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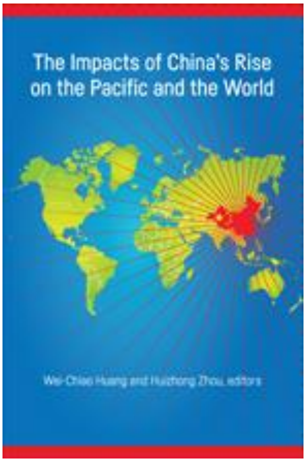

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The Impacts of China's Rise on the Pacific and the World

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3
Is There a Xi Jinping Model of Economic Reform?

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Since becoming president of the People's Republic of China in 2012, Xi Jinping has shaken up every aspect of Chinese policy. In the economic realm, Xi laid out an ambitious program of reform in the Third Plenum Resolution of November 2013. However, since that time, progress on economic reform has been slow and uneven. While reform is certainly not dead, there is real reason to question the consistency and effectiveness of Xi's economic policies. This analysis is based on three short steps. First, China is currently undergoing a growth transition. As the period of "miracle growth" ends, nearly every aspect of policy must adapt to a new economic environment. Second, contrary to what we would normally expect under such conditions, Xi Jinping's policy agenda generally relies on a strengthening of government and, especially, party intervention in the society and economy. This orientation is very different from what we would expect for a country moving into middle-income status whose society is far richer and more successful than ever before. Third, the result is a policy regime marked by inconsistent and sometimes contradictory objectives. Xi has attempted to overwhelm these inconsistencies by developing a centralized policy process that gives him very direct control over specific policy outcomes. However, it is unlikely that this approach will succeed in a country as big and complex as China.

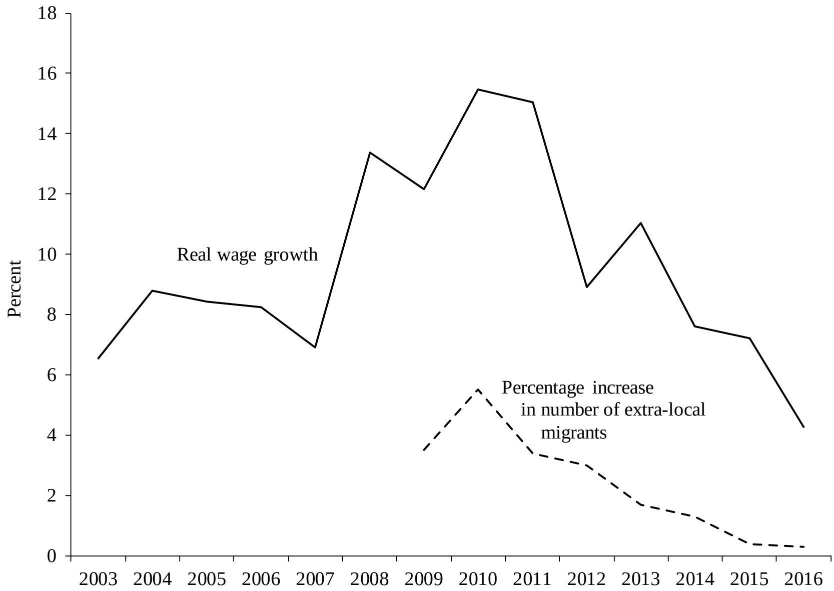
THE END OF MIRACLE GROWTH

Between 1978 and 2010, the Chinese economy grew at an average rate of just over 10 percent a year. However, in 2010 the growth rate fell below 8 percent and was 6.7 percent in 2016. This slowdown is not a short-term, cyclical slowdown but, rather, the reflection of a historical turning point. China's miracle growth period was quite similar to that which was experienced earlier by Japan, Korea, and Taiwan. China's growth lasted longer, to be sure, perhaps because some processes of structural change had been delayed during the Cultural Revolution and ended up contributing to the miracle phase of 1978–2010. We learned from the forerunner economies that when the end of the miracle growth era comes, it is often surprisingly abrupt and difficult to manage. This is the case with China as well.

China's economic policy was uniquely well adapted to the high-growth era. Government policy stressed investment, and infrastructure was built out ahead of demand. Since there was a huge reservoir of underutilized labor in the countryside eager to move into the cities, building the roads, factories, airports, and railroads at maximum speed was effective in maintaining high-speed growth. After China entered the World Trade Organization in 2001 with a network of export-oriented factories and regions already in place, there was virtually no limit to the speed with which exports could grow and industrialization could proceed. China could follow the precedents of earlier developing economies, copying and adapting hard and soft technologies, and reproducing systems of infrastructure.

Those days are over. As China moves into middle-income range it is immediately confronted with three fundamental challenges. The first is the end of "Cheap China." As the pool of underutilized labor in the countryside has been drawn down, wages for unskilled workers have risen rapidly. As Figure 3.1 shows, unskilled wages increased particularly rapidly from 2008 to 2013. Since 2014 and 2015, the pace of wage growth has slowed but still remains at 7–8 percent. Despite higher wages, the pace of migration from the countryside has slowed dramatically in recent years. The lower line in Figure 3.1 shows the growth in migrants working outside their home communities. In 2015, the number of cross-country migrants increased only 0.4 percent from the previous year. The increase in wages inevitably means that China's competitiveness in labor-intensive manufactures is eroding. Producers of garments, shoes, and sporting goods are beginning to find that cheaper wages in Vietnam and Bangladesh make it worthwhile moving there, even though overall productivity is still far below that in China. Most importantly,

Figure 3.1 Migrant Worker Earnings and Numbers (real annual growth rates)

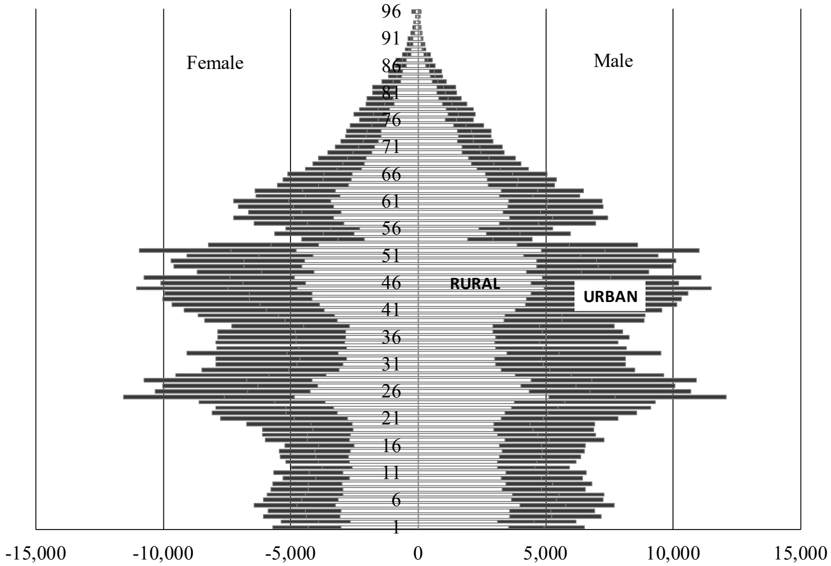


SOURCE: National Bureau of Statistics of China (2016).

these changes in relative costs will likely only strengthen in the future. This fundamental change in labor costs is strongly correlated with the end of the miracle growth era in earlier developing economies such as Japan, Korea, and Taiwan. China, in that sense, is no different.

In one respect, however, China has a distinctive labor force problem. Because of the country's "one-child policy," cohorts of young people entering the labor force today are unusually small. Figure 3.2 is a 2014 population age pyramid. It shows that the age groups graduating from high school and college are already much smaller than the age cohorts just above them, which are the mainstay of the current labor force. Indeed, the cohorts entering the labor force are slightly smaller than the age groups retiring from active labor. The second challenge is thus that since 2010 China's total labor force has plateaued and actually shrunk slightly. The really large decline in China's labor force will not begin until after 2020, but the process has already begun. It is worth

Figure 3.2 2014 Population Age Pyramid: Urban and Rural

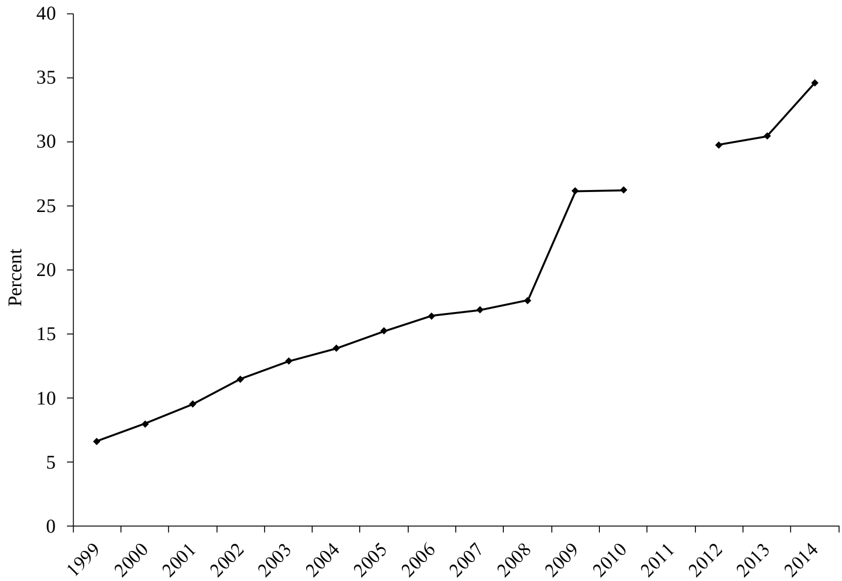


SOURCE: National Census Office (2016).

emphasizing how different this is from the experience of Japan and Korea. In those economies, the end of low-cost labor and the decline in total labor force size were two distinct events separated by decades. For example, Japan's first growth slowdown occurred in 1972, but the Japanese labor force only began to decline in the late 1990s, more than 25 years later. In China, both these changes are occurring at the same time, which means that the two effects reinforce each other, and the adaptation is bound to be especially challenging.

The third challenge is the debt overhang that China has built up over the past 7–8 years. China managed to sustain growth through the global financial crisis. Moreover, since the crisis, policymakers have attempted to keep the growth rate from falling too abruptly. In both cases, one of the primary tools they have used has been to aggressively expand bank lending to keep investment high. For example, one aspect of that debt overhang has been the debt accumulated by local government "funding vehicles." Between 2007 and 2014, that debt jumped from 17 to 35 percent of GDP (Figure 3.3). Debt loads have been increasing in

Figure 3.3 Local Government Funding Platform Debt—Share of GDP



SOURCE: 1990–2010: Gang and Yan (2012). 2012–2014: National Audit Office (2013, 2015).

other areas of the economy as well. While the overall debt level is not yet unsustainable, the trajectory certainly is. China needs to find a way to both slow the increase in debt and restructure the portion of debt that will never be repaid. In a broader sense, sustaining rapid growth by continuously increasing credit simply cannot work indefinitely. Economic policy needs to be adapted to be consistent with an economy growing in the 5–7 percent range.

THE POLICY OBJECTIVES

As described above, the end of China's miracle growth phase echoes and recapitulates what happened earlier in Japan, Korea, and Taiwan. Policymakers in each of those previous miracle growth economies responded in a distinctive fashion, but their responses shared a common feature: they all moved to a lower-investment and a "lighter touch" pattern of government intervention. For Japan and Korea, the heyday of government industrial policy occurred before the slowdown, during the latter half of the miracle growth era. In those countries, industrial policy arguably sustained high growth rates by making sure that the economy could move smoothly into large, capital-intensive heavy-industry sectors. Then, as the miracle growth era ended, both Japan and Korea shifted to a less interventionist industrial policy stance. The logic was that as these countries approached the world technological frontier, it was less likely that government bureaucrats would have an advantage over private actors in foreseeing the next stage of technological or sectoral evolution. Rather than trying to tell businesses how to invest, bureaucrats in Japan and Korea shifted to provide support for private businesses in whatever choices they made. Government investment in research and development, for example, remained high but was increasingly carried out by universities and government research institutes, and it sought to improve society's general knowledge base. Of course, this transition also corresponded with a transition to democracy in both Korea and Taiwan, and in general to more permissive and diverse societies.

Although China has a very different political and economic system from Japan and Korea, the general direction in which China has evolved since 1978 seemed consistent with the earlier evolution of Korea and Japan. Since the 1980s, the Chinese government has stepped back from many aspects of society, and as China became richer, Chinese society became more diverse and tolerant. However, to a remarkable extent, Xi Jinping has sought to reverse this direction. This is most evident in the purely political aspects. Xi Jinping has consolidated his own individual power more rapidly than anyone expected, and he has established his own personal dominance of the political process more thoroughly than most believed possible. The result has been a qualitative change from what had been called the "collegial enlightened dictatorship" of the Deng-Jiang-Hu era toward a more personal rule. Moreover, Xi seeks to infuse the political system with a kind of revivalist spirit and a stronger, top-down discipline. He seeks to project his own charismatic rule to nearly every corner of the system. We can see this objective in Xi's crusade against corruption, in his focus on strong party leadership, and in the ongoing ideological crackdown that is affecting many areas of Chinese society.

In a sense, Xi's policies can be seen as the opposite of those adopted in Japan or Korea, but for structurally similar reasons. As Chinese society has become middle income, the urgency of political goals has faded and materialism and corruption have increased. Rather than acceding to those changes, Xi seeks to reverse them. He has laid out an ambitious agenda that includes Chinese nationalism, assertive and charismatic authoritarian rule, and also economic reform. The question is, do these elements fit together?

Xi Jinping has consistently positioned himself as the architect of a significant economic reform program. The Third Plenum, in November 2013, laid out an economic reform agenda that was bold and broad. Although many parts of the reform resolution were vague—as is normal in top-level China policy documents—a number of concrete commitments were built into the document in order to establish credibility. Moreover, Xi Jinping himself took over a new "leadership small group" (LSG) that had direct authority over the economic reform process. The LSG was an implementation device: the overall reform resolution was broken down into 336 "initiatives" that were farmed out to specialized subgroups under the LSG. The most important of these subgroups from an economic standpoint was the "Economic System and Ecological Civilization Specialized Group." (Paradoxically, it is the only one not headed by a Politburo member.) This specialized group was given the responsibility for 118 out of the 336 total initiatives. Headed by Xi Jinping's close economic counselor, Liu He, this specialized group serves as a kind of economic secretariat, charged with implementing Xi's policy preferences.

This implementation process is a significant departure from past Chinese practice. Since the early 1980s it has been standard practice for economic policy to be run directly out of the governmental State Council by the premier. Successive premiers Zhao Ziyang, Zhu Rongji, and Wen Jiabao all controlled day-to-day economic decision making and placed their own personal stamp on economic policy. Under Xi Jinping, however, most of the crucial economic decisions relating to economic reform have been pulled back into the specialized group.

These changes mean that Xi Jinping's personal stamp is inevitably on the economic reform process. Xi has laid out a set of goals that shape and constrain the economic reform process. He has identified his own personal leadership with economic reform. The policy process has been changed in important respects that reflect Xi's wishes. The success or failure of economic reforms in China today, therefore, depend directly on whether the "Xi Jinping model" of economic reform is a reality or an illusion.

2015: THE ANNUS HORRIBILIS OF ECONOMIC REFORM

Reforms came out of the gate quickly after the Third Plenum in November 2013. There was a great deal of activity during 2014 that seemed to be focused on moving the reform process ahead in productive ways. However, during 2015, these initiatives met with unexpected problems. Indeed, it is reasonable to say that in 2015 economic reforms failed. We can see this in three major reform initiatives:

1) restructuring local government debt,
2) opening the stock market, and
3) state enterprise reform.

Each of these initiatives went off track in 2015. Whether they can be revived is an open question.

Restructuring Local Government Debt

Beginning in 2014, the Minister of Finance, Lou Jiwei, laid out an ambitious program of local debt restructuring. Even more impressive, in Lou's vision, debt restructuring was merely the first phase of a broader fiscal system reorganization. After weaning local governments off their dependence on debt, Lou believed he would be able to create appropriate conditions for an across-the-board overhaul of the fiscal system. In his original vision, this overhaul would be carried out in three years, from 2014 to 2016.

Following Lou's program, overall government debt was audited and officially registered as of December 2014. The intention was to cap debt at this year-end level and then begin to transform debt into new, local government "municipal bonds," which would be sold into the marketplace at an interest rate that reflected the relative creditworthiness of different local governments. This bold vision not only comprised restructuring fiscal relations but also the creation of a new fixed-income market that would contribute to China's financial reforms as well. However, this initial program of debt restructuring failed. When the first batch of bonds created by Jiangsu Province was offered to the market in April 2015, buyers and sellers were unable to agree on an interest rate. If this were to be a truly market-based sale of debt, buyers wanted substantially higher rates as compensation for their risk than the Jiangsu government was willing to pay. The government was forced to withdraw the offer.

The program was reformulated and converted essentially into a bailout. The mechanism was that the banks, which held the existing debt, were now pressured to buy the new municipal bonds. While a fiction was maintained that the interest rate was to be "mutually agreed," banks were led to understand that the appropriate interest rate should be similar to that of central government bonds—that is, extremely low. The banks were given some sweeteners to induce their compliance, but of course these predominantly state-owned banks could not refuse a central government policy initiative in any case. Under these new circumstances, local debt restructuring proceeded quickly. An initial quota of 1 trillion RMB was rapidly converted and, over the course of 2015, slightly more than 3 trillion were sold. Further debt restructuring continued, and even accelerated, and in 2016, an additional 5 trillion RMB in debt was converted.

Debt restructuring achieved some partial objectives, since it lowered interest rates and reduced the debt servicing burden on local governments. In that sense, it was not a complete failure. However, the objective of debt restructuring is not simply to reduce financial burdens but also to place the system on a new, more sustainable basis. A restructuring that is little more than a bailout sends a message to local governments that fiscally reckless behavior will be accepted and, indeed, may be costless. Of course, the Ministry of Finance has argued that local governments are no longer allowed to take on any new debt, but it remains to be seen whether this prohibition is credible. Moreover, the broader Ministry of Finance program of fiscal restructuring is in shambles. Major new taxes have not been introduced, and the restructuring of central-local relations is still far over the horizon.

Stock Market Reform

Beginning in 2014, Chinese policymakers laid out an ambitious reform of equity markets. Two measures exemplified this reform. First, all qualified firms were allowed to be listed on the market. This was a dramatic departure from past procedure in which only a select few firms, individually approved by the securities regulator, could list on the Shanghai Stock Exchange. The old system had unduly favored state-owned enterprises and led to delays, inefficiency, and corruption. Moreover, the old system had repeatedly tempted the government to use the pace of new listings as a tool to manipulate the stock markets' overall level. When the market was sluggish, policymakers would suspend new listings, so market participants could be confident that there would be no liquidity shocks. Indeed, new listings had been suspended for years before 2014. By taking steps to open up the listing process, the government was committing to a much more market-driven stock market, even at the risk of allowing short-term downward pressure on the market. Second, the Chinese stock market was de facto opened up to international investors for the first time. The creation of the Hong Kong–Shanghai Capital Connect allowed Hong Kong brokers to buy and sell shares on the Shanghai market up to a certain relatively generous quota. Since any international financial institution can maintain a Hong Kong subsidiary, this was a tentative and gradualist, but still unmistakeable, opening of the Shanghai market to foreign investment.

The impact of these initial reform measures was swept away by a huge boom and bust in the Chinese stock market. The Chinese market soared to a peak of 5,166 on June 12, 2015. From there, it wobbled and then crashed, amid something close to panic, to a low point of 3,507 on July 8. When the market plummeted, China's leaders lost their nerve. Beginning on July 5, Premier Li Keqiang presided over a series of meetings designed to bail out the stock market. An existing organization, the China Securities Finance Corporation, was provided with unlimited liquidity to buy up blue-chip (or, rather, red-chip) stocks. Remarkably, despite this massive intervention, the market continued to drop for another three days before finally stabilizing. With substantial direct government ownership now complementing already large state enterprise holdings, the stock market ended up further away than ever from genuine marketization. Moreover, public funds had once again been used to bail out politically influential groups.

From this account, it might seem that Premier Li Keqiang was the crucial actor in the stock market fiasco, but that is not the case. The entire political leadership, including Xi Jinping, had been complicit in statements that directly or indirectly encouraged the stock market bubble. Xi Jinping was widely quoted in Weibo (Chinese Twitter) as having advocated much higher market valuations. While there is no official source for these comments, the Chinese government could easily have denied or deleted them, had it chosen to do so. It is inconceivable that Xi Jinping did not either instruct Li Keqiang to intervene or at least signal his support for such intervention. After the bailout, new listings were once again suspended. The Hong Kong–Shanghai stock connect was still intact, but interest from overseas investors quickly evaporated. Not only did the market still seem to be in a bear mode, but the added risk of unpredictable government policy was too great for most foreign investors to take. A later episode in January 2016 merely accentuated these fears. As of mid-2016, government holdings in the stock market were still large, and the overall Shanghai index was languishing at around 3,000 points, which is to say below what it was after the summer of 2015 crash. The overhang of government holdings deters new investors from entering the market.

State Enterprise Reform

State-owned enterprise (SOE) reform started strong after the Third Plenum (November 2013) resolution. It was given high priority in the resolution, which also generated excitement because it introduced a number of potential innovative approaches. These included an expanded role for "mixed ownership," new investment funds that would manage government wealth, and a role for employee share owning. However, the attempt to translate these innovative ideas into reality was quickly stifled. Disagreements about basic definitions and philosophy prevented progress. Then, in the summer of 2014, the reform LSG made several decisions that thoroughly upended the stalled (but gradual) SOE reform process. Most strikingly, the LSG approved a limitation on the salaries of SOE managers. This policy, designed to bring SOE managers' salaries in line with those of bureaucrats at a similar level, reduced salaries in listed state-owned enterprises and dramatically lowered the salaries of managers at Chinese state-owned banks. The abrupt adoption of these salary caps underlined the extent to which Xi Jinping was seeking to achieve mixed objectives in his approach to SOEs.

Perhaps as a result of this confusion, at the same meeting a new specialized "SOE Reform LSG" was created to hammer out a compromise. However, this group—whose composition must have been endorsed by Xi Jinping—was headed by a long-time veteran of the economic bureaucracy, Vice-Premier Ma Kai. Moreover, it was staffed by the head of the existing agency that controlled SOEs, namely, the State Asset Supervision and Administration Commission (SASAC). This choice was unfortunate, to say the least. The whole purpose of SOE reform was to replace SASAC, which had evolved out of earlier government agencies, with a mixed mandate of incremental improvements to state firm management. However, if there were to be a substantial improvement in the way state ownership was exercised, it would almost certainly have to involve the creation of new kinds of investment funds. By handing the design of SOE reform over to SASAC leaders, Xi Jinping effectively ensured that the creation of new investment funds would be controlled by the insiders in charge of existing institutions. SASAC leaders would understandably seek to limit change, or at least make sure that any reorganization occurred under their own direct control.

It took one year for the SOE Reform LSG to draft its program. When that program finally emerged in September 2015, it was marked by contradictions and compromises and was met with a general sense of disappointment. Underlying this disappointment was the realization that SASAC had opted for an extremely gradual process of insider-controlled change. The 2013 reform resolution had called for the creation of new "State Capital Investment and Operation Companies." Much of the previous deadlock had been due to competing conceptions of what those companies should do. One version of the investment companies, proposed by the Ministry of Finance, held that those companies should manage state firms as purely financial assets. The investment funds would seek to maximize the financial returns of their holdings, potentially by having competing managers evaluated by the return they generate. This conception evoked comparisons with successful sovereign wealth funds, such as Singapore's Temasek. The alternative version of the investment companies, proposed by SASAC, stressed their utility as development agencies. After the SOE reform document was published, SASAC announced that it would convert two of its existing companies into "State Capital Investment and Operation Companies." These companies were designed to have specific developmental objectives and engage in hands-on restructuring. Thus, from the standpoint of the firms, the new ownership agencies that emerged from the SOE reform process were really not much better than the old SASAC control.

It was clear that Xi Jinping's vision of SOE reform included many competing objectives. Related to his anticorruption drive, Xi clearly wanted to improve oversight of SOE management. Paralleling his overall stress on Communist Party leadership, Xi insisted that Communist Party committees in the enterprise should have first right to discuss important strategic decisions on the enterprise. Overall, this meant that Xi Jinping was asking for SOEs to be given new tasks and to be subject to new oversight, even while telling them they should be given more autonomy to work as market-oriented entities.

The above account oversimplifies the complex process of SOE reform. On the positive side, the long, stalled agenda of converting all SOEs into corporations, with an established board of directors, has been given new momentum. In addition, firms are to be categorized according to whether they are in a competitive market environment or primarily a public service operation. In addition, many different provinces are experimenting with accelerating SOE reform. These positive elements may well improve the conduct and performance of China's SOEs in the medium term. But in 2015 it was clear that dramatic progress in SOE reform had not been achieved, and this was because of the conflicting goals and obligations placed on SOEs by top political leadership without a dramatic push toward a stronger market orientation. The SOE reform that emerged from this jumble of objectives is unlikely to be a real reform at all.

CONCLUSION AND EVALUATION

By the end of 2015, all three of the reform initiatives described in the previous section had failed. While the government continues to give verbal support to the goals of the Third Plenum, it has tacitly acknowledged the failure of the program by shifting emphasis to a new reform initiative called "Supply-Side Structural Reform." First floated at the end of 2015, this complex new initiative clearly represents a new approach. Policymakers have shown some inclination to resume progress in equity and fiscal system reform, and 2016 was designated as the first year of implementation of SOE reform (taking the September 2015 document as the definitive elaboration of the program). However, as of 2016, progress in these areas has been extremely modest.

What can we conclude from this situation? First, there is a Xi Jinping model—a model of economic reform that follows from his commitment to top-down, personalized rule. Xi declares a bold set of objectives, but they are not in the form of a broad, philosophical commitment to a new type of system; rather, they represent a wish list of objectives Xi would like to achieve from the existing system. In order to achieve those objectives, Xi sets up a new top-down implementation process.

At the beginning of the Xi administration, a number of analysts suggested that Xi Jinping's efforts to concentrate political power on its own hands were a necessary prelude to dramatic economic reforms. According to this view, entrenched interest groups had made incremental reform increasingly difficult in China. Therefore, an authoritative policymaker would need to concentrate power first and then push through with reforms. The experience of 2015 indicates that this view has very little explanatory power. On the contrary, concentration of power in the hands of just a few may even retard the reform process. Xi's personalized style leads him to impose contradictory demands on the reform process. This in turn leads to sometimes abrupt about-faces in the tasks set for other policymakers, which is exemplified in each of the reform areas discussed in this chapter. Xi's sudden moves to cap SOE salaries, abandon high-quality municipal bond markets, and intervene to save the stock market all had dire implications for the overall reform process.

The new organs Xi set up to implement these policies have also not worked well. These new agencies do not themselves have direct implementation capabilities—they can talk about bold reforms, but when it comes to actually designing a reform process, they end up falling back on the same government agencies that cater to interest groups. This is shown by the fate of SOE reform in 2015–2016. There really is no benefit to concentrating power if that newly concentrated power needs to compromise with existing interest groups to achieve institutional change.

Finally, there may be a deeper contradiction between the requirements of this stage of economic reform and the exercise of authority by a single individual. To be sure, an authoritative leader may be helpful in the first stage of reform, adapting to crises and throwing off old constraints. However, at a certain point, market-oriented reforms require the authoritative leader to step back and allow market forces to work without constraint. China today has developed a vigorous market economy—the greatest need at this stage is for independent regulatory and financial institutions, which have not been a prominent part of the Xi Jinping reform package. Therefore, the year 2015 provided little support for the idea that an authoritative Xi Jinping leadership can contribute effectively to the economic reform process.

With the failure of reform initiatives in 2015, China has been left without a good strategy to cope with the end of the miracle growth period. In a general sense, everyone understands that the "new normal" requires greater innovation, stronger orientation to domestic consumers, and the shift to a service economy. Economic reform is ideally suited to facilitate those structural shifts. Without a successful program of economic reform, Xi's China will be forced to rely on endless programs of government investment supported by an ultimately unsustainable increase in credit and debt.

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