

**Reform and Reorganisation of Monopolistic Industries:
The Need for a China Internal Trade Organisation**

by

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**Opening remarks in discussion of the paper by Wang Qishan, Minister of
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Comments on presentation of Mr Wang Qishan, Director (Minister), the Economic Restructuring Office of the State Council, by Professor Ross Garnaut, The Australian National University.

Mme Jiang Qiangui from the Chair usefully identified two types of monopolies in China: those that arise from assertion of a special Government interest in a sector (such as the monopolies in tobacco, and the military industries); and the natural monopolies (such as railways, telecommunications and electric power).

Minister Wang noted that significant progress had been made in reducing the costs of monopoly in the second set of industries. One means of progress had been the separation of Government policy and regulation from management of business (for example, by the abolition of the power Ministry and the establishment of the state-owned power company). Another means had been the breaking down of activities in the “natural monopolies” into different lines of business, so that competition could be introduced into those activities that were suitable for it. Here, the breaking up of the telecommunications enterprises was an example.

I would like to discuss the problems of monopolies more generally. There is no set of economic problems that have been ameliorated more by reform over the past 20 years than those of monopoly. At the beginning of the reform period, even the parts of the economy that were potentially highly competitive had been converted into monopolies by Government policy. The process of reform has been one of introducing competition and an effective role for markets into more and more parts of the economy.

In all economies there are some activities in which there are truly natural monopolies, in which economies of scale in production and distribution are so

large relative to demand that it would be technologically inefficient to have more than one producer. The truly natural monopolies are probably smaller in number and economic importance in China than in any other country. This is above all because of China's large population and its dense concentration in the Eastern Provinces. It is also partly because effective Government is more likely to involve relatively light government in a large country. As a result, a high proportion of the monopolies that remain in China after 20 years of reform are protected by unnecessary Government policy and regulation, rather than being imposed by nature.

It is important to note that no industry is a natural monopoly if it is subjected to competition from foreign suppliers. Reductions in international transactions costs (with technological and institutional change) and official barriers to trade have been reducing monopolistic power in many industries. China's entry into the WTO will be important in extending that process.

The continued internationalisation of the Chinese economy will reduce but not remove the importance of natural monopolies. For the rest, the two approaches emphasised by the Minister are of primary importance: separation of policy from management of business; and the disaggregation of the activities of the natural monopoly enterprises, in a manner which allows competition in some of them.

For some time yet in China, there will still be a problem of unnatural monopolies, mainly kept in place by State or local government regulation, and sometimes by collusion amongst well-established producers.

Some unnatural monopolies are created by restrictions on inter-provincial trade imposed by local governments to protect local businesses. The breaking down of these barriers to internal trade is of central importance to the Government's

ambitions to link the inland and especially the Western provinces to the dynamism of coastal China.

Despite the progress in reducing the scope of the regulatory powers of state-owned enterprises, there are still some unnatural monopolies maintained by Central Government regulation that are greatly damaging to the welfare of Chinese households. The most important of these are probably in the grain trading sector, which restrict farmers' options for raising their incomes, and consumers' options for raising their welfare.

It would be a mistake to think that the removal of the State from business management in the process of reform can be accompanied by a general withdrawal of the State from the economy. The residual natural monopolies, and the unnatural monopolies for as long as they remain in China, will do less damage to China if there is an effective regulatory system, built around an effective agency. The agency would establish and enforce rules on pricing and related business behaviour.

There would be large advantages in giving the regulatory agency the role of analysing, and where appropriate removing, or recommending to the relevant authorities the removal of, official restrictions on internal trade and business collusion that create unnatural monopolies.

The role of the agency would therefore be to promote competition wherever feasible and to regulate the behaviour of residual monopoly. The role is in some ways similar to that of the World Trade Organisation for international trade. In a large country, internal trade is worthy of at least as much attention as international trade in relation to the promotion of competition on a level playing field. This is especially the case in China, given the high priority of development away from the coast.

I recommend calling the regulatory agency the China Internal Trade Organisation (CITO).

CITO would have independence both from business and from the day-to-day exercise of government policy-making. It would operate within a clear framework of policy established by the State Council. It would have power, within this policy framework, to recommend the removal of State and local regulations that have the effect of supporting national or local monopolies. It would have the power to block actions by firms that restrict competition, including collusion in the setting of prices and predatory pricing. And it would have the power to regulate prices for natural monopolies, again within a clear policy framework laid down by the State Council.

CITO would need to be professionally strong. Its staff would include people who were well trained in economics, law and management and who were closely familiar with the management of competition policy and price regulation in other market economies.

CITO's work would be transparent, so that business and the community were able to see the reasons for decisions. It would seek to build up a logical framework for decisions, that provided a reasonable degree of certainty about how CITO would respond to issues before they arose for decision. This would remove the need for business to negotiate rules on a case-by-case basis, which introduces the likelihood of inconsistency, uncertainty and corruption.

Many of the challenges facing China in building a competitive internal trading environment cannot be achieved simply by the removal of regulation, but rather require learning and institutional development within enterprises. There will inevitably be large problems in the adjustment to a competitive environment of enterprises that were once monopolies. The adjustment takes time, and there are advantages in a gradual approach to deregulation, to allow professional

development of staff. Appropriate forms of education and training can help the adjustment. But in the end, enterprises and their personnel will only complete the adjustment to operation in a market environment through wading into the sea of competition, where not all firms and not all personnel will keep their heads above water. Inevitably there will be costs and pains of adjustment.

This leads me to one final observation.

There will be large enterprise adjustment problems associated with increased international competition following China's entry into the World Trade Organisation. It will take time for some enterprises and their personnel to learn the arts of effective operation in a competitive market environment. There will be costs and pain of adjustment.

These adjustment problems would be more severe if the adjustment to greater competition occurred at a time when the Chinese yuan was overvalued.

There is no certainty but some danger of yuan overvaluation in the period ahead, when the adjustment to WTO entry may be at a critical point. The Asia Pacific economies, in North America as well as the Western Pacific, experienced their most general and rapid slowing of growth ever in the last quarter of 2000, and the weakness in economic growth continued early in 2001. For economies other than the United States with floating currencies, this was associated with substantial currency depreciation against the United States dollar. Because the Chinese yuan has been pegged to the United States dollar, this amounted to a substantial appreciation of China's effective exchange rate.

If the weakness in the Asia Pacific economies persists for some time, and if the United States dollar remains relatively strong, there is some danger that signs of overvaluation of the Chinese yuan will emerge. Weak import demand in China's export markets in the Asia Pacific region may combine with effective

exchange rate appreciation substantially to reduce the rate of growth of China's exports, and to a lesser extent to increase the growth of China's imports above what it otherwise would be. Trade liberalisation associated with WTO entry would also tend to raise the rate of growth of imports.

It would be undesirable as a matter of Chinese policy, and inconsistent with WTO principles and rules, for China to respond to a weakening of the trade and current account balances by increasing export incentives and tightening administrative controls on imports, as it has done in the past. It would be better to respond to these pressures from the international economy by allowing the renminbi to weaken.

The Chinese yuan does not now show signs of overvaluation. It may not show signs of overvaluation over the next few years: the economy's competitiveness is receiving a boost from strong productivity growth in the export industries, and it would be supported by any weakening of the United States dollar against other currencies. Overvaluation is much less likely if there is an early acceleration of growth in other Asia Pacific economies.

I would suggest, however, that China take out insurance against the worst possibilities by floating the renminbi now, while circumstances are favourable. Its first movement now may even be upwards against the United States dollar. A floating Chinese yuan may remain strong against the United States dollar. But if the yuan were now allowed to float, if the most unfavourable circumstances emerged in future, it could float downwards with far less economic dislocation and political trauma than would be associated with a discrete devaluation from a fixed peg against the United States dollar. This would reduce the risks of severe problems in the process of adjustment to increased import competition following adjustment to China's entry into the WTO.