Working Party of Senior Budget Officials

Bold Strategy or Irrational Exuberance – Can China’s Fiscal Foundation Support the Belt and Road Initiative?

39th Annual Meeting of Senior Budget Officials

6-7 June 2018
King David Hotel
Jerusalem

This paper was prepared by Professor Christine Wong, University of Melbourne, Australia.
It serves as the discussion background for the Keynote Luncheon Address.

For further information, please contact Jón BLÖNDAL – jon;blondal@oecd.org

JT03432603
Bold Strategy or Irrational Exuberance – Can China’s Fiscal Foundation Support the Belt and Road initiative?

I. Introduction

1. In a hearing before the U.S.-China Economic and Security Review Commission in January 2018, Jonathan Hillman of the Center for Strategic and International Studies described the Belt and Road Initiative as the “best-known, least-understood foreign policy effort underway”. This characterization seems apt. Since the program was launched in late 2013, it has emerged as China’s most important foreign policy initiative that is tirelessly promoted by the government, including staging a two-day gala Belt and Road Forum in May 2017 in Beijing that drew 29 foreign heads of state and representatives from more than 130 countries and 70 international organizations.

2. Despite the veritable cottage industry that has sprung up to explain, anticipate, conjecture and speculate about the size and shape of the program and its ramifications for China, the global economy and the world order, however, the BRI is still in its infancy, and specifics of the program are as yet hazy and poorly understood.

3. The idea of a new "Silk Road Economic Belt” was first introduced in September 2013 in Kazakhstan, where Xi Jinping called for regional cooperation in building a network of overland road and rail routes, oil and natural gas pipelines, and other infrastructure projects. This was followed in October, in a speech to the Indonesian Parliament, in which he called for building a "Maritime Silk Road”, a maritime equivalent of the “Silk Road Economic Belt”, with a network of ports and other coastal infrastructure projects. To help finance this “Road”, he proposed the creation of an “Asian Infrastructural Investment Bank” dedicated to the task.

4. As outlined in Xi’s speeches and elaborated in a 2015 document issued jointly by the National Development and Reform Commission, the Ministry of Foreign Affairs, and Ministry of Commerce, the program is of breathtaking scope that aims to building ‘multi-dimensional’ networks that link more than 60 countries from Asia to Europe, going through Central Asia, the Middle East and Africa (Figure A). Together, these countries would comprise almost two-thirds of the world’s population and some 40% of total gross world product, and the cost of building this “Belt and Road” would be enormous – with some estimates running up to US$8 trillion.1

---

At the risk of over-simplification, we can divide the BRI into two components: one is a hardcore economic program that comprises a mammoth set of infrastructural investments, and the other is an aspirational regional integration program that calls for cooperation and coordination with the participating countries on several levels: customs, trade, investment and financial policies; cultural and people-to-people exchanges, etc. Fostering multilateralism is a big part of the BRI strategy from the outset. While China has proposed the BRI and is spearheading the program, the government insists that it will be a joint effort, in partnership with participating countries. In support of this strategy, China has in recent years led numerous efforts in building multilateral cooperation and even new institutions. In November 2014, Xi introduced the idea of a Free Trade Area for Asia-Pacific at the APEC meeting in Beijing and won approval for a new “APEC Connectivity Blueprint 2015–2025”. It has also been proactive in other multilateral organizations in advocacy of reducing trade barriers, including the Regional Comprehensive Economic Partnership – a pan-Asia group of 16 countries (ASEAN +6) launched in 2013, which has already undertaken 20 rounds of trade talks, and hope to reach an agreement in 2018. At the same time, China led in the creation of new multilateral financial institutions including the Asian Infrastructure Investment Bank (AIIB), the New Development Bank (previously the BRICS bank), and smaller regional funds such as the China-Central Eastern Europe Fund, and have provided generous financial commitments as inducement for others to join.

The Belt and Road is a key part of the China Dream – to return China to its rightful place in the world. It serves clear and extremely important geopolitical objectives in China’s development strategy. In

---

2. https://www.ibanet.org/Article/NewDetail.aspx?ArticleUid=4c748836-b7e1-405b-af44-7dcbea257e64

3. Both the AIIB and NDB have projected capital commitments of US$100bn. The CEEF began Phase 2 of its operation in 2017, when capital commitment was increased to US$10bn from the initial US$1bn.
this paper I focus on the economic and financial considerations of the BRI, with a specific objective of assessing whether China has the financial wherewithal to implement this grand scheme. This assessment places the BRI in the long arc of fiscal expansion in China that began at the turn of the century, when a long run of double-digit annual growth of the economy brought government coffers to overfilling. To keep up, government spending ramped up from ¥1.6 trillion in 2000 to ¥12.6 trillion in 2012, and new programs proliferated, each one bigger and more ambitious than the last. The BRI was likewise conceived in that golden era of high economic growth, rising export surpluses and high foreign reserve accumulation.

This paper asks whether the BRI is affordable in the current era of the ‘new normal’, when China’s growth rate has fallen a long way from those double-digit levels. Aside from looking at the numbers, I offer a brief review of recent reforms to assess whether China’s fiscal institutions are robust enough to manage the transition to slower growth, and avoid overextending the nation’s finances under the BRI.

In the rest of the paper, I proceed by putting together the knowns and the unknowns of the BRI. Section II reviews the economic rationale for the BRI, both for China and for its partner countries along the Belt and Road. Section III assembles available information on the financing arrangements for BRI projects. Section IV looks at the main sources of risks for the program. Section V examines recent reforms and the safeguards they have instituted. Section VI concludes by pointing to a few risk factors to watch going forward.

II. The economic rationale

The Belt and Road Initiative is a key program in China’s economic development strategy. It was included in the “Decision” of the Third Plenum of the 18th Party Congress in November 2013 as a national strategy, and endorsed at the Central Economic Work Conference held a month later in December 4. It was also adopted into the Party constitution in October 2017.

The BRI is part of the strategy to find new sources of growth as its traditional ‘engines’ that had driven the “miracle growth” in earlier decades have sputtered: the transfer of labour from low-productivity agriculture to higher-productivity industry that began in the 1980s has slowed down. With the end of ‘unlimited supply of labour’ coming off the farms, rapidly rising wages have driven low-end labour-intensive manufacturing to neighbouring Vietnam and Cambodia. Exports, which had for a long time grown at a rate of 20-25 percent per year, have flattened out since the Global Financial Crisis, and even shrank in 2015. Finally, while building infrastructure has been a big contributor - and sometimes even the main driver, of growth over the past decade, China has reached saturation level for many types of infrastructure, especially housing and transport. Moreover, the high leverage level in the economy is forcing curtailment of investment rates. To sustain high growth, China must revamp its economic model and find new drivers.

The BRI contributes to this paradigm shift in several ways. First, it is designed to open new markets. Most immediately, the BRI project will create new demand for transport and construction equipment, knowhow and logistics services, and these will facilitate China’s transition to higher value manufacturing and exports, and spur innovation. Indeed, after more than two decades of catch-up investment in transport infrastructure, high speed rail, ports and logistics facilities, China has honed a competitive advantage in these industries, and is a world leader in high speed rail technology. The transport infrastructure networks that lie at the heart of the BRI are tailor-made to let China’s new comparative advantages shine.

12. Improved connectivity and reduced transport costs from the networks will spur trade. They have already turned China into the leading exporter to many countries in central Asia and the Middle East, and it is fast gaining ground in Eastern Europe. A rail service to Tehran since 2016 has delivered Chinese-made clothes, bags and shoes via Kazakhstan and Turkmenistan (Miller 2017). At the BRI Forum, Xi Jinping said that total trade between China and the Belt and Road countries exceeded $3 trillion in 2014-2016.5

13. Second, the BRI is well-timed for China’s structural transformation. Just as pressures of rising costs had led Hong Kong, Taiwan and South Korea to relocate labor-intensive, low-end manufactures offshore to China as they reached upper middle income levels in the 1980s-1990s, China is now poised to do the same in relocating some labour-intensive and low-end manufacturing to poorer countries in Southeast and Central Asia to maintain cost competitiveness. In addition, as China aims to achieve higher quality, greener growth in the 21st century, officials hope to find markets for plant and equipment from some of its resource- and pollution-intensive industries. Jin Qi, Chairwoman of the Silk Road Fund, argued that moving factories with excess capacity to B&R countries helps China reduce the supply glut at home while helping these less developed countries build up their industrial bases, just as China had imported second-hand production lines from unwanted surplus capacity from Germany, Taiwan, and Japan in the 1980s.6

14. Third, the BRI is an integral part of China’s regional development strategy. It was adopted in the 2014 Central Economic Work Conference as one of the three prongs of regional strategy, to promote development in the central and western provinces. Extending highways and rail links to hitherto hard-to-reach regions will turn deep-inland cities into transport hubs and raise their economic potential. For example, the China-Pakistan Economic Corridor will link Kashgar in Xinjiang to the Port of Gwadar, and rail connections to and from Urumqi is already making the city the gateway to central Asia. Likewise, the economic corridors to south and southeast Asia will link Yunnan and Guangxi to overseas markets.

15. Finally, the BRI will help to provide a more secure route for China’s energy and raw materials supplies, reducing its current heavy reliance on shipping through the Malacca straits and the South China Sea.

16. This recitation of the economic logic of the Belt and Road for China would be incomplete without a discussion of the genesis of the idea in the particular historical milieu in the early part of the 21st century, when China experienced a period of extraordinary economic growth and expansion of government. During 2000-2012, GDP grew at a rate of 13.9% per annum in real terms, and government revenues grew at a rate of 21.8% per annum in nominal terms (and 18.6% p.a. in constant prices). Figure B shows the amount of “fiscal space” provided by the rapid revenue growth that accrued to the central government under the current fiscal arrangements - the discretionary, unencumbered revenues at the central government’s disposal7. This amount was RMB 4.39 trillion yuan in 2015 (USD$704.4 billion). Needless to say, such budget surpluses can be expected to be emboldening.

---


7 Strictly speaking, these funds are not entirely “unencumbered” – this is the amount the central government transfers to local governments to help fund their budgets. Of these transfers, only tax rebates (the returned portion of shared taxes) are set by law or regulation, all the rest are made at the discretion of central government. With tax rebates having fallen from half of the total at the end of the 1990s to just 12% in 2015, broadly speaking, we can call this mostly discretionary.
17. During the administration of Hu Jintao and Wen Jiabao (2002-2012), spending on social services ramped up rapidly under the call to build a “Harmonious Society”. New programs proliferated, each one bigger and more ambitious – the free basic education program provided schooling for 140 million children, the rural cooperative health insurance scheme covered more than 800 million rural residents, and the urban and rural residents’ basic pension schemes provide coverage for everyone not already under workplace programs – completing the framework for a basic social welfare system, albeit at low and uneven levels of provision.

18. China also undertook massive investments in infrastructure, building expressways, airports, high speed rail lines, ports and logistics facilities at unprecedented rates. The rate of investment in infrastructure rose from a level of 5-6% of GDP in the mid-1990s to 12-14% during the 2000’s – more than twice the average for OECD countries (Wong 2014, Zhang and Barnett 2014). With GDP expanding at double-digit rates each year, actual investments in infrastructure rose from a level of RMB ¥1 trillion in 2000 to ¥7 trillion in 2012 and some ¥10 trillion today.8 The results can be seen everywhere. From a starting point of only 147 km of expressways in 1988, by 2011 China had built 68,000 km; and has added 10,000 km each year since then to reach 130,000 km today.9 The pace of building high speed rails has been even more astonishing. China has 25,000 km of lines linking 29 of the 31 provinces and cities, and account for two-thirds of the world’s high-speed rail lines.10

19. These investments coincided with China’s rapid growth and equally rapid ascent to world-leader status as a manufacturing and exporting power, and they propelled China to a top tier ranking in the World Bank’s logistics performance index, joining an exclusive group almost entirely of high-income

---

8 Author’s calculations.
10 https://en.wikipedia.org/wiki/High-speed_rail_in_China
countries.\textsuperscript{11} This experience undoubtedly cements the belief among Chinese planners in the power of infrastructural investments.

20. In the meantime, strong export growth and persistent current account surpluses after China’s accession to the World Trade Organization in 2001 brought foreign reserves flooding into the central bank vaults (Figure C). These reserves came partly from the currency controls which, until they were loosened starting around 2006, required the central bank to intervene in purchasing dollars to sterilize the effect of the current account surpluses on the yuan-dollar exchange rate.\textsuperscript{12} The secular increase in foreign reserves gave rise to the “going out” policy, which encourage Chinese firms and the government itself to invest outside of China to earn better returns than provided by holding US Treasury bonds.\textsuperscript{13} The “going out” push grew even stronger after the global financial crisis in 2008, when the resultant loose monetary policies in the US and Europe drove interest rates to near zero, and the People’s Bank ran heavy losses on its dollar holdings.

**Figure C. China’s foreign reserves**
*(unit: USD$ billion)*

21. Moreover, under conditions of financial repression and given China’s high savings rates and central bank’s sterilisation operations, banks were flooded with cheap money and eager to lend. On the financial side, then, toward the end of the 2000-2012 period conditions in China were extremely favourable for launching the BRI, providing a strong reinforcement for China’s need to find new growth drivers. Add to that the almost-fundamentalist belief in the power of infrastructure among Chinese leaders, and the BRI was not only the natural next step in China’s development, but also, in this mindset, a bold and innovative foreign policy to win hearts and minds in China’s neighbourhood.

**Benefits for participating countries**

22. The main argument for neighbouring countries to participate in this scheme is connectivity, strongly reinforced by the network effect and financing.

\textsuperscript{11} China was ranked 23\textsuperscript{rd} among 160 countries in infrastructure, and 27\textsuperscript{th} overall. The only country with a higher LPI score but lower per capita GDP is South Africa.

\textsuperscript{12} Until 2006/2007, China maintained a fixed exchange rate pegged to the US dollar.

\textsuperscript{13} The China Investment Corporation was established in 2007 as a vehicle to diversify China's foreign exchange holdings.
23. The importance of infrastructure in promoting economic growth and development has long been recognized – until the turn of the century, 70 percent of World Bank lending was in infrastructure. Even more important is the network effect\textsuperscript{14} that the BRI proposes to create, which could potentially multiply the impact of infrastructure and change the calculus of the investments – what may be an uneconomic undertaking for a single country may become viable when it is linked up and joined by infrastructure in other countries. These effects may be especially large in opening up market access for the land-locked regions and countries along the routes. In one of the more unexpected examples of expanding markets through connectivity, the deputy director of the Guangzhou Cargo Transport Center suggested that the opening of the Shenzhen-Minsk freight train has turned Shenzhen into a bridge between the 21\textsuperscript{st} Century Maritime Silk Road and the Silk Road Economic Belt, because “Goods such as rice and fruit from ASEAN countries like Vietnam and Laos can first be transported to Shenzhen by sea and then to Russia and Belarus by freight train.”\textsuperscript{15}

24. Many of China’s neighbours are poor. They have poor infrastructure, weak tax bases and little access to market finance since many have below investment-grade credit ratings (Miller 2017). Their economic potential could be significantly improved with investments in infrastructure that the BRI is proposing. For these countries, China’s offer of financing is a huge inducement to participate. In fact, many of the B&R projects were made possible with Chinese funding after being rejected by other funders, including the Hambantota Port project in Sri Lanka.

25. In sum, by taking the leadership in designing and proposing the BRI and committing substantial financial resources, China has put on the table a credible, highly attractive development plan and invited its neighbours to participate. The fact that Beijing was able to convene an international forum on short notice that drew 29 heads of state and representatives from more than 130 countries and 70 international organizations shows the program has won, if not necessarily converts, substantial interest around the world.

III. The Finances

26. One of the big unknowns about the Belt and Road Initiative is the scale of investment – especially Chinese investment. Headline numbers look huge. In the course of 2014-2015 alone, China committed a quarter trillion US dollars to creating financial entities dedicated to the BRI: US$100bn for the AIIB, another US$100bn for the New Development Bank (NDB, formerly the BRICS Bank), and US$40bn for its Silk Road Fund. During the Belt and Road Forum held in May 2017, Xi pledged to put an additional RMB 100 billion ($14.5 billion) into the Silk Road Fund, and said the China Development Bank and Export-Import Bank would be setting up new lending schemes of RMB 250 billion ($36.2 billion) and RMB 130 billion ($18.8 billion), respectively, for Belt and Road projects.\textsuperscript{16} Elsewhere, the number “$1 trillion” is frequently mentioned as the government’s promised injection (The Economist, WSJ, Caixin).

27. How large is China’s investment in BRI? The government’s statements have been notably restrained in estimating the government’s input to date. The 2015 vision statement repeatedly emphasized cooperation and coordination in implementation, with the strong implication that projects should be jointly funded. Elsewhere, the government and its advisors have urged Chinese entities not to get ahead of

\textsuperscript{14} The network effect is a phenomenon where a product’s value to the user increases as the number of users grows. Indeed, Metcalfe’s Law states that the value of a network is proportional to the square of the number of members in the network. Modern day examples include the internet and Facebook.


\textsuperscript{16} http://china.org.cn/china/2017-05/14/content_40811348.htm.
their partners. The National Development and Reform Commission (NDRC), the lead coordinating agency for BRI, reported in November 2017 that “more than US$50bn” has been invested since the 2013 launch, with nearly 2000 projects underway. The Ministry of Commerce reported that investments have totalled “almost US$30 billion in 2015-16” – also at a pace of about $15 billion per year. As for the quarter trillion dollar commitments to AIIB, NDB and the Silk Road Fund, these are long term promises. Paid-in capital has been much more modest – US$20 billion for AIIB, and US$10 billion for the NDB, stretched out over five years or more (Kroeber 2015).

28. When we turn to reports of cumulative investments and overseas lending to BRI projects financed by Chinese banks, the numbers are much larger. These are shown in Table 1. Together, they add up to a combined total of USD $846 billion already invested or lent. These numbers must be interpreted with caution, however. The reports do not make clear when the loans were made, and may include projects that predate 2013 and perhaps even only remotely related to the Belt and Road. Since its inception, the concept of BRI has been expanded and stretched to draw in even a “polar silk road”. The Exim Bank figure probably includes a substantial amount of trade credit, lumped together with infrastructure loans. Nevertheless, the size of these numbers point to a potential source of risk that merits watching, since they reflect credit extended to state-owned enterprises and local governments for their BRI projects.

17 This was the same figure cited by Xi Jinping in his speech at Davos.
IV. The main sources of financial risks and their containment

29. There are two main sources of financial risk for the BRI. First, a program that looked sensible may no longer be affordable in the current, less buoyant economic environment, when the consensus view is that China has reached a phase of development where its growth rate will be much slower. The government has coined the term the “New Normal” to characterise this era, whose growth rate they peg optimistically at 6-6.5%. Second, in China’s highly fragmented and decentralised economic system, the government has often struggled to rein in investment drives once they have been unleashed, such as what happened to the 2008 fiscal stimulus program. In that episode, the program ballooned from an original target of RMB ¥4 trillion to more than RMB¥10 trillion, and, a decade later, local governments are still digging out from under the mountain of debt they ran up (Wong 2011).

A. Is the BRI still viable under the New Normal?

30. China’s growth rate has been slowing since 2010, once the 2008 fiscal stimulus had run its course. This has had immediate and significant effects on government revenues, shown in Figure C. Not
only has revenue growth fallen, so has buoyancy – revenue growth is now less than GDP growth. In 2016, revenues grew by just 4.5% when GDP grew by 6.7%.

**Figure C. GDP and Revenue Growth**

31. The budget is also coming under growing pressure as programs introduced over the past decade require continuing funding, and the government’s fiscal space has shrunk. In Figure D, it can be seen that while expenditure growth lagged behind revenue growth during the first half of the period, with revenues growing faster than expenditures in 6 out of 7 years during 2001-2007; the reverse was true in the second half, when expenditures grew faster in six of the nine years after 2007.

**Figure D. Revenue and Expenditure Growth**

32. Going forward, China will face intense pressures to further increase expenditures in many areas. For example, even though China raised budgetary spending on education and health at an extraordinary
rate of 24% per annum during 2000-2014, at 4% and 6% of GDP, China remains below average levels for middle income countries in both sectors. As China strives to become an innovative economy, it will need to further improve investments in human capital. Other expenditure needs include investments in diplomacy and military support to the country's rapidly growing global footprint.

33. Foreign currency reserves have also come under pressure in recent years. After climbing to USD $3.8 trillion in 2013-2014, foreign reserves declined by $500 billion in 2015 and another $320 billion in 2016. This trend was stemmed in 2017, but only with the aid of strict capital controls.

34. The changed circumstances point to a need for greater caution in proceeding with the BRI, but are far from making the program unaffordable. China is now a US$12 trillion economy that has $3 trillion in foreign reserves and a healthy current account balance. Its capacity to invest is enormous: the financial sector has assets of more than RMB ¥300 trillion, and domestic investments are some RMB ¥35 trillion (US$5 trillion) per year. It can easily absorb US$10-15 billion per year investment in BRI, or even $100 billion.

B. Can decentralised investments be contained?

35. The tendency toward overinvestment by decentralized agents – not just local governments, but also state owned enterprises and even central government ministries, is the Achilles heel of Chinese macroeconomic management. Throughout the history of the People’s Republic, China has struggled with managing its sprawling, fragmented and decentralized structure of government. Since the 1950s it has gone through repeated cycles of centralization – decentralization in the search for the right balance between maintaining control and encouraging local initiative. One scholar has called this the “groundhog day” cycle, where “high investment supported by expansionary policy drives growth; inflation follows after (sic) lag; policy is tightened; growth drops away, but inflation is still high; more tightening; inflation falls at last, but growth falls away more than desired at the same time; policy is shifted from tight to expansionary; again, led by investment, growth rebounds” and the whole cycle starts again (Yu 2013).

36. The main source of financial risk for the BRI today is that these decentralized agents can push the program to overextend China’s finances. When the government called upon all provinces and cities to make plans for supporting the BRI, some commentators warned that it risked opening the door to a repeat of the fiasco during the 2008 fiscal stimulus program, when local governments responded to the same call with frenzied enthusiasm. In that episode, local governments rushed to support the central government’s stimulus plan by declaring huge investments of their own. One report noted that within less than a month of the announcement of the stimulus package, they had proposed a combined staggering total of RMB¥18 trillion in investment projects. By March 2009, Caijing estimated the first 18 provinces to publicize plans had announced investments worth RMB¥25 trillion yuan.

37. In this round, every province has reportedly produced a BRI plan, as did many cities, although not all of them are publicly available. Among the most ambitious was a 67-page ‘Construction Plan for the Transportation Hub and Silk Road Economic Zone for 2016-2030” presented by Xinjiang. The plan calls for the autonomous region to be transformed into a transport hub for the Silk Road, with Ürumqi and Kashgar becoming “comprehensive exchange centres for people, logistics and information between China, Central and West Asia, and Europe.” The Plan calls for investments of RMB¥1.86 trillion, front-loaded to have ¥1.4 trillion spent during the 13th Five Year Plan (2016-2020). Henan Province issued a

---

18 Estimated at 45% of GDP. In 2016, investment in infrastructure was estimated to be RMB ¥15 trn, and was expected to increase to ¥18 trillion in 2017 (Caixin Global).

plan for developing the "Silk Road in the Air" from Zhengzhou to Luxemburg, with each to become a logistics hub for the Asia-Pacific and Europe-America regions, respectively.

38. While these are indeed frothy, they appear to be the exception, and most plans are more modest and vague. For example, Chengdu’s plan calls for building 10 industrial parks or trade zones in countries along the Belt and Road and participating in 100 overseas investment projects with a total value of more than US$10 bn by 2018, and to double these figures by 2020. Quanzhou (Fujian) called for making the city a “Pioneer Zone for the 21st Century Maritime Silk Road”, and set targets for making overseas investments worth US$2bn and attracting FDI of US$3.5bn to Quanzhou by 2020. The restraint shown in these local plans probably reflect local officials’ expectation that overly ambitious plans were unlikely to pass through the tough vetting process that has been put in place by recent reforms.

V. Will this time be different? Recent fiscal reforms

39. The centrepiece of recent fiscal reforms is the new Budget Law (BL) passed in 2014. Under a process that then-Minister of Finance Lou Jiwei described as “opening the front door and closing the back door”, the BL allows local governments to borrow, but only through bond issuance, and with approval by the National People Congress and review by people’s congresses at the same level. At the same time, the BL and associated State Council documents have prohibited local government financial vehicles (LGFVs) from borrowing on behalf of local governments – a practice that was rampant over the past two decades, and ordered the LGFVs to delink their finances from those of local governments. To facilitate monitoring, a national registry of local government debt has been created, and regularly updated.

40. Another key provision of the Budget Law was that it imposed a mandate for governments at all levels to compile and release to the public a comprehensive government financial report within 20 days of approval by the people’s congress. It also required budget reporting to include not only revenues, expenditures and direct debts, but a balance sheet of government assets, liabilities and cash flows.

41. Another change is the vigorous enforcement of the budget transparency rule. Unlike previous attempts that had little penetration at local levels (Wong 2005), the Ministry of Finance Supervision Department is now auditing hundreds of thousands of spending units down to the county level to check for compliance. Their efforts have been supplemented by those of the National Audit Office, which has been given expanded powers and resources to conduct regular, rather than random audits of key departments and projects.

42. Finally, whereas previous rounds of reform often ended with the rollout of new policies, this time around there is recognition that the work is far from done. As follow-up monitoring has revealed continuing problems, additional provisions and adjustments have been rolled out, especially aimed at plugging loopholes that local governments keep finding to evade debt limits. In October 2016, the State Council issued “Plan for emergency response to local government debt risks” requiring all local governments to set up a Debt Management Leading Group.20 In April-May 2017, a package of decrees issued jointly by the MOF, NDRC, PBC, CBRC, CSRC and Ministry of Justice further laid out the responsibilities of local governments for monitoring and assigning accountability not only for direct debt, but also for contingent debts; and again stressing that LGFVs must be delinked from government finances.

43. To add to the enforcement efforts, tweaks have been made to add debt to the list of criteria for cadre evaluation, along with the assignment of personal life-long responsibility for it.

44. In 2017 the government began to focus attention on scrutinizing public-private partnerships and government procurement of public services as two new avenues for hidden debt accumulation by local governments. It also turned to strengthening regulation of the financial sector to stop the proliferation of off-balance sheet “innovations”, aimed squarely at shadow banking and internet lending – newly emerged areas that had fallen through the cracks of the regulatory framework.

VI. Conclusion

45. The Belt and Road Initiative is a bold strategy that has sound economic rationale but substantial risks – geopolitical as well as economic. In introducing the BRI, China imposed a coherent vision to what had already been taking place in a piecemeal fashion over the past decade – of Chinese firms (often SOEs) investing in and building infrastructure in Southeast and central Asia. The recasting of these activities in a new framework of collaboration fits neatly into Xi’s emerging foreign policy framework, and may be seen as China’s new pledge to improved behaviour, or, as one author calls it, Asian Integration 2.0 (Miller 2017).

46. At this stage in its development, China is well-endowed with the technical and financial capacity for implementing the BRI. The question is whether the government can manage the program prudently. After undertaking reforms and institution-building over the past three years in public financial management, China is better able to manage the risks today. These are still just works in progress, though, and local governments are still running ahead of regulators. However, with continuing efforts from the Ministry of Finance, the National Audit Office and other ministries, and with strong reinforcement from the anti-corruption campaign, prospects are good that China will be able to finally build frameworks that can curb the ability of local governments to go off-budget for resources.

47. While recent reforms have introduced safeguards for managing bottom-up risks, however, they provide little protection against risks introduced from the top – those introduced by central ministries, large SOEs, and hubris. In the 2008 episode, central ministries had also piled on to take advantage of the stimulus program as an opportunity to grow their portfolios. The most egregious was the Ministry of Railroads. Under then-Minister Liu Zhijun pushed investments up more than 10-fold from 2004-2010 by adding lines and pushing up the speed of trains. The China Development Bank, too, expanded its portfolio of lending overseas far beyond its mandate, as did the China Exim Bank. The biggest risk today is that of the Belt and Road program being pulled into irrational exuberance by an overambitious foreign policy agenda.