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Industry in China from an OECD perspective.

I wish to address four points in my presentation:

- Over two decades industrial progress in China has been remarkable, but problems remain and time to solve them is running short.
- The entry of China into WTO requires more efforts to increase domestic competitiveness of industry and focus on framework conditions, rather than top-down sector specific industrial strategies.
- At the current stage the issue of mobilisation of resources, labour and capital, but also land, to the most effective use is becoming a priority. China should avoid wasting resources.
- There is need for policy coherence in the implementation and sequencing of reforms in the industrial sector.

1. There has been much progress in industry since the starting of market reforms in 1978. Increase in industrial output contributed to total output growth at remarkable rates, in spite of the caveats on Chinese statistics. The rapid process of industrialisation and productivity growth was facilitated by the possibility of moving resources from agriculture while also ensuring agricultural output growth. One could argue that similar results could have been obtained also under a centrally planned economy. Under a planned economy, however, the risk is that industry does not meet consumer demand and that output, in the end, is wasteful.

The collapse of output in Russia and other European transition countries, after the disintegration of the Soviet Union and the transition to market was to a large extent the result of industrialisation forced from above with no concern for consumers' demand.

China, thanks to the starting of reforms in 1978, has managed to avoid this scenario. Industrial progress has benefited from government-led structural changes: namely the transformation of industry ownership and the progressive opening of the Chinese economy to foreign trade and investment. Wholly owned or state controlled government entities currently account for less than 30 per cent of industrial output. SMEs have become the engine of growth. Progressive liberalisation has brought the average tariff rate in China down to 15 per cent from 40 per cent some ten years ago. In recent years FDI inflows have averaged 4-5 per cent of GDP.

Nonetheless, in spite of some improvement over the last few years, many large, as well as medium and small-sized, state enterprises are still making losses. Deterioration in industrial performance became apparent in the 90s. Our study documents which sectors are particularly affected and analyses the underlying negative factors. On the one hand, Chinese large-scale enterprises suffer from the legacies of past central planning and policies: high social costs that in OECD countries are borne to a large extent by the government budget, territorial fragmentation that force them to a sub-optimal scale of activity, inadequate technology and limited capacity to innovate. Their managements have been drawn from government bureaucracy and lack the skills, experience, and incentives to focus on efficiency and profits as their overriding objectives. On the other hand, the lack of external discipline hinder the incentives to reform. Bankruptcy and liquidation are not used for restructuring and preferential treatment shelter large-scale enterprises from competition.

There are, of course, some very dynamic segments of the Chinese enterprise sector that have become highly competitive and efficient. Typically, these have been enterprises that have *not* been favoured by special government attention or been part of 'champion' or other government industrial programmes-- indeed such enterprises have generally performed poorly. Rather, the dynamic enterprises have succeeded in large part due to their exposure to competition and other external disciplines. But a large portion of Chinese industrial enterprises are ill prepared to withstand competitive pressures that are bound to increase with the entry of China into WTO.

2. To boost competitiveness China will need to keep restructuring SOEs, that in economic terms means to force harder budget constraints on loss-making enterprises, and create a more favourable business climate for SMEs. The issue of how to improve both the static and dynamic competitiveness of Chinese industry in the light of Trade and Investment Liberalisation is becoming paramount. Improvement in static competitiveness will need accelerated restructuring and consolidation. Fostering dynamic competitiveness will need addressing the issue of technological upgrading.

On the first point (static competitiveness), the policy of mergers and acquisitions (M&A) carried out under government impulse goes in the right direction if the aim is to provide enterprises with the autonomy that is needed to select a market-oriented production strategy. Our study documents some successful examples of M&A. This policy goes, however, in the wrong direction if the aim is to rescue non viable enterprises, putting the burden on the viable ones, because, in the end they will all suffer.

Our study focuses on measures directed to create a favourable business climate and introduce harder budget constraints to all players. A favourable business climate means that both entry in the market, and exit from the market is made easier to any type of enterprise, whether state or non- state owned. Once the market rules of the game are introduced, government authorities, at any level, should refrain from interfering in areas that are not of their competence or clear national interest.

OECD experience shows that the business climate improves when politicians refrain from interfering with business. In practical terms this means that there is a net benefit if central, local or municipal authorities divest their interests (property) in non-strategic enterprises and let market incentives play their role. Corporate governance should be aimed at fostering profit seeking by autonomous commercial entities. But in order to work properly, corporate governance needs not only structures that resemble those of OECD countries, such as boards of directors and boards of supervisors. China has already introduced these structures, but these are likely to remain void in the absence of enforceable regulations (such as proper accounting, auditing and transparency) and incentives that prompt management to respond to market, rather than to political directives. In the area of natural monopolies, when competition principles can be introduced and help cutting costs, there is need for complementary regulatory reforms to avoid that non-state monopolies turn out to work as badly as state monopolies.

The second point (rising dynamic competitiveness) is also important. Moving from low to high value added industries, and in particular those that offer greater scope for technological advance and spillover benefits should allow China to attain a higher growth path potential.

Structural shifts of this sort need strengthening the capacity of industry to innovate and absorb new technologies and involve a complex learning process where new skills, focused networking and new forms of organisation need to develop.

In pursuing improvements in both static and dynamic efficiency, the role of domestic policies is to create the framework conditions for industrial restructuring and technological upgrading. OECD experience in this area is that decisions made on purely commercial criteria are superior to, and less costly than, those taken by administrative fiat.

3. Mobilisation of resources will be necessary to support the most dynamic sectors and enterprises. This concerns primarily labour and capital, though in a not too long distant future China will have to tackle also the issue of land. Mobilisation of land means allowing for its alternative uses in response to profit incentives. Entire rural communities could benefit from more liberalisation in this field.

The mobility of labour to comparatively more dynamic regions, districts and cities while moderating wage pressures in these regions, will relieve unemployment pressures in less dynamic areas. The mobility of capital to regions where wage levels are comparatively lower will foster their development. To support market-driven mobility of resources, in particular labour, our study argues that administrative barriers must be gradually removed. Policy action against product market segmentation, where this exists, will also help this process and contribute to reduce interregional disparities. My colleagues in the following sessions will discuss the implications of reforms, or lack of reforms in these areas.

4. Let me conclude with a comment that draws from the study in its entirety. This study addresses the policy implications of the further integration of China in the world economy in a number of specific areas. What the entire study, however, shows is that separate reforms would be ineffective if pursued under a separate agenda. There is need for policy coherence and sequencing of reforms.

Specifically, to make China’s industry more competitive in the world economy, domestic competitiveness must also increase. At present there are several weaknesses in the competitive environment: established enterprises are often able to prevent the entry of outsiders in their own field of activity, often thank to local political backing. Different legal and regulatory frameworks applying to different categories of ownership also limit competition whether through differentiated minimum capital requirement or through rather unclear criteria of selection of “strategic” enterprises.

Finally, now more even than in the past, reforms need to proceed on a broad range of fronts concurrently and be mutually supportive. Nearly all reports in the study highlight the critical importance of improvements in the capabilities of the financial system, the need to strengthen competition, governance, and other framework conditions, if the payoff from individual measures to address problems in industry or other specific sectors is to be adequate. The challenges of improving technology of Chinese industry is a good illustration of this need. China's technology capabilities have suffered not simply because of insufficient government spending on R&D, or any other single cause. More important is that firms have had limited incentives to keep up their technologies and limited capabilities because of their poor governance, inadequate management, and burdens of government interference in their operations. Equally important are weaknesses in the external "enabling environment" for dissemination and sharing of technological knowledge, which depend upon the protection of intellectual property rights and incentives and capabilities that allow firms to develop and sustain longer-term relationships to develop technology at all levels. Thus, as the report points, out, while government still has an important, but limited, direct role to play in promoting technological upgrading in certain areas, China's technological capabilities are likely to continue to be inadequate until these these broader incentives and capabilities in the external environment are substantially improved.

My presentation focused on what remain to be done to strengthen the benefits of TIL for China's industry and make it more competitive. There is much to be done, indeed, but this is feasible, particularly if assessed in the light of China's past achievements. Building a large consensus for the acceleration of reforms that can be socially painful in the short run will facilitate the task. Hopefully, the Chinese experts present at this meeting will be able to play a fundamental role in persuading policymakers and the public that:

Liáng Yào Ku Kou.
(an effective medicine needs to be bitter)