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Antidumping Investigation
Public Document

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DATE: May 15, 2006

SUBJECT: The People's Republic of China (PRC) Status as a Non-Market Economy (NME)

On December 22, 2005, counsel on behalf of respondents Watanabe Paper Product (Shanghai) Co., Ltd., Hotrock Stationary (Shenzhen) Co., Ltd., and Watanabe Paper Product (Linqing) Co., Ltd. (collectively, the Watanabe Group) submitted a request that the Department of Commerce (the Department) reevaluate China's status as an NME country under the U.S. antidumping law. On February 2, 2006, the Department received a letter from the PRC Ministry of Commerce expressing support for the Watanabe Group's request.

The Department has treated China as an NME country in all past antidumping duty investigations and administrative reviews. See *e.g.*, Notice of Final Determination of Sales at Less Than Fair Value and Affirmative Critical Circumstances: Magnesium Metal from the People's Republic of China, 70 FR 9037 (February 24, 2005); Notice of Final Determination of Sales at Less Than Fair Value: Certain Tissue Paper Products from the People's Republic of China, 70 FR 7475 (February 14, 2005); and, Notice of Final Determination of Sales at Less Than Fair Value: Certain Frozen and Canned Warmwater Shrimp from the People's Republic of China, 69 FR 70997 (December 8, 2004). A designation as an NME country remains in effect until it is revoked by the Department. See section 771(18)(C)(i) of the Act.

In considering this request for a review of China's NME status, the Department has taken note of the economic reforms that China has implemented to date, as well as the significant areas of China's economy where, it is generally recognized, fundamental reforms continue to lag. China's selective and gradualist reforms have contributed to impressive economic growth. However, the level of government intervention in certain important sectors of the economy remains significant, as do deeply rooted institutional problems, *e.g.,* with respect to the banking sector, land ownership and property rights, and rule of law.[1] The Department must, therefore, continue to question seriously the validity of prices and costs in China as meaningful measures of value for the purposes of the U.S. antidumping law.

In making an NME country determination under section 771(18)(A) of the Act, section 771(18)(B) requires that the Department take into account:

1. the extent to which the currency of the foreign country is convertible into the currency of other countries;
2. the extent to which wage rates in the foreign country are determined by free

[1] See generally *The Economist Intelligence Unit; Risk Briefing; China Risk: Legal & Regulatory Risk,* March 8, 2006. See also Ho, Samuel and Lin, George, *Emerging Land Markets in Rural and Urban China: Policies and Practices* (The China Quarterly, 2003), p 682-683 and 704-707.

bargaining between labor and management;

3. the extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country;
4. the extent of government ownership or control of the means of production;
5. the extent of government control over the allocation of resources and over the price and output decisions of enterprises;
6. such other factors as the administering authority considers appropriate.

In evaluating the six factors listed above, the Department has recognized that the removal or withdrawal of state controls over the economy is not sufficient for revocation of NME status. Rather, the Department considers whether the facts, as applied to the statutory factors, demonstrate that the economy is generally operating under market principles. We intend to continue to analyze China's economy and will issue a memorandum addressing the six statutory criteria upon which the NME designation is based in the final determination of the lined paper antidumping investigation.

At this time, however, we must note the limited extent to which market forces have taken root in important sectors of China's economy despite recent reforms and substantial growth, as well as the continued lack of effective institutional reform, especially with respect to private property and land rights and rule of law. We also note, as is discussed in greater detail below, that with respect to the fifth factor, *i.e.,* the government's control over the allocation of resources, the various levels of government in China, collectively, have not withdrawn from the role of resource allocator in the financial sector, principally the banking sector. Given the investment-driven nature of China's economy and the significant share of investment that is bank-financed,[2] the decentralized government's continued role in the allocation of financial resources indicates that it exerts significant leverage over the allocation of resources in the economy as a whole. While the

[2] As discussed below, a significant share of investment in China is bank-financed, notwithstanding the recent upturn in the share of self-financed investment that may or may not be pro-cyclical in nature, *i.e.*, when retained profits decrease, enterprises will once again turn to the banking sector for continued access to capital for investment.

discussion below focuses mainly on the banking sector, we note that the forthcoming memorandum on China's economy will discuss all six statutory factors, including the PRC government's intervention in resource allocations beyond the banking sector.

China has implemented many reforms in its banking sector. These reforms, particularly with respect to the "Big Four" state-owned commercial banks (SOCBs), are intended primarily to improve the way the existing system allocates and prices credit. However, they do not directly address the fundamental institutional and property rights issues that underlie the banking sector's problems. Impressive headline reform efforts are focused on improving loan classification standards, bank management and lending practices, financial accounting and reporting, credit risk assessment and regulatory oversight. Despite ongoing efforts since 1994 to compel the SOCBs to operate on the basis of profit maximization and subject to hard budget constraints, the SOCBs continue to be plagued by functional and operational problems that have necessitated repeated, large government capital injections and debt write-offs to remain solvent.[3]

Banks have been slow to implement the regulatory reforms that would otherwise strengthen the sector.[4] However, a more fundamental gap in the banking sector's reforms is the state's continued ownership of virtually all of China's banking sector assets and the virtual captive market

[3] The PRC government established four asset management companies (AMCs) in 1999 to absorb almost US $170 billion of non-performing loans (NPLs) from the SOCBs, leaving the four largest SOCBs with an official NPL ratio of 21.4 percent and, by unofficial estimates, as high as 40 to 50 percent. In December 2003, the PRC government provided a further capital injection of U.S. $45 billion in foreign exchange reserves into two of the four state banks. By the end of 2003, the four AMCs had recovered in cash only 20 to 30 percent of the NPLs. *China's Growth and Integration into the World Economy, Prospects and Challenges*, (Washington, DC: International Monetary Fund, 2004), p 47. See also *People's Republic of China: 2005 Article IV Consultation - Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion,* (Washington, DC, International Monetary Fund, November 2005), p 20. See also *Banking Reform in China; Catalyzing the Nation's Financial Future*, Barth, J. Et al., (The Milken Institute, February 2004), p10-13.

[4] The China Bank Regulatory Commission (CBRC), formed in 2003 with a mandate to improve supervision and regulation of the banking sector, concluded after inspecting eleven banks in 2005 that implementation of regulatory reform remains problematic and that transparency continues to be a problem. *The Economist, A Great Big Banking Gamble - China's Banking Industry,* October 29, 2005.

for state-held bank deposits that the SOCBs enjoy.[5] Despite recent sales of minority shares to foreign investors, the government signaled its intention to "retain majority control of the state banks in the long run."[6] The four large SOCBs represent 50 to 60 percent of the sector's assets and deposits. Limited ownership diversification has been introduced through the joint stock commercial banks (JSCBs), which represent 13 percent of the sector's assets, and foreign banks, representing a scant one percent.[7] The remaining sector assets are accounted for by small state-owned institutions, such as rural credit cooperatives. Therefore, with few alternatives for external financing and the underdeveloped stock and bond markets, the SOCBs carry out the majority of financial intermediation.[8]

While the Big Four SOCBs (along with smaller regional banks and cooperatives) now have greater autonomy than in the past, government interests at both the central and local levels still exercise a great deal of control over banking operations and lending decisions.[9] For example, consistent with the general policy to maintain the state-owned industrial sector, empirical evidence shows that credit has flowed disproportionately towards large state-owned enterprises in larger

[5] China's banking assets are buoyed by the extremely high rate of household savings (averaging 28 percent of gross domestic product) and the capital account restrictions that limit overseas investment opportunities. *China's Growth and Integration into the World Economy, Prospects and Challenges*, (Washington, DC: International Monetary Fund, 2004), p 44. See also *China and the WTO*, (Washington, DC, World Bank, 2003), p 182.

[6] Statement by Wen Jiabao, Chinese Premier, at the National People's Conference. See *The Economist Intelligence Unit, Business China, Go Away, Crocodiles?*, Business China, March 27, 2006.

[7] *China's Growth and Integration into the World Economy, Prospects and Challenges*, (Washington, DC: International Monetary Fund, 2004), p 44. *OECD Economic Survey: China*, (Paris, Organisation for Economic Co-operation and Development, 2005), p139.

[8] *China's Growth and Integration into the World Economy, Prospects and Challenges*, (Washington, DC: International Monetary Fund, 2004), p 44. See also *Finance and Development, Next Steps for China,* (Washington, DC: International Monetary Fund, September 2005).

[9] "(R)ooting out the legacy of government directed lending, and training banks to make lending decisions based on purely commercial considerations, with adequate regard to viability and riskiness of projects remains a major reform challenge." *Finance and Development, Next Steps for China,* (Washington, DC: International Monetary Fund, September 2005).

eastern cities, despite the fact that returns are higher in smaller non-state enterprises in rural areas. Recent directed lending to the agriculture sector, in line with the government's stated priorities, is another example of the government's heavy involvement in the allocation of financial resources.[10]

This state control is not always exercised centrally or coherently, as different levels of government often have competing plans for the allocation of financial resources. For example, the recent over-investment in industries such as steel and autos was spurred by sub-central government officials, who continue to play a significant role in the operations of the SOCBs.[11] As the scale of this over-investment became clear, the central government pushed to restrict lending to these sectors, confirming continuing state influence on both ends of the cyclical credit pattern that has led to periods of boom and bust in certain industries.

Certain market economies have also grappled with problems of uncontrolled lending and over-investment. However, lending decisions in market economies are made primarily by market actors facing real budgetary constraints who are held accountable for their actions. This is in stark contrast to lending decisions made by NME government actors who do not face any real budgetary constraints and who are able to draw on the vast deposits of individuals who are essentially forbidden from investing their money elsewhere. These non-market characteristics remove the incentive to properly assess risks, as evidenced by the sector's cyclical struggle with non-performing loans (NPLs). While NPL ratios were reduced in 2004, both in absolute value and as a ratio to total loans, this decline is mainly due to increased loan volumes, transfers of bad assets to asset

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[10] *The Economist Intelligence Unit: Country Report, China,* March 2006, p 19.

[11] *OECD Economic Surveys: China* (Paris, Organisation for Economic Co-Operation and Development, September 2005), p 141. See also *People's Republic of China: 2005 Article IV Consultation - Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion,* (Washington, DC, International Monetary Fund, November 2005), p 44: "The staff acknowledged the progress made in reducing government involvement in management and business operations of banks. However, more needs to be done, particularly with regard to local governments, to remove this serious impediment to fully commercialize banks."

management companies, and direct capital injections from the PRC government, rather than an improvement of the banking sector's ability to assess and manage credit risk.[12] Considering the significant lending to industries characterized by overcapacity, such as autos and steel, NPLs may again surface in the future as growth in these industries slows.[13]

In addition to other areas of China's economy where reforms remain incomplete, such as private property and land rights and the extent of privatization in the economy, the continuing collective influence of the various levels of PRC government over the banking sector is a critical element of China's designation as an NME for purposes of the U.S. antidumping law because of the importance of the banking sector for investment and, thus, resource allocation in the economy. Investment as a share of gross domestic profit (GDP) is extremely high, over 45 percent in 2004. The ratio of credit to GDP is extremely high and has been growing substantially since the 1990s.[14] In particular, enterprises in the state-owned industrial sector have required substantial capital merely to sustain operations. The continued presence of these enterprises that might have otherwise exited the market significantly distorts the operating environment for the much smaller private sector. Thus, not only does the banking sector fundamentally distort financial resources in China, it also distorts the allocation of other important resources, *e.g.,* labor, material inputs and energy, that are

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[12] As reported by the CBRC, NPL ratios fell to 8.8 percent of total loans by June 2005, down fifty percent since the end of 2003. However, independent sources estimate NPLs to be much higher. *The Economist, A Great Big Banking Gamble - China's Banking Industry,* October 29, 2005. See also *Financial Times*, *China bad loans may reach total of $900bn*, May 3, 2006.

[13] *People's Republic of China: 2005 Article IV Consultation - Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion,* (Washington, DC, International Monetary Fund, November 2005), p 21.

[14] *People's Republic of China: 2005 Article IV Consultation - Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion,* (Washington, DC, International Monetary Fund, November 2005), p12. *See also China's Growth and Integration into the World Economy, Prospects and Challenges*, (Washington, DC: International Monetary Fund, 2004), p 43. *OECD Economic Surveys: China* (Paris, Organisation for Economic Co-Operation and Development, September 2005), p 138.

wasted in economically unjustifiable investments. We acknowledge that government officials do not direct all lending and that there have been several positive reforms, such as interest rate liberalization on loans and a limited diversification of ownership in the sector through recent public offerings. Nevertheless, the continued significant government involvement in China's banking sector reflects an assumption that the state, not markets, should determine the growth sectors or individual companies that deserve access to credit. The forthcoming memorandum on China's economy will discuss other aspects of the government's intervention in resource allocations outside the banking sector.

As stated above, the Department will continue to analyze China's economy and intends to issue an analysis of all six statutory factors within the context of the lined paper investigation. However, we note at the outset the limited extent to which market forces and institutional reform have taken root in critical sectors of China's economy despite recent reforms and substantial growth. For example, the Department notes the absence of private land ownership, the lack of effective rule of law and protection of property rights, as well as the government's preserving a leading role for the state-owned enterprise sector.[15] An economy operating under such conditions cannot be considered market-based under the Department's statutory criteria. Nevertheless, we wanted at this time to apprise interested parties of the Department's fundamental analysis of China's economy.

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[15] See generally footnote 1. See also *The Economist Intelligence Unit, Country Commerce, China,* March 2006, p 10.

We recommend that China should therefore continue to be considered an NME country for the purposes of the U.S. antidumping law.

______________ Agree

______________ Disagree

______________ Let's Discuss

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David M. Spooner
Assistant Secretary
for Import Administration

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Date