the network and units integrated into the market sphere, and view its expansion according to prioritized spatial focus of the stimulus package (Maps 4/a and 4/b and Maps 5/a and 5/b)

Maps reveal the characteristics of the transforming economic system in the Chinese party-state in prioritized regions, in both construction sector and in manufacturing sector mobilized by the input demands of construction sector, by the designated manufacturing industries in the stimulus package and by the recuperating export production. Private sphere promptly reacted to the input demands of the prioritized economic units in the network sphere, thereby increasing the amplitude of overheating. Distribution of loans in 2010 and 2011 according to enterprise size and ownership clearly show distribution priorities towards large state owned enterprises integrated into the network. At the same time it reflects the increasing share of medium and small enterprises, and within those the radical growth of the share of privately owned medium and small enterprises (Tables 4, 5 and 6).

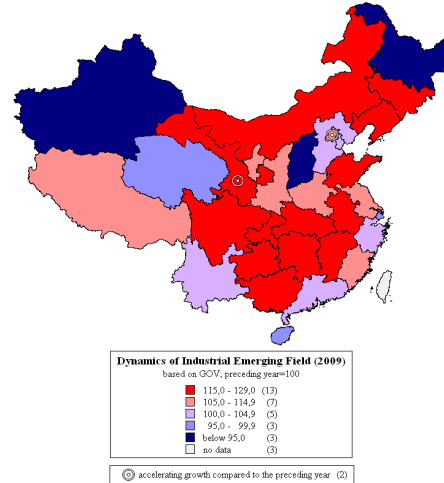
Map 4/a

### Expansion of output in the network in manufacturing sector in 2009



Map 4/b

### Expansion of output in the activated private sphere in manufacturing sector in 2009

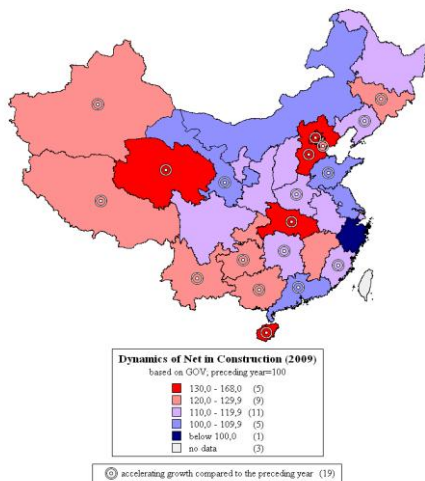


Source: State-owned: China Statistical Yearbook 2009, Table 13-8; 2010, Table 14-8; Private: China Statistical Yearbook 2009, Table 13-12; 2010, Table 14-12

<http://www.stats.gov.cn/english/statisticaldata/yearlydata/>

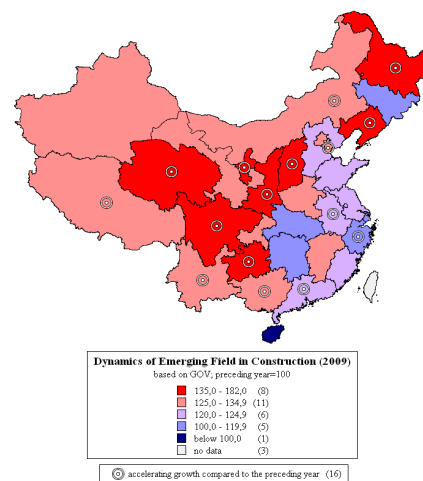
Map 5/a

### Expansion of output in the network in construction sector in 2009



Map 5/b

### Expansion of output in the activated private sphere in construction sector in 2009



Note: The colors show the different speed of growth for network and market fields in construction and manufacturing.

Source: China Statistical Yearbook 2009, Table 14-16; 2010, Table 15-16; 2011, Table 5-6

<http://www.stats.gov.cn/english/statisticaldata/yearlydata/>

Table 4

**The share of loan distribution according to ownership in 2010 and 2011**

<b>2010</b>	<b>Large</b>	<b>Medium</b>	<b>Small</b>	<b>Total</b>	<b>2011</b>	<b>Large</b>	<b>Medium</b>	<b>Small</b>	<b>Total</b>
<b>Summa loans</b>	<b>43,4</b>	<b>32,6</b>	<b>24,0</b>	<b>100,0</b>	<b>Summa loans</b>	<b>39,6</b>	<b>30,7</b>	<b>29,7</b>	<b>100,0</b>
<b>SOE</b>	<b>59,5</b>	<b>27,2</b>	<b>13,3</b>	<b>100,0</b>	<b>SOE</b>	<b>57,0</b>	<b>25,1</b>	<b>18,0</b>	<b>100,0</b>
<b>Collective</b>	<b>41,9</b>	<b>37,2</b>	<b>20,9</b>	<b>100,0</b>	<b>Collective</b>	<b>39,0</b>	<b>34,4</b>	<b>26,6</b>	<b>100,0</b>
<b>Private</b>	<b>16,4</b>	<b>38,3</b>	<b>45,3</b>	<b>100,0</b>	<b>Private</b>	<b>14,4</b>	<b>35,9</b>	<b>49,7</b>	<b>100,0</b>
<b>HK-M-T</b>	<b>38,8</b>	<b>43,3</b>	<b>17,9</b>	<b>100,0</b>	<b>HK-M-T</b>	<b>37,0</b>	<b>40,5</b>	<b>22,5</b>	<b>100,0</b>
<b>Foreign</b>	<b>44,8</b>	<b>38,1</b>	<b>17,2</b>	<b>100,0</b>	<b>Foreign</b>	<b>41,2</b>	<b>37,2</b>	<b>21,5</b>	<b>100,0</b>

Note: KH-M-T means Hong Kong, Macao, Taiwan

Source: Compiled by the author from Almanach of China's Finance and Banking Magazine, Beijing, 2011, 303; 2012, 369

Table 5

**Share of loan distribution according to enterprise size in 2010 and 2011**

<b>2010</b>	<b>Large</b>	<b>Medium</b>	<b>Small</b>	<b>2011</b>	<b>Large</b>	<b>Medium</b>	<b>Small</b>
<b>Summa loans</b>	<b>100,0</b>	<b>100,0</b>	<b>100,0</b>	<b>Summa loans</b>	<b>100,0</b>	<b>100,0</b>	<b>100,0</b>
<b>SOE</b>	<b>71,6</b>	<b>43,6</b>	<b>29,0</b>	<b>SOE</b>	<b>70,3</b>	<b>39,9</b>	<b>29,5</b>
<b>Collective</b>	<b>9,0</b>	<b>10,7</b>	<b>8,2</b>	<b>Collective</b>	<b>9,9</b>	<b>11,2</b>	<b>8,9</b>
<b>Private</b>	<b>11,4</b>	<b>35,4</b>	<b>56,7</b>	<b>Private</b>	<b>12,2</b>	<b>39,2</b>	<b>55,9</b>
<b>HK-M-T</b>	<b>3,6</b>	<b>5,3</b>	<b>3,0</b>	<b>HK-M-T</b>	<b>3,5</b>	<b>5,0</b>	<b>2,9</b>
<b>Foreign</b>	<b>4,4</b>	<b>5,0</b>	<b>3,1</b>	<b>Foreign</b>	<b>4,1</b>	<b>4,7</b>	<b>2,8</b>

Note: KH-M-T means Hong Kong, Macao, Taiwan

Source: Compiled by the author from Almanach of China's Finance and Banking Magazine, Beijing, 2011, 303; 2012, 369

Table 6

**Change of loan distribution according to ownership and enterprise size from 2010 to 2011**

<b>Change 2010-11</b>	<b>Large</b>	<b>Medium</b>	<b>Small</b>	<b>Total</b>
<b>Summa loans</b>	<b>5,3</b>	<b>9,0</b>	<b>43,2</b>	<b>15,6</b>
<b>SOE</b>	<b>3,5</b>	<b>-0,3</b>	<b>45,3</b>	<b>8,0</b>
<b>Collective</b>	<b>14,7</b>	<b>13,8</b>	<b>56,0</b>	<b>23,0</b>
<b>Private</b>	<b>12,9</b>	<b>20,7</b>	<b>41,2</b>	<b>28,7</b>
<b>HK-M-T</b>	<b>4,9</b>	<b>2,8</b>	<b>37,7</b>	<b>9,9</b>
<b>Foreign</b>	<b>-3,2</b>	<b>2,7</b>	<b>31,6</b>	<b>5,0</b>

Note: KH-M-T means Hong Kong, Macao, Taiwan

Source: Compiled by the author from Almanach of China's Finance and Banking Magazine, Beijing, 2011, 303; 2012, 369

These tendencies are supposedly reinforced by the distribution of resources of different types of financial institutions, other than state banks and different financial instruments other than loans less attained by restrictive state control. According to a Peoples Bank of China (PoBC) internal research report, shadow banking instruments include commercial banks off-balance-sheet wealth management products (investment products), pooled wealth management products managed by securities firms, separate account wealth management products, securities investment funds, variable annuity investment accounts, industrial investment funds, venture capital investment funds, private equity funds, corporate pension plans, housing savings accounts, consumer finance companies, and non-bank leasing companies (Century Weekly, October 22, 2012, referred by Jingu, 2012)

## **CONCLUSIONS**

The global economic crisis bursting in late 2008 exerted dramatic impact on the Chinese economy. For a short while, the threat of political and economic destabilization emerged. However, the Chinese economic policy promptly adapted to the external shock. Besides usual state regulations it mobilized huge budgetary and bank resources to stimulate the economy. In order to relieve strong export reliance the stimulus package focused on central and western regions instead of export-oriented coastal provinces. Rather than stimulating the export oriented manufacturing sector it prioritized infrastructure building. Instead of supporting export oriented small and medium sized foreign private enterprises it privileged large domestic state owned enterprises.

China's crisis management between 2008 and 2011 proved to be successful. The national and local level responses to the global crisis met the original goals of compensating economic decline and decreasing export reliance. Different level governments and banks became promptly active, investments accelerated, economic indicators quickly improved, and unemployment rate soon dropped to the pre-crisis level. Infrastructural investments at central and western regions skyrocketed, attracting similar growth pace in manufacturing sector; moreover, demands of preferred state owned enterprises' investments and input demands in prioritized fields activated the market field as well.

However, stimulating state intervention initiated by the Chinese government turned into overheating; budgetary expenditures increased in enormous pace; legal and illegal land-confiscations and land-use sales grew unlimited; advancement of local bank lending kept steady; bad loans quickly re-emerged; growth of local governments' indebtedness through fiscal vehicles was uncontrollable; shadow banking widely spread; bubbles developed in production and infrastructure building requiring new, restrictive intervention.



Behind overheating systemic explanations are found both on national and local levels. We argue that though the transformation of the Chinese economy advanced substantially towards the market, state intervention activates the characteristics of party-state systems and their Chinese specifics. On the one hand, general system characteristics will define in time, space and different levels of aggregation, the system-specific distribution of resources to large, state-owned and politically integrated entities. On the other hand, these same characteristics will stimulate the drive for growth and for integration through the accumulation of political and social capital and government connections to meet selection priorities.

These characteristics will catalyze the translation of economically rational goals into politically rational criteria of distribution and similar motivations in investment behavior of actors and institutions both at national and local levels. Politically rational behavior with no economic efficiency constraints will lead to overheated economy. The individual characteristics of the network will define the locations of overheating: in the Chinese case, overheating not only emerges at central, but overwhelmingly at local levels. It will manifest in uncontrollable land transfers, overexpanding loans and other resources, budgetary overcommitments, unlimited investment activity of local financial vehicles resulting in local investment overheating and local indebtedness.

Priorities of state intervention will temporary expand the network through the faster growth and investments of integrated economic units at the detriment of those in the private sector, temporary slowing down the transformation process towards market economy. However, private sector activity will soon „top up” the overheating while responding to the input demands of prioritized economy born on politically rational motivation. At the same time, adaptation of the private sphere accelerates the expansion of the market sphere, thereby reinforcing the transformation process while adapting to the lack of efficiency constraints.

All in all, three systemic factors contribute to repeated overheating and local indebtedness in China: (1) the consequences of politically rational motivations of economic behavior as a general characteristic of party-state systems that are prone to overheating. These characteristics will catalyze the translation of economically rational goals into politically rational criteria of distribution and similar motivations in investment behavior of actors and institutions, both at national and local levels; (2) the decentralized character of the Chinese party-state network that locates the focus of overheating and indebtedness; and (3) the Chinese specifics of system transformation that increase the amplitude of overheating through the adaptation of market entities to the input demands of those prioritized by the selective distribution of resources. Amplified overheating and local indebtedness trigger new, restrictive state intervention.

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