

# Speeding up the Reform and Liberalization Processes to Meet the New Challenges for China's Post-WTO Accession\*

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China's likely WTO accession would mark its overall integration into the world economy as well as its participation in economic globalization. It would provide an international market with broader dimensions and more opportunities for China's economic development and would create greater impetus for promoting reform and development. However, China's economy would undoubtedly be faced with severe challenges on many fronts as well, which is not necessarily a bad thing. In any event, China should, under the pressure of these new challenges, speed up its reform and the opening of Chinese markets in order to provide a better institutional platform and legal infrastructure for China's economy to take off.

## I. Challenges after China's WTO Accession

### A. INTERNATIONAL COMPETITIVENESS OF SOME SECTORS AND ENTERPRISES IN CHINA

After China's WTO accession, those administratively monopolized, state-protected, infant or problem-ridden sectors and industries would be greatly impacted. One example of this is the auto industry. Currently, the overall level of auto industrial development in China is far below that of developed countries. The aggregate production of all auto works in China is less than that of one single auto manufacturer in some developed countries. Therefore, it is impossible for China to achieve economies of scale in the auto industry. After China's accession to the WTO, the double protection of tariff and non-tariff barriers would be removed. In such a situation, many auto works operating on small scales, with high costs and with backward technology would be forced out of competition. In addition, telecom-

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munications, banking, insurance, and hi-tech industries as well as agriculture probably would be similarly impacted.

International competitiveness of enterprises is fostered by intense market competition. With little policy protection, China's television and textile industries have grown substantially. Therefore, within the limited "cushion period" of China's overall market opening, China's domestic market should be opened without delay to strengthen the competitiveness of home enterprises.

#### B. THE ADMINISTRATIVE SYSTEM OF THE CHINESE GOVERNMENT

The challenge to be faced by China's administrative system is deep. Owing to the influence of the planned economy, the Chinese government imposes too much direct and arbitrary administrative intervention over economic activities, lacks an institutional framework for encouraging creative and dynamic development, has a weak ability to formulate and enforce rules, and forms separate systems in different departments and industries that do not coordinate with each other. In view of these facts, it is imperative to strengthen the government's administrative system reform, clarifying the relationship between government and market and modifying the government's role in this relationship.

#### C. UPGRADING THE INDUSTRIAL STRUCTURE

In recent years, developed countries in the West have been undergoing a new round of industrial structure upgrading and transition, with labor-intensive industries transferred to developing countries on a large scale. This creates both opportunity and challenge to China's accession to the WTO. On the one hand, China could increase its export of labor-intensive products to developed countries and attract direct foreign investment in labor-intensive industries to alleviate the employment pressure and stimulate economic growth. On the other hand, China would probably always be in an unfavorable position in the international division of labor if it fails to create dynamic comparative advantages and only passively restructures its industries while developed countries are upgrading their industrial structure.

#### D. CHINA'S MACROECONOMIC REGULATION ABILITY

After its entry into the WTO, China's current account would be more open and capital flight would perhaps become more serious as a result. With the opening of the financial service sector, more foreign banks would be allowed to enter the Renminbi business in a larger scope and a great number of home enterprises would turn to foreign banks for financing services. This would inevitably strengthen the exchange between home currency and foreign currencies as well as increase the inflow and outflow of international capital, thus making the control of capital assets more difficult. On the other hand, the WTO principles on tariff protection also require the gradual removal of non-tariff barriers, which would make China rely more on indirect regulatory measures such as monetary, fiscal and foreign exchange policies for controlling its international balance of payments. This would pose new challenges to China's ability to coordinate conflicts between internal balance and external balance to stabilize the macroeconomy.

## II. Countermeasures to Be Taken

### A. SHAPE THE MICRO BASIS OF MARKET ECONOMY AND INCREASE THE COMPETITIVENESS OF ENTERPRISES WITH STRATEGIC RESTRUCTURING AS THE FOCUS

The strategic restructuring of the state economy should be based on the clarification of the respective roles of government and market and hence sectors of "entry" and "exit" for the state economy according to the laws of market economy. First, the role of the state economy should be clarified as fulfilling the goal of state public policies and there should be specific limitations on which sectors can realize increased government investment. For industries with mature market mechanisms, the government shall not increase investment in principle, whereas for strategic industries or industries where the market mechanism fails or other market players can hardly enter, the state economy shall play a dominant role. Second, state-owned-enterprise (SOE) reform and asset restructuring should be advanced in certain categories. For industries with overcapacity, the assets should be transferred to public departments or new industries where government reinforcement is necessary through asset replacement or restructuring. Unprofitable and insolvent enterprises without potential should be declared bankrupt. Third, the state economy and collective economy should complement each other, and the administrative monopoly in departments and sectors should be broken to allow the entry of non-SOEs to participate in the restructuring of SOEs.

### B. ACCELERATE FISCAL AND FINANCIAL SYSTEM REFORM TO ENSURE RELATIVELY RAPID ECONOMIC GROWTH

A sustained and rapid economic growth could provide a relatively favorable environment for China's likely accession to the WTO and strengthen China's ability to fend off external negative impact. Currently, besides the expansion of government spending, the spending structure should be properly readjusted. The taxation and fee collection policies should also be adjusted to transfer production-based, value-added taxes into consumption-based, value-added taxes so as to reduce the burden hindering enterprise development. In the financial system, special attention should be given to establishing regular and standardized financing channels for the private economy, including setting up credit unions primarily serving the needs of non-SOEs and small and medium-sized enterprises, and exploring effective ways for promoting financing of non-SOEs in the capital market. Moreover, listed companies should actively reform their equity structure and reduce limitations on the purchasing of listed companies by collective and private businesses to encourage legal purchasing by substantial collective and private businesses through the capital market. This would help the private economy become the major engine fueling China's economic growth.

### C. ACCELERATE THE DEVELOPMENT AND URBANIZATION PROCESS OF THE WESTERN REGIONS AND FACILITATE THE COORDINATED DEVELOPMENT ACROSS REGIONS AS WELL AS BETWEEN RURAL AND URBAN AREAS

In order to prevent regional disparities from widening after China's WTO accession, the development of the western regions should be accelerated. While carrying out the strategy of overall development of western regions, work should properly be done with regard to market entry, policy support, smooth channels, and legal guarantees. Market entry refers

to breaking administrative monopolies in certain industries, allowing and encouraging various types of enterprises at home and abroad to invest under the same terms in the western regions and without discriminating between domestic enterprises, private and collective. Policy support refers to offering necessary tax credit and personnel incentives to stimulate investment. Smooth channels refers to the ease in financing and information exchange, whereas legal guarantees are helpful for boosting the confidence of private investors with regard to the prospects of investment in western regions.

The widening gap between urban and rural areas in China is a result of the fact that its urbanization process has long been lagging behind the industrialization process. With the acceleration of industrialization after China's WTO entry, the problem would become even more serious. Therefore, measures should actively be taken to accelerate the urbanization process and narrow the gap between urban and rural areas. The focus in the near future is to expedite the construction of small cities and towns around large and medium-sized cities and economically developed areas. Meanwhile, the limitations of the residential registration system on the migration of rural population into small and medium-sized cities should be removed as should other discriminatory policies against the rural population in employment, education and social security. In this way, farmers would be encouraged to lease land in cities and towns.

#### D. SPEED UP THE GOVERNMENT'S ADMINISTRATIVE SYSTEM REFORM AND GRADUALLY PERFECT THE BASIS FOR THE RULE OF LAW IN THE MARKET ECONOMY

Currently, the Chinese government's administrative system does not comply with the requirements of a market economy. Government intervention often distorts the market, and fails to achieve the objectives of a market economy. If this situation is not changed, the competitiveness of enterprises would be seriously undermined after China's entry into an evermore competitive international market.

The first reform should be to standardize the government's behavior and transfer the government's role. The government should give way to markets in areas where its direct participation is not appropriate. Direct administrative intervention of the government over microeconomic units should gradually be phased out and administrative monopolies dominating various industries and sectors should be removed to create an environment for equal competition. At the same time, the government should strengthen its role in protecting property rights, guaranteeing the implementation of legal contracts, providing infrastructure and public utilities and stabilizing the macroeconomy. Second, the scope of jurisdiction and budgetary expenditures of governments at various levels under market economic conditions should be specified, and the democratic decision-making and legal administering by the government should be advanced to strengthen the legal, public, and social supervision over government behavior. Third, the efficiency of the civil service should be improved through downsizing, improving worker morale, strengthening supervision on corruption, and raising the quality of civil servants.

Legal construction should become the main way to advance overall reform. In a market economy, the fundamental property system and credit system should be built, the legislative process should be actively pushed forward, and judicial supervision should be strengthened.

#### E. VIGOROUSLY IMPLEMENT THE STRATEGY OF INVIGORATING THE STATE THROUGH EDUCATION AND SCIENCE TO SPEED UP THE UPGRADING OF THE INDUSTRIAL STRUCTURE

In the areas of science and technology, the government should raise its input in Research and Development by a wide margin. Enterprises should gradually become the major sources

for technological innovation and an incentive mechanism should be established to stimulate the creativity of researchers. Intellectual property rights should be fully protected to encourage innovations by enterprises or individuals. Meanwhile, a risk investment system should be established to expedite the transfer of scientific research findings into realistic productive forces. Meanwhile, civil and social resources should also be mobilized to expand the scale of higher education and enhance the quality of education. Measures in this regard would provide a solid foundation for the sustainable development and enhancement of competitiveness of China's economy.

#### F. CARRY OUT THE LIBERALIZATION PROCESS DILIGENTLY

Further, opening China's market is not only in line with the requirements for joining the WTO, but also advances the long-term interests of China's economic development. In spite of such a definite direction, the timing and degree of opening China's market should be properly managed. Before realizing trade liberalization, China should first stabilize its macroeconomy and improve its international balance of payments. A well-functioning financial supervisory system, strong economic strength, and sufficient foreign exchange reserves are preconditions for lifting controls over capital flow. Before the Renminbi can become fully convertible, the serious debt problems of the banking system should be resolved. Only in this way can we take full advantage of China's accession to the WTO and reduce the negative impact to the lowest possible level.

#### G. PROMULGATE RELEVANT LEGISLATION CONCERNING FOREIGN ECONOMIC ACTIVITIES

In essence, the WTO provides a complete legal framework for coordinating and regulating international trade activities. Accession to the WTO would inevitably mean full integration with these international rules and conventions. Currently, many of China's policies toward foreign investors still exist in documentary forms and lack transparency, which is unfavorable to attracting foreign capital and foreign trade. In addition, some articles of law are too general, resulting in low feasibility. Therefore, laws and regulations that are inconsistent with the WTO principles should be resolutely abolished; those consistent ones should be standardized and specified; and those too general should be supplemented by implementing regulations. Efforts should be made to study the antimonopoly laws in western countries and the transparency of laws should be increased. Since numerous cases of foreign trade disputes would arise after China's accession to the WTO, China should perfect its arbitration law for foreign economic and trade activities and train large numbers of professionals who are adept in WTO law and regulations as well as its operational mechanisms so as to better safeguard the national interest in international economic activities.

### III. Questions and Answers

*Dean Attanasio:* Professor Gao, it is a great honor and delight to have you here at the SMU Law School. As Professor Norton pointed out, your work on economic reform in China started as early as 1956, a time in your country's history very different from today. You have been what Americans would call "ahead of the curve." One very interesting aspect about your recent book is that you predicted the Asian financial crises in 1996. Essentially, jot for jot, you set out the problems in a report to your government in 1996, which even-

tually was published in 1998. That report predicted the Asian financial crises virtually line for line. For example, you talked about currency speculators coming in the openings that are provided by some economies.

But one of the things not published in your book is your comments about George Soros specifically, who I understand is a friend of yours of at least fourteen years. I gather you have prepared a separate appendix in Chinese on your recent discussions with Mr. Soros. I was wondering if you would reveal to us what is in this appendix concerning Soros, because there has been different speculation about his role in igniting the crisis by going into Thailand in particular. Because you are a government official, it would be perfectly appropriate for you to refuse to comment on it.

*Professor Gao:* As you indicated, I have known George Soros for fourteen years. When the Asian financial crisis started there were different responses from all the Asian countries. For instance, the Prime Minister of Malaysia criticized George Soros as the creator of the crisis. The other Asian countries, such as South Korea, had a totally different attitude about the crisis: South Korea, in fact, appointed George Soros as a Counselor of the State and invited him to visit Korea.

By comparing the totally different replies from the above two countries, I decided that we (China) should be more positive to the facts of the crisis and to the international investors such as George Soros. So I suggested to our Prime Minister, Zhu Rongji, that we should meet with Mr. Soros and start a dialogue with him. Eventually, the President of the World Bank, Mr. James Wolfenson, arranged a meeting with George Soros and me.

I asked Soros about his opinions on the Asian financial crisis, especially as to the short-term capital flow problem. He confessed that short-term capital flows were harmful to the Asian countries. I said, since it is harmful, why do we not find some methods to limit the harm?

At the time, Soros believed that there was no way to do this. He compared the crisis with the rising of the tide. When the tide comes, the only thing you can do is to avoid it or you would be drowned.

I disagreed with him and insisted there should be some way to at least limit the harm if we would cooperate with each other. Eventually he changed his mind. In a later article, he began to suggest that the world should strengthen its financial supervision to restrain the regional crises. He further concluded that the world economy had two different cycles—rise and fall.

I asked Soros whether the American economy had reached the cycle of fall. The answer was negative. He believed the world economy has also not yet reached the complete fallen cycle because of the prosperity of the United States. But he also had a lot of worry about the “bubbles” in America’s economy.

Soros also believed that the Asian financial crisis was largely due to the systemic problems of the world financial system. He stated that capital flows had been reversed from the developed/developing countries trend to the developing/developed countries trend after the crisis. These two points have been published in both newspapers and his books.

I first met George Soros in 1986, when I led a delegation with eighteen members visiting Hungary and Yugoslavia. Four of the delegation members have now become ministers of the PRC. After he knew we were there, he flew over to Hungary from the United States and met us in the hotel. His purposes were first, to cover the expenses of the whole delegation and second, to plan to invest US\$2 million to establish an “open society fund” in China. That is how we could meet each other again on September 2, 1998.

At the time of that meeting, Hong Kong's financial market was under massive attacks and in great danger. The stock market also had fallen to the 6,000 point by the strike of the international speculators. I told Soros that it was very dangerous to get into Hong Kong's market now. Because first, the Hong Kong government was well prepared at the time; second, Hong Kong's sufficient foreign currency reserve (\$96 billion) could also help it to defend itself; and third, the PRC central government would give full support to Hong Kong no matter what it would take. (It was so interesting that someday I may put this story into my biography.) By taking my advice, Soros withdrew from Hong Kong earlier.

*Dean Attanasio:* Was that related to China's crucial decision to hold the line on not depreciating the Renminbi? In other words, was there some fear that if the currency speculators went into Hong Kong, it would put additional pressure on the Renminbi and could eventually force a devaluation? If China devaluated its currency, most economists agree, this would have been a disaster, at least in Asia, if not in the rest of the world.

*Professor Gao:* The currency depreciation of the Southeast Asian countries threw great pressure on China at the time. When I was working in the World Bank Group, many people, including experts from the IMF, asked me whether China would depreciate its currency. I told them that the Renminbi would not be depreciated even though the pressure was growing. The Chinese government sacrificed itself to support the crisis-affected countries by contributing US\$4 billion to those countries and by stabilizing its own currency. If the Renminbi had been devalued, those countries would have been put under the threat of greater depreciation.

*Professor Norton:* I do not think we in the West appreciate China's central role in being highly responsible to its disadvantage in one, holding its currency, and two, in implicitly letting the world know that it was going to support its new Special Administrative Region, which has a separate monetary system. It would have been a very close situation for Hong Kong were it not for this type of support. Hong Kong has been successful in the past fending for itself, but the prevailing view is that without this level of Mainland support they would have failed this time because the attack was so great. That would have really created a much worse situation. Also, the contributions that China made to some of the other countries in the region affected by the crises have not been appreciated. In this area of stabilizing the crises, one of the more responsible players certainly has been the PRC government and certainly the people I have talked to at Hong Kong Monetary Authority are well appreciative of this. The Mainland did not interfere in the political process, but the PBC, as a cooperative central bank, let the world know that it was going to support the Monetary Authority. It was very, very close for about two weeks as to whether the Hong Kong market was going to collapse or not.

*Dean Attanasio:* As you know, Professor Gao was one of the key economic advisers leading China through this decision-making process; and, in addition, he led China when there was the reunification of China with Hong Kong. He represented China and was head of the Chinese delegation from the economic team, so he knows a lot and the information you are getting is absolutely first-hand.

*Student:* Can you estimate a certain period by which China will open its capital account to the world?

*Professor Gao:* The time for opening the capital account depends on the maturity of certain conditions. Being a WTO member will speed up the process. Although it is hard to estimate, I shall assume that the capital account will be open pretty soon. In about 2005, I think such conditions will be found mature.

*Student:* When the financial crisis happened, the Western economies criticized the fact that the economic growth that Asian countries (such as South Korea) had shown was a mere transfer from agricultural industry to an urbanization economy, not real quality growth into, for example, hi-tech industry. So in my opinion, China is trying to promote its economic development by joining the WTO. I think this is quite risky to promote the internal economy without having stabilized its industrial infrastructure. How do you think this situation compares with China?

*Professor Gao:* Joining the WTO would do more good for China than harm and would make more opportunities than challenges. I believe several reasons can be addressed to the cause of the Korean financial crisis. One of them is that the relationships among the government, the banks and the enterprises were not well harmonized. The government normally encouraged the enterprises to expand themselves and the banks to offer financial assistance upon such expansion. Such expansion could be handled properly only when the world market showed good performance. Thus, any possible changes to the world market would stimulate the contradictions in such expansion. Since such overexpansion of the enterprises was heavily relying on the capital from the banks, when the expansion proved unsuccessful, these enterprises were disabled from repaying the loans and brought themselves into financial collapse.

For example, Daewoo was one of those victims. Before the crisis, when the president of Daewoo Group visited China, he seemed to have great ambitions for the enterprise's future, since the business range of Daewoo had covered business activities of several Chinese ministries. However, the later facts showed that Daewoo's overexpansion was largely restrained by the power and the experience of the sector. Therefore, Daewoo's failure cannot be simply described as the result of Korea joining the OECD. This is just my personal opinion.

*Student:* Whenever you talk about changing government policy for the economy, reallocation of the economy from agriculture to industry, you also have the "social cracks" and that usually brings a lot of public criticism. To what extent will the PRC government try to soften the blow of the social effects that will happen as the economic changes and reforms occur? And what consequences do you expect from, for example, NGOs?

*Professor Gao:* First, I would like to say that after China joins WTO, some parts of Chinese industry will be under the impact from abroad and this will bring a higher unemployment rate to those business sectors. That is very true. However, I believe that without joining WTO, many of the inefficient enterprises would keep on leading themselves into insolvency. After China joins WTO, good-faith competition should bring all Chinese enterprises the strongest incentive to survive and to develop themselves if they do not want to be replaced.

As to the unemployment problem, the PRC government will offer necessary welfare assistance to satisfy the basic needs of the unemployed people. Further, training will also be held out to the unemployed people, especially the younger ones to make them more re-employable. I can also deem that more employment opportunities will be created after China joins WTO.

As to the nongovernmental organizations, I think they are playing very important roles in the market economy. If any inappropriate act has been performed by an international organization, this international organization may be criticized by a state government and may also be criticized by the nongovernmental organizations. Of course, the international organizations will never be found perfect, even if they have done a lot of good for all the countries.



*Student:* After Thailand suffered its currency crisis, the world soon fell into the abyss of the full Asian crisis. As a domestic remedy, Thailand adopted a rescue package from the IMF. This package requested the Thai government to cut off all of its “unnecessary” expenditures. And now people are questioning whether the package was too tough, that it has become an obstacle to Thailand’s swift recovery. What do you think about that?

*Professor Gao:* I have also heard various of these critical comments respecting the IMF rescue packages when I was working in the World Bank Group, including disagreement between the World Bank and the IMF. Many professors and scholars have heavily criticized the IMF as well. They complain that the IMF’s prescriptions did not fit the injury of each patient country too well. Personally, I think some of the remedies that the IMF offered were proper, but some of them were not.

