

Overview of the OECD's China Study on *China in the World Economy: The Domestic Policy Challenges*

**Introductory remarks by Andrew Dean,¹
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I am pleased to have the opportunity to participate in this joint seminar on the domestic economic policy challenges of China's trade and investment liberalisation. Although the OECD study has been prepared on our own responsibility, it could not have been done without the generous and excellent help and support we have received from Chinese government agencies, and especially from the Development Research Centre. We were particularly fortunate to have a number of experts from Chinese government agencies as authors, or co-authors, of several chapters of our study, and I am glad to see that many of them are here today.

As the Secretary-General has just mentioned, we still have much to learn about China, and indeed this study has increased our awareness in this regard. We have worked hard to understand China's current situation and problems. And we hope that the conclusions and suggestions in our reports will be useful in contributing to the policy dialogue among China's policy makers, and its citizens, about the policies that need to be taken to reap the benefits of WTO entry.

Let me now turn to the study itself. I am going to give an overview and summary of what we see as the main conclusions and messages from our study, as a warm up to the more specific points the others on our team will talk about in the following sessions. I would like to divide my remarks into three themes:

- First, the issue of where China's economy stands as it embarks on further trade and investment liberalisation.
- Second, the main overall messages about changes that will be needed to reap the full benefits of opening to the international economy.
- Third, and to close, some more specific and distinctive messages that we intend to discuss during the later sessions of today's seminar.

1. I am grateful to the various contributors to the OECD's study on China for making possible the launching of this study in Beijing and to our colleagues in the DRC who have supported the work and organised this Symposium. I am particularly grateful to Charles Pigott for his role as project leader and for helping me in putting together these remarks giving an overview of the study. They draw heavily on his synthesis report which is available on the OECD website.

Theme 1: Where does China's economy stand as it begins further international opening?

All of the individual reports which make up the 22 chapters of the full study review the tremendous accomplishments China has made during the reform era. These accomplishments are well known to you and to outside observers, and they have been documented in previous OECD studies and other studies on China. However our goal in this study has been to concentrate on the future by seeking to provide constructive and specific suggestions for how China can build on these accomplishments. To this end, we have focused on identifying the main problems that China will need to overcome as it adjusts to, and seeks to reap the benefits from, its further opening to the international economy.

In an overall sense, we see four basic conditions in the economy as a whole that will need to be addressed:

- First, there is extensive unemployment, under-employment, and inefficient allocation of resources in the economy, particularly human and capital resources. Mr. Kwiecinski and Mr. Reutersward will later discuss the challenges of absorbing the large surplus of workers from the rural economy, and Mr. Thompson will highlight the weaknesses in the capabilities of the financial system to allocate capital. In effect, as impressive as its performance has been, China is operating below its full potential and we see the achievement of that potential as a central challenge to policy.
- Second, as Ms. Malle will discuss, while part of industry is doing well and is prepared to meet the challenges of WTO entry, much of industry is suffering from serious problems hampering its efficiency and its ability to compete. There will need to be extensive restructuring in the business sector, but key mechanisms needed to accomplish this restructuring will have to be improved.
- Third, the economy has become fragmented and segmented, and this is a key cause of the problems in resource utilisation and an obstacle to efficient business restructuring. As we all know, there are important barriers that distort movements between rural and urban labour markets, and different types of businesses are still subject to different rules and treatment. In some respects, China's coastal provinces are becoming more integrated with the international economy than they are with the central and western provinces of China.
- Fourth, as Mr. Pigott will discuss later this afternoon, these structural problems have become a drag on real GDP growth and macroeconomic performance more generally. This poses a risk because adjustment to WTO, and China's overall development, depends on a virtuous circle in which good macro performance facilitates structural adjustments, so that they in turn can sustain adequate growth. This interaction between macroeconomic and structural policies and performance has been found in OECD countries to be the key to raising growth.

Theme 2: The change of emphasis needed in the direction of policy

The main overall message from our study is that the key to the realisation of the benefits of WTO membership lies in the success of domestic economic reforms to address these problems and to foster the development of the economy more broadly. The pragmatism and flexibility that have characterised China's past reforms and which have been important contributors to its success will continue to be needed. However addressing the problems I have mentioned, and realising the full benefits of trade and investment liberalisation, is likely to require a significant change in the emphasis of reform policies from those that have been pursued for much of the past.

A point emphasised repeatedly throughout the individual chapters of the study is the *increasing interdependence among the problems and the policies needed to deal with them*. Thus, as Ms. Malle will discuss further, raising China's technological capabilities is not simply a matter of more government money spent on R&D or more incentives for firms to improve their technology. It depends as much or more on broader reforms to improve corporate governance so that companies pay proper attention to technology needs, on increased competition to bolster incentives to keep up technologically, and on improved financial system capabilities to assess and meet the needs of promising new technology companies.

This interdependence has several important consequences for how reforms will need to be carried out:

- The potential gains from policies to promote particular sectors on a preferential basis are likely to be much less in the future; the risks that they will have counter-productive effects are greater.
- The emphasis now needs to be on *economy wide policies* to address problems that have accumulated from the past. These policies need not only to address problems that have been built up from the past, such as the woes of state-owned enterprises and the financial problems of the banking system. They also need to level the playing field among markets, businesses and regions in order to improve the integration of the economy. Equally important they need to improve the incentives and capabilities of businesses, workers and other economic actors to respond to market forces.
- Thus, even more than in the past, reforms need to be pursued on a broad range of fronts, in a co-ordinated, mutually supporting fashion. Payoffs to individual policies depend increasingly on progress on supporting measures.

In this context, our study lays out three basic objectives that need to be achieved over the next five to ten years to realise the benefits from China's further opening:

- *To improve resource utilisation* so that China moves closer to its productive potential. This will depend in large part on success in achieving better integration among the various segments of the economy.
- *To strengthen 'framework' conditions* essential to the effective functioning of markets. These include competition policy, financial supervision and regulation, corporate governance, property rights, and judicial enforcement.
- *To improve the capacity of the government to support economic development*. As Mr. Pigott will discuss further this afternoon, this involves reforms to public finances and spending, increasing the flexibility of macroeconomic instruments to manage the aggregate economy and facilitate structural adjustment, and the development of a framework for regulatory policy in which government formulates and enforces rules for market functioning but does not seek to intervene directly in resource allocation or other decisions best left to markets.

As I have indicated, a broad range of policies, pursued concurrently, are likely to be needed to achieve these goals. However policies also need to be pursued with a clear sense of priorities, so that reforms pursued initially provide the foundation needed for successive reforms. In this spirit, the study highlights three sets of measures we see as needing to be accomplished over the next several years, to remove obstacles that are now blocking progress:

- *To remove present obstacles to business sector restructuring, so as to ‘unleash’ market forces to become the driving force* in this area. Particularly important in this regard are measures to end government interference in enterprise management and restrictions on their autonomy to carry out value-enhancing mergers and other restructuring; and on curtailing regional and other forms of domestic protectionism.
- *To accelerate and to deepen the process of financial reform, with the most immediate priority being to restore financial health to the banks and other financial institutions* that are now weighed down by high non-performing loans. Admittedly, this is only a first step and one that needs to be taken with broader reforms. However our experience in the OECD, underscored by some painful experiences, notably in Japan over the past decade, is that allowing non-performing loan problems to persist in the hope that institutions will ‘grow out’ of them only leads to higher costs later on and damages macroeconomic performance in the meantime.
- *To move decisively to place public finances on a sound and sustainable basis.* This is critical if China’s government is to be able to pay for its part of the clean up of financial institutions’ balance sheets, provide the unemployment and other ‘safety net’ benefits necessary to cushion the social costs of domestic adjustment, and increase government funds for education, technology, and other areas key to China’s longer-term development.

Theme 3: Some distinctive points from the OECD study

Finally, as a preview for the later sessions, I would like to highlight a few points that my colleagues will develop that seem to us to be somewhat ‘distinctive’. I mean distinctive in either being somewhat different from other analyses, or ‘conventional wisdom’, or which represent a somewhat different emphasis from current policies, as we read them.

- On the enterprise sector, as Ms. Malle will discuss, we see small and medium size enterprises as critical to China’s development and conclude that they need to be given greater emphasis compared to that now being devoted to large enterprises.
- On agriculture, Mr. Kwiecinski will argue that the agricultural sector may not suffer as much of a shock from WTO entry as many observers have feared.
- On the financial sector, as Mr. Thompson will discuss, the main threat from liberalisation in the financial sector does not come from foreign institutions, but from the poor capabilities and financial conditions of domestic banks and other financial institutions, *and* the poor financial state of many of their traditional business customers.
- On the social security system, Mr. Reutersward will explain why a key priority in reform of social benefit programmes is to achieve greater equality in burdens on businesses and workers.
- Finally, on macroeconomic issues, Mr. Pigott will argue that the government should be able to afford to pay the necessary costs of reforms, including restoring the health of financial institutions, *and* sustain sound public finances - provided that there is success in carrying out certain key reforms.

As mentioned already, these issues are all related and need to be tackled in a coherent way. That is why we are happy to see many Chinese experts here today, and why we are grateful to the Development Research Centre for giving us the chance to jointly discuss these issues at today's seminar.