BIAC THE VOICE OF BUSINESS AT THE OECD

Priorities for China-OECD Cooperation

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Executive Summary

In the run-up to the 20th anniversary of China's cooperation with the OECD in 2015 and China's possible G20 Presidency in 2016, this BIAC discussion paper presents priorities for where the OECD can advise on the implementation of urgently-needed policy reforms in China. It is accompanied by an annex offering private sector perspectives on China's economic challenges.

While not a definitive list (recognizing that this is an evolving agenda), BIAC encourages the OECD to consider the following three priorities for its cooperation with China in the coming year:

1. **Equip the OECD's senior representative in Beijing with the resources to significantly scale-up the OECD's presence in China, with the ultimate goal of establishing an official OECD representation in Beijing.**
2. **Establish a regular program for policy dialogue in China on key policy reform issues.**
3. **Carefully develop the OECD's future economic projections for China's economy, drawing upon a range of quantitative and qualitative evidence.**

Introduction

China's cooperation with the OECD will celebrate its 20th anniversary in 2015. This relationship is vital for both parties. OECD evidence and good practices are key tools for supporting reform in China and ensuring higher, more sustainable growth. Meanwhile, as the second largest economy in the world, China's engagement in OECD activities is increasingly important to OECD analysis and policy advice.

Despite the long-standing history of China-OECD cooperation, the depth of this relationship holds room for improvement. Compared to other OECD key partner countries (with which relations were formed only more recently), China appears to lag behind in several respects. We observe for example that China participates either as Associate or Participant in only 7 OECD bodies/related organizations and adheres to only 5 OECD instruments. By comparison, India participates in 12 bodies and adheres to 8 instruments, while Brazil participates in 18 bodies and adheres to 13 instruments.[1] China's comparatively slower pace of participation may be due to historical issues relating to Chinese Taipei as well as concerns about its positioning vis-à-vis other emerging economies.

In the past years and in particular since the new leadership has been appointed, however, China's engagement in OECD activities appears to be picking up pace. To highlight just a few examples, the National Development and Reform Commission (NDRC) has invited the OECD to contribute to the conceptual preparation of the 13th Five Year Plan; China has signed the OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters; and the Chinese G20 Sherpa requested OECD advice on avoiding the middle-income trap.

Such progress is welcome, though there is significant room to do more, particularly ahead of China's possible G20 Presidency in 2016. This BIAC paper presents priorities and ideas for enhancing China-OECD cooperation in the coming years.

1. *OECD presence in China*

The OECD permanent representative in Beijing has been invaluable in opening new relationships between OECD and Chinese officials and key stakeholders in recent years.

The new OECD representative needs to have a more visible and effective representation in Beijing.

<u>*Considerations:*</u>

- *Ensure that the OECD permanent representative in Beijing has enough support by local staff and OECD headquarters in order to foster relations with senior Chinese officials and key stakeholders.*

- *Establish a dedicated OECD office in Beijing in order to increase the OECD's visibility and credibility in China.*

[1] OECD (2014) "Strengthening the OECD's Global Reach".

- *Equip the OECD permanent representative in Beijing with the necessary financial resources to build dialogues and support activities in China.*
- *Consider scaling up the office in due course to include more than one senior representative, in order to respond to increasing workload and to deliver timely, well-founded advice.*

2. *Policy dialogue*

As highlighted in the June 2014 BIAC China Task Force session with the OECD Informal Reflection Group on China, there are a number of business priorities for policy reform in China where closer cooperation with the OECD would be valuable. These include, for instance, reforms of state-owned enterprises (SOEs), market access, export credits, bilateral and regional trade and investment agreements, anti-corruption, corporate governance, responsible business conduct, and green growth, among others. Details of business views on these issues can be found in the Annex.

These issues are likely to remain or increase in China over the coming 1-2 years. BIAC expects there will be increased financial stress in China's economy, greater popular demand for better corporate governance, more disclosed cases of corruption, increasing awareness of environmental damage, and growing globalization of Chinese business. The OECD's work on these issues is therefore evermore relevant.

OECD Directorates and bodies already work together with relevant Chinese authorities in many of these areas. Sometimes these pieces of work are ad-hoc or project-based, while others may be longer-term. There could be scope to synthesize developments in these streams of work through regular events and/or short reports that could [1] promote the use of OECD instruments and good practices in China, [2] help to ensure greater visibility of OECD work among senior Chinese officials to mobilize momentum for reform, and [3] ensure greater coherence and coordination across China-OECD cooperation activities.

Considerations:

- *Establish, in cooperation with the Ministry of Commerce (MOFCOM), a series of informal workshops/roundtables (e.g. a "China-OECD Policy Dialogue Series") bringing together OECD experts, interested OECD country representatives, Chinese Government officials, business and other key stakeholders as appropriate, on a 6-*

12 monthly basis. Ensure Chatham House rules to promote open dialogue on key policy reform priorities.

- *Ensure that the OECD's contribution to the 13th Five Year Plan addresses a broad range of priorities for institutional reform that the OECD believes as necessary for a strong and sustainable growth pattern.*

- *Prioritize discussions on the OECD's landmark instruments and activities, such as the OECD Declaration on International Investment and Multinational Enterprises, the OECD Anti-Bribery Convention, OECD work on trade in services, the revision of the OECD Principles of Corporate Governance, the update of the OECD Policy Framework for Investment (and encourage a new Investment Policy Review of China), the OECD Export Credits Arrangement, among others.*

- *Build dialogue on market access issues and SOEs in order to promote good practices, reduce discrimination, and foster more transparency in regulations.*

- *Engage China actively in the review of the 2002 OECD Guidelines for the Security of Information Systems and Networks. This is a field where technical knowledge of best practice may be shared between experts on both sides. If not already the case, it would be advisable to contact the Ministry of Public Security as a first step, followed by the newly created cybersecurity council.*

- *Encourage discussions with China's main antitrust regulators (NDRC, SAIC, and MOFCOM) on topics such as "encouraging global investment in China through non-discriminatory regulation", "market-based antitrust reforms", "adhering to international antitrust standards", and "transparency in regulatory processes". The OECD could seek to engage the Office of the Central Leading Group for Financial and Economic Affairs.*[2]

- *Engage the Ministry of Environment in discussions regarding waste management and water treatment, extended producer responsibility and green transition of the economy.*

[2] Contact BIAC Secretariat for details.

3. Economic projections

The OECD Economic Outlook projections for the GDP growth of China's economy were significantly readjusted in recent years. In March 2013, the OECD forecasted real GDP growth of 8.5% for 2013 and 8.9% for 2014. By November 2013, these figures were reduced to 7.7% in 2013 and 8.2% in 2014. By March 2014, the forecast for 2014 was reduced again to 7.4%.

Considerations:

- *Make greater use of qualitative evidence (e.g. discussions with BIAC, surveys of foreign and domestic business in China, etc.), in addition to the OECD's quantitative models, in order to provide an increasingly comprehensive and accurate view on the outlook for China's economy.*

- *Ensure that economic analyses, including the forthcoming OECD Economic Survey of China (2015), consider regional economic variations in China. While some regions are still experiencing moderate growth, other parts have experienced major slowdowns. Notable attention should be paid to concerns of growing asset bubbles, increased production costs, and also factors such as regional geopolitical tensions.*

Conclusions

The 20th anniversary of China-OECD cooperation is an opportunity to step-up the pace and increase the regularity of relations. Developing greater visibility and senior-level Chinese Government support for OECD-China work should be a priority, and this should be aided through the establishment of the next OECD representative in Beijing with the necessary resources.

More generally, the OECD should not shy from making its views known to China. In order to increasingly engage China in OECD activities, the OECD should focus on its key strengths – its quality analysis and policy tools, and crucially its policy recommendations. A strong but consistent OECD voice on China's policy reforms would garner respect and credibility, and could ultimately encourage China to come to the discussion table.

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Annex: China's economic challenges and the need for reforms[3]

The drivers that have delivered China's impressive growth over the past several years – the country's demographic dividend and prior reforms – appear to be nearing their limits. Stimulus measures through monetary expansion can offer temporary help, and have been used extensively since the onset of the global financial crisis, but it is increasingly clear that fundamental reforms are urgently needed to secure strong growth that is sustainable in the longer-term.

For China's economy to succeed in the 21st Century, the government will need to adjust its level of involvement in the economy through a combination of strengthening certain roles of the government while relinquishing other responsibilities. In some areas, the government is too absent from the market and needs to strengthen its capacity to formulate top-level regulations while enforcing existing regulations in a transparent and fair manner. In other areas, the government is too dominant and needs to step back in order to strengthen market forces, primarily through institutional reforms to the financial system and to the role of State-owned Enterprises (SOEs), as well as through the reduction of industrial policies and costly subsidies that are distorting markets.

Encouragingly, at the China Development Forum in Beijing in late March 2014, Vice Premier Zhang Gaoli hinted at reforms aimed at freeing up market forces on the mainland which would result in a reduced role for government. Market forces, depicted as an "invisible hand", would play a bigger role, while the government, viewed as the "visible hand", would use its powers more effectively and transparently.

Reforms for better governance and new roles for the "visible hand"

The drive towards a more effective State was already evident in May 2013, when the State Council abolished or decentralized a number of administrative approval items, reduced the number of ministries and commissions under the State Council from 27 to 25, and merged several agency-level regulators in order to reduce overlapping and conflicting responsibilities. Two other symbolic steps were taken in July 2013: the People's Bank of China took additional measures, towards a liberalization of interest rates, including the elimination of the lending rate floor for commercial loans; and the State Council announced the creation of the Shanghai Integrated Free Trade Zone,

[3] This Annex is adapted from an article by Wuttke and Greenhill (2014), entitled "China's reforms: Is Beijing playing its hand well?" – World Commerce Review, Volume 8, Issue 2, June 2014.

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although the regulatory and market liberalizations adopted within the Zone have been narrower and more limited in scope than many had anticipated.

While these are positive steps, they are only the start of a long process to modernize the regulatory system to better suit an increasingly complex economy. There is significant opportunity for streamlining at many levels. Some parts of the central level government remain highly bureaucratic, with a number of ministries holding overlapping responsibilities for important regulatory and enforcement functions. This frequently results in added burden, reduced efficiency, and market delays for enterprises that have to comply with either duplicative or contradictory regulations, and may give rise to instances of corruption.

In some cases, there is a conflict of interest due to the government being both a regulator and a (regulated) service provider, resulting in a typical principal-agent problem. Government, business and society would benefit from providing regulators with greater independence and imposing stronger rules against conflicts of interest. A strong regulator needs to be free from commercial influence.

Despite a sound framework of regulations for the business environment in most areas, problems still remain. In some instances, this is due to weak and inconsistent enforcement of existing regulations. A lack of enforcement at local levels of government and a lack of punishment for regulatory violations may hinder the valuable legislative efforts of the central government.

As the economy becomes more complex and in order to meet growing societal needs, greater focus should also be given to developing guidance to assist business compliance. Business also welcomes consultation with the government, including through its participation in international fora in order to benefit from international best practices and to ensure business understands and complies with the eventual decisions. A strong government is an open government.

While the government should be inclined to simplify pre-market approval processes by devolving some self-regulatory and risk management powers to companies, at the same time there should be a strengthening of the government's role in terms of regulatory impact assessments to ensure appropriate implementation of supervisory standards. A successful economic transition must be preceded by a regulatory transition in which the government finds its proper role in an increasingly modern economy. Regulating a huge and complex economy is an extremely difficult task. The government therefore needs to increasingly focus its efforts and resources on building up the regulatory capacity that is required to foster a vibrant market economy.

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The case for structural reforms and increasing the role of the "invisible hand"

Equally important to better governance is leveraging the contributions that business can make through greater structural reform. For China to achieve its goal of moderately fast growth in the new era, new catalysts for economic growth need to be identified—and already have been—through reforming the State-led development model. This includes implementation of reforms to financial services, a dismantling of protectionist industrial policies, reforms to and greater privatization of SOEs, and opening of market access.

The government is currently not only setting and enforcing the rules of the game, but also carrying out commercial activities through SOEs and directing the flow of investment through control over the financial system and industrial policies. While this model enabled incredible growth through massive fixed-asset investments and export-oriented practices, it has generated a reliance on capital injections and is causing resources to flow to inefficient areas of the economy. This has led to market-distortions, mispriced capital and overcapacities, stifled consumer demand and innovation, local and corporate debt, and other undesirable results. The fact that SOEs both benefit from and often implement protectionist industrial policies has also thwarted competition and stifled growth among private sector firms.

Financial reform

China's financial system, and the privileged relationship between the State-owned banks, SOEs and local governments that it serves, means that household savings are used to subsidize lending, much of which is directed at marginal investment projects to prop up unproductive SOEs and to finance inefficient local government projects. This results in risk being built up in bank, corporate and local government leverage. Financial reform should give banks the freedom and incentives to fulfil their intended role in evaluating returns on investment and directing capital to productive areas of the economy, free from political interference from local governments and SOEs.

The use of market price signals—in particular in more flexible interest rates—would also serve to reduce the current high levels of credit growth and incentivize economic efficiency by requiring borrowers and banks to reassess marginal investment projects. This would also create a more level playing field for credit allocation to private industry and end financial repression of household savings, potentially leading to a more equitable distribution of wealth and increased domestic consumption spending.

Industrial policy reform

The government uses a plethora of interventionist measures to attempt to develop domestic industries. Such industrial policies are practical tools used by most governments. However, due to China's goals to develop 'national champions' and, in some sectors, to reach target market shares for its domestic industry, China's industrial policies often function in practice as protectionist measures that favor SOEs or other domestic suppliers and impose discriminatory barriers or burdens on foreign suppliers. These policies include protectionist procurement policies, ineffective protection for foreign innovations or other intellectual assets, discriminatory application of antitrust or other market regulations, and various forms of subsidies in particular to domestic heavy industries and the manufacturing sector, which have resulted in a large number of companies becoming reliant upon government support. Local government implementation of industrial policies usually serve to support SOEs or other 'local champions' as well as companies that are major local employers in pillar industries. Local governments have provided direct and indirect subsidies, as well as favorable treatment to local companies in a number of sectors into which the Chinese Government has encouraged significant financial investment. This is a major cause for market inefficiencies and overcapacity in many of these sectors.

SOE reform

SOEs can play an important role by providing public goods and services (e.g. public transportation, mail delivery services, etc.) at affordable prices in sectors where demand is not sufficient to generate an efficient or effective market-based response from the private sector. SOEs can also play a role in sectors of special strategic interest to the government, though should not be protected from competition or enjoy special privileges to the detriment of the private sector, or at a significant cost to Chinese taxpayers.

However, the reality in China is that SOEs' privileged position has inevitably led to preferential treatment and subsidies, and a vast amount of the State-led investment on which the economy has come to rely is directed through SOEs.

This system has also created inefficiencies as it provides a mechanism to provide inefficient cycles of economic support from household savings in the banking sector to value-destroying companies, overcapacity sectors, and to support the often narrow aims of local governments, meaning that poorer services and higher costs are frequently transmitted to the Chinese end-user. Further inefficiencies result when the government seeks to implement its industrial policy goals through the actions of

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SOEs—for instance, when the government directs SOEs to extend preferential terms to domestic suppliers or customers.

SOE reform and orderly privatization of key SOEs—especially those that compete with privacy companies in the commercial marketplace—has the potential to unleash a wealth of innovation and efficiency in key sectors currently dominated by SOEs that constitute the foundation of China's economy, including telecommunications, energy, financial services, transportation, logistics and construction. Allowing equal competition and greater opportunities for all could bring considerable societal dividends and economic growth through boosted productivity, more efficient allocation and utilization of capital, increased tax revenues, strengthened regulatory capabilities and decreased corruption.

China's sustainable economic development and economic rebalancing relies upon private enterprises being able to fully develop alongside SOEs in an environment of fair competition. As the SOE reform process develops, the result would be greater opportunity for the private sector and lower prices and greater choices for consumers. Indeed, a number of government ministries have issued guidelines over the last couple of years to permit private investment into a number of heavily State-controlled and monopolized sectors, including telecoms, financial services and health care.

Market access reform: a two-way street

It is concerning that most government pronouncements to encourage 'private capital' only include Chinese capital and not foreign investment. As the country's growth rate slows during its economic restructuring, Chinese companies will increasingly need to go global to ensure sustained growth. China's domestic policies have important international implications and can negatively affect the perception of its domestic companies abroad. Moreover, Chinese companies that are insulated from competition with foreign suppliers within China—and who accordingly may find it far more difficult to forge partnerships and other deals with such suppliers—will be far less capable of competing successfully when they seek to enter foreign markets. Until China provides the same level of access to its markets that it receives elsewhere in the world—and particularly in OECD countries—it will not be seen by other countries as an equal and fair player. Protectionist domestic policies could therefore generate additional obstacles to the internationalization of Chinese companies due to the isolation of Chinese companies from global competition, the trade tensions such policies generate with China's major trading partners, and the potential for growing calls for reciprocal treatment against Chinese companies abroad.

China's degree of openness to foreign business will therefore increasingly have implications for the interests of Chinese business on a global stage, especially as Chinese firms are stepping up their overseas investments, in particular in OECD countries. Reforms for open markets should be viewed as a two-way street.

The potential benefits of an opening of markets, in which all companies – public and private, domestic and foreign – can compete fairly and are subject to non-discriminatory rules applied even-handedly to both domestic and foreign firms, would bring about increased competition and would lead to increased efficiencies, innovation and greater economic development, ultimately to the benefit of consumers in China and the rest of the world.

The voice of the private sector

Recognizing that China's success in the 21st Century will depend to a large extent on enabling the market to play a bigger a role in the Chinese economy, it is essential that the needs and views of the private sector can be heard through effective mechanisms for consultation and dialogue.

At the international level, the BIAC China Task Force supports China-OECD cooperation by providing OECD business expertise and advice. The OECD, equipped with its extensive expertise on structural reforms and good policy practices, is uniquely well-placed to work with China and the business community to ensure strong and sustainable growth going forward.

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